



Dear Clients and Friends:

April 15. That's the date most taxpayers think of as their federal tax deadline.

However, the best date for a taxpayer to focus on is December 31. Why? You always can file an extension to avoid the April 15 deadline; but you can't move the end of your tax year.

Once December 31 passes, your taxable income, deductions, credits and tax liability for the year are all "set in concrete" with little if any opportunity to change the outcome. As a result, year-end tax planning should form an essential part of your financial strategy. Changes brought about during this year, and forecasts for 2010, make that advice even more compelling for year-end 2009.

Effective year-end tax planning for 2009 combines use of traditional techniques of acceleration and deferral of income/deductions with appropriate responses to a constantly changing tax landscape. Below are various topics that you may want to consider for year-end planning.

Tax law changes

Year-end tax planning is made more urgent in 2009 because of some significant tax law changes. In February, Congress passed the American Reinvestment and Recovery Act of 2009 (2009 Recovery Act), providing for a first-time homebuyer credit of 10 percent of the purchase price (up to \$8,000) and enhanced net operating loss (NOL) carryback rules for certain small businesses. Both of these benefits were extended and enhanced when, this November, Congress passed the Worker, Homeownership and Business Assistance Act of 2009.

With the Worker, Homeownership and Business Assistance Act now in place, the homebuyer credit is available to qualified taxpayers purchasing principal residences on or before April 30, 2010. If a taxpayer enters into a binding contract before May 1, 2010, to close on the purchase of a principal residence before July 1, 2010, the new law treats the credit as not expiring until July 1, 2010.

The Worker, Homeownership and Business Assistance Act also provides a reduced credit for "long-time homeowners." Individuals who have owned and used the same residence as their principal residence for any five consecutive year period during the eight year period ending on the date of the purchase of a subsequent principal residence may be eligible for a reduced credit of \$6,500 (\$3,250 for married couples filing separately). Both credit opportunities carry an adjusted gross income ceiling, which itself can be subject to a "prior year" election. Year-end tax planning can help those close to this income line qualify in certain instances.

For businesses, the Worker, Homeownership and Business Assistance Act enhances the ability to carry back NOLs. All businesses, and not just qualified small businesses, may be eligible to elect to carry back applicable NOLs and obtain immediate cash refunds. An applicable NOL is the taxpayer's NOL for a tax year ending after December 31, 2007 and beginning before January 1, 2010. There are special rules for small businesses and for carryback offsets in the "fifth year." Many variables factor into taking this benefit, with some of them able to be changed by year-end tax planning before 2009 NOLs are set in stone.



Converting Traditional IRAs to Roth IRAs in 2010

Beginning in 2010, a significant tax planning opportunity may arise for those who have traditional IRA accounts. Depending on your individual circumstances, you may or may not have been able to take advantage of converting your traditional IRA to a Roth IRA prior to 2010 due to the \$100,000 adjusted gross income (AGI) limitation or the filing status limitation. As a result of the Tax Increase Prevention & Reconciliation Act of 2005 (TIPRA), in 2010, the \$100,000 AGI limitation and the filing status limitation no longer apply; therefore, allowing anyone the ability to convert their existing traditional IRA to a Roth IRA regardless of income level.

Two of the most significant advantages of Roth IRAs are that the appreciation grows tax free and there are no required minimum distributions (RMDs). These advantages can play an important role in retirement and estate planning.

When a conversion from a traditional IRA to a Roth IRA is made, the amount converted generally must be included as ordinary income in the year converted, which results in paying tax on the conversion amount. However, in 2010, the taxpayer will have the choice of including the conversion amount as income for 2010, or spreading the conversion amount between tax years 2011 and 2012 (50% each year). In other words, a \$500,000 traditional IRA converted to a Roth IRA in 2010 would either be included as \$500,000 of income in 2010, or \$250,000 of income in 2011 and \$250,000 in 2012.

Another great thing about the Roth conversion strategy is you can always change your mind well after the fact. Believe it or not, you have until October 15 of the year following the conversion year to re-characterize (unwind) your converted account (or accounts) if they do not perform as expected or your circumstances have changed.

Income shifting

The traditional year-end strategy of income shifting is still valuable this year but there is a twist. Under this strategy, you time your income and deductions so that your taxable income is about even for 2009 and 2010 so your tax bracket remains the same. If you anticipate being in a higher tax bracket for 2010, you may want to accelerate income into 2009 and defer deductions into 2010. Income can be delayed through setting up deferred compensation arrangements, postponing year-end bonuses, maximizing deductible retirement contributions, and delaying year-end billings. The twist is the uncertain future of the individual marginal income tax rates. Currently, the top two rates are 33 percent and 35 percent, but these rates are temporary and will expire after December 31, 2010. The Obama administration has proposed reinstating the 36 percent and 39.6 percent rates for higher-income taxpayers. Congress could allow the higher rates to return after 2010 or make the higher rates retroactive to January 1, 2010. Our office will keep you posted on developments.

