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2009 Year-End Tax Planning Letter

Dear Clients and Friends:

Year-end tax planning is always a tricky proposition, and this year is no exception. No one likes to pay taxes any sooner than required. So, traditional year-end strategies tend to focus on deferring income from 2009 to future years and accelerating deductions from 2010 into 2009.

This year, those strategies are complicated by the potential for higher tax rates in the next few years and the absence of details concerning what future tax changes may look like.

The key to success in any year-end tax strategy involves considering two years, 2009 and 2010 at a minimum, at the same time. Unfortunately, this tactic requires you to predict a series of unknown future events.

Despite the difficulties involved, you will need to make educated guesses and reasonable assumptions. Remember, no tax strategy is cast in stone until the time for changing strategies has past. Tax planning is a dynamic process.

Before going into more specific, detailed planning tips, here are some basic principles that can help guide your overall thinking:

- If you expect your tax rate will be higher next year, you may want to accelerate income into this year and defer deductions into next year.
- If you think your tax rate might be lower in 2010, consider deferring income to next year and accelerating deductions into this year.

Remember, the question is about *your* marginal tax rate. That is the highest rate at which your last, or marginal, dollar of income will be taxed. Even though overall tax rates may rise in the future, if your income will be substantially lower than in 2009, your marginal tax rate may actually decrease.

Here are a couple of additional guidelines:

- If you think your deductions might be restricted next year, accelerate some deductible expenses into this year.
- If you could qualify for the standard deduction in either year, consider shifting qualified expenditures into the year you expect to itemize your deductions.

Fewer deductions are allowed under the alternative minimum tax (AMT). So if you expect to pay the AMT in one year, you may want to shift deductions into the non-AMT year. The \$5,700/\$11,400 standard deduction will remain the same for 2009 and 2010 for most taxpayers. Head of household filers get a \$50 increase from \$8,350 in 2009 to \$8,400 in 2010.

In constructing this letter, we have tried to focus attention on tax planning opportunities that involve actions you can take during the last few weeks of 2009. This letter certainly does *not* include *every* tax planning opportunity that may be available to you. We would be pleased to meet with you to discuss all aspects of your tax situation.

We also recognize that not every year-end tax strategy will apply to every reader. As you read through the list, check the box next to those items that might apply to you. Then you can easily go back to review the more pertinent planning points that you want to follow up on.

Remember, it is not about taxes – it is about your money!

Personal Tax Strategies

Moving income or deductions between tax years

- **Salaries, bonuses, etc.** – If your employer is willing, compensation you earn in 2009 can be paid to you in early 2010. Your employer may even be entitled to its tax deduction in 2009. If you are self-employed and your business operates on the cash method, you can delay sending out bills for 2009 work until late in the year, so payment comes to you in 2010. Alternatively, you can offer a discount to a client who prepays, if you are trying to increase 2009 income.
- **Capital gains and losses** – You generally recognize gains and losses from securities sales on the trade date, not the settlement date. December trades will be 2009 transactions, while January trades will be reported in 2010. Sales at a loss can reduce other capital gains, and a net loss up to \$3,000 can be deducted to offset other income.

Before you recognize a gain, check your holding period. Long-term capital gains from the sales of assets with a holding period greater than one year are eligible for a significantly lower tax rate – generally no more than 15 percent. It could be as low as 0 percent – see “Zero percent tax rate” discussion below.

When selling to recognize a loss, do not run afoul of the wash-sale rules. A wash-sale occurs if you repurchase substantially identical assets within the 61-day period beginning 30 days prior to your loss sale and ending 30 days after the sale. A wash-sale will wipe out any loss you thought you had.

When planning year-end stock sales, be sure to consider any capital loss carry-forward that may be available to you in 2009. Excess capital losses above the \$3,000 deduction limit are available to offset capital gains in future years.

- **Installment sales** – Selling an asset at a gain and collecting the proceeds in future years may allow you to defer part of the income until the years in which you receive the payments.
- **Credit card payments** – Paying tax-deductible expenditures, including charitable contributions, with a credit card secures the deduction, even if you do not actually pay the credit card company

until the following year. A pledge—or promise—to make the contribution is not good enough. You actually have to make the payment or charge it to your credit card.

You will need adequate records to support your tax deductions. Receipts, canceled checks or bank records may be sufficient to support most expenditures. However, certain types of deductions, e.g., meals, travel, and entertainment expenses and charitable contributions, have specific record-keeping requirements.

