



November 1, 2010

To Our Clients and Friends:

We have already seen legislation with major tax changes this year, and, even though the year is almost over, more legislation is almost certainly on the way. Despite confusion created by the never-ending changes, the 2010 federal income tax environment is still a relatively favorable one. However, we may not be able to say that for 2011 and beyond. Therefore, tax planning actions taken between now and year-end may be more important than ever. This letter presents some planning ideas to consider while there is still time to act before the year-end. Some of the ideas may apply to you, some to family members, and others to your business.

Some General Comments before We Get Started...

First of all, the goal of year-end tax planning is to identify strategies that will allow you to pay the lowest overall tax. You should look at your tax situation for at least a two-year period, with the objective of reducing your tax liability for the two years combined rather than just for 2010. Also, it is important to limit tax planning to achieving your financial goals in a tax efficient manner. What matters is not tax minimization per se, but rather net worth maximization.

Watch out for AMT. While many recent tax law changes have been helpful in reducing your 2010 regular federal income tax bill, they did not do much to reduce the odds that you will owe the Alternative Minimum Tax (AMT). Therefore, it is critical to evaluate all tax planning strategies in light of the AMT before actually making any moves. Because the AMT rules are complicated and we still do not know exactly what they will be for 2010, you may want our assistance assessing various scenarios.

With these general principles in mind, let us take a look at some specific tax planning ideas that apply to the vast majority of taxpayers—that is, those in a regular tax situation.

Traditional Strategy of Deferring Income Is Dickey This Year

Be careful when considering the time-honored strategy of deferring taxable income from this year into next year. The strategy makes sense if you are confident you will be in the same or a lower tax bracket next year, but the tax picture for 2011 is blurry. With just under two months left in 2010, the fate of many tax provisions for 2011 and beyond is still very much unknown.

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Congress will return to Washington after tomorrow's elections to hopefully deal with these issues. In the meantime, we are left with a whole lot of conjecture and very little time for planning once the eventual outcome is known.

The top two rates have widely been expected to increase in 2011 from the current 33% and 35% to 36% and 39.6%, respectively—at least for taxpayers earning \$250,000 or more (\$200,000 or more if single). Therefore, such taxpayers might want to consider reversing the traditional strategy and accelerating income into 2010 to take advantage of this year's presumably lower rates. If you are in business for yourself and a cash-method taxpayer, you may be able to accelerate taxable income into 2010 by sending out client invoices as soon as feasible so that you will receive payment for them in late 2010. You can also increase taxable income by postponing deductible business expenses such as office supplies and repairs and maintenance until next year. If you are an employee of a family-owned business that will pay you a bonus for this year, you might want to get it paid in 2010, rather than waiting for 2011.

However, the state of the economy and the November elections results could cause legislators to delay any tax increase to after 2011. Therefore, it would be wise to start identifying ways you could accelerate some of your 2011 income into 2010, but wait to act on anything until later in the year when hopefully we will know more.

The conventional wisdom also says that the existing 10%, 15%, 25%, and 28% rate brackets will be left in place for next year. However, Congress must take action for that to occur, and there is not a lot of time left. If Congress fails to act, the four lowest rates will automatically be replaced by three higher rates: 15%, 28%, and 31%. Therefore, individuals in the existing 10%, 15%, 25%, and 28% rate brackets should also be skeptical about following the traditional strategy of deferring income into next year. Again, the best course of action may be to start now to identify ways you could defer or accelerate some of your income between 2010 and 2011, but wait to pull the trigger until we know more. To defer income, you could do just the opposite of what we described earlier (e.g., wait to send invoices until late in the year so payments are received in 2011 and pay deductible business expenses this year). You might also consider setting up a retirement plan and/or making additional deductible retirement plan or IRA contributions for the year.

We wish we could give you more definitive advice about the advisability of deferring vs. accelerating income, but the uncertainty about future tax rates makes it impossible at this moment. Please check back with us later when we may have much better information about what is going to happen with 2011 tax rates—hopefully, this will be before the end of 2010.

Higher-income Individuals May Benefit from Accelerating Itemized Deductions into This Year

For 2010, the phase-out rule that previously reduced write-offs for the most popular itemized deduction items (including home mortgage interest, state and local taxes, and charitable donations) is gone. However, the phase-out rule is scheduled to come back with a vengeance in 2011 unless Congress takes action to prevent it, which looks increasingly unlikely.

If the phase-out rule comes back as expected, it will wipe out \$3 of affected itemized deductions for every \$100 of Adjusted Gross Income (AGI) above the applicable threshold. Individuals with very high AGI can see up to 80% of their affected deductions wiped out. For 2011, the AGI threshold will probably be around \$170,000, or around \$85,000 for married individuals who file separate returns.

