PUBLICATION

Year-End Individual Tax Planning in Uncertain Times

November 18, 2010

In the current uncertain Congressional climate, effective tax planning is challenging at best. And with many favorable federal tax provisions set to expire or significantly change on January 1, 2011, it is very important that individuals take the time to focus on year-end tax planning.

Federal Income Taxes

Background: In response to a flailing national economy caused by the bursting of the technology bubble and the rash of accounting scandals in the early 2000s, Congress enacted two substantial pieces of legislation containing numerous favorable rate reductions and other tax provisions: the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs Growth and Tax Relief Reconciliation Act of 2003. Without action from the current lame-duck Congress, these favorable tax provisions are set to expire at the end of 2010, and the threat of such expiration will likely motivate many individual taxpayers to take substantial action before year end.

Change in Income Tax Rates: Perhaps the most direct impact of the expiring tax provisions will be felt as a result of the current favorable individual income tax rates reverting to their pre-2001 levels. The following table demonstrates the rate changes applied to married individuals who file joint returns:

- Recognizing deferred compensation during 2010;
- Accelerating the execution of profitable commercial contracts into 2010;
- Postponing charitable cash contributions until 2011;
- Delaying payment of mortgage interest or deductible health expenditures until 2011;
- Delaying 529 account contributions until 2011; and
- Recognizing income by converting a Traditional IRA to a Roth IRA.

2010 Income Tax Rates	
0 - $16,750	10%
$16,750 - $68,000	15%
$68,000 - $137,300	25%
$137,300 - $209,250	28%

$209,250 - $373,650	33%
$373,650 - above	35%

2011 Income Tax Rates	
0 - $58,200	15%
$58,200 - $140,600	28%
$140,600 - $214,250	31%
$214,250 - $382,650	36%
$382,650 - above	39.6%

The promise of increasing income tax rates frustrates the very core of modern tax planning. Nearly all tax-savings strategies are based on the two underlying principles that individual taxpayers benefit from: 1) deferring income and 2) accelerating deductions. This dual-principled approach is turned on its head, however, when an income tax rate increase is threatened. Instead, an analysis of one's potential tax liability may well prove that payment of tax at current rates results in a lower overall tax burden than if the payment is delayed. Consequently, in anticipation of some adjustment next year in the higher tax rates, individual taxpayers affected by such higher rates may be best served where practical by: 1) deferring deductions and 2) accelerating income. Such taxpayers should consider (again, where practical to do so) the following planning opportunities to take advantage of any future rate increase:

Change in Capital Gains Rate: In addition to affecting income tax rates, the expiration of the favorable tax provisions will also directly impact the maximum capital gains rate. Since May 6, 2003, taxpayers have enjoyed a maximum tax rate of 15 percent on all long-term capital gains. In addition, dividends received by individuals have been taxed at capital gains rate rather than being treated as ordinary income. Beginning January 1, 2011, however, that capital gains rate will revert to its pre-2003 level of 20 percent and dividends received will no longer be taxed as capital gains. In preparation for this increase, taxpayers should consider implementing the following techniques where practical:

- Accelerating the sale of property with built-in-gains this year; and
- Avoiding the realization of losses on the sale of depreciated property until next year.

Estate and Gift Taxes

As mentioned in our January 15, 2010 Alert, "A Letter to Our Estate Planning Clients," the federal estate and gift tax rates will also likewise revert to pre-2001 levels on January 1, 2011 without action from the current lame-duck Congress. Regardless of whether or not Congress acts, and as mentioned in our September 8, 2010 Alert, "Gifting: A Tax-Saving Technique," the final months of 2010 may afford individuals the last opportunity to make substantial gifts to younger generations free of generation- skipping transfer tax and at a maximum federal gift tax rate of 35 percent.

