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Tax Strategies for Small Businesses

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# 2010 Year-End Tax Planning

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## 2010 Year-End Tax Planning

The midterm elections have changed the Congressional landscape, with Republicans winning control of the House of Representatives and picking up seats in the Senate. Even so, it's still too early to know exactly how this will affect open tax issues for 2010 and 2011.

Specifically, when the "lame-duck" Congress returns this month, it must decide whether to "patch" the alternative minimum tax (AMT) for 2010 (increase exemption amounts, and allow personal credits to offset the AMT), as it has done in past years. It also must decide whether to retroactively extend a number of tax provisions that expired at the end of 2009. These include, for example, the research credit for businesses, the election to take an itemized deduction for state and local general sales taxes in lieu of the itemized deduction permitted for state and local income taxes, and the additional standard deduction for State and local real property taxes.

In addition, Congress must decide whether to extend the Bush tax cuts for some or all taxpayers. They and other Bush-era tax rules expire at the end of this year. Without Congressional action, individuals will face higher tax rates on their income, including capital gains. Also, unless Congress changes the rules, the estate tax, which isn't in effect this year, will return next year with a 55% top rate.

**In short, year-end planning - which always involves some educated guesswork - is a bigger challenge this year than in past years.**

That said, we have compiled a checklist of actions that can help you save tax dollars if you act before year-end. These moves may benefit you regardless of what the lame-duck Congress does on the major tax questions of the day. Not all actions will apply in your particular situation, but you will likely benefit from many of them. Please review the following list for planning ideas.

## Year-End Moves for Individuals

- Increase the amount you set aside for next year in your employer's health flexible spending account (FSA) if you set aside too little for this year. Don't forget that you cannot set aside amounts to get tax-free reimbursements for over-the-counter drugs, such as aspirin and antacids (2010 is the last year that FSAs can be used for nonprescription drugs).

- Realize losses on stock while substantially preserving your investment position. There are several ways this can be done. For example, you can sell the original holding, then buy back the same securities at least 31 days later.

- Increase your withholding if you are facing a penalty for underpayment of federal estimated tax. Doing so may reduce or eliminate the penalty.

- Take an eligible rollover distribution from a qualified retirement plan before the end of 2010 if you are facing a penalty for underpayment of estimated tax and the increased withholding option is unavailable or won't sufficiently address the problem. Income tax will be withheld from the distribution and will be applied toward the taxes owed for 2010. You can then timely roll over the gross amount of the distribution, as increased by the amount of withheld tax, to a traditional IRA. No part of the distribution will be includible in income for 2010, but the withheld tax will be applied pro rata over the full 2010 tax year to reduce previous underpayments of estimated tax.

- Make energy saving improvements to your main home, such as putting in extra insulation or installing energy saving windows or buying and installing an energy efficient furnace, and qualify for a 30% tax credit. The total (aggregate) credit for energy efficient improvements to the home in 2009 and 2010 is $1,500. Unless Congress acts, this tax break won't be around after this year. Additionally, substantial tax credits are available for installing energy generating equipment (such as solar electric panels or solar hot water heaters) to your home. This break stays on the books through 2016.

- Convert your traditional IRA into a Roth IRA if doing so is expected to produce better long-term tax results for you and your beneficiaries. Distributions from a Roth IRA can be tax-free, but the conversion will increase your adjusted gross income for 2010. However, you will have the choice of when to pay the tax on the conversion. You can either (l) pay the tax on the conversion when you file your 2010 return in 2011, or (2) pay half the tax on the conversion when you file your 2011 return in 2012, and the other half when you file your 2012 return in 2013.

- Purchase qualified small business stock (QSBS) before the end of this year. There is no tax on gain from the sale of such stock if it is (1) purchased after September 27, 2010 and before January 1, 2011, and (2) held for more than five years. In addition, such sales won't cause AMT preference problems. To qualify for these breaks, the stock must be issued by a regular (C) corporation with total gross assets of $50 million or less, and a number of other technical requirements must be met. Our office can fill you in on the details.

- Take required minimum distributions (RMDs) from your IRA or 401(k) plan (or other employer-sponsored retired plan) if you have reached age 70 ½. Failure to take a required withdrawal can result in a penalty of 50% of the amount not withdrawn. A temporary tax law change waived the RMD requirement for 2009 only, but the usual withdrawal rules apply in full force for 2010. So, individuals age 70 ½ or older generally must take the required distribution amount out of their retirement account before the end of 2010 to avoid the penalty. If you turned age 70 ½ in 2010, you can delay the required distribution to 2011, but if you do, you will have to take a double distribution in 2011 - the amount required for 2010 plus the amount required for 2011. Think twice before delaying 2010 distributions to 2011 - bunching income into 2011 might push you into a higher tax bracket or have a detrimental impact on various income tax deductions that are reduced at higher income levels.

- Make annual exclusion gifts before year-end to save gift tax (and estate tax if it is reinstated). You can give $13,000 in 2010 or 2011 to an unlimited number of individuals free of gift tax. However, you can't carry over unused exclusions from one year to the next. The transfers also may save family income taxes where income-earning property is given to family members in lower income tax brackets who are not subject to the kiddie tax.

## Year-End Moves for Business Owners

- Hire a worker who has been unemployed for at least 60 days before year-end if you are thinking of adding to payroll soon. Your business will be exempt from paying the employer's 6.2% share of the Social Security payroll tax on the formerly unemployed new-hire for the remainder of 2010. Plus, if you keep that formerly unemployed new-hire on the payroll for a continuous 52 weeks, your business will be eligible for a nonrefundable tax credit of up-to-$1,000 after the 52-week threshold is reached. This credit will be taken on the business's 2011 tax return. In order to be eligible, the formerly unemployed new-hire's pay in the second 26-week period must be at least 80% of the pay in the first 26-week period.

- Put new business equipment and machinery in service before year-end to qualify for the 50% bonus first-year depreciation allowance. Unless Congress acts, this bonus depreciation allowance won't be available for property placed in service after 2010.

- Make expenses qualifying for the $500,000 business property expensing option. The maximum amount you can expense for a tax year beginning in 2010 is $500,000 of the cost of qualifying property placed in service for that tax year. The $500,000 amount is reduced by the amount by which the cost of qualifying property placed in service during 2010 exceeds $2 million. Also, within the overall $500,000 expensing limit, you can expense up to $250,000 of qualified real property (certain qualifying leasehold improvements, restaurant property, and retail improvements). Note that at tax return time, you can choose not to use expensing (or bonus depreciation) for 2010 assets. This is something to consider if tax rates go up for 2011 and future years, and you'd rather have more deductions after 2010 than for 2010.

- Set up a self-employed retirement plan if you are self-employed and haven't done so yet.

- Increase your basis in a partnership or S corporation if doing so will enable you to deduct a loss from it for this year. A partner's share of partnership losses is deductible only to the extent of his partnership basis as of the end of the partnership year in which the loss occurs. An S corporation shareholder can deduct his pro-rata share of an S corporation's losses only to the extent of the total of his basis in (a) his S corporation stock, and (b) debt owed to him by the S corporation.

- Consider whether to defer cancellation of debt (COD) income from the reacquisition of an applicable debt instrument in 2010. The business can elect to have the COD income included in gross income ratably over five tax years beginning with the fourth tax year following the tax year in which the repurchase occurs (i.e., beginning with 2014).

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**Warmest Regards,**

**Douglas Rutherford, CPA**

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