Bottom Line: Depending on your AGI, you may get more tax-saving benefit from accelerating into 2010 your state and local tax payments that are due early next year and some charitable donations that you would normally make in 2011. However, things get a bit tricky if you will be subject to the AMT this year. Scenarios like this cannot be addressed intuitively. They require running software projections. Please contact us if you have questions about the advisability of accelerating itemized deductions into this year.

Time Investment Gains and Losses and Consider Being Bold

As you evaluate investments held in your taxable brokerage firm accounts, consider the impact of selling appreciated securities this year instead of next year. The maximum federal income tax rate on long-term capital gains from 2010 sales is 15%. However, that low 15% rate only applies to gains from securities that have been held for at least a year and a day. In 2011, the maximum rate on long-term capital gains is scheduled to increase to 20%. That will happen automatically unless Congress takes action, which looks increasingly unlikely right now.

To the extent you have capital losses from earlier this year or a capital loss carryover from pre-2010 years, selling appreciated securities this year will be a tax-free deal because the losses will shelter your gains. Using capital losses to shelter short-term capital gains is especially helpful because short-term gains will be taxed at your regular rate (which could be as high as 35%) if they are left unsheltered.

What if you have some loss securities (currently worth less than you paid for them) that you would like to dump? Biting the bullet and selling them this year would trigger capital losses that you can use to shelter capital gains, including high-taxed short-term gains, from other sales this year. If you think your investments that are currently underwater are poised for a comeback, you can buy them back after taking a loss as long as you do not reacquire them within 30 days before *or* after the sale. You CAN buy them back within 30 days (remember, investment considerations should trump tax considerations) but by doing so you will lose the tax loss (for tax purposes, it will be as if you never sold the security).

If selling a bunch of loss stocks would cause your capital losses for this year to exceed your capital gains, it is not a problem. You will have a net capital loss for 2010. You can then use that net capital loss to shelter up to \$3,000 of this year's high-taxed ordinary income from salaries, bonuses, self-employment, and so forth (\$1,500 if you are married and file separately). Any excess net capital loss gets carried forward to next year.

Important Point: Selling enough loss securities to create a big net capital loss that exceeds what you can use this year might turn out to be a good idea. You can carry forward the excess net capital loss to 2011 and beyond and use it to shelter both short-term gains and long-term gains recognized in those years. This can give you extra investing flexibility in future years because you will not necessarily have to hold appreciated securities for over a year to get better tax results. Remember: It is widely expected that the maximum federal income tax rate on long-term capital gains will be increased to 20% after 2010 (up from the current 15%).

Also, the top two federal rates on ordinary income, including short-term capital gains, are scheduled to be increased starting in 2011 to 36% and 39.6% (up from the current 33% and 35%).

Convert Traditional IRA into Roth IRA

If your traditional IRA has dropped in value and you expect to pay higher federal income tax rates in future years, now might be a very good time to consider converting all or part of your traditional IRA balance into a Roth IRA. If you convert, it will trigger a current tax hit on the amount you convert. However, with your traditional IRA balance at a depressed level (and possibly your overall income too), the tax hit will be less. After the conversion, all the income and gains that accumulate in your Roth IRA, and all withdrawals after you reach age 59¹/₂, will be totally free of any federal taxes—assuming you meet the tax-free withdrawal rules. In contrast, future withdrawals from a traditional IRA could be hit with tax rates that are higher than today's rates (maybe much higher).

Before this year, there were two big restrictions on the Roth IRA conversion privilege. First, your Modified Adjusted Gross Income (MAGI) could not exceed \$100,000. Second, you were completely ineligible if you used married filing separate status. For 2010, both restrictions are eliminated. Now, virtually anyone who owns a traditional IRA can do a Roth IRA conversion.

However, conversion should not be viewed as the automatic thing to do. You have to be satisfied that paying the upfront conversion tax bill makes sense in your circumstances. In particular, converting a big account all at once could push you into higher tax brackets, which would not be good. However, for 2010 conversions only, you can elect for federal income tax purposes to spread the income triggered by conversions evenly over 2011 and 2012 and thereby defer the related federal income taxes. You must also make assumptions about future tax rates, how long you will leave the account untouched, the rate of return earned on your Roth IRA investments, and so forth.

In general, our view is that conversion of a regular IRA to a ROTH IRA is a good idea in the following situations:

- You have a non-deductible IRA with very little in earnings (i.e. the triggered income will be minimal).
- You are very young and have a long horizon for the tax-free (not just deferred, but FREE) growth to overtake the tax price you are paying now.
- You are older and are SURE that you will not need the IRA resources and thus want to convert to a ROTH for estate planning purposes.
- Given any of the above, you also have the liquid resources to pay the income tax bill on the conversion (i.e. you do not have to use the IRA itself – take a distribution – to pay the taxes).