Timing of Deductions and Credits

Planning for deductions and credits at year-end can also get complex but can be equally as rewarding. Timing and qualification rules create traps and opportunities:

- Pre-paying certain expenses, such as real estate taxes or mortgage interest, does not necessarily translate into a larger deduction this year.



- Paying a spring college tuition bill in late December instead of early January, however, can impact whether you maximize the benefit of the new American Opportunity Tax Credit for both 2009 and 2010.
- Year-end charitable giving generally has been a smart way to reduce current year taxes but strict timing rules and revised substantiation requirements for property donations cannot be overlooked.
- Homeowners should also not ignore taking advantage of the new residential energy property credit, which has a unique set of rules on qualifying expenses and deadlines for installations.

Losses

A special word about losses, especially as this difficult year draws to a close. Matching losses with gains is not necessarily a simple task in the tax law. Different rules apply to different losses. Losses can be ordinary losses, passive losses, at-risk losses, capital losses, hobby losses, casualty losses, gambling losses, or Code Sec. 1231 losses. Knowing the differences and acting before year-end to match them correctly can mean significant tax savings.

Cash contributions

Congress has tightened the rules for cash contributions. In order to take a deduction for charitable contributions of cash, check or other monetary gift – no matter what the amount – you must be able to substantiate the gift with a bank record or a written communication from the charity indicating the amount of the contribution, the date the contribution was made, and the name of the charity. Self-created log books will not suffice.

A cash-basis taxpayer generally takes a deduction when cash or property is actually paid, regardless of when a pledge is made. Payment by check is considered a payment. If the check is mailed, the payment is made at the time of mailing, even if the check is received in the following year, as long as the check is honored in the routine course of business. However, if the taxpayer post-dates the check to 2008, if the check bounces, or if the recipient holds the check because the account lacks sufficient funds, no payment has been made. If the recipient delays but ultimately cashes the check, and the date of delivery is not disputed, the payment dates back to the time the check is delivered or mailed.

Payment by a credit card is also considered a payment. The IRS treats the transaction as a cash equivalent. In effect, the taxpayer has borrowed funds from the bank issuing the card and has paid the seller for goods or services. Likewise, payment with a debit card is treated as a payment when the sale is completed, not when funds are later deducted from the purchaser's account.

Household goods and clothing

Just like the rules for cash gifts, the rules for deducting donations of clothing and household items have also been tightened. In order to take a deduction for household goods and clothing, the clothing must be in at least "good" condition, which is undefined, however. The amount of the charitable contribution is based on the fair market value of the clothing or household item. Household items must also be in good or better condition. Ensure that your donations of furniture, pots and pans, dinnerware, sheets and blankets, home furnishings, electronics, appliances, and



similar items are not broken or in disrepair. You must obtain a receipt from the charity, showing the name of the charitable organization, the date and location of the gift and a detailed description of the property contributed.

Moreover, gifts of \$250 or more must be substantiated by a contemporaneous written acknowledgment from the charity containing a description of the contribution, whether you received any goods or services in consideration for the contribution, and a good faith estimate of the value of any goods or services. If the claimed deduction exceeds \$500, donors must include Form 8283, Noncash Charitable Contributions, with their return. Special rules apply for deductions of \$5,000 or more. Our office can help navigate you through the various rules.

Contributions of automobiles

There are special rules that apply to donations of motor vehicles to charities. For instance, if you want to donate your car to charity (or a plane or boat) with a claimed value of more than \$500, your charitable deduction amount will depend on the charity's use of the vehicle. You can deduct the full fair market value (FMV) of the vehicle if the charity actually uses the vehicle to substantially further its regularly conducted charitable activities and the use is significant. Alternatively, you can deduct the full FMV if you have made a material improvement such as a major repair that improves the vehicle's condition in a way that increases its value. Otherwise, your contribution will be valued at its "auction price," which is typically quite low.

Contributions from an IRA

The deductible amount of an individual's charitable contributions made during a tax year generally may not exceed 50 percent of the taxpayer's "contribution base" (basically, a modified adjusted gross income amount). Certain distributions made directly from an IRA to a charity before 2010, however, are not limited by this 50 percent ceiling nor do they count toward that limit in the case of other types of contributions. This special treatment is accomplished not by allowing a charitable deduction for an IRA contribution, but rather by excluding any qualifying distribution from inclusion into the taxpayer's income. The exclusion may not exceed \$100,000 per taxpayer per taxable year. To be a qualified charitable distribution, the distribution must be made after the IRA owner turns age 70 1/2 and is made directly from the IRA trustee to a qualifying charitable organization and not a donor advised fund. The ability to make a donation directly from our IRA to a charity is only available through 2009, unless Congress acts to extend this provision.

Making Work Pay Credit

Many individuals are seeing a little more in their paychecks because of the Making Work Pay Credit. However, some taxpayers may be surprised to find that their refunds will be lower than expected next year or that they may owe tax. Our office can check your withholding allowances. You may need to file a new Form W-4 with your employer if you do not want the Making Work Pay Credit to reduce your withholding more than the amount of the credit. For example, our office has been contacted by individuals with more than one job, who have discovered that both employers are reducing withholding for the credit. Married taxpayers whose combined income places them in a higher tax bracket may also want to file a new Form W-4. The credit may also impact your tax liability if you are self-employed or receiving a pension. Please contact our office for details.



