

R. L. DePanfilis & Company LLC

Guiding You to Financial Success Since 1979

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Year-End Tax Planning--Special Concerns for 2010



Year-end tax planning is as much about 2011 as it is about 2010. Often, there's a real opportunity for year-end tax savings when you can predict that you'll be paying taxes at a lower rate in one year than in the other. For example, under the right circumstances, deferring a year-end bonus or potentially accelerating deductions into the current year can pay off in a big way. Of course, to effectively plan, it helps to have a good idea of what next year's tax rates will be. Unfortunately, as 2010 draws to a close, 2011 brings some uncertainty in that regard.

Will there be higher tax rates in 2011?

Currently, there are six marginal federal income tax brackets: 10%, 15%, 25%, 28%, 33%, and 35%. These brackets--the result of 2001 tax legislation--expire at the end of 2010. As things stand now, in 2011 the 10% bracket disappears, and the remaining brackets return to their pre-2001 levels: 15%, 28%, 31%, 36%, and 39.6%. Though it would take action by Congress, the president has indicated that he would like to permanently extend the 2010 rates for individuals earning less than \$200,000 and married couples earning less than \$250,000 (these dollar benchmarks would be reduced by an amount that reflected the standard deduction and exemption amounts), but allow the two highest brackets to return to 36% and 39.6% for higher earners.

What about long-term capital gains?

Currently, long-term capital gain is generally taxed at a maximum rate of 15%. If you're in the 10% or 15% marginal income tax bracket in 2010, though, a special 0% rate applies (in other words, you owe no tax on any long-term capital gain). The same rates apply to qualified dividends received in 2010.

These rates also expire at the end of the year. The maximum rate on long-term capital gain in 2011 will generally increase to 20%, with a 10% rate applying to individuals in the lowest tax bracket (special rules would apply to qualifying

property held for five years or more). Qualifying dividends will be taxed as ordinary income. The president has proposed to permanently extend the 0% and 15% rates, with a new 20% rate applying to high-income individuals (those in the 36% and 39.6% tax brackets). Again, though, that all depends on what Congress does in the next few months.

Other considerations

- **2010 Roth IRA conversions:** A special rule applies to Roth IRA conversions in 2010 that allows you to postpone paying federal income tax on the income that results from the conversion. Instead of including the taxable income that results from the conversion on your 2010 federal income tax return (still an option if you so choose), you can report half the income on your 2011 return and half on your 2012 return. Whether a Roth conversion makes sense for you depends on your individual circumstances, including your marginal income tax rate in 2011 and 2012.
- **Alternative minimum tax (AMT):** In a now-familiar pattern, legislation that temporarily increased AMT exemption amounts, forestalling a dramatic increase in the number of individuals ensnared by the tax expired at the end of 2009. Congress is likely to act, but the specifics are uncertain.
- **Required minimum distributions (RMDs):** The requirement to take minimum distributions from IRAs and defined contribution plans was temporarily suspended for 2009; minimum distribution requirements are once again in effect for 2010.
- **Pending legislation:** Legislation is pending to extend some popular provisions that had expired, including the ability to deduct state and local sales tax in lieu of income tax on Schedule A, the additional standard deduction for state and local real property tax, and the above-the-line deduction for qualified tuition and related expenses. And additional legislation is likely, too, so stay up-to-date.

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Self-employed individuals, including partners and sole proprietors, 2% shareholders of S corporations, and 5% owners of an employer, are not treated as employees for purposes of this credit. Sole proprietorships are not entitled to the credit by virtue of employing family members, and these individuals are not taken into account in determining the number of FTEs or average full-time equivalent wages.



By 2014, employers with fewer than 100 employees may be able to compare and purchase qualified employee health insurance plans at competitive prices through state-based Small Business Health Options Program (SHOP) Exchanges.

Health-Care Reform Creates Small Business Tax Credit

Beginning this year, if you're a small business employer, you may be able to take advantage of the small business tax credit provided by the new health-care reform legislation. To be eligible for the tax credit, you must be a qualified small business employer who contributes at least 50% of the premium cost of a qualifying health plan (health insurance coverage purchased from a licensed insurance company).

Qualified small business employer

To be a qualified small business employer, you must employ fewer than 25 full-time equivalent employees (FTEs) during the taxable year, and your employees must have annual full-time equivalent wages that average less than \$50,000 (indexed to the Consumer Price Index for Urban Consumers beginning in 2014). The full amount of the credit is available only if you have 10 or fewer FTEs whose average annual full-time equivalent wages is not more than \$25,000 (also indexed to the Consumer Price Index for Urban Consumers beginning in 2014).

Full-time equivalent employees

Calculate your FTEs by totaling all hours worked by all your employees during the tax year, and dividing the result by 2080. For purposes of the calculation, the maximum number of hours that can be attributed to an individual employee is 2080.

Average full-time equivalent wages

To determine annual full-time equivalent wages, divide the total wages paid for the year, divided by the number of FTEs, rounding the result down to the nearest \$1,000. Hours and wages paid for seasonal employees aren't included unless they worked more than 120 days during the taxable year.

