“Year-end tax planning variables galore”

Year-end tax planning for 2009 presents a unique set of challenges, in addition to reprising some traditional ones. Many more tax breaks this year are temporary, either sunsetting in 2009 or 2010. Congress, in 11^{th}-hour brinkmanship, is not helping to signal in advance which provisions will be extended. Further, the conventional tax advice of accelerating deductions and deferring income may not wit well if deferring income runs the risk of not receiving it at all in an uncertain economy or receiving it when tax rates go higher.

On the other side of the ledger is the increased pressure on tax advisors to add to a taxpayer’s bottom line through tax savings while tax advisors themselves are covering unfamiliar ground, refocusing on how to maximize the use of tax losses when income is not as plentiful for sheltering.

Starting year-end tax planning early in October can yield dividends, as can remaining adaptable to any change in the business environment, or tax legislation, between now and December 31. Here are some issues to keep you busy.

EXPIRATION DATES

Many more tax benefits seem to be perishable items, requiring use before an expiration date. For 2009 year-end tax planning, one eye should be kept of provisions expiring in 2009 or 2010, and the other on provisions that may be set to begin in 2010 0r 2011.

PROVISIONS ENDING IN 2009

Some provisions officially end in 2009 and, therefore, require immediate action or al least careful consideration. Of those, a handful are likely candidates for extension by

Congress into 2010. Of the latter group, any planning that assumes an extension should be revisited closer to year's end " just in case." That group includes:

- Extension of the estate tax, with an exemption amount of $3.5 million;
- Extension of the individual Alternative Minimum Tax "patch," likely at current levels but possibly passed retroactively in 2010; and,
- Extension of the R&D credit, a perennial favorite to be made permanent but again in danger of only an extension because of revenue costs.

Provisions that are expiring in 2009 and likely not to be extended, at least in their present forms, include:

- **Longer NOL carrybacks.** Eligible small businesses can elect to use an extended three, four or five year carryback period for 2008 net operating losses. For many eligible taxpayers, the deadline for making the election has already passed. Although talk abound over adding 2009 NOLs to the special carryback election and even broadening it to include more businesses, the lost revenues to the government that these extensions would require make their success on Capitol Hill a tough sell.
- **Unemployment compensation.** Up to $2,400 of unemployment compensation is excludable from gross income for 2009. This exclusion's fate for 2010 remains uncertain.
- **New car purchases.** Most individuals who purchase qualified new motor vehicles before 2010 can deduct the general sales tax (based on up to $49,500 of the purchase price of any vehicle) either as an additional standard deduction or as an itemized deduction. With Cash for Clunkers stealing much of the thunder from

this tax break (and much of the revenue for further assistance to the auto industry), extension into 2010 is unlikely. Those rushing to beat this deadline should remember that they must take delivery of the vehicle by Dec. 31, 2009, to be entitled to the deduction; a contract of sale is not enough.

- **First-time homebuyer credit.** The $8,000 credit for first-time homebuyers expires after Nov. 30, 2009. Title must close by Nov. 30, making “time is of the essence” clauses in contracts of sale advisable in many more cases as that date approaches. Such clauses, however, do not bind the mortgage lender or the Internal Revenue Service, so diligence in moving the deal along may be necessary.
- **Bonus depreciation.** The 5o percent first-year bonus depreciation was extended by the 2009 Recovery Act generally through 2009 only. Similarly, the $8,000 additional first-year depreciation allowed for new vehicles placed in service ends in 2009. Many observers on Capitol Hill believe that an extension of this provision into 2010 is unlikely, not only because of its cost but because businesses that have delayed capital purchase will find it increasingly necessary to make purchases anyway, with or without an incentive. For bonus depreciation to apply under current law, the equipment must be placed in service by the end of calendar year 2009. Being locked into a purchase order on customized equipment is not enough, even if late delivery is not the fault of the taxpayer. Accelerated credits in lieu of bonus depreciation also ends in 2009.
- **Code Section 179 expensing.** Code Sec. 179 expensing (a.k.a. small-business expensing) at its present 2009 levels is schedule to drop for tax years beginning

after Dec. 31, 2009. For 2009, the cap on Code Sec. 179 expensing remains at the 2008 level of $250,000 for qualifying purchases of new or used property, together with an $800,000 threshold for deduction phase-out. Businesses placing property in service for tax years beginning in 2010 will be confined to a $125,000 maximum deduction with a $500,000 cap.

