



November 2010

Happy Thanksgiving!

Happy Thanksgiving and Holidays!!! Can you believe it's already the end of November? This year truly has flown by. If you happen to be traveling this weekend or later for the holiday season, please be safe and enjoy your time with friends and family.

This newsletter contains many planning ideas, however to properly evaluate a planning strategy we recommend you schedule time for a planning meeting and strategize on how these rules will affect you before implementing any tax planning techniques.

As we do every year, Schmidt & Associates would like to offer you some year end tax planning ideas and update you on new tax law changes. This month's letter is longer than most because we want to update you on the many new laws that you need to be aware of. Year-end tax planning is particularly critical for 2010 because Congress has enacted a series of business tax breaks that are scheduled to expire after 2010, and several others that expire after 2011. We are sending you this letter to bring you up-to-date on these new rules, and the planning opportunities that they create. This letter also reminds you of the traditional year-end tax planning strategies.

Although this letter contains many planning ideas, you cannot properly evaluate a particular planning strategy without calculating the overall tax liability (including the alternative minimum tax) with and without the strategy. We recommend that you call our office to schedule your year end tax planning meeting or to discuss how these new rules will affect you before implementing any tax planning technique.

NEW TAX LEGISLATION

- §179 Deduction Increased From \$250,000 to \$500,000 for 2010 And 2011. For the last several years, Congress has temporarily increased the maximum §179 deduction for the cost of qualifying new or used depreciable business property to \$250,000 to help spur the economy. However, for property placed-in-service in tax years beginning in 2010 and 2011 the limit is \$500,000. In addition, for 2010 and 2011 purchases, a taxpayer may elect for "qualified real property" (discussed in the next segment) to be §179 property. Prior to this change, real property did not generally qualify for the §179 deduction and was depreciated over 15 or 39 years.
- **Beware Of Taxable Income Limitation!** The §179 deduction generally is not allowed to the extent the deduction exceeds the taxpayer's business taxable income (determined without the §179 deduction). Thus, due to this so-called taxable income limitation, the §179 deduction generally cannot create a taxable loss (or NOL). Unused Sec. 179 amounts can be carried forward to the next year.

Qualified Real Property includes property within any of the following three categories: 1) Qualified Leasehold Improvement Property (generally capital improvements to an interior portion of certain leased buildings that are used for nonresidential commercial purposes), 2) Qualified Retail Improvement Property (generally capital improvements made to certain buildings which are open to the general public for the sale of tangible personal property), and 3) Qualified Restaurant Property (generally capital expenditures for the improvement, purchase, or construction of any building (new or used), if more than 50% of the building's square footage is devoted to the preparation of, and seating for, the on-premises consumption of prepared meals). If you elect to take up to \$250,000 of the §179 deduction on qualified real property, the \$500,000 overall §179 deduction limitation is reduced to \$250,000 (\$500,000 - \$250,000). In other words, the \$250,000 §179 limitation for "qualified real property" is a part of the overall \$500,000 §179 limitation and not in addition to the \$500,000 limitation.

- **50% Bonus Depreciation Extended Through December 31, 2010. The 50% bonus depreciation has been extended for one more year, through calendar year 2010.** Bonus Depreciation For Passenger Automobiles, Trucks, And SUVs. The maximum annual depreciation deduction (including the §179 deduction) for most business automobiles is capped at certain dollar amounts. For a business auto first placed in service in calendar year 2010, the maximum first-year depreciation deduction is generally capped at \$3,060.

Due to bonus depreciation, the amount has been increased by \$8,000 for new vehicles.

Trucks and SUVs with loaded vehicle weights over 6,000 lbs are generally exempt from the passenger auto annual depreciation caps discussed above. However, the §179 deduction for an SUV is limited to \$25,000. However, pickup trucks heavier than 6,000 lbs are not subject to the \$25,000 limit imposed on SUVs, if the truck bed is at least six feet long.

