

# tax IMPACT

September/October 2009

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Tax Tips  
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# Year end tax planning in uncertain times

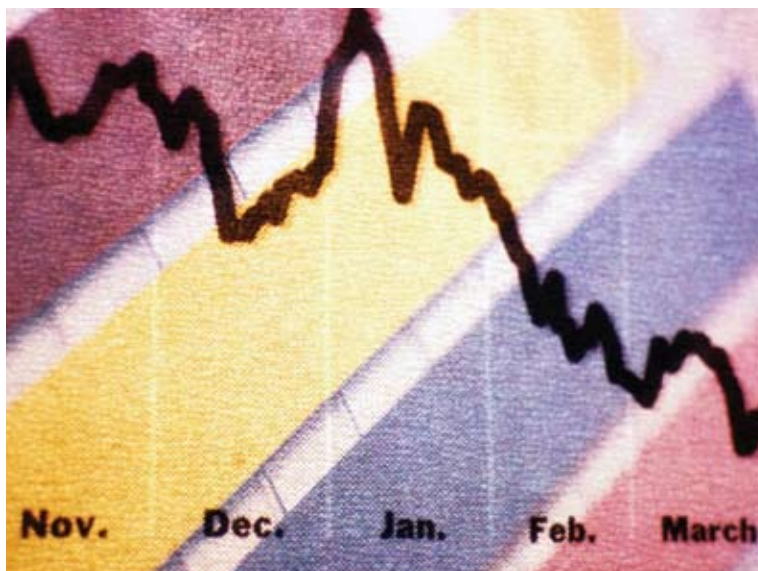
In today's uncertain economic times, with potential tax law changes on the horizon, tax planning can be a challenge. Between now and year end, it's important to monitor your financial situation closely, keep an eye on congressional developments and work with your tax advisor to devise a tax plan based on your best guess as to what the future holds. With that in mind, let's look at strategies that may work for your financial situation.

## Revisit your portfolio

Like most people, you probably have some investments that have taken a beating lately. But even if an investment's value has declined, it may still reflect unrealized gains if its value exceeds your cost basis. If you plan to sell any of these assets or if you've already recognized some capital gains this year, it may make sense to sell some losing investments to offset those gains.

If you have both unrealized gains and unrealized losses in your portfolio, and you plan to unload some of these assets, here are a few rules of thumb to keep in mind:

- ⊙ Generally, it's preferable to sell long-term gain assets (those held more than a year) first because they qualify for a lower tax rate.
- ⊙ On the losing side, it usually makes sense to sell assets that generate short-term losses first because you can use them to offset higher-taxed short-term gains (with any leftover losses used to offset long-term gains).



- ⊙ If you have a net capital loss for the year, you can use it to offset up to \$3,000 of ordinary income (such as from salary or interest). You can carry forward the excess to future tax years, but a better strategy might be to sell some investments at a gain to take advantage of those nondeductible losses this year.
- ⊙ If you're not selling all of your shares in an investment, use the specific identification method to designate which shares you want to sell. For example, if your objective is to minimize your gain or maximize your loss, instruct your broker to sell the highest-cost shares first.

As you implement your plan, watch out for the wash-sale rule, which prohibits you from deducting a loss on an investment if you acquire a substantially identical investment within 30 days before or after the sale.

### **Weigh your “alternatives”**

This year’s alternative minimum tax (AMT) “patch” boosted the AMT exemption, for 2009 only, to \$70,950 for joint filers and \$46,700 for individuals and heads of households. Unless Congress enacts another patch for next year, the exemptions will roll back to \$45,000 and \$33,750, respectively, resulting in AMT liability for many taxpayers.

If you expect significant AMT liability in 2010, consider shifting some AMT income into 2009 to take advantage of this year’s exemption amounts. Keep in mind that there are other strategies you may be able to implement to reduce the AMT tax bite.

### **Buy a home**

If you haven’t owned a principal residence during the previous three years and buy a home before Dec. 1, 2009, you may qualify for the “first-time homebuyer” tax credit. For qualifying purchases after Dec. 31, 2008, generally the credit is equal to 10% of the purchase price, up to \$8,000, and you won’t be subject to the repayment obligation that applied to the credit last year. But the credit phases out beginning when adjusted gross income (AGI) reaches \$75,000 (\$150,000 for joint filers).

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*If you expect significant AMT liability in 2010, consider shifting some AMT income into 2009 to take advantage of this year’s exemption amounts.*

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### **Buy a car**

If you buy a new car, light truck, motorcycle or motor home before year end, you can take an above-the-line deduction for state and local sales or excise taxes. The deduction is limited to the tax on the first \$49,500 of a vehicle’s purchase

### **Mind your own business**

If you own a business and expect to be in the same or a lower tax bracket in 2010, consider deferring tax by deferring income until after Dec. 31. Cash-basis taxpayers can simply delay billing for products or services. Accrual-basis taxpayers must delay the actual shipment of products or delivery of services.

