Family Tax Planning Forum

By Robert S. Keebler

2010 Year-End Income Tax Planning

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In the past, year-end tax planning was relatively straightforward. Taxpayers would try to defer income and accelerate deductions and losses. With numerous expiring provisions and the likelihood of higher rates in the future, planning for the end of 2010 is much more challenging. While some of the perennial strategies still make sense, others must be reversed. The key planning ideas for year-end 2010 are as follows:

- Accelerate taxable income into 2010.
- Defer above-the-line deductions until 2011.
- Generally, accelerate itemized deductions into 2010.
- Harvest losses.
- Take advantage of expiring credits.

Accelerate Taxable Income into 2010

When tax rates remain constant from one year to the next, it makes sense to defer income recognition. When rates are increasing, however, the benefit of tax deferral must be weighed against paying tax at a higher rate. At the time of this writing, it appears that the so-called Bush tax cuts will be allowed to expire (at least for high income taxpayers) and will go back to the rates in effect prior to 2001. The tax rate increases are shown in Table 1.

Table 1.

Ordinary Income	
2010	**2011**
10%	15%
15%	15%
25%	28%
28%	31%
33%	36%
35%	39.6%
Capital Gains	
2010	**2011**
0%	10%/8%
15%	20%/18%*

* The eight-percent and 18-percent rates apply only to assets held more than five years at the time of the sale.

On the surface it might appear that taxpayers would be better off accelerating income from 2011 to 2010 because they would pay tax at a lower rate. Given the timing difference between the two payments, however, it is not possible to make a direct comparison between the amounts of tax paid in 2010 and in 2011. Rather, time-value-of-money principles must be employed. To illustrate, assume that a taxpayer (T) who is in the 39.6-percent marginal tax bracket has a choice between a $10,000 item of income in 2010 and a $10,000 item of income in 2011. The tax payable in 2010 would be $3,500 and the tax payable in 2011 would be $3,960. Is it worth paying $460 more in tax to get one-year of deferral?

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The answer is that it depends on the rate of return T could achieve on the $3,500 if he decided to invest this amount rather than using it to pay tax in 2010. Suppose, for example, that T could earn an after-tax rate of 20 percent. If so, the $3,500 amount would grow to $4,200 after one year. T could then use $3,960 to pay the 2011 tax and have $240 left over. On the other hand, if the $3,500 grew at only 10 percent, T would have $3,850 after one year, resulting in a $110 shortfall. Thus, T would end up with $110 less than if he had elected to defer the tax payable.

If we solve for the break-even rate of return given this pair of tax rates and a one-year deferral period, we get 13.143 percent. In other words, if T invested the $3,500 at 13.143 percent, it would grow to exactly $3,960 after one year. Table 2 shows the break-even rate of return for all pairs of 2010 and 2011 tax rates.

Table 2.

2010	2011	Break-Even ROR
10%	15%	50%
15%	15%	0%
25%	28%	12%
28%	31%	10.7%
33%	36%	9.1%

In deciding whether to accelerate income into 2010, taxpayers must ask themselves whether they think they could earn a return in excess of the rate of return (ROR) shown in Table 2 for their applicable tax bracket. Clearly taxpayers currently in the 10-percent bracket would be better off paying tax in 2010 and taxpayers in the 15-percent bracket would be better off deferring tax until 2011 to take advantage of deferral. For taxpayers in the higher marginal brackets, the decision isn't so obvious. The RORs are comparable to historical returns on stocks, but given the current condition of the economy, it is likely that most taxpayers would not expect to earn these returns after tax and would be better off accelerating tax into 2010.

Taxpayers who determine that accelerating income would be favorable for them have a number of options for doing so. One excellent strategy would be to sell appreciated property at the end of 2010 and pay capital gains tax at 15 percent instead of 20 percent. Even more favorable results could be obtained by having C corporations with adequate earnings accelerate dividend payments. Assuming the special rate for qualified dividends is allowed to expire, this would enable taxpayers to pay tax on dividends at 15 percent in 2010 instead of at their regular ordinary income tax rate in 2011. Other, more sophisticated methods, include accelerating bond interest and making a sale and repurchase of bonds that have appreciated in value.

Some commentators have suggested that it may also be a good idea to accelerate gain recognition on an installment sale. This would again raise the issue of whether paying tax at a lower rate in 2010 is enough to offset the loss of tax deferral on the remaining payments. As noted above, where the deferral period is only one year, accelerating income into the current year might generally be a good idea. The longer the term of the installment note, however, the greater the benefit of deferral relative to the benefit of the lower tax rate.

