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2010 YEAR-END INSIGHTS
(Income Tax Planning)

As a holiday gift to our clients and friends, we are pleased to provide a select number of unique year-end insights for you to consider as 2010 closes. In this first of a series, we address income tax planning.

INCOME TAX PLANNING

1. Roth IRA Conversions - Last Chance, or Mirage?

There has been a lot written about converting traditional IRAs to a Roth IRA to allow current tax-free accumulation and future tax-free distributions in 2010. But evaluating the merits of a Roth conversion before the end of 2010 involves a careful weighing of the pros and cons.

CONS:

(a) Income taxes on the conversion must be paid from outside assets to make the conversion tax beneficial;

(b) The conversion makes sense only if there is a long horizon for accumulation;

(c) Recognizing the bump in income on the Roth conversion could lead to other adverse income tax consequences, like phase out of personal exemption and certain tax credits, increased income tax on social security, and higher AMT tax; and

(d) There is no guaranty that Congress will keep its word and not tax the inside accumulation of income and the tax-free distribution in the future, given the enormous pressure on the Federal budget.

PROS:

(a) If the taxpayer is likely to live long enough to realize the tax-free growth which outstrips the initial upfront tax costs;

(b) The taxpayer has no need to withdraw during his or her life time, which allows the Roth IRA to pass to beneficiaries who can stretch out withdrawals and maintain the inside income tax-free treatment;

(c) The income tax payment on the 2010 conversion will be deferred until 50% at April 15, 2012 and April 15, 2013 (or extended to October 15);

(d) The taxpayer has until October 15, 2011 to convert back from a Roth IRA established in 2010 to a traditional IRA, if the benefits have not been, or are not likely to be, realized; and

(e) 2010 is the last year that a Roth conversion can be accomplished without limitations on certain high income taxpayers that otherwise make them ineligible to convert.

2. Residential Energy Credits - Let Uncle Sam Warm Your Home.

Until the end of 2010, a tax credit is available to individuals for the installation of certain qualifying residential exterior doors and window, insulation, heat pumps, furnaces, central air conditioners, and water heaters. It only applies to a taxpayer's principal residence, and the installation must consist of new property. The credit available is equal to 30% of the costs of the appliances up to $1,500.

***HINT:* If you intended to install qualifying home improvements, do it before December 31, 2010.**

3. Investment in Small Business Stock - In the Nick of Time for America's Future.

Investors can exclude from Federal income tax 100% of the gain from the sale or exchange of qualified small business stock held for more than five years, which is purchased after September 27, 2010 and before December 31, 2010. The maximum gain that can be excluded is $10,000,000, or ten times the taxpayer's adjusted basis of the qualified stock disposed of during the tax year. There is no alternative minimum tax imposed on the gain. Qualified small business stock must be issued by a domestic C Corporation which is in certain active businesses, whose assets do not exceed $50,000,000, and must be acquired by the taxpayer in an original issue.

The state of Illinois has an analogous provision that applies beginning after December 31, 2010 and ending on or before December 31, 2016, in the form of an "Angel Investment Credit." The income tax credit is equal to 25% of the amount invested in a qualified new business venture. The maximum investment used for the credit is $2,000,000 per investment and includes a five-year carry forward. The program is capped at $10,000,000 per calendar year. The investment must be held for at least three years to avoid recapture. The enterprise must be in certain active businesses, be headquartered in Illinois, have at least 51% of its employees in Illinois, have fewer than 100 employees, have been in operation less than ten years, and have not received more than $10,000,000 in private equity investment in cash, or $4,000,000 in investments that qualify for the Angel Investment Tax Credit. The act was signed effective June 24, 2010. The Department of Commerce and Economic Opportunity of Illinois will implement a program to certify applicants on an annual basis by issuing tax credit certificates, stating the amount of the credit for which they are eligible. The credits are nontransferable.

HINT: If you believe that the future revival of the economy lies in investing in small businesses, you can so invest, while achieving beneficial tax advantages too.

4. Charitable Gifts - The Biggest Bang for Doing Good.

A taxpayer gets the biggest bang for his or her buck in 2010 for a charitable gift. The charitable gift could be either cash, securities, household goods, or a more sophisticated leveraging technique like a charitable lead trust or a charitable remainder trust.

HINT: The attraction of making larger charitable gifts in 2010 is due to the fact that the limit on itemized deduction caused by the "phase out" does not apply in 2010, but comes back into effect in 2011 and after. Therefore the entire charitable gift in 2010 qualifies for an undiminished itemized deduction for Federal income taxes.

5. 529 Plans - Income Tax-Free Savings for College.

A superior way to save, in advance, for paying college education costs is to use a 529 Plan. While deposits are not income tax deductible, they are free of gift taxes if the amount is under the gift tax annual exclusion amount ($13,000 in 2010) (and permit a prepayment of five years' worth of gift tax annual exclusions). The distribution from 529 Plans to a child-beneficiary for tuition expenses is income tax free, and the accumulation of earnings within the 529 Plan is income tax free. The funds in a 529 Plan can be transferable among different children/grandchildren as beneficiaries to be used for tuition expenses.

HINT: If you are confident about future market appreciation and earnings of an investment fund, this is a good way to prepay for college education expenses for a young child, in order to accumulate enough in the future to help pay for college.

6. Credits for Higher Education Tuition - Subsidies for College from the IRS.

(a) The End of the American Opportunity Credit. The Hope Scholarship Credit was liberalized and called the American Opportunity Credit, applicable to 2010. A maximum of $2,500 is available as an income tax credit based on a maximum of $4,000 paid for qualified tuition and related expenses during the year 2010. The credit is available for any of the first four years of college. The credit equals 100% of the first $2,000 of qualified tuition expenses plus 25% of the next $2,000 of qualified tuition expenses. The credit phases out between $80,000 and $90,000 for single taxpayers (or between $160,000 and $180,000 for joint filers). Therefore, it is best if an income earning student claims the credit.

(b) Hope Scholarship Credit. This income tax credit is available only for the first two years of college, and the maximum credit is $1,800 (based on 100% of the first $1,200 of qualified tuition expense), and 50% of the second $1,200 of qualified tuition expense. It similarly phases out for high income taxpayers.

(c) Lifetime Learning Credit. The maximum lifetime learning income tax credit is $2,000, based on 20% of the first $10,000 of tuition. The Lifetime Learning Credit can be used for college and post-graduate education, but phases out between $50,000 and $60,000 for single taxpayers, or between $100,000 and $120,000 for joint filers.

HINT: ***An income-earning student, rather than a high-income parent, should pay his or her own qualified tuition expenses. Qualified expenditures should be made before 2010 ends in order to qualify for the higher American Opportunity Credit before that Credit expires in 2010. After 2010, only the Hope Scholarship Credit and Lifetime Learning Credit remain available.***

The information described herein is of a general nature, based on information currently available, and should not be relied upon to make planning, purchase, sale, or exchange decisions without seeking personal professional advice.

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