- **Self-Employed Individuals May Deduct Health Insurance Premiums In Calculating Self-Employment Taxes For 2010 Only.** Generally, if you are self-employed, you are entitled to deduct your health insurance premiums, paid for you and your family, as an "above-the-line" deduction. However, traditionally, your health insurance premiums were not deductible for purposes of computing the Self-Employment (S/E) tax (Social Security and Medicare taxes) that is imposed on your self-employed income. For tax years beginning in 2010, self-employed individuals to deduct their health insurance premiums for S/E tax purposes, as well as for regular income tax purposes.
- **Up-Front Deduction For Business Start-Up Expenses Increased For 2010 Only.** If you start a new business, you are generally not allowed to deduct any portion of your start-up expenses until the tax year your business actually begins operations. Start-up expenses are generally expenses incurred prior to the date you "begin business" (e.g., before you open your doors for business). Under the Jobs Act, for tax year beginning in 2010, the first \$10,000 (previously \$5,000) of start-up expenses are deductible up-front. However, the \$10,000 up-front deduction is reduced for each dollar the total start-up expenditures exceed \$60,000. As under prior law, start-up expenses in excess of the up-front deduction amount are amortized over 180 months beginning with the month business begins.
- **Small Employers Get New Credit For Providing Employee Health Insurance.** One of the pleasant surprises included in the Health Care Act is a new tax credit for "eligible small employers" that 1) provide health insurance to employees, 2) pay a uniform percentage of the cost for each covered employee, and 3) pay at least 50% of the cost of insurance. For tax years beginning after 2009 and before 2014, the Health Care Act allows an eligible small employer a credit of up to 35% of the employer's cost of qualifying employee health insurance. For tax years beginning after 2013, the maximum credit is increased to 50%.

To receive any credit, an Eligible Small Employer (ESE) must have less than 25 full-time equivalent employees (FTEs) during the year, and average

annual FTE wages of under \$50,000. In addition, to receive the full 35% credit, the employer must have no more than 10 FTEs and average FTE wages of no more than \$25,000. The credit is phased out as FTEs go from 10 to 25 and as average FTE wages go from \$25,000 to \$50,000. The IRS has recently added links to its main website (www.irs.gov) providing "tax tips," "guidance," and "answers to frequently asked questions" with respect to this credit.

- **Reimbursements Of Over-The-Counter Drugs No Longer Tax Free.** Before Health Care Reform, taxpayers were allowed tax-free reimbursements for most nonprescription drugs and medicines from a health savings account (HSA), health flexible spending arrangement (FSA), health reimbursement arrangement (HRA), or other qualified employer health plans. Effective for expenses incurred after 2010, reimbursements for drugs and medicines will be tax free only for a prescribed drug or insulin. If you have been using a tax-favored reimbursement arrangement to pay for your over-the-counter medications these reimbursements will generally be tax able starting in 2011, unless you have a prescription. The IRS has stated that you may receive tax-free reimbursements after 2010 for non-prescription drugs that you purchased on or before December 31, 2010.
- **"Eligible Small Businesses" Get Temporary Tax Breaks For General Business Tax Credits.** Generally, a business that does not have sufficient tax liability to use its general business tax credits may carry its unused credits back one taxable year to offset the taxes it paid in that previous year. Any remaining amount may be carried forward up to 20 years to offset future tax liabilities. Moreover, many business tax credits are not available to offset a taxpayer's alternative minimum tax (AMT) liability and, therefore, have limited benefit. Under new law, "eligible small business credits determined in the first tax year beginning in 2010 can be carried back to the 5 years (instead of 1 year) preceding 2010 and carried forward for up to 20 years. These 2010 credits may also offset the taxpayer's AMT during 2010, the carry back years and/or the carry-forward years. An "eligible small business credit" is a general business credit generated by a taxpayer:1) that is a sole proprietorship, a partnership (which generally may be a limited liability company), or a non-publicly traded corporation (which includes S corporations and closely-held C corporations), and 2) that has \$50 million or less in average annual gross receipts for the prior three years.
- **S Corp 10-Year Built-In Gain Period Temporarily Shortened To 5 Years.** If a regular "C" corporation elects "S" corporation status (a "Converted S Corporation"), the election itself generally does not trigger income. However, the Converted S Corporation must generally pay a 35% corporate "built-in gains tax" on the sale of any built-in gain asset, if sold during the first 10

years following the S election ("10-Year Recognition Period"). A built-in gain asset is generally any asset with a market value greater than the asset's basis on the effective date of the S election. New law reduces the original 10-Year Recognition Period to 5 years for tax years beginning in 2011. The Act provides that there will be no tax on the net recognized built-in gain of an S corporation for any taxable year beginning in 2011, if the 5th year (i.e., 12-month period) in the recognition period precedes such year.