Educational credits and deductions

Generally, educational assistance such as scholarship, fellowship, or employer-provided educational benefits are excludable from income. For education costs not covered by educational assistance, tax benefits include the Hope scholarship credit (also known as the American Opportunity credit for 2009 and 2010) and the lifetime learning credit. Alternatively, you may have the option of deducting qualified tuition and fees expenses "above the line." These credits and deductions are coordinated with the exclusion for distributions from education savings plans, such as, Coverdell Savings Accounts and qualified tuition programs. For taxpayers who take out a loan to pay for their education, a deduction is available for the student loan interest.

The amount of the American Opportunity tax credit is computed as 100 percent of the first \$2,000 of qualified tuition and related expenses plus 25 percent of the next \$2,000 of such expenses, for a total maximum credit of \$2,500. The lifetime learning credit is generally available for 20 percent of education expenses up to \$10,000. For taxpayers who do not itemize, an above-the-line higher education tuition deduction can be claimed in 2009 for up to \$4,000.

Each education credit and the deduction have adjusted-gross-income phase out limitations. In addition the education credits are coordinated with the deduction and Coverdell Savings Accounts and qualified tuition programs so that taxpayers cannot realize duplicate tax benefits for the same dollars of education costs. Because of the variety of tax benefits and the variations as to eligibility and the definition of qualifying education expense, some or all of the benefits may apply to you. Every taxpayer should review their tax plan in order to take maximum advantage of the tax savings for education.

Green incentives

When considering home improvements, do not forget a variety of federal tax incentives that can help you save money. One of the more popular tax breaks is the residential energy property credit. The credit is 30 percent of the sum of expenditures for qualified energy efficiency improvements, including windows, furnaces, water heaters, heat pumps, and more, which are placed in service in 2009 and 2010. The credit is limited to \$1,500 for 2009 and 2010. The improvement must meet strict energy efficiency standards. If it does not, you cannot claim a credit. This is a common error and it can be a costly one. Our office can review your planned purchase and make sure you will qualify for this valuable incentive.

The Tax Code also rewards taxpayers who purchase "green" vehicles, such as hybrid vehicles and soon to be available plug-in electric drive vehicles. As with home improvements, the vehicle must meet certain energy efficiency standards. The IRS has certified the eligibility of many hybrid vehicles for the alternative vehicle tax credit. Additionally, the alternative motor vehicle credit is now treated as a nonrefundable personal tax credit. This means that it can be used to offset regular tax liability and AMT liability the same as other nonrefundable personal credits to the extent allowed. Do not forget, also, that as a bonus for purchasing any new vehicle by the end of 2009, you may deduct the sales tax that you pay on up to \$49,500 of the purchase price, depending on the amount of your adjusted gross income.



Alternative minimum tax

Another planning complication is the alternative minimum tax (AMT). As you know, the AMT was intended to ensure that very wealthy individuals did not evade taxation. Because the AMT was not indexed for inflation, and for other reasons, the AMT today encroaches on many moderate-income taxpayers, especially two-income married couples. Now is an opportune time to compute if you will be subject to the AMT for 2009 or 2010. Our office can explore whether certain deductions should be more evenly divided between 2009 and 2010 and whether certain deductions will qualify, or will not be as valuable, for AMT purposes. Congress has extended to 2010 a temporary AMT "patch" that insulates many moderate-income taxpayers from the AMT.

S corporations

S corporations are a popular choice of business entity. The IRS reminded S corporation shareholders that when corporate officers perform a service for the corporation and receive, or are entitled to receive, payments, these payments are considered wages.

Life changes

Year-end tax planning is not only about what is happening in Congress and at the IRS. Addressing the changed circumstances in your life has always been a large part of year-end tax planning. What you planned for at the beginning of 2009 may not be what you are faced with now. Changes in your employment status, family, investments, or retirement plans raise new tax issues:

- Self-employment, severance pay, sign-on bonuses, stock options, moving expenses, and COBRA health benefits, to name a few employment-related events, all present unique challenges.
- In your personal life, marriage, divorce, a larger family, and child care or eldercare expenses arising in 2009 can impact your tax situation.
- Investments, too, generally benefit from year-end tax strategies. You can take steps to balance out gains and losses. You also should take a year-end tally of dividends and interest to make certain that you are paying the correct estimated tax.

Working to rebuild a retirement nest egg through maximizing deductible 2009 contributions and making certain that rollovers from former employers are done correctly should also be a top priority at year end 2009.

Call Us

Because of the complexity of the tax law, understanding what planning provisions to incorporate into your year-end tax planning strategy can be daunting. While this letter alerts you to several tax opportunities on which you might follow through before year end, there are many more techniques that you can utilize depending upon your individual circumstances. For a more detailed solution, customized to your particular circumstances, please don't hesitate to call us. Our contact information may be found at www.elliottdavis.com. An electronic version of this letter is also there that you may share with others.