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**Year-End Tax Planning 2010  
(Requires Gazing into 2011 Crystal Ball)**

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Many of us recently filed our 2009 income tax returns, and we now have less than two months left to do something about our 2010 taxes. Before you store your 2009 returns away until April 2011, I would encourage you to do some real analysis of the items which impacted your taxes and note those which have ongoing relevance to your tax return for 2010 and beyond. A good starting point for year-end tax planning is always a projection of income and deductions for the year, with special attention to limitations which may apply and/or items of income or expense which you can choose to accelerate or defer.

Consider or meet with your tax preparer to determine whether your 2009 tax return indicates any of the following:

1. Unused credits or deductions; e.g. contribution carryovers due to limits based on adjusted gross income; or investment interest expense carryovers limited by net investment income.
2. Alternative minimum taxes (AMT) paid. If you were subject to AMT for 2009, it is very possible that AMT will apply to your tax return in 2010.
3. Capital loss carryovers. Your unused capital losses are fully available to offset capital gains realized in 2010 and beyond.
4. Passive activity losses. To the extent you have unused passive activity losses from 2009 or earlier years, those losses may shelter net income from passive activities this year. You may also have the opportunity to sell an interest in a passive activity and be able to deduct the unused losses from prior years.
5. Limitations on deductions “passed through” from interests in partnerships or S corporations due to insufficient “tax basis.” Even if not limited in 2009, you should know your “basis” situation for 2010.

This year’s tax planning is also impacted by the uncertainties of tax rate changes and other legislative proposals which will affect 2011 and subsequent years. Congress presently faces the dilemma of how to deal with unemployment and other weaknesses in the economy, while at the same time trying to

reduce our deficit. When legislators return for a brief lame-duck session this month, they must either pass some extension of the Bush-era tax rates for certain individuals, or the higher pre-2011 rates will automatically become law.

Without legislative action, the 2011 tax brackets will revert back to the five previous rate levels (15%, 28%, 31%, 36% and 39.6%), and the maximum rate on long-term capital gains will increase from 15% to 20%. Further, qualifying dividends would no longer be taxed at the capital gains rate, but instead be taxed as ordinary income. The highest marginal tax rate may even be closer to 41%, depending on whether Congress allows the itemized deduction phase-out to return.

Although there is broad support in Congress for extending certain expiring provisions, a clear lack of consensus exists as to whether higher-income taxpayers should continue to enjoy today's lower rates. A popular suggestion is to allow today's lower rates to continue up to taxable income of \$200,000 for single individuals and \$250,000 for joint filers. Look to the lame-duck session for a possible compromise on this and perhaps a temporary set of tax rates on incomes over \$250,000. Individuals with higher income already face future tax increases beginning in 2013, due to provisions in the recent health care legislation. The most notable provision is a new "unearned income Medicare contribution" of 3.8% on the lesser of a taxpayer's investment income or modified gross income in excess of these same threshold amounts. These individuals now have a little more than two years to review the tax efficiency of their investments and possibly re-allocate certain holdings which currently produce taxable interest, dividends, and other "investment" income.

In light of these potential tax increases, certain individuals may benefit by accelerating income into 2010. As indicated earlier, carryovers of capital losses or other deductions may be available to shelter certain gains or other income. If the long-term capital gain rate increases to 20% in 2011, this year-end may be attractive for recognizing capital gains at 15%.

Before accelerating income into 2010, however, it is recommended that you calculate your expected taxes for both 2010 and 2011 and consider the time value of paying taxes in each year. If you decide to accelerate income into 2010, here are some alternatives which you might consider:

1. Do a Roth conversion during 2010. More on this later, and note that you will have a choice whether to recognize the related income in 2010, or spread it evenly between tax years 2011 and 2012.
2. Increase taxable dividends. Perhaps you can influence the declaration of taxable dividends by a closely held corporation.
3. Accelerate collections of receivables or other income from your cash basis business, including a pass-through entity.
4. Sell property, but only after careful consideration of whether subject to ordinary versus capital gain rates, and available capital loss or passive activity loss carryovers. If you decide to sell securities in order to utilize the 15% long-term capital gain rate, note that you could subsequently acquire the same securities without concern for any "wash sale" rule (which applies only to losses). If otherwise planning on raising cash in 2013 (after the new 3.8% tax on unearned income is in effect), you should compare the possible tax savings of a 2010 sale with the expected return from holding the asset.

Similarly, deferring deductions to 2011 has the same effect as accelerating income. For example:

1. Delay the payment of certain deductible expenses. If subject to the alternative minimum tax, be aware that certain expenses such as state and local taxes and miscellaneous itemized deductions are not deductible in any year.
2. For depreciable property acquired, elect slower depreciation and/or a reduced amount of first-year expensing under Section 179.

Traditional year-end tax planning is typically the opposite of the foregoing in that income would be deferred where possible and deductions accelerated. Certain individuals will likely still employ this traditional strategy if their marginal 2011 tax bracket is expected to be similar to that for 2010.

An important area to consider before the end of 2010 is your participation and contributions to qualified retirement plans. If your plan will still allow increased tax deductible contributions for 2010, consider this year's impact while also considering your planned contributions for 2011. Many plans require you to submit your 2011 election prior to the end of 2010, so your 2010/2011 projections will again be helpful.

A unique opportunity is available in 2010 to do a Roth IRA conversion. Within a Roth IRA, earnings grow tax-free, and distributions are tax-free provided no distributions are made until more than five years after the first contribution and the individual has reached age 59<sup>1/2</sup>. Distributions may be made earlier in the event of the individual's disability or death.

For a Roth conversion, funds in a traditional IRA or other qualified plan may be rolled over into a Roth IRA, which results in a deemed distribution and taxation of the converted amount (except to the extent of any after-tax contributions deemed distributed). In past years, a taxpayer's AGI (whether married filing jointly or single) was limited to \$100,000 to make such a conversion. Beginning in 2010, the \$100,000 income limit on Roth IRA conversions is repealed.

For 2010 only, there is the one-time option of spreading the income ratably over two taxable years (2011 and 2012), or alternatively including all of the income in 2010. One other planning strategy allows you the option to undo the Roth conversion by the due date of your 2010 tax return if you choose, because of poor investment performance or otherwise. You might then do the conversion in 2011, although the income would then be fully taxed in that year.

Finally, a number of business tax incentives were added or enhanced by the recently passed small business tax bill. If you are in business as a sole proprietor or as a member of a pass-through entity, be aware of the increased Section 179 expensing limit of \$500,000 and the higher phase-out threshold which apply to 2010 and 2011. Other favorable provisions for 2010 include the additional 50% first-year depreciation and changes to general business credits, allowing them to offset AMT and increasing the available carryback period to five years for unused credits.

As December 31st approaches, we can hope that legislators act sooner rather than later on how our incomes will be taxed in 2011 and future years. Until more certainty appears, now is the time to evaluate your personal situation and identify your year-end options.

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