Also consider accelerating deductible expenses into 2009. Cash-basis taxpayers can make an estimated state tax payment before Dec. 31, so they can deduct it this year rather than next. Both cash- and accrual-basis taxpayers can charge expenses on a credit card and deduct them in the year charged, regardless of when paid.

But if you’re experiencing a low-income year, the negative impact these strategies might have on your cash flow may not be worth the potential tax benefit. And, if it’s likely you’ll be in a higher tax bracket next year, the opposite strategies (accelerating income and deferring deductions) may save you more tax.

price and phases out beginning when AGI reaches \$125,000 (\$250,000 for joint filers).

### **Buy your college student a computer**

If you’re paying for college expenses with a 529 plan, you can take tax-free withdrawals to pay for the student’s computer and Internet access. This benefit is available for 2009 and 2010.

### **Dust off your crystal ball**

These are just a few of the many moves you can make before year end to reduce your tax bill. To start the process, estimate your income, deductions and tax liabilities for both this year and next. Then you and your tax advisor can look for opportunities to shift income and expenses between 2009 and 2010 to produce the best tax result. (For a few business tips, see “Mind your own business” above.) ©

# Be reasonable!

## *Court weighs in on executive compensation*

The Internal Revenue Code allows a business to deduct a “reasonable allowance for salaries or other compensation” it pays to executives and other employees. When an executive is also a shareholder of a C corporation, the IRS may challenge compensation it believes is unreasonably high, arguing that the excess is really a disguised dividend. Dividends aren’t deductible, so by characterizing payments as deductible compensation, the company reduces its tax bill.

### **Compensation vs. dividends**

This incentive to pay high salaries isn’t as powerful as it once was. Qualified dividends are now taxed at only 15% — compared to ordinary tax rates on compensation, which can be as high as 35%. So

a company that treats payments as compensation rather than dividends to save corporate taxes may significantly increase the recipient’s tax liability.

Still, depending on their respective tax brackets and other factors, a company and its owners may enjoy an overall tax savings by characterizing payments as compensation. Under those circumstances, however, the IRS may attempt to reclassify a portion of compensation as dividends.

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### **Guidance from the Seventh Circuit**

In *Menard, Inc. v. Commissioner of Internal Revenue*, the Seventh U.S. Circuit Court of Appeals provided valuable insight into the meaning of reasonable compensation. John Menard, CEO of the retail home improvement chain that bears his name, was paid approximately \$20 million in 1998. The Tax Court had ruled that \$7 million was reasonable compensation and that the remaining \$13 million was a nondeductible dividend.

In reaching this conclusion, the Tax Court applied the Seventh Circuit’s “independent investor test,” which presumes that compensation is reasonable if the company’s investors “are obtaining a far higher return than they had



any reason to expect.” The Tax Court found that this presumption had been rebutted by evidence that other home improvement chains paid their CEOs substantially less. It adjusted Menard’s deductible compensation using a formula based on the compensation competitors paid their CEOs and returns on investment their investors received.

The Seventh Circuit rejected this decision. It found that the Tax Court’s formula failed to consider all of the CEOs’ full compensation packages, including severance packages, retirement plans and perks. It also ignored differences in their responsibilities and performance. The evidence showed, for example, that Menard worked long hours and was involved in every detail of the company’s operations; similar information about his competitors wasn’t included.

The Seventh Circuit also noted that the Tax Court had disregarded the level of risk associated with Menard’s compensation. The company had a good year in 1998, the Seventh Circuit observed, but if it had lost money, Menard’s total compensation — which was primarily performance-based — would have been only \$157,500, regardless of whether Menard was at fault. Yet the Tax Court focused on Menard’s 1998 pay without regard to the fact that his compensation was likely to vary substantially from year to year.

### **A custom approach**

The *Menard* case illustrates how important it is to determine the reasonableness of compensation on a case-by-case basis, weighing executives’ actual responsibilities and performance, the level of risk involved, and other factors unique to their situations. ☺

## **Married with children?**

*A QTIP trust can help you achieve your estate planning goals*

As a spouse and parent, you have the difficult challenge of ensuring your spouse is provided for after your death while making certain there are assets left for your children’s inheritances. Trying to meet both objectives while minimizing estate taxes is no small feat. Fortunately, a qualified terminable interest property (QTIP) trust can help.