Other Changing Provisions

click to edit In addition to the increasing income tax rates and capital gains rate, other expiring favorable tax provisions include:

- The Small Business Jobs Acts of 2010 amends Section 162 to allow self-employed individuals to deduct the cost of health insurance for themselves, their spouses and their children who have not attained age 27 (as of the end of the taxable year), for purposes of computing their self-employment tax. This provision is effective only for the 2010 tax year.
- The special rule allowing taxpayers with modified gross income above $100,000 to convert their IRAs to Roth IRAs with deferral of taxation until 2011 and 2012 in equal parts, will expire after December 31, 2010. A conversion after 2010 will require inclusion of all of the taxable income in the year of conversion.
- The special rule allowing a participant in a Section 401(k) or 403(b) plan to convert existing plan accounts to Roth accounts within the employer-sponsored plan (rather than roll the accounts to an IRA and convert the IRA to a Roth account) with deferral of taxation until 2011 and 2012 in equal parts, will expire after December 31, 2010. Plan participants should contact their plan administrators to determine whether the plan will permit the conversion to a Roth account during 2010.
- The special rule under the Patient Protection and Affordable Care Act (PPACA) allowing medical flexible spending accounts (FSA) to purchase over-the-counter drugs and medicines without a prescription (other than insulin), will expire after December 31, 2010. When elections are made in late 2010 for contributions to medical FSAs for 2011, consideration should be given to decreasing the amount contributed for nonprescription drugs and medicines.
- The overall limitation on itemized deductions under Section 68(g), generally known as the "Pease limitation" (which was enacted by the Omnibus Budget Reconciliation Act of 1990 and limited in its effect by subsequent federal tax acts) will be fully restored so as to limit certain personal and dependent deductions after December 31, 2010.
- The repeal of the personal exemptions phase-outs for high income taxpayers under Section 151(d)(3)(F) will expire after December 31, 2010.
- A number of changes related to the student loan interest deduction will occur after December 31, 2010. First, the increase and indexation for inflation of the phase-out ranges under Section 221(f)(1) will reset to pre-2001 levels. Second, the repeal of the limit on the number of months that interest payments are deductible will be reinstated as will the repeal of the rule that voluntary payments of interest are not deductible.
- The increase of maximum annual contributions to Coverdell education savings accounts (also known as Educational IRAs) from $500 to $2,000 under Section 530(b)(1)(A)(iii) will be eliminated after December 31, 2010. Furthermore, the definitional expansion of qualified education expenses will revert to its pre-2001 limitation under Section 530(b)(2), which will include the elimination of the definition of elementary and secondary education expenses under Section 530-(b)(3). Finally, Section 530(b)(4) allowing current-year contributions to be made until April 15 of the following year will be eliminated.

Other Year-End Planning Opportunities

The following provisions may offer new end-of-year tax planning opportunities:

- Medical FSAs are now permitted (but not required) to cover a child's expenses until the year the child reaches age 27, and Section 125 cafeteria plans are also permitted to accept pre-tax premium payments for such children. Interested employees should contact their cafeteria plan administrators to determine what will be permitted under that employer's plan in 2011, and may wish to increase their 2010 elections regarding pre-tax contributions in 2011 accordingly.
- PPACA requires employer-sponsored health plans which are not grandfathered to cover children of employees until attaining age 26, regardless of marital or student status. Children who have already been dropped from coverage must be provided at least a 30-day election period to re-enroll in the plan. For calendar year plans, an election to cover a child should be made during 2010. The plan administrator should be able to provide further information on whether coverage for a child until age 26 will be available in 2011, and what the election procedure will be.

Summary

The purpose of this Alert is simply to advise you of certain possible year-end individual tax planning considerations. Whether any one or more of these considerations, or other time-sensitive favorable tax provisions not covered by this Alert, present real opportunities for you will depend upon your particular facts and circumstances that you should discuss with your tax advisor. Further, given the uncertainty of the current lame-duck Congress, it is impossible to know for sure at this point whether legislative action will be taken during 2010 or perhaps during 2011 (with or without some retroactivity to the beginning of 2011) to prevent or at least compromise the tax rate increases otherwise scheduled for 2011. However, even during these uncertain times it is important to address and, where practical, implement tax planning measures.

If you have any questions regarding the effect of these or other tax provisions on your year-end tax planning, please contact one of the attorneys in our Tax Department.