Maximum credit

The full credit for years 2010 through 2013 is equal to 35% of the lesser of (1) the amount of contributions you made on behalf of employees during the taxable year for qualifying health coverage, and (2) the amount of contributions that you would have made during the taxable year if each employee had enrolled in coverage with a small business benchmark premium.

The benchmark premium is the average total premium cost in the small group market for employer-sponsored coverage in your state. The premium and the benchmark premium vary based on the type of coverage provided to your employees.

Beginning in 2014, the maximum credit is equal to 50%, determined in the same manner as in years prior to 2014. However, the credit is only available if you purchase employee health insurance coverage through a state Exchange. The credit is available for a maximum coverage period of two consecutive years, beginning with the first year in which you offer one or more qualified plans to your employees through an exchange.

Sliding scale tax credit

The tax credit is reduced if you have more than 10 FTEs and/or if the average annual wages exceed \$25,000.

If you have more than 10 FTEs, the credit reduction is determined by multiplying the amount of the maximum credit by the number of FTEs exceeding 10, then dividing this total by 15.

If your average annual wages exceeds \$25,000, the credit reduction is calculated by multiplying the maximum credit amount by the average annual wages in excess of \$25,000, then dividing this total by \$25,000.

If you have more than 10 FTEs and average annual wages in excess of \$25,000, the credit reduction is the sum of the total of the two reductions.

Example: In 2011, you have 11 FTEs with average annual wages of \$30,000, and your premium cost for the year is \$100,000. To determine the reduced credit:

1. *Maximum credit before reduction:* $(35\% \times \$100,000) = \$35,000$
2. *Credit reduction for FTEs exceeding 10:* $(\$35,000 \times 1/15) = \$2,333$
3. *Wages exceeding \$25,000:* $(\$35,000 \times \$5,000/\$25,000) = \$7,000$
4. *Total credit reduction:* $(\$2,333 + \$7,000) = \$9,333$
5. *Total credit in 2011:* $\$25,667 (\$35,000 - \$9,333)$

Tax-exempt organizations

The tax credit is also available if you are a 501(c) organization exempt under IRC Section 501(a). However, the credit percentage for 2010, 2011, 2012, and 2013 is 25% (rather than 35%), and the credit percentage for taxable years beginning in years 2014 and later is 35% (rather than 50%). You can only apply the tax credit against your liability for payroll taxes.

Transferring Your Family Business to Your Children

You've spent years building your family business. It's been a source of pride and income for both you and your family. But now you may be thinking about how to hand over the reins to your children. Because transferring your business interest to your children may have income, gift, and estate tax consequences, it can take careful planning to prevent some (or all) of the business assets from having to be sold to pay those taxes. Your business succession planning should include ways to ensure the continuity of your business with the smallest possible tax consequences.

Some common strategies for minimizing taxes are discussed briefly below, but remember, none of these strategies are without drawbacks. Before you act, consult a tax professional as well as your estate planning attorney.

Gifts or bequeathing your interest outright

If you don't need continued income from the business and you don't want to retain some control, you can simply give the business to your children outright. To minimize the gift tax consequences, you can first use your \$1 million lifetime exemption. Then, you can begin a systematic program of making annual gifts to your children in amounts that equal the annual gift tax exclusion (currently \$13,000 per year per recipient). By transferring your interest in this manner, you may be able to transfer all or a significant portion of the business free from federal gift tax (although these transfers may still be subject to state gift tax). The disadvantage here is the amount of time that may be needed to transfer your entire interest.

If you can wait and transfer your business at your death, Section 6166 of the Internal Revenue Code allows any estate taxes incurred because of the inclusion of your family business in your estate to be deferred for 5 years (with interest-only payments for the first 4 years and interest plus principal due in the fifth year), and then paid in annual installments over a period of up to 10 years. This will allow your beneficiaries more time to raise sufficient funds to pay the taxes or obtain more favorable interest rates if they need to borrow the money. Be aware that the business must exceed 35% of your gross estate and other requirements must be met.

Selling your interest outright

If you need income from your business, you can sell your business interest (for full fair market value) to your children. This will avoid gift and estate taxes, but you may owe capital gains taxes. Long-term capital gains tax rates,

however, are currently lower than gift and estate tax rates.

Using a buy-sell agreement

If you want to sell your business interest to your children but retain control over the business for a while, consider using a buy-sell agreement. This is a legal contract that prearranges the sale to happen when a specific event occurs, such as your retirement, disability, divorce, or death. When the triggering event occurs, the children will be obligated to buy your interest from you or your estate. The price and sale terms will have been predetermined.

Remember, however, that you will be bound under a buy-sell agreement: you won't be able to sell or give your business to anyone except the buyers named in the agreement (unless they consent).

Using a grantor retained annuity trust (GRAT)

A GRAT is a trust into which you would transfer your business interest. The value of the gift is determined using the IRS's current interest rate (published monthly by the IRS). The trust must terminate at a specified time (e.g., 10 years). You receive annuity payments during the term of the trust, and at the end, your children will receive the business. Hopefully, the business will have appreciated beyond the IRS's interest rate, allowing the excess to pass tax free. Be aware however, that if you die during the GRAT term, your entire business interest will be included in your gross estate for federal estate tax purposes. You will have failed to transfer your business interest and lost the tax advantages of the GRAT, and you will have incurred the costs of creating and maintaining the GRAT for nothing, so structure your GRAT carefully.