- **Individual estimated tax payments.** For individuals with qualified small-business income, estimated tax payments for tax years beginning in 2009 may be based on 90 percent of the prior year's tax liability. Taxpayers who took advantage of this provision should remember that the difference may need to be paid this April 15.
- **Required minimum distributions.** For 2009, the required minimum distribution requirements generally applicable to retirement plans are suspended. It does not require, however, that any plan or arrangement actually eliminate the plan's distribution requirement for 2009. Plans and arrangements must be formally amended to eliminate the requirement. An amendment will be treated as timely as long as it is made on or before the last day of the first plan year beginning on or after Jan. 1, 2011.

Also sunsetting at the end of 2009 and requiring a year-end strategy for many taxpayers if no congressional action is taken are, for individuals:

- The itemized state and local sales tax deduction in lieu of state and local income taxes;
- The higher education above-the-line tuition deduction of up to $4,000;
- The additional standard deduction for real property taxes;

- The above-the-line $250 class-room expense deduction;
- The 65 percent COBRA coverage benefit for those separated from employment; and,
- District of Columbia enterprise zone provisions and the D.C. homebuyer credit.

For businesses, the following are set to sunset:

- 15-year cost recovery for leasehold and restaurant improvements;
- An enhanced deduction for contributions of food to charitable organizations, and books of computer equipment to qualifying schools;
- An extended New Markets Tax Credit; and,
- An election to expense the production costs of qualifying film and television productions.

PROVISIONS RUNNING THROUGH 2010

Several recently enacted provisions extend through 2010. Although their use into 2010 removes the urgency associated with most action before January 1, many of these provisions carry limits that are applied on an annual basis.

- **American Opportunity Credit.** For 2009 and 2010, the Hope Scholarship Credit has been replaced by a more generous American Opportunity Credit. Generally, an education tax credit is allowed only for payments of qualified expenses for an academic period beginning in the same tax year as the year the payment is actually made. However, if qualified expenses are paid during one tax year for an academic period that begins during the first three months of the allowing tax year, the academic period is treated as beginning during the tax year in which the expenses were paid. For example, a taxpayer who pays qualified tuition and related expenses to a college in December 2009 for the semester beginning in 2010 may claim an education credit only for tax year 2009. This year-end planning trap may be further exacerbated by the common mistake of adding up education credits based on an academic year, rather than a calendar tax year.

- **Public transportation fringe benefits.** Through 2010, the limit on excludable fringe benefits for vanpools and transit passes stays at an increased $230-per-month level to match the limit applicable to parking benefits. Nevertheless, the benefit must be formally adopted, and retroactive reimbursement for months in 2009 in which no plan existed is not allowed.
- **Residential energy property credit.** The residential energy property tax credit is now 30 percent, with a maximum cap of $1,500 aggregate amount for 2009 and 2010 installations.
- **Making Work Pay Credit.** Most workers with earned income can claim a refundable credit of up to $400 ($800 on a joint return) for 2009 and again for 2010. However, the benefits are generally spread throughout the year by way of a slightly deceased payroll deduction each pay period. Planning therefore is focused primarily on preventing having to refund amounts when dealing with two jobs or higher-than-qualifying income.
- **Cancellation-debt-income.** Business can elect to defer cancellation of indebtedness income arising from a qualified re-acquisition of certain of its business debt instruments. Re-acquisition after Dec. 31, 2008, and before Jan. 1, 2011, may be elected to be includible in gross income ratably over a five-tax-year period. Whether the COI income is realized in 2009 or 2010, the deferred income

starts to be recognized in 2014; there is no tax benefit to accelerating a debt buyback into 2009, rather then 2010.

