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CPA Client Bulletin

Smart Tax, Business & Planning Ideas *from your* Trusted Business Advisor[sm]

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Tomorrow's Taxes

Under current law, the federal income tax rates for 2011 will be 15%, 28%, 31%, 36%, and 39.6%.

Save Tax by Filling Up Your Bracket

If you will be in the 10%, 15%, or 25% brackets this year, consider filling up these relatively low brackets. Even if you are in a higher bracket, you can suggest some of these strategies to a lower income child, parent, or other loved one.

As the third quarter of 2010 comes to a close, you probably have a good idea of your income for the year. By matching your projected income with federal tax brackets, you may be able to make some tax saving moves.

The 2010 tax rates are listed subsequently. These rates are for *taxable income*, after you have taken your deductions:

	Single Filers	Joint Filers
10%, up to	$ 8,375	$ 16,750
15%, up to	34,000	68,000
25%, up to	82,400	137,300
28%, up to	171,850	209,250
33%, up to	373,650	373,650
35%, over	373,650	373,650

Take traditional IRA distributions

If you are at least age 59½, you generally can tap your traditional IRA without owing the 10% early withdrawal penalty. By filling up your tax bracket, you might receive some needed funds at an attractive tax rate.

Example 1: Ralph and Bonnie Clark are both 60 years old. They have taken early retirement but can't begin to collect Social Security benefits before age 62. For 2010, they project their taxable income at $50,000. The Clarks will be able to take up to $18,000 from one or both of their traditional IRAs by year end. They will owe tax on these withdrawals at only 15%, as long as their taxable income remains no higher than $68,000.

As mentioned, this strategy might not work well if you are under age 59½ because of the 10% early withdrawal penalty. However, several exceptions to the penalty

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exist, such as withdrawals to pay for qualified higher education costs.

Example 2: Harry and Sarah Watson are both 50 years old. For 2010, they project their taxable income at $50,000. In 2010, they spend $15,000 on college costs for their son, Jake. The Watsons can withdraw up to $15,000 from their traditional IRAs and owe tax at only 15%; they will not owe the 10% penalty because of the exception for higher education costs.

Partial Roth IRA conversions

Regardless of whether you can withdraw money from your traditional IRA, penalty free, you can convert it to a Roth IRA. That's the case no matter how old you are or how much income you have. Converting a traditional IRA to a Roth IRA will generate income tax, but you can tailor a conversion to fill up a tax bracket.

Example 3: Nora Greene is 35 years old and single. She has $50,000 in her IRA, all from pretax contributions. Nora estimates her taxable income for 2010 at $70,000. She can convert up to $12,400 of her traditional IRA to a Roth IRA in 2010 and remain in the 25% tax bracket. This way, Nora will owe only an additional $3,100 on the conversion (25% of $12,400) if she executes it this year. Nora fears she or her beneficiaries eventually may owe tax at higher rates on future withdrawals from her traditional IRA.

Nora decides to implement this plan. By the time she reaches age 59½ she can withdraw that entire amount from her Roth IRA, plus any investment earnings, tax free. Nora anticipates that she'll be in a much higher tax bracket by the time she retires and is ready to tap her Roth IRA.

By converting in 2010, Nora is able to choose between two tax efficient strategies. Next year, she can decide to pay the tax on her 2010 return at today's relatively low rates. Alternatively, Nora can opt to evenly divide the taxable income from the Roth IRA conversion between her 2011 and 2012 tax returns, which would defer complete payment of the tax due until 2013.

If you are interested in such tax effective strategies, our office can help you estimate your taxable income for 2010 and suggest