Creating a family limited partnership (FLP)

An FLP is a type of business entity. First, you establish a partnership with both general and limited partnership interests. Then, you transfer the business to this partnership. You retain the general partnership interest for yourself, allowing you to maintain control over the day-to-day operation of the business. Over time, you gift the limited partnership interests to your children, leveraging your lifetime gift tax exemption and the annual gift tax exclusion. You also save taxes because the value of the gifts may be eligible for valuation discounts, such as the minority interest and lack of marketability discounts.



With a GRAT, you receive a fixed dollar amount that does not change even if the value of the trust property (corpus) increases or decreases. You may, alternatively, retain the right to receive a fixed percentage of the trust corpus, determined annually. That type of trust is called a grantor retained unitrust (GRUT).

A rolling or cascading GRAT is a technique that involves creating a series of short-term GRATs (typically two or three years) with each successive GRAT being funded by the annuity payments from the previous ones. This technique can minimize the risk of the grantor dying during the GRAT term, and can also minimize interest rate risk.

Ask the Experts



Will the new health-care law affect my Medicare drug plan?

Yes, it might. Many Medicare Part D beneficiaries have had to pay for prescriptions

out-of-pocket after reaching a gap in their annual coverage, referred to as the "donut hole." Currently, if you're a Medicare Part D beneficiary, you may pay up to an additional \$3,610, out-of-pocket, for medicines after reaching an initial threshold of \$2,830 in total prescription drug costs (including Part D payments, beneficiary co-pays, and deductibles). But, in 2010, if you fall in the coverage gap, you will receive a \$250 rebate.

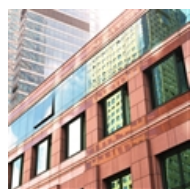
Starting in 2011, you will receive a 50% discount on the cost of brand-name drugs in the coverage gap. Additionally, a reduction in coinsurance for generic drugs in the coverage gap will be phased in, starting in 2011, and a similar reduction in coinsurance for brand-name drugs begins in 2013. By 2020, a combination of federal subsidies and a reduction in co-payments will reduce your total out-of-pocket costs for medications in the donut hole to 25%.

Another change affecting Medicare Part D beneficiaries relates to full-benefit dual-eligible beneficiaries (individuals eligible for both Medicaid and Medicare). Dual-eligible beneficiaries receiving institutional care, such as in a nursing home facility, do not owe any co-payments for prescriptions covered by Part D. However, dual-eligible beneficiaries receiving long-term care services at home or in a day-care community setting are subject to such co-payments. Beginning in 2012, the new legislation removes this imbalance; individuals receiving services at home or in a community setting will no longer be subject to co-payments.

Also, beginning in 2011, the time period during which Part D and Medicare Advantage beneficiaries can make changes to their coverage is extended and runs from October 15 through December 7. This extension should provide more time for beneficiaries to consider their options while ensuring that any benefit changes are properly incorporated into the plan for the following year.

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This information is provided for general information only and should not be applied to any specific situation without consulting a professional advisor. We make every effort to keep the information up to date as much as possible, but due to the changing matter of the tax laws, all information should be verified before being relied upon.



Does the new health-care reform law affect health spending accounts?

Yes. The new health-care reform legislation impacts flexible spending arrangements (FSAs), health reimbursement arrangements (HRAs), health savings accounts (HSAs), and Archer medical savings accounts (MSAs).

Over-the-counter medications. Beginning in 2011, FSAs and HRAs will not be able to make reimbursements for the cost of over-the-counter medications, and HSA and Archer MSA distributions used to pay for the cost of over-the-counter medications will not be made on a tax-free basis. However, insulin and over-the-counter medications prescribed by a physician will still be reimbursable on a tax-favored basis by these plans. You may want to stock up on your over-the-counter drugs to take advantage of the available reimbursement before the end of this year.

Tax increase on nonqualified distributions. Generally, distributions from HSAs and Archer MSAs for qualified medical expenses are received income-tax free. Plan distributions

for other than qualified medical expenses are subject to ordinary income tax plus a penalty tax. In the case of HSAs, the penalty is 10%, and for Archer MSAs the penalty is 15%. However, the health-care reform legislation increases the tax penalty for both of these plans to 20%, beginning in 2011.

FSA contribution limit. If you participate in an FSA as part of a cafeteria plan, beginning in 2013, the annual amount available for reimbursement for qualified medical expenses is limited to \$2,500 (this figure will be adjusted for inflation in subsequent years). This reduction does not apply to health FSAs that aren't part of a cafeteria plan.

If these changes will affect you, and you or a family member needs substantial dental work such as orthodontia, or corrective vision surgery, you might want to plan for and address these needs prior to 2013. And remember, FSAs are subject to the "use it or lose it" rule, meaning that any pretax money in your plan that is not used by the end of the plan year is forfeited.

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