Sugar Felsenthal
Grais & Hammer LLP

30 N. LaSalle St., Ste. 3000
Chicago, Illinois 60602
Office: (312) 704-9400
Fax: (312) 372-7951

www.SugarFGH.com

New Rules for Purchases, Savings, Investments, And Business Incentives (2009-10) – Part III

In these extraordinary times, the economic landscape is changing dramatically. To help you journey through this landscape, we have authored a four-part series called "New Rules for Purchases, Savings, Investments, and Business Incentives," summarizing some of the more important developments and their likely impact. We hope you find these helpful.

We continue below with the third of the four-part series.

PART 3

3. New Rules for Investments.

New changes in the law impact the way investors view certain investments. We describe below a few of the more interesting changes.

3.1 Gain on Sale of Small Business Stock. The potential tax benefits for investing in small business corporations have been increased. If you invest in stock of a C corporation, between February 17, 2009 and December 31, 2010, which conducts an active business and has gross assets of $50 million or less, you can exclude 75% of the gain on sale of that stock from federal taxable income, after holding it for 5 years. The maximum gain that can be excluded from taxes is either $10 million, or 10 times the amount of your investment, if less.

TIP*:** ***For example, an investor who enjoys a $9 million gain on sale of small business stock in 2014 on a $1 million investment made in 2009, can exclude 75% of that $9 million gain in 2014 and pay tax only on $2.25 million of gain. At the current 15% long-term capital gain rate, that is only $337,500 in taxes on $9,000,000 of gain, or an effective rate of 3.75%.

3.2 AMT Exclusion for Private Activity Tax Exempt Bonds. For "private activity" tax exempt bonds issued in 2009 and 2010 by any municipality, the dreaded AMT will not apply to treat the earned bond income as "tax preferences", so high income taxpayers need not worry about an unexpected federal income tax on the interest received from such bonds.

> ***TIP**:* ***However, the interest yield is likely to be lower on such bonds, as compared with private activity bonds that would have been subject to the AMT and that require a higher yield to compensate taxpayers for the AMT.***

3.3 Build America Taxable Bonds. Build America bonds are a new special category of municipal bonds, the interest of which is fully taxable for federal income tax purposes. An investor in a Build America bond obtains a federal income tax credit equal to 35% of the interest paid (the tax credit itself is also taxable income). So, as an alternative to issuing tax exempt bonds (for which the federal government subsidizes the municipality for the lowered interest cost via tax exempt status), municipalities can now issue fully taxable bonds at a higher yield to attract more investor support, and the taxpayer-investors who receive a credit from the federal government will be generally restored, on an after-tax basis, to a tax exempt yield. These bonds must be issued before January 1, 2011 and must not be "private activity" bonds. The biggest advantage to the municipalities is that Build America bonds are not subject to limitations on total bond amounts issues. Build America bonds may not have premiums over their stated principal amount on issuance. It is generally expected that the Build America bonds will begin to crowd out tax exempt municipal bonds, probably causing tax exempt bond prices to drop and yields to rise.

> ***TIP**:* ***The Build America bonds should have a higher yield, once they are introduced, than comparable tax exempt bonds. For that very reason, it is likely that many municipalities will elect an alternative route for issuing taxable bonds – they can elect to get a direct federal government grant from the U.S. Treasury equal to the 35% credit (as an alternative to the 35% credit afforded directly to the taxpayer-investor). Under those circumstances the net out-of-pocket cost to the municipality would be lower than issuing and paying the whole interest on a taxable Build America bond to the taxpayer-investor and allowing the taxpayer-investor to claim the tax credit, instead of the municipality obtaining a refund of 35% of the interest cost. For the municipality to get the direct credit from the federal government, the municipal project must be for capital expenditures.***

3.4 Roth IRAs. In 2010, you can convert traditional IRAs to Roth IRAs, allowing you to pay the tax on the value of the IRA at conversion, spread out over two years (50% reported in 2011 and 50% reported in 2012), and allowing you to avoid paying federal income tax on any further accumulation on the assets retained in the Roth IRA, as well as at the time the assets are paid out of the Roth IRA. The year 2010 is significant because, prior to 2010, the conversion is unavailable to high income taxpayers (i.e., AGI greater than $100,000) and after 2010, the tax upon conversion must be paid immediately. This is a powerful tool when used over an extended period of time, because no tax is imposed, ever, on the post-conversion earnings.

> ***TIP:*** ***The conversion only makes sense if you do not expect to withdraw from the Roth IRA soon, so that the Roth IRA can continue to accumulate earnings tax free. In addition, some commentators believe the permanent escape from taxation of the post-conversion accumulation of earnings is too good to be true, especially compared to traditional IRAs and traditional pension, profit-sharing, and 401-K accounts. These skeptics think the temptation for Congress to change the Roth IRA rules in the future and recover taxes on the tax-free earnings accumulation will be too great to avoid, when facing trillions of dollars of deficits.***

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