

# Client Bulletin

BUSINESS & TAX PLANNING IDEAS for OUR CLIENTS and FRIENDS

## Year-End Tax Planning for Investors

If you expect to sell securities for a profit in a taxable account, consider doing so in 2009 while tax rates are at low levels. Some predict that those rates may soon move higher. What's more, you may be able to shift your gains to loved ones who'll owe no tax in 2009.

**Example #1:** John Brown has two children, ages 18 and 21. Both will be full-time college students in 2010. To pay their college bills, John expects to sell some securities. Because all the securities in his taxable account now trade at prices higher than his purchase price, John expects to generate capital gains when he sells them to raise money for college costs. John may be able to avoid some capital gains tax if he transfers appreciated securities to his children and takes advantage of the "kiddie tax." Under the "kiddie tax" rules, full-time students under 24 are considered to be "kiddies" as long as their earned income is less than half of their support. These "kiddies" can sell appreciated assets and owe 0% tax under rules in effect in 2009.

Suppose, in this example, that John's two children will each have \$400 in interest from bank accounts this year and no other investment income. John transfers appreciated securities that he has held for more than one year to each of his children. (He should make these transfers early enough in the year that the children can sell the securities in 2009.) If each child sells securities for a \$1,500 gain, each will have \$1,900 of unearned income this year: \$1,500 of long-term capital gains plus \$400 of interest. John's children, who qualify as "kiddies," can sell the appreciated assets and owe 0% tax.

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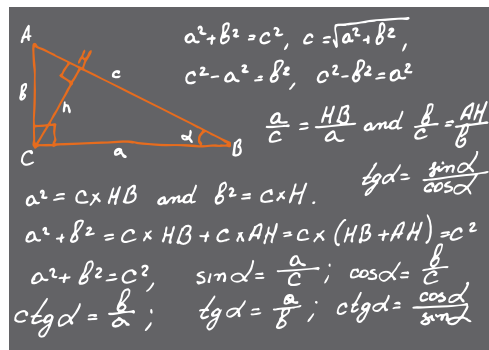
#### Did You Know?

Among all students completing an undergraduate degree in 2007-08, 59% had education debt. The median debt level of 2007-08 bachelor's degree recipients at public four-year colleges was \$17,700; at private four-year institutions it was \$22,375.

Source: The College Board



America Counts on CPAs



Thus, if your children qualify as "kiddies" and you hold appreciated securities, transfer those you've held for more than one year to your children for a sale this year. Such sales will qualify for the 0% rate as long as each child's total unearned income, including any transfers, is no more than \$1,900. As of this writing, the 0% tax rate for low-income taxpayers is scheduled to remain in effect for 2010. If that is still the case in January, you can repeat this maneuver then. In fact, the \$1,900 kiddie tax ceiling might be slightly higher in 2010 because it increases with inflation. (In the "Green Book" published by the Treasury Department in May 2009, the Obama administration proposes to retain the 0% tax rate for low-income taxpayers.)

Other loved ones, such as your parents and children 24 and older, are not subject to the \$1,900 kiddie tax limit. Single taxpayers may have taxable income up to \$33,950 and owe 0% on long-term capital gains in 2009. For couples filing joint returns, the upper limit is \$67,900. If you plan to sell appreciated securities, you may wish to transfer them to taxpayers who will be under those ceilings for tax-free sales in 2009.

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## The 15% Solution

In the preceding example, the securities that John Brown transfers to his children might not provide enough money to pay their college bills. If that's the case, John may have to sell more appreciated securities and pay tax on long-term capital gains. John can wait until 2010, thus deferring his tax bill. However, there is no guarantee that the 15% maximum tax rate on long-term gains will remain in effect next year. Congress may respond to financial pressures on the federal government by raising that rate, perhaps limiting the increase to high-income taxpayers. For this reason, John might decide to make planned sales in 2009, locking in the tax on the gains at 2009 rates. (The Green Book proposes an increase in the tax on high-income taxpayers' long-term capital gains from 15% now to 20% in 2011. However, Congress might legislate such an increase in 2010.)

## Selling short

If some of your stocks are now worth less than you paid for them, you may want to sell them—and realize those losses—before year end. You can offset net capital losses up to \$3,000 against your ordinary income on your 2009 tax return and carry forward capital losses over \$3,000 to future years' tax returns with no time limits. Piling up a "bank" of capital losses may help you if you have gains from a 2009 investment and want to take profits. If you sell securities you've held for one year or less, you'll generate short-term gains, which are taxable at ordinary income rates (up to 35% in 2009). Instead, you can use your capital losses to offset the gains you generate by selling the securities held short term—and avoid tax.