2010 ROTH CONVERSION

Before 2010, only individuals with modified adjusted gross incomes of $100,000 AGI limit on conversions of traditional IRAs to Roth IRAs is eliminated. Filing status restrictions are also lifted, allowing married taxpayers filing a separate return to convert. Furthermore, the taxable income generated from a 2010 conversion will be able to be deferred ratably until 2011 and 2012, or taxed all in 2010 if so elected.

For individuals below the $100,000 AGI level this year, converting to a Roth IRA right away while the traditional IRA account balance is probably still low because of stock market declines generally will make more sense than waiting to take advantage of the 2011-2012 tax deferral option. As the new year gets closer, of course, the difference in value diminishes and, at some point, deferral of the conversion into 2010 makes more sense. (This summary does not touch upon all the considerations that should be weighed in planning for nest year's Roth conversion opportunity. More to come in a future column.)

ANTICIPATE TAX INCREASES

The consensus is that someone must pay the piper for all the stimulus expenditures over the past year. The multi-billion-dollar question is, "Who?" Although no tax increase is expected until 2011, that prospect can already impact on 2009 year-end tax planning, especially for higher-income individuals.

With the real prospect of increased income tax rate brackets and capital gains rate increases for those with more than $200,000-$250,000 in annual income, loading income into 2010, rather than 2009, only makes sense if that year-end technique does not overload income into 2010 when combined with 2010 year-end planning that may call for accelerating income into 2010. Complicating this numbers analysis is the possibility that the income on Roth conversions in 2010 may be better recognized in 2010, rather than deferred at higher post-2010 rates.

NETTING LOSSES

In planning to accelerate deductions and losses to offset income (or in a year in which losses just naturally happened because of the economic climate), taxpayers should remember that not all losses are created equal. There are special rules for carrying forward and carrying back net operating losses. There are also limitations on claiming deductions for certain types of losses, including:

- **Passive losses.** Under Code Section 469, taxpayers may not claim deductions for net passive activity losses against nonpassive income. Any excess losses can be carried forward to offset future passive income.
- **At-risk losses.** The at-risk rules under Code Sec. 465 limit taxpayers' deductions for losses to the amount they are financially "at risk" in the business.
- **Stock losses.** Capital losses deductible by a taxpayer are generally limited to the capital gains realized in the same year. Net stock losses are generally nondeductible, except to the extent of $3,000 ($1,500 for married individuals filing a separate return). Any losses over $3,000 can be carried forward to the succeeding year, to offset capital gains for that year and to deduct another $3,000 in losses.

- **Gambling losses.** Code Sec. 165(d) limits losses incurred in a wagering activity to the amount of gains experienced. As a result, a taxpayer (unless a professional gambler) cannot claim a deduction for losses incurred while gambling or betting in excess of the amount gained from that activity.
- **Hobby losses.** An activity that is proven to be conducted as a hobby, rather than a business, can only offset expenses against income earned in that activity. Net losses are not deductible, but may be carried forward to a year in which income is realized from that same activity.
- **Code Sec. 1231 losses.** Net gains from the disposal of Sec. 1231 property are taxed at capital gain rates, while net losses from the disposal of Sec. 1231 property are taxed as ordinary losses. Sec. 1231 property is depreciable property and real estate that is held for more than one year and used in the taxpayer's trade or business.

CONCLUSION

Year-end tax planning is undeniably getting more complicated, but is also unassailably more valuable to a greater number of taxpayers. Different expiring provisions affect different cross-sections of individual and business taxpayers.

Carryover losses from 2008, along with different types of losses realized in 2009, provide opportunities to maximize immediate tax benefits, as well as setting the stage for future growth. Tax breaks wither extending into 2010 or starting next year, as in the case of "unlimited" Roth conversions, further establish year-end 2009 as a time to prepare as well as protect.

Perhaps most of all, however, year-end tax planning, through its expanding applicability, offers help to a greater number of weary clients looking toward a brighter future, one tax dollar at a time.