- **Required minimum distributions (RMDs) from IRAs** – If you are over age 70½, you were not required to take a required minimum distribution from your IRAs and other qualified retirement plans during 2009. Unless Congress acts to change the law, RMDs will be restored in 2010.

You can accelerate income into 2009 and reduce next year's required minimum distribution by taking a distribution before December 31st. Taking a distribution in 2009 also creates a small reduction in 2010's RMD because it is based on the IRA's value as of December 31st of the previous year. So reducing the December 31, 2009, IRA balance reduces the 2010 required minimum distribution.

- **Suspended passive activity losses** – If you own a passive activity with a suspended loss, and you do not expect sufficient passive income in 2009 to allow you to deduct the suspended loss, consider disposing of the activity before December 31st. If you dispose of a passive activity with a suspended loss, you can claim the deduction in the year of disposal.

Other year-end strategies for individuals

- **Sales tax deduction for new car purchase** – Even though the Cash-for-Clunkers program has expired, you can still secure an income tax deduction for state and local sales or excise taxes paid on a new vehicle purchased between February 17 and December 31, 2009. Importantly, the deduction is available even if you don't itemize.

If your new vehicle is very expensive, the deduction is limited to the portion of the tax attributable to the first \$49,500 of the purchase price. To qualify for the full deduction, your modified adjusted gross income cannot exceed \$125,000 for individuals or \$250,000 for married couples. No deduction is available if your modified adjusted gross income is greater than \$135,000 for individuals or \$260,000 on a joint return.

- **Home buyer credits** – Congress recently extended the first-time home buyer credit and added a new home buyer credit for long-term residents of the same principal residence.
 - **First time home buyer credit** – This credit, which was originally slated to expire on November 30, 2009, has been extended and expanded. The maximum credit for first-time home buyers is \$8,000. The credit does not have to be repaid if the buyer keeps the home for at least three years. A first-time home buyer is someone who has not owned a home during the prior three years. The credit has been extended to include homes under contract by April 30, 2010, and closed by June 30, 2010.

- **Credit for owners of existing homes** – A new \$6,500 credit is available for those who have owned their existing home for at least five years. This credit is available for home purchases after November 6, 2009, and before May 1, 2010, as long as closing takes place by June 30, 2010.

The income limits to qualify for both credits have been increased to \$125,000 for individuals and \$225,000 for married couples. After November 6, 2009, the credits are not available for homes priced above \$800,000. Both credits are also limited to 10 percent of the cost of the new home.

- **Charitable contributions from IRAs** – The provision for making charitable contributions from an IRA is set to expire on December 31, 2009. Normally, when you make a charitable contribution from an IRA, it is treated as a distribution and included in your gross income. You receive a charitable contribution deduction only if you itemize your deductions.

If you are age 70½ or older, you can have charitable contributions made directly to a charity by your IRA custodian. There is no deduction for the contribution, but it also is not treated as a distribution and is not included in your gross income. This contribution is limited to \$100,000.

- **Charitable contributions of appreciated assets** – Consider fulfilling your charitable goals by contributing appreciated securities instead of cash. You can deduct the fair market value of long-term capital gain property contributed to charity. You avoid taxes on the gain and can deduct the full fair market value.
- **Tax credits for home improvements** – A tax credit for 30 percent of the cost of qualifying home improvements, up to a maximum credit of \$1,500, is available for improvements placed in service in 2009 and 2010. The credit applies to energy-efficient improvements such as insulation and exterior windows, as well as heating and air conditioning systems. You will need to complete your purchase before December 31 to qualify for the credit in 2009.
- **Tax credits for alternative vehicles** – Four different tax credits are available to purchasers of various types of motor vehicles that utilize fuel saving or alternative fuel technologies. The credits vary in amount by the type of credit and type of vehicle. Check with the manufacturer to see what tax credits may be available if you are considering the purchase of a new vehicle.
- **Zero percent tax rate on capital gains and dividends** – The maximum rate of tax on qualified dividends and most long-term capital gains is 15 percent. For those whose marginal tax rate does not exceed 15 percent, the tax rate on these special types of income is reduced to zero. If you are single and your taxable income for 2009 is under \$33,951, or you are married with taxable income under \$67,901, the 0 percent rate applies to you.

Many people with taxable income below these thresholds do not experience the types of income that qualify for the 0 percent rate. The kiddie tax rules (see next section) prevent your children from qualifying. However, if you assist aging parents, you might consider gifting appreciated

stock to them if they are in the 10 or 15 percent tax brackets. They could then sell the investment and qualify for the 0 percent tax rate on the gain.