## Looking backward

As mentioned previously, you can deduct up to \$3,000 worth of net capi-

tal losses on your tax return and carry forward excess losses to future years. Therefore, you should check your 2008 tax return to see if you're carrying forward any unused capital losses. You'll find that information on Schedule D of Form 1040. If you have such losses from the 2008 bear market or prior years, you can take gains to soak them up without paying any taxes out of pocket.

**Example #2:** Louis Ward has \$20,000 worth of loss carry forwards from previous years. He hasn't taken any capital gains or losses this year. If Louis generates \$17,000 in net capital gains by the end of 2009, his loss carry forwards will offset the tax on those gains. He can deduct the remaining \$3,000 of net loss against his 2009 ordinary income, reducing his existing taxable income for the year and his resulting tax obligation.

## Year-End Tax Planning for Mutual Funds

### Mutual fund methods

If you invest in mutual funds, proceed cautiously at year end. At this time of year, funds may distribute any net capital gains for 2009 to their shareholders. These distributions are taxable to investors (unless the fund is held in a tax-favored retirement account), and the share price typically drops to reflect the distribution.

**Example #1:** Caitlin Carter invests \$10,000 in Mutual Fund ABC in early December 2009. She acquires 500 shares at \$20 apiece. One week later, ABC makes a \$2-per-share capital gain distribution, and the share price drops to \$18. Caitlin owes tax on a \$1,000 capital gain distribution (\$2 per share times 500 shares)—even though the

distribution is essentially a return of her own money.

Therefore, if you are going to invest in a mutual fund between now and December 31, 2009, you may be better off waiting until after any distribution. You might be able to avoid this tax trap and buy at the post-distribution reduced trading price. Check the fund's website for information about capital gain distributions; if the fund won't distribute capital gains because of bear market losses, you can buy at a time of your choosing.

If you are thinking of selling mutual fund shares, on the other hand, you may decide to advance your plans if you learn that your fund will make a capital gain distribution.

**Example #2:** Steve Davis invested \$10,000 in Mutual Fund XYZ many years ago. He now owns 700 shares of the fund, trading at \$25, for a total of \$17,500. Steve wishes to take his gains in 2009 while the maximum tax rate on long-term gains is 15%.

On the XYZ website, Steve sees that a \$3 per share distribution is



planned for December 15, 2009. The fund estimates that \$2.50 per share of that distribution will be in the form of short-term capital gains from this year's rally. Thus, if Steve holds onto

his shares, he will receive a distribution of \$2,100 (\$3 times 700 shares), most of which will be taxed in his 28% ordinary income tax bracket as short-term capital gains.

Instead, Steve sells before XYZ's distribution. With a \$10,000 cost basis and a \$17,500 selling price, Steve will have a \$7,500 long-term gain, all of which will be taxed at only 15%.

## Year-End Tax Planning for IRAs

Through 2009, you can convert a traditional IRA to a Roth IRA only if your 2009 modified adjusted gross income (MAGI) is no greater than \$100,000 on a single or joint tax return. The \$100,000 cap will come off in January 2010. Under current law, this change is permanent. Therefore, high income taxpayers can convert traditional IRAs to Roth IRAs in 2010, 2011, 2012, and so on. For taxpayers whose 2009 MAGI is \$100,000 or less, year-end 2009 presents a dilemma.

**Example #1:** Wendy Ames expects her MAGI to be \$80,000 this year. She would like to invest in a Roth IRA because these accounts may permit tax-free withdrawals in the future and Roth IRA owners don't have to take required distributions. Also, if she wishes, Wendy can leave her Roth IRA intact for her beneficiaries, who will have to take scheduled distributions but will owe no tax as long as the account is at least five years old.

### Crafting a conversion

Should Wendy convert her traditional IRA to a Roth IRA in 2009 or wait until 2010? Although she will owe tax on the amount she converts, in this example her traditional IRA has a much lower value now than it did in 2007. Therefore, a Roth IRA conversion now would generate a lower tax obligation than it would have created two years ago. A 2009 conversion also will lock in this year's income tax rates, which might be higher in the future, and start the five year clock for tax-free withdrawals at January 1, 2009.