EXPIRING (AND EXPIRED) BUSINESS TAX BREAKS

Congress has given us an ever-expanding list of temporary tax breaks that expire every few years. However, even though it often waits until the last minute, Congress has historically extended most of the more popular provisions before they actually expire. Unfortunately, Congress has yet to extend many popular tax breaks that expired after 2009.

- **Selected Business Tax Breaks That Expired At The End Of 2009.** Some of the more popular business tax benefits that expired at the end of 2009 include the:1) 15-year (instead of 39-year) depreciation period for "qualified leasehold improvements;" 2) 15-year (instead of 39-year) depreciation period for "qualified restaurant property;" 3) 15-year (instead of 39-year) depreciation period for "qualified retail improvement property;" 4) 5-year (instead of 7 year) depreciation period for certain farming business machinery and equipment; 5) research and development credit; 6) employer differential wage credit for payments to military personnel; 7) various tax incentives for investing in the District of Columbia; 8) favorable S corporation charitable contribution provisions; and 9) enhanced charitable contribution rules for qualifying business entities contributing computer equipment, book, and food inventory. Although several pieces of "proposed" legislation would have extended these provisions, at least through 2010, they have yet to be enacted. Our firm continues to monitor the status of these expired provisions.
- **Selected Business Tax Breaks That Are Currently Scheduled To Expire At The End Of 2010.** The following are selected tax breaks that are scheduled to expire after 2010; consequently, this will be the last year you will be able to take advantage of these tax breaks unless Congress extends them beyond 2010: 1) maximum long-term capital gain and qualified dividend rates of 15% (scheduled to return to 20% and 39.6%, respectively, after 2010); 2) employer-provided educational assistance tax-free fringe; 3) credit for employer-provided child care facilities; 4) accumulated earnings and personal holding company penalty tax rates of 15% (scheduled to return to 39.6% after 2010); 5) Work Opportunity Tax Credit (WOTC) for certain unemployed

veterans and disconnected youth; and 6) deferral and ratable inclusion of income from certain business debt discharges.

TRADITIONAL TAX PLANNING

- **Planning With Capital Gains And Losses.** Generally, the current maximum long-term capital gains rate of 15% is scheduled to increase to 20% starting in 2011. Lower-income taxpayers who have long-term capital gains that would otherwise be included in the 15% (or below) ordinary income tax bracket, are taxed at a zero percent rate through 2010 (scheduled to increase to 10% starting in 2011).
- **Planning With Zero Percent Capital Gains Tax Rate.** Long-term capital gains and qualified dividends that would otherwise be included in the 15% (or below) ordinary income tax bracket for 2010, are taxed at a zero percent tax rate. For 2010, all ordinary income (e.g., W-2 income, interest income) up to \$68,000 for joint returns (\$34,000 if single) is taxed at the 15% rate, or below. Thus, taxpayers filing jointly can benefit from the zero percent capital gains rate if (and to the extent) they have 2010 ordinary taxable income under \$68,000 (\$34,000 if filing single).
- **Year-End Considerations For Capital Assets.** Timing your year-end sales of stocks, bonds, or other securities may save you taxes. After fully evaluating the economic factors, the following are time-tested, year-end tax planning ideas for sales of capital assets. Caution! Always consider the economics of a sale or exchange first!
- **Timing Your Capital Gains And Losses.** If you have already recognized capital gains in 2010, you should consider selling securities (that have declined in value) prior to January 1, 2011. These losses will be deductible on your 2010 return to the extent of your recognized capital gains, plus \$3,000.

POSTPONING TAXABLE INCOME

It continues to be a good idea to defer income into 2011, if you believe that your marginal tax rate for 2011 will be equal to or less than your 2010 marginal tax rate. Also, deferring income into 2011 could increase various credits and deductions for 2010 that would otherwise be phased out as your adjusted gross income increases.

If you are a cash method, self-employed taxpayer and, after considering the uncertainty of 2011 tax rates, you believe that deferring taxable income into 2011 will save you taxes, consider delaying year-end billings to defer income until 2011.