- **Kiddie tax rules** – For 2009, all children under 19 and dependent college students under 24 will have their unearned income in excess of \$1,800 taxed at their parents' marginal tax rate. Unearned income includes interest, dividends and capital gains.

Shifting investments to a child's account was once a popular college savings strategy, especially when the child was in a lower tax bracket. Now, a good alternative may be investing in a Section 529 college savings plan, in which funds grow tax-free and subsequent withdrawals are tax-free for qualified secondary education expenses.

- **Income tax prepayments** – Your withholding may not be what you expect because of new withholding tables issued during 2009 under the Making Work Pay tax credit enacted in the stimulus law. If your estimated tax payments and withholding are not high enough to avoid penalties, increase payments. Even better, if you receive wages, IRA distributions, annuity payments or other payments from which you can ask for withholding, have the additional taxes withheld. You are more likely to avoid penalties by increasing withholding than by increasing your last estimated tax payment.
- **The dreaded alternative minimum tax (AMT)** – An increasing number of middle-income earners, especially retirees, are falling victim to the AMT. High itemized deductions (other than charitable contributions), high personal exemptions and large capital gains, among other items, can trigger the AMT. New retirees often run afoul of the AMT because they experience lower income, while their itemized deductions remain high. On a positive note, more energy and rehabilitation credits can be used to offset the AMT.

Before implementing any year-end tax strategy, be sure to check the impact of the alternative minimum tax.

- **Funding your retirement plans** – To qualify for a deduction in 2009, your retirement plan generally must be in place before the end of the year. Exceptions are IRA and SEP (simplified employee pensions) plans, which must be set up by April 15, 2010.

The following limits apply for both 2009 and 2010:

- Participants in a 401(k) plan can defer up to \$16,500 (\$22,000 for ages 50 or older).
 - The IRA contribution limit is \$5,000 (\$6,000 for ages 50 and older).
 - Simple IRA participants can defer up to \$11,500 (\$14,000 for age 50 and older).
 - Self-employed individuals can contribute 20 percent of their self-employment income up to \$49,000.
- **North Carolina's 529 plan** – If you are saving for college, consider North Carolina's 529 plan. For state taxes, there is a deduction of up to \$5,000 for contributions made.

- **Saver's credit** – If you contribute to a retirement plan at work (e.g., 401(k) or 403(b), 457, SEP IRA, SIMPLE) or a traditional IRA, and your income is less than \$55,500 for married couples or \$27,750 for singles, you may qualify for the saver's credit. You must be at least 18 years of age, not a full-time student and not claimed as a dependent on someone else's tax return.

Depending on your income, the tax credit ranges from 10 percent of your contribution to as high as 50 percent of your contribution. Even if you do not qualify for this credit, it may be available to your older children.

Business Tax Strategies

- **Retirement plans for your business** – Starting a small business retirement savings plan can be easier than you think. In addition, a retirement plan has significant tax advantages. Employer contributions are deductible from the employer's income, employee contributions are not taxed until distributed to the employee and investments in the program grow tax-deferred. Further, the tax law offers a small incentive of a \$500 per year tax credit for the first three years of a new SEP, SIMPLE or other retirement plan to cover the initial setup expenses.
- **Depreciation** – The American Recovery and Reinvestment Act of 2009 (ARRA) extended the expensing and depreciation incentives contained in the Economic Stimulus Act of 2008, but only through December 31, 2009.
 - **Section 179** – Congress extended the \$250,000 expensing election limit to qualifying property purchased and placed in service during 2009. As a result, many businesses will receive an immediate tax write-off for the cost of most new and used tangible personal property. Unless Congress acts to further extend the higher limit, it will drop to \$134,000 in 2010.

Companies that purchase more than \$800,000 of qualifying property during 2009 have their deduction amount reduced, dollar-for-dollar, for purchases in excess of \$800,000. So the deduction is not available to those companies that purchase and place in service more than \$1.05 million of qualifying property during 2009.

Businesses that use a fiscal year as their tax accounting year should note that the new deduction limit applies to property purchased and placed in service during tax years beginning in 2008 and 2009.

- **Bonus depreciation** – Property that does not qualify for an immediate tax write-off under the expensing election may qualify for an increased first-year depreciation deduction under bonus depreciation rules, which were also extended for one year by ARRA. This deduction is equal to 50 percent of the cost of qualifying property purchased and placed in service by December 31, 2009.