On the other hand, Wendy can wait a short time and convert in 2010. Her IRA balance might be little changed by then, and tax rates for moderate income individuals like Wendy may not move up in the near future. If she waits a few weeks and converts in 2010, Wendy will have two choices. She can report the taxable income from her 2010 Roth IRA conversion on her 2010 tax return. Or she can take advantage of a special rule for 2010 conversions and report half of the income on her 2011 tax return and the remaining half on her 2012 return, thus obtaining a period of tax deferral.

### Taking action

Some taxpayers may choose to convert by year-end 2009 because they will have a chance to reverse their conversion. All Roth IRA conversions can be recharacterized by October 15 of the following year; the account will revert to a traditional IRA and the taxpayer will get a refund of any tax paid on the conversion.

**Example #2:** Tim Bradley decides to convert his \$100,000 traditional IRA to a Roth IRA in late 2009 to take advantage of a low IRA balance and today's relatively low tax rates. He pays the tax on \$100,000 of income on his 2009 tax return. In October 2010, Tim sees that his Roth IRA is worth \$125,000. He decides to leave his Roth IRA in place, with \$25,000 of tax-free growth in the account.

**Example #3:** Assume the same facts as in Example #2, except that Tim's

Roth IRA has declined to \$80,000 by October 2010. He recharacterizes the account to a traditional IRA and files an amended tax return for a refund. After waiting at least 31 days, Tim can re-convert this traditional IRA to a Roth IRA. If the account value has not changed materially in the interim, Tim will owe less tax on this Roth IRA conversion than he owed on his 2009 conversion. What's more, if he executes the re-conversion in 2010, he can defer the tax payments to 2011 and 2012, as explained previously.

### Be prepared

Taxpayers who expect their 2009 MAGI to be over \$100,000 also may want to do some year-end IRA planning for 2010, when it will be possible to convert a traditional IRA to a Roth IRA regardless of income. Following are three steps you should take.

First, decide whether you want to convert your traditional IRA to a Roth IRA. If you are concerned that upper income individuals and couples will pay much higher taxes in the future, you may want to convert your tax-deferred traditional IRA to a tax-free Roth IRA.

Second, if you would like to have a Roth IRA, decide how much you are willing to convert. If you do a partial conversion, you will reduce your tax obligation.

Finally, if you decide to convert your traditional IRA to a Roth IRA, and you have determined how much you'd like to convert, notify the custodian of your traditional IRA in advance. There may be a rush to convert to Roth IRAs at the beginning of the year as many taxpayers seek to take advantage of their IRAs' diminished values.

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By notifying your IRA custodian in advance about your plans, you may be able to get your paperwork ready for a

Roth IRA conversion in early 2010.

If you or a loved one face a similar decision, our office can help you make

an IRA plan that's appropriate for your specific circumstances.

## Year-End Tax Planning for Itemized Deductions

When you fill out your tax return for 2009, you'll have to choose whether to itemize deductions or claim a standard deduction. If you itemize, you'll deduct certain amounts you spent this year on charitable donations, mortgage interest, and so on.

You may, instead, claim a standard deduction. For 2009, the standard deduction is \$11,400 for married couples filing a joint return, \$5,700 for singles and married individuals filing separately, and \$8,350 for heads of household. Taxpayers who are over age 65 receive an additional standard deduction: \$1,400 for single taxpayers and \$1,100 apiece for married taxpayers in 2009. Similar deductions are available to the blind. If you qualify on both counts, you'll get two deductions.

### Two tax breaks

In 2009, you may need to consider two special tax laws when you decide whether to itemize or take the standard deduction.

- 1. Homeowners can deduct up to \$500 of property tax paid in 2009 in addition to their standard deduction.** Married couples can deduct up to \$1,000. If you itemize deductions instead of taking the standard deduction, you generally can deduct all the property tax you pay.
- 2. You can deduct the sales tax paid on a new vehicle, even if you take the standard deduction.** You must have bought the new car, light truck, motor home, or motorcycle from February 17, 2009–December

31, 2009. If so, you can deduct the sales tax paid on a purchase price of up to \$49,500. If you itemize and choose to deduct state and local general sales taxes (instead of deducting state and local income taxes), you can only deduct the sales tax on the vehicle once as part of the general sales tax deduction. If you deduct state and local income taxes, you can include the vehicle sales tax with your other deductions, such as mortgage interest and charitable contributions.

Both of these tax benefits are scheduled to expire after this year.

### Making the choice

As year end nears, you can determine whether you will be better off itemizing or taking the standard deduction this year. If you think you'll take the standard deduction, you may want to defer itemized deductions until 2010, when you might get a tax benefit. Moreover, if you are considering buying a new vehicle, you may want to buy before December 31 so you'll get the sales tax deduction.