If the Roth IRA conversion idea interests you, please contact us so we can discuss with you the possibility of doing a full analysis of all the relevant variables.

Ideas for Your Business

Consider Paying a Dividend in 2010. If you are a shareholder in a closely held C corporation, the current federal income tax rate structure is helpful to your cause. If the company pays you a taxable dividend in 2010, the maximum federal rate is only 15% (it is 0% to the extent you are in the 10% or 15% ordinary income tax brackets). However, this may well change in the near future. Thus, now may be a good time to convert some of your C corporation wealth into personal cash at a very manageable tax cost (and possibly none at all). Although the current administration has stated that it wants to hold the dividend tax rate to 20%, unless Congress acts soon, the maximum federal rate on dividends is scheduled to skyrocket from the current 15% to 39.6% starting with 2011.

Take Advantage of Tax Breaks for Purchasing Equipment, Software, and Certain Real Property. If you have plans to buy a business computer, office furniture, equipment, vehicle, or other tangible business property or to make certain improvements to real property, you might consider doing so before year-end to maximize your 2010 deductions. Here is why.

- *Bigger Section 179 Deduction.* Your business may be able to take advantage of the temporarily increased Section 179 deduction. Under the Section 179 deduction, an eligible business can often claim first-year depreciation write-offs for the entire cost of new and used equipment and software additions. Thanks to the Small Business Jobs Act passed in late September, for tax years beginning in 2010 and 2011, the maximum Section 179 deduction is a whopping \$500,000, as long as the amount of qualifying property placed in service during the year does not exceed \$2 million. Furthermore, for the first time, up to \$250,000 of some types of real property can qualify, including restaurant buildings and improvements made to interiors of retail and leased nonresidential buildings.

Note: Watch out if your business already has a tax loss for the year (or is close to it) before considering any Section 179 deduction. You cannot claim a Section 179 write-off that would create or increase an overall business tax loss for the year. Please contact us if you think this might be an issue for your operation.

- *50% First-year Bonus Depreciation.* Above and beyond the increased Section 179 deduction, your business can also claim first-year bonus depreciation equal to 50% of the cost (reduced by the Section 179 deduction) of most new (not used) equipment, software, and qualified leasehold improvements placed in service by December 31 of this year.

Claim New Health Insurance Tax Credit for Small Employers. Qualifying small employers can claim a new tax credit that can potentially cover up to 35% of the cost of providing health insurance coverage to employees. A qualifying small employer is one that: (1) has no more than 25 Full-time Equivalent (FTE) workers, (2) pays an average FTE wage of less than \$50,000, and (3) has a qualifying healthcare arrangement in place.

A qualifying arrangement is one that requires the employer to—(1) pay at least 50% of the cost of each enrolled employee's coverage, and (2) pay the same percentage for all employees.

For tax years beginning in 2010, however, a favorable transition rule allows the credit to be claimed when the employer does not pay the same percentage for each enrolled employee, but instead pays for each enrolled employee an amount equal to at least 50% of the cost of single coverage (even if the employee has more-expensive family or self-plus-one coverage).

The allowable credit is quickly reduced under a complicated two-tiered phase-out rule when the employer has more than 10 FTE employees or an average FTE wage in excess of \$25,000. Please contact us if you have questions about this new break.

Social Security Tax Exemption for Wages Paid to New Hires. Wages paid to a qualified new employee between March 19, 2010 and December 31 2010 are exempt from the *employer's* portion of the Social Security tax (the employer portion equals 6.2% of wages up to \$106,800). The exemption does not apply to the *employee's* portion of the Social Security tax (also 6.2% of wages of up to \$106,800).

Qualified new employees are full-time or part-time workers who—(1) start work after February 3, 2010 and by no later than December 31, 2010, and (2) were not employed more than 40 hours during the 60-day period ending on the start date. The new worker cannot displace a current employee unless that person quit voluntarily or was discharged for cause. Wages paid to workers who are related to an owner of the employer may be ineligible. Please contact us if you think you might qualify for this tax break.