### **Enjoy a valuable exception**

The unlimited marital deduction allows you to transfer any amount of property to your U.S. citizen spouse — either during your life or at death — free of gift and estate taxes. A QTIP trust allows you to take advantage of the deduction while controlling the ultimate disposition of the trust’s assets.

Ordinarily, to qualify for the marital deduction, you must transfer property to your spouse outright or through a trust in which your spouse’s interest cannot terminate for any reason. A QTIP trust is an exception to this rule: It allows you to provide your spouse with a “terminable interest” in the trust while still qualifying for the marital deduction. This can provide some valuable estate planning benefits.

### **Equalize your estates**

If one spouse owns the bulk of assets, the couple risks wasting the other spouse’s exemption and incurring unnecessary estate taxes. The simplest way to equalize estates is for the wealthier spouse to transfer assets to the other spouse. This may

not be a viable option if the wealthier spouse is concerned that his or her spouse might squander the money or later marry someone who's after the inheritance.

With a lifetime QTIP trust, you can equalize your estates while avoiding these concerns. How? The trust must pay all of its income to your spouse for the rest of his or her life, but you can retain control over the assets and restrict your spouse's access to the principal. When your spouse dies, the assets go to your children (either outright or in trust), but they're treated as part of your spouse's estate so you don't waste his or her exemption. This strategy has one potential disadvantage: If you and your spouse divorce, he or she will still be entitled to all of the trust income for life.

### **Preserve assets for children**

Providing for your spouse is important, but it may be just as important to preserve as much wealth as possible for your children. If you leave property to your spouse outright, there's no guarantee that this objective will be met.

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*A QTIP trust allows you to provide your spouse with a “terminable interest” in the trust while still qualifying for the marital deduction.*

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A properly designed QTIP trust provides your spouse with income for life while protecting the trust principal and preserving it for your children. By appointing a qualified trustee, you can have greater confidence that the assets are invested and managed wisely.

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### **Ease family tension**

Even in the most harmonious families, matters of inheritance can create conflicts. This may be the



case if you've remarried and want to provide for your current spouse as well as for children from a previous marriage. A QTIP trust can help ease the tension by providing for your spouse while giving some assurances to your children that something will be left for them.

This strategy may backfire, however, if your spouse is considerably younger than you. In that case, your children may have to wait a long time to receive their interests in the trust — or they may effectively be disinherited altogether if your spouse survives them.

### **Consider other tools**

A QTIP trust is just one of many tools you can incorporate into your estate plan to reduce estate taxes and help ensure your assets are distributed according to your wishes. And it's a tool that you can use in conjunction with other tools. Take the time now to evaluate your situation or you may miss out on other tax-saving opportunities. ☺

# tax TIPS

## On the hunt

If you're among the millions of people looking for work, be sure to keep receipts and other documents to substantiate job-hunting expenses that may be deductible, including:

- ⊙ Employment and outplacement agency fees,
- ⊙ Travel expenses if the primary purpose of your trip is to look for a new job,
- ⊙ Resumé preparation and mailing expenses, and
- ⊙ Telephone calls to prospective employers.

Because job-hunting expenses are considered “miscellaneous itemized deductions,” they're deductible only to the extent that total deductions in that category exceed 2% of your adjusted gross income. Also, you can't deduct these expenses if you're looking for a job for the first time or in a “new occupation,” or if there was a substantial break between the time your last job ended and the time you started looking for a new one. ⊙

## Now's the time for a cost segregation study

If your business has acquired, constructed or substantially renovated a building recently, consider a cost segregation study.

Ordinarily, the costs associated with a commercial building are depreciable over 39 years. A cost segregation study applies engineering,

tax and accounting principles to identify building components that are eligible for accelerated depreciation, which can dramatically reduce your tax bill. For example, land improvements — such as fences, sidewalks, parking lots and light poles — are depreciable over 15 years. And many



building components can be classified as personal property and depreciated over five or seven years. Examples include machinery and equipment, movable partitions, certain wall and floor coverings, awnings, and certain light fixtures.

The impact of a cost segregation study can be even more dramatic for projects completed in 2009, because many of these items may also qualify for the enhanced Section 179 expensing election. ⊙

## Ensure names and SSNs match

If you get married or divorced this year, notify the Social Security Administration of any name changes before you file your 2009 income tax return. Otherwise, the IRS computers may have trouble matching names with Social Security Numbers (SSNs). This can delay your refund.

If you have a child this year, be sure to obtain an SSN for him or her. You're required to furnish an SSN on your tax return for each child you claim as a dependent. ⊙

Dear reader:

In these difficult economic times, our tax team is ready to help you with tax planning, trust, estates, and wealth succession, business consultations and other valuable tax services. We always welcome your inquiries.

Sincerely,



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