**Example #1:** Wallace and Diane Franklin are both 66 years old. They own their home without a mortgage and pay \$2,000 per year in property tax. They bought a new car for \$30,000 this June and paid \$1,200 (4%) in sales tax. The Franklins expect to pay around \$4,000 this year in state income tax. They have not had significant unreimbursed medical expenses. So far this year, they have not made substantial

charitable contributions.

If the Franklins decide to take the standard deduction, their total will be **\$15,800:**

Standard deduction for all couples filing jointly	\$11,400
Additional deduction for married people 65 and older	2,200
Special property tax deduction	1,000
Special vehicle sales tax deduction	1,200
<b>Total</b>	<b>\$15,800</b>

If the Franklins decide to itemize, their deductions would include only \$4,000 in state income tax, \$2,000 in property tax, and \$1,200 for the special sales tax deduction—**\$7,200** total. Thus, in this example they would be much better off taking the standard deduction. Therefore, the Franklins probably should delay their usual year-end charitable contributions until January 2010 because they might save tax in 2010 by itemizing deductions. In contrast, taxpayers whose itemized deductions clearly will top the standard deduction amount generally should incur itemized deductions such as charitable contributions in 2009.

### Drive hard for tax breaks

As previously mentioned, the special sales tax deduction for new vehicles will expire at year end unless Congress

extends it. Does this mean that if you're in the market for a new car, light truck, etc., you should purchase it before year end? Probably, but not necessarily. Some examples can illustrate the tradeoffs:

**Example #2:** Emily Gibson regularly itemizes deductions, including state income taxes paid. In late 2009, she buys a car for \$40,000 and pays \$2,000 (5%) in sales tax. Emily can itemize her state income taxes and also take a special deduction for the \$2,000 in sales tax she paid for her new car. Conclusion: Buying a new car in 2009 is a good choice for Emily.

**Example #3:** Barry James always takes the standard deduction. He had planned to buy a new car and decides to make the purchase before year end to lock in the special sales tax deduction. Conclusion: For Barry, buying a new car in 2009 makes sense.

**Example #4:** Karen Little likes to have a new car every two years, so she leases a car. The special sales tax deduction applies only to purchased cars, not leased cars. Therefore, Karen decides to wait until 2010, when her current lease will be up, to lease a new car. She will get little or no tax advantage by leasing a car in 2009. Conclusion: For people like Karen who lease cars, the special sales tax deduction will not affect year-end planning.

**Example #5:** Saul Thompson has MAGI of \$180,000 as a single taxpayer. He cannot take the special sales tax deduction, which is phased out for taxpayers with MAGI between \$125,000 and \$135,000 (\$250,000 and \$260,000 on a joint return). Saul should buy or lease a car at any time of his choosing and pay the indicated sales tax. When he files his tax return for the year, Saul can determine which is the larger deduction: (1) the sales tax deduction (adding the amount of sales tax paid for the car to the amount otherwise deductible per the IRS's tables) or (2) the income tax deduction. Conclusion: For high-income taxpayers like Saul, the special sales tax deduction will not affect year-end planning.

### Healthier deductions

Regardless of whether you plan to buy a new car by year end, there are steps you can take to increase your deductions for 2009 if you decide to itemize rather than take the standard deduction. For instance, you can figure out whether you are likely to deduct medical costs this year. You can deduct such costs only to the extent they exceed 7.5% of your adjusted gross income (AGI).

**Example #6:** Melody Neale expects her AGI this year to be around \$100,000. Thus, she'll be able to deduct health care expenses over \$7,500—7.5% of \$100,000.

When Melody tallies her medical outlays for the year, she finds she already has spent \$10,000, so she is over the threshold. She can go to the dentist, get doctors' checkups, buy prescription eyeglasses, and so on before December 31. Melody will be paying those bills with tax-deductible dollars.

On the other hand, suppose Melody's health care expenses are only \$4,000 for the year, through November. She can decide to postpone all elective medical procedures until 2010, when they might lead to tax deductions.

### Make the most of miscellany

You should approach miscellaneous itemized deductions in the same manner. Such deductions include outlays for tax preparation, unreimbursed employee business expenses, investment expenses, Roth IRA losses, and 529 college savings plan losses. You add up all of those items and take deductions to the extent they exceed 2% of your AGI.