Tax Credit for Retaining New Hires. Above and beyond the Social Security tax exemption, employers can also claim a new tax credit of up to \$1,000 for wages paid to each qualified new employee (defined the same way as for the Social Security tax exemption). However, there are some additional requirements to collect this break. You must keep the worker on the payroll for at least 52 consecutive weeks, and wages during the second 26 weeks must equal at least 80% of wages paid during the first 26 weeks. The credit equals the lesser of—(1) 6.2% of qualifying wages paid during the 52-consecutive-week period or (2) \$1,000. To claim the maximum \$1,000 credit, the worker must be paid at least \$16,130 during the 52-week period. Also, the credit is claimed in the tax year that the 52-week period is met for the worker. Therefore, the credit will be claimed on your 2011 return. To potentially be eligible for any of this, you have to start by hiring the new employee in 2010.

Ideas for the Office

Maximize Contributions to 401(k) Plans. If you have a 401(k) plan at work, it is just about time to tell your company how much you want to set aside on a tax-free basis for next year. Contribute as much as you can stand, especially if your employer makes matching contributions. You give up “free money” when you fail to participate to the max for the match. Also, check and see if your employer has a ROTH 401(k) option. Contributions are post-tax, not pre-tax, and should be viewed basically the same way as making a ROTH IRA contribution instead of a traditional deductible contribution. ROTH 401(k) contributions are not AGI-tested and limited, however.

Take Advantage of Flexible Spending Accounts (FSAs). If your company has an FSA, before year-end you must specify how much of your 2011 salary to convert into tax-free contributions to the plan. You can then take tax-free withdrawals next year to reimburse yourself for out-of-pocket medical and dental expenses and qualifying child care costs.

Be careful, though, FSAs are “use-it-or-lose-it” accounts—you do not want to set aside too much more than what you will likely have in qualifying expenses for the year (and thus give back the tax savings you realized with the set-aside). Also, starting in 2011, over-the-counter drugs (e.g., aspirin, antacids and generics that are now OTC) will no longer qualify for reimbursement by FSAs without a doctor’s prescription, so you need to consider that when you determine your 2011 contribution amount.

If you currently have an FSA, make sure you drain it by incurring eligible expenses before the deadline for this year. Otherwise, you will lose the remaining balance. It is not that hard to spend the money: think in terms of new glasses or contacts, dental work you have been putting off, or prescriptions that can be filled early. Also, for 2010, over-the-counter drugs still are eligible.

Adjust Your Federal Income Tax Withholding. If it looks like you are going to owe income taxes for 2010, consider increasing the Federal income taxes withheld from your paychecks now through the end of the year. When you file your return, you will still have to pay any taxes due less the amount paid in. However, as long as your total tax payments (estimated payments plus withholdings) equal at least 90% of your 2010 liability or, if smaller, 100% of your 2009 liability (110% if your 2009 adjusted gross income exceeded \$150,000; \$75,000 for married individuals who filed separate returns), penalties will be minimized, if not eliminated.

Make Energy Efficiency Improvements to Your Home

A great way to cut energy costs and save up to \$1,500 in federal income taxes this year is to make energy efficiency improvements to your principal residence. Basically, if you install energy efficient insulation, windows, doors, roofs, heat pumps, furnaces, central A/C units, hot water heaters or boilers, or advanced main air circulating fans to your home during 2010, you may be entitled to a tax credit of 30% of the purchase price. However, the maximum total credit you can claim for 2009 and 2010 combined is limited \$1,500. Absent Congressional action, the credit will not be available after 2010. Following is a link to the Energy Star web page addressing the credits: http://www.energystar.gov/index.cfm?c=tax_credits.tx_index

Retirement Plan Distributions for Seniors Age 70¹/₂ Plus

The tax laws generally require individuals with retirement accounts to take withdrawals based on the size of their account and their age every year after they reach age 70¹/₂. 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 minimum distribution requirement for 2009 only. This waiver does *not* apply for 2010. So, if you are age 70¹/₂ or older, you generally must take your required distribution before the end of the year to avoid the penalty. However, if you turned age 70¹/₂ in 2010, you can delay your 2010 required distribution to 2011 if you choose.

But, waiting until 2011 will result in two distributions in 2011—the amount required for 2010 plus the amount required for 2011. While deferring income is normally a sound tax strategy, here it results in bunching income into 2011. Thus, think twice before delaying your 2010 distribution to 2011—bunching income into 2011 might throw you into a higher tax bracket or have a detrimental impact on your other tax deductions. Barring year-end tax legislation, tax rates will be higher next year as well.

Conclusion

This letter is intended to give you a few ideas about tax planning moves for the rest of this year. Please do not hesitate to contact us if you want more details or would like to schedule a tax planning strategy session.

Very truly yours,

GORDON & ASSOCIATES, P.A., CPAs

A handwritten signature in blue ink, appearing to read "H. Gordon", with a stylized flourish at the end.

Horace C. Gordon, IV, CPA/PFS, CFP®

HCG/lrc

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