To qualify for bonus depreciation, the property must be new. Used property does not qualify. In addition, the property must either:

- ✓ Have an applicable modified accelerated cost recovery system (MACRS) recovery period of 20 years or less,
 - ✓ Be water utility property, computer software not covered by the Section 197 amortization rules, or
 - ✓ Be qualified leasehold improvement property.
- **Buildings and other structures** – Buildings and other real estate generally do not qualify for bonus depreciation or the expensing election. However, a cost segregation study may be able to identify qualifying property within the overall project.
- **Losses from pass-through entities** – Economic pressures are causing many historically profitable businesses to experience operating losses. If you are an owner of a pass-through business entity operating as a partnership, LLC, S corporation or trust, and the business incurs a loss in 2009, you need to plan ahead to be sure you can take advantage of that loss on your personal tax return.

If your business activity is “passive” – generally a rental real estate activity or a business in which you do not materially participate – you may not be able to deduct the loss unless you also experience passive income. Even if you are actively involved in the business, your loss may not be deductible if you do not have “basis.” These rules are complicated, and you should consult with your tax professional. But if you can take steps prior to the end of the tax year to invest more in the business or otherwise increase your basis, you may be able to deduct the loss on your return.

- **Five-year carry-back for net operating losses** – Corporations and owners of pass-through entities that experience a net operating loss may be entitled to an extended five-year carry-back period. Even if you took advantage of the extended carry-back period in 2008, under the new law, you may be again eligible for an extended carry-back of a 2009 loss. And the rules have been expanded to allow more businesses and their owners to qualify.

If you are expecting a net operating loss for 2009 and could benefit from the extended carry-back period, you may want to take steps to try to maximize the amount of the loss by, to the extent possible, deferring income and accelerating deductions. You may also want to plan to complete your 2009 tax return early to accelerate the filing of your carry-back claim so that you can get your tax refund as soon as possible.

Estate & Gift Tax Planning Strategies

- **Estate planning** – The estate tax exemption amount for 2009 is \$3.5 million. The estate tax is scheduled to disappear for 2010—which is highly unlikely—and reappear in 2011 with a \$1 million exemption. While Congress continues to do nothing about changing the law, it is important that your estate plans remain flexible. Make sure your will distributes your assets in the appropriate manner. If you have younger children, your will should appoint a guardian in the event of the death of both parents. You certainly do not want the probate court making decisions on your behalf.

With states looking for additional revenue to balance their budgets, state inheritance taxes are getting increased attention. Be sure your estate plan minimizes inheritance taxes in your state of residence and in any states in which you own property.

- **Gift tax** – The annual gift tax exclusion for 2009 was increased to \$13,000 per person and will remain at the level for 2010. If you are married, you can gift up to \$26,000 per donee by using the gift-splitting rules, without any federal gift tax ramifications. Gifting is a good way to reduce your taxable estate and may be important in a good estate plan. For example, if you and your spouse have two children, with gift-splitting you can give each child \$26,000 in late December and another \$26,000 in early January. If your children are married and/or you have grandchildren, the opportunity increases accordingly.

Conclusion

The so-called Bush tax cuts passed in June 2001 reduced marginal tax rates for all taxpayers, provided relief for the marriage penalty, increased child tax credits, expanded education-related tax benefits and phased out the estate tax. These laws are set to expire, or sunset, on December 31, 2010. If Congress does not act, most of these tax benefits will disappear, and taxes will automatically increase to pre-2001 levels on January 1, 2011.

Without congressional action to extend these provisions, tax liabilities for most individuals will increase by 10 to 22 percent in 2011, compared to 2010 liabilities. The highest marginal income tax rate will increase from 35 percent to 39.6 percent, the capital gains rate will increase from 15 percent to 20 percent, and the highest tax rate on qualifying dividends will go up from 15 percent to 39.6 percent. The top estate tax rate will go from 0 to 55 percent. Businesses will also be affected. For example, the Section 179 expense election limit will drop to \$25,000 in 2011.

Future legislation may address these issues, but the final result is always a mystery until a bill is passed. For example, some proposals to pay for healthcare changes include a new income tax bracket approaching 45 percent for the highest income earners.

Although we have covered a number of topics in this letter, we undoubtedly did not address every issue relating to your specific situation. Please consult with your tax adviser before implementing any of these tax planning strategies.

Sincerely,

Davenport, Marwin, Joyce & Co., LLP