**Example #7:** Phil Roberts expects his AGI this year to be around \$150,000. Therefore, he'll be able to deduct miscellaneous itemized deductions over \$3,000: 2% of \$150,000. As of early December, Phil finds that his miscellaneous deductions for 2009 are already at \$4,000; thus, further expenses will be deductible. Before year end, he can pay for investment publications and software with tax-deductible dollars. If



Phil closes out his sole Roth IRA and sole 529 account for losses this year, those losses also will be deductible on his 2009 tax return.

On the other hand, if Phil has only a few hundred dollars in miscellaneous costs in 2009, he may decide to incur additional miscellaneous costs in 2010, when they might be more valuable.

### Adjusting for the AMT

Your strategies for itemized deductions will be different if you are subject to the alternative minimum tax (AMT). Increasingly, moderate and upper income taxpayers owe the AMT in addition to regular tax; our office can tell you if you will pay the AMT this year.

Taxpayers who are subject to the AMT can deduct medical costs only to the extent those costs exceed 10% of AGI, rather than 7.5% of AGI. Therefore, your decision on whether to incur elective medical bills by year end will be based on whether they'll be greater than 10% of your AGI, not 7.5%.

If you are subject to the AMT, you won't be able to take miscellaneous itemized deductions, no matter how much you spend. Therefore, if you will owe the AMT this year, you shouldn't close out Roth IRAs or 529 college savings plans at a loss because you won't get any tax benefit. Instead, wait until next year to see if those tax-favored accounts recover—or if you'll escape the AMT in 2010 and perhaps

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## Compliance Alert: FTC Red Flags Rule

A rule requiring “creditors” and “financial institutions” to implement identity theft prevention programs is scheduled to go into effect on November 1, 2009. Small business owners, professionals, and corporate managers—at a minimum—should head to the Federal Trade Commission’s (FTC) website to learn what the Red Flags Rule is and how it may affect their business. The website is [www.ftc.gov/redflagsrule](http://www.ftc.gov/redflagsrule).

At this time, it appears that many professionals and businesses may fall under the rule. According to the FTC, “creditors” may be “finance compa-

nies, automobile dealers that provide or arrange financing, mortgage brokers, utility companies, telecommunications companies, nonprofit and government entities that defer payments for goods and services, and businesses that provide services and bill later, including many lawyers, doctors, and other professionals.” Accepting credit cards as payment does not, by itself, make an entity a creditor.

The FTC’s Red Flags Rule website offers a number of resources to help entities determine if they are covered and, if so, how to comply with the rule.

The website includes an online, fillable compliance template that enables companies to design their own identity theft program, FAQs, guidance manuals, and articles directed to specific businesses and industries. In addition, the FTC has stated that it will create a specific web link for small and low-risk entities with materials to help them navigate the rule.

Our office can help you determine whether you or your business will be covered by the Red Flags Rule and what you should do to comply with it.

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be able to deduct miscellaneous expenses.

Just as you can’t take miscellaneous itemized deductions for AMT purposes, you also can’t deduct state and local

tax payments. Taxpayers who itemize deductions may decide to prepay in 2009 any property tax or state and local income tax due in early 2010 to get a current deduction. However, if

you will owe the AMT in 2009, you might as well wait until those tax payments are due in early 2010, because you might be able to deduct them on your 2010 return.

## Tax Calendar

### NOVEMBER 2009

#### November 2

**Employers.** For Social Security, Medicare, and withheld income tax, file Form 941 for the third quarter of 2009. Deposit or pay any undeposited tax. (If your tax liability is less than \$2,500, you can pay it in full with a timely filed return.) If you deposited the tax for the quarter in full and on time, you have until November 10 to file the return.

For federal unemployment tax, deposit the tax owed through September if more than \$500.

#### November 10

**Employers.** For Social Security, Medicare, and withheld income tax, file Form 941 for the third quarter of 2009. This due date applies only if you deposited the tax for the quarter in full and on time.

#### November 16

**Employers.** For Social Security, Medicare, withheld income tax, and non-payroll withholding, deposit the tax for payments in October if the monthly rule applies.

### DECEMBER 2009

#### December 15

**Employers.** For Social Security, Medicare, withheld income tax, and non-payroll withholding, deposit the tax for payments in November if the monthly rule applies.

**Corporations.** Deposit the fourth installment of estimated income tax for 2009.

In accordance with IRS Circular 230, this newsletter is not to be considered a “covered opinion” or other written tax advice and should not be relied upon for IRS audit, tax dispute, or any other purpose.

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