Deferring Above-the-Line Deductions

The issue here is similar to the issue addressed in the previous section. By pushing deductions into 2011, the taxpayer can use them to offset income taxed at a higher rate, but loses the time value of a present deduction. A $100 deduction in 2010 offsets $35 of tax while a $100 deduction in 2011 offsets $39.60 of tax. Thus, we save the same question of whether $35 now is better than $39.60 next year, whether $33 now is better than $36 next year and so on.

Itemized Deductions

The reason for separating above-the-line and itemized deductions is that the Code Sec. 68 phase-out of itemized deductions goes back into effect in 2011. This section provides that itemized deductions other than those for medical expenses, investment interest and casualty, theft and wagering losses, are reduced by three percent of a taxpayer's AGI above certain threshold levels. For 2011, these levels are $171,100 for married taxpayers and $85,500 for single taxpayers. To decide whether to take deductions in 2010 or 2011, taxpayers will have to compare the amount of the deduction in 2010 with the amount of the deduction in 2011 after application of the phase-out and then adjust for the time value of money. Here's an example of the calculation:

> Married taxpayers H and W have AGI of $400,000 and $60,000 of itemized deductions. The phase-out amount is the lesser of (1) 0.03($400,000 – $171,100) = $6,867, or (2) 0.8($60,000) = $48,000. The allowable itemized deduction will be $60,000 – $6,867 = $53,133. The income tax eliminated by claiming the deduction in 2010 would be $21,000 (0.35 x $60,000) and the amount of tax eliminated in 2011 would be $21,041 (0.396 x $53,133).

Loss Harvesting

Although it makes sense to accelerate gain into 2010 to take advantage of the current 15-percent rate, it is even better to eliminate tax on capital gains entirely. Thus, taxpayers should generally offset as much of their 2010 capital gains as possible by selling off loss assets, particularly stocks.

If the taxpayer thinks the loss stocks are a bad investment, there are no special planning considerations. The taxpayer simply sells the stock and is glad to be rid of it. If the taxpayer considers the stock desirable, however, and wants to repurchase the shares that are sold, it is necessary to plan around the wash-sale rules of Code Sec. 1091. Under these rules, losses on a sale of stock or securities are not deductible if, within 30 days before or after the sale, the taxpayer acquires substantially identical stock or securities. The rationale for the rule is that taxpayers who sell stocks and repurchase them a short time later haven't really cashed in their investment.

Taxpayers who are really bullish on a stock, however, do not wish to be out of the market for the 30-day period. A number of strategies have been developed to address this problem:

(1) Buying stock of a similar company
(2) Doubling-up and waiting for 30 days
(3) Buying a call option at the money at least 31 days before the sale of the loss stock

Buying Stock of a Similar Company

The wash-sale rules apply only if the taxpayer buys nearly identical stock. Thus, a taxpayer could cover herself by purchasing stock in a similar company with similar prospects for the 31-day period; the taxpayer must be out of the market with respect to the loss stock.

Doubling up

Under this strategy, the taxpayer purchases, at least 31 days prior to the planned sale date, the same number of units of Stock X that she plans to sell later. As a result, the taxpayer never has fewer shares than she currently owns. A potential problem with this strategy is that the taxpayer owns more of Stock X during the 31-day period prior to the sale than she might otherwise wish to own, reducing portfolio diversification.

Buying a Call Option at the Money

Suppose that the loss stock is selling for $40/share. The taxpayer purchases a call option with a strike price of $40 and an exercise date that is 31 days after the planned sale. If the stock price goes up during the 62-day period, say to $44, T can exercise the call option, buy the stock for $40 and keep the benefit of the $4 increase in value. The taxpayer has lost nothing because of being out of the market with respect to the loss stock. If the price of the stock is below $40 on the expiration date, the taxpayer simply lets the option expire unexercised. This $4 benefit is reduced, of course, by the cost of the call option.

Claiming Expiring Credits

Perhaps the most important expiring credit to take advantage of at the end of 2010 is the Energy Efficient Home Improvement Credit. Taxpayers can generally get a 30-percent tax credit, up to a maximum of $1,500, for making energy-efficient upgrades. Upgrades include buying an energy-efficient furnace, electric heat pump, water heater or high-efficiency central air conditioner, replacing windows, replacing doors and adding insulation. Some states provide an additional credit.