- **Accelerating "Above-The Line" Deductions Into 2010.** As a cash method taxpayer, you can generally accelerate a 2010 deduction into 2010 by "paying" it in 2010. Accelerating an "above-the-line" deduction (e.g., IRA or Health Savings Account (HSA) deduction, health insurance premiums for self-employed individuals, qualified student loan interest, qualified moving expenses, deductible alimony) into 2010 may allow you to reduce your "adjusted gross income" (AGI) below the thresholds needed to qualify for many other tax benefits (e.g., the child credit, education credits, the adoption credit, the Making Work Pay credit, the ability to contribute to a deductible IRA, etc.). However, "itemized" deductions (i.e., below-the-line deductions) do not reduce your "adjusted gross income" and, therefore, will not affect your 2010 deductions and credits that are reduced as your income increases.
- **Accelerating "Itemized" Deductions Into 2010 May Be Particularly Valuable.** If your itemized deductions fail to exceed your standard deduction in most years, you are not receiving maximum benefit for your itemized deductions. You could possibly reduce your taxes over the long term by bunching the payment of your itemized deductions in alternate tax years. This may produce tax savings by allowing you to itemize deductions in the years when your expenses are bunched, and use the standard deduction in other years. The easiest deductions to shift from 2011 to 2010 are charitable contributions, state and local taxes, and your January, 2011 home mortgage interest payment. For 2010, the standard deduction is \$11,400 on a joint return and \$5,700 for single individuals. If you are blind or age 65, you get an additional standard deduction of \$1,100 if you're married (\$1,400 if single).
- **Charitable Contributions.** A charitable contribution deduction is allowed for 2010 if the check is mailed on or before December 31, 2010, or the contribution is made by a credit card charge in 2010. However, if you give a note or a pledge to a charity, no deduction is allowed until you pay off the note or pledge. Planning Alert! For the past several years, we have had a popular (but temporary) rule that allowed taxpayers who had reached age 70½, to contribute up to \$100,000 from their IRAs directly to a qualified charity, and exclude the distribution from income. This provision expired after 2009, and is not available for 2010 unless Congress decides to extend it. If you are interested in this provision, please call our office and we will give you a status report.
- **Time Payment Of State And Local Taxes To Your Benefit.** If you anticipate deducting your state and local income taxes, consider paying them (fourth quarter estimate and balance due for 2010) and any property taxes for 2010 prior to January 1, 2011 if your tax rate for 2010 is higher than or the same as your projected 2011 tax rate. This will allow a deduction for 2010 (a year

early) and possibly against income taxed at a higher rate. State and local income and property taxes are not deductible for AMT purposes. Consequently, you should not employ this tactic without carefully calculating the alternative minimum tax impact. Please consult us before you overpay state or local income taxes!

Tax Credits

- **Up To \$1,500 Credit For Qualified Energy-Efficient Home Improvements.** For improvements to your principal residence located in the U.S. and placed-in-service in 2009 or 2010, last year's "American Recovery Tax Act of 2009" provided a 30% credit for qualified expenditures with a \$1,500 maximum cumulative credit for the 2009 and 2010 tax years. Qualified improvements can include properly certified energy efficient roofs, insulation, exterior windows (including skylights), exterior doors, heat pumps, hot water boilers and air conditioners. Before making energy-efficient improvements to your home, you should first check to see if the manufacturer has certified the products as qualifying for the energy tax credit
- **30% Credit For Qualified Residential Solar Water Heaters, Geothermal Heat Pumps, Wind Energy Property, And Solar Electric Generating Property.** If you install a qualifying solar water heater, solar electric generating property, geothermal heat pump, or small wind energy property in your residence located in the U.S., you may qualify for a credit equal to 30% of the equipment's cost (including onsite labor costs). The residence does not have to be your "principal residence," so installations in your second residence or vacation home may qualify. To take the credit for 2010, the property must actually be installed no later than December 31, 2010. This credit is not currently scheduled to expire until after 2016.
- **Establishing A New Retirement Plan For 2010.** Calendar-year taxpayers wishing to establish a qualified retirement plan for 2010 (e.g. profit-sharing, 401(k), or defined benefit plan) generally must adopt the plan no later than December 31, 2010. However, an SEP may be established by the due date of the tax return (including extensions), and a SIMPLE plan must be established no later than October 1, 2010.
- **The "Production Deduction."** If your business generates "qualified production activities income" from manufacturing, construction, farming, ranching, engineering services, architectural services, software development, film production, production of sound recordings, etc., the business may qualify for a \$199 production deduction. Generally, this deduction of 9% for

2010 (up from 6% in 2009) of the qualifying income cannot exceed 50% of the qualifying W-2 wages paid by your business. Since the production deduction may not exceed 50% of W-2 wages paid to employees, the deduction is lost if there are no wages paid with respect to a qualifying business.

SHOULD YOU CONSIDER CONVERTING YOUR "TRADITIONAL IRA" TO A "ROTH IRA?"

Whether to convert (roll over) your traditional IRA to a Roth IRA (Roth conversion) continues to be a hot topic, and there are many variables that impact this decision. Probably the most significant consideration is your current tax rates compared to the rates you expect when you retire. Therefore, uncertainty as to future tax rates creates uncertainty as to whether a Roth conversion is right for you. Prior to 2010, you were not allowed to convert your traditional IRA into a Roth IRA unless your modified adjusted gross income was \$100,000 or less. Starting in 2010, this income threshold is eliminated, and individuals of all income levels are allowed to convert to a Roth. If the recession has caused a significant, but temporary, decline in your income for 2010, you may be a good candidate for converting all or a portion of your regular IRA to a Roth. This is particularly true if: 1) your temporary drop in 2010 income places you in a much lower tax bracket than you expect in the future, 2) you believe that the value of your IRA is currently at or near an all time low, 3) you expect your IRA to significantly appreciate in the future, and 4) you have funds outside the IRA to pay the income taxes caused by the conversion and your after-tax rate of return on these outside funds is less than the rate of return in the IRA. If you want the conversion to be effective for 2010, you must transfer the amount from the regular IRA to the Roth IRA no later than December 31, 2010.

When you convert a traditional IRA to a Roth IRA, you generally must pay tax on the amount converted as if you withdrew the funds from the traditional IRA. However, if you convert in 2010, your conversion income will be included ratably in 2011 and 2012 (unless you "elect" to include the income entirely in 2010). Roth conversions can also be undone in 2011 as long as you change your mind before filing your tax return. Caution! Please don't attempt a Roth conversion or implement a Roth conversion strategy without calling us first. There is a host of factors you should evaluate before deciding to convert your traditional IRA to a Roth.

PREPARING FOR POTENTIAL TAX RATE INCREASES

Unless Congress changes current law, most individual owners of pass through business entities are facing an increase in their federal income tax rates beginning next year. For example, in 2011, the top individual income tax rate on income, other than long-term capital gains, is scheduled to jump from 35% to 39.6%. The maximum tax rate on long-term capital gains is scheduled to increase from 15% to 20%. And,

the top tax rate on dividends is scheduled to increase from 15% to 39.6%. Furthermore, starting in 2013, the Health Care Act imposes a new .9% Medicare Surtax on the earned income of higher-income taxpayers. Also, beginning in 2013, there will be a 3.8% Medicare Surtax on net investment income of higher-income taxpayers, which could apply to the pass-through operating income taxed to a "passive" owner of an S corporation, partnership, or LLC unless the income is subject to self-employment taxes.

Until we have firm guidance as to the 2011 income tax rates for the individual owners of proprietorships, partnerships, and S corporations, taking actions in 2010 in anticipation of the 2011 rates is full of uncertainties. However, as we approach year-end we can hopefully decide if individual business owners should accelerate income into 2010 to avoid any increase in the tax rates for 2011 and future years. We will be ready to assist you with these calculations and with other year-end planning considerations as we approach the end of 2010.

FINAL COMMENTS

Please contact us if you are interested in a tax topic that we did not discuss. Tax law is constantly changing due to new legislation, cases, regulations, and IRS rulings. Our firm closely monitors these changes. Please call us before implementing any planning ideas discussed in this letter, or if you need additional information. Note: The information contained in this material represents a general overview of tax developments and should not be relied upon without an independent, professional analysis of how any of these provisions may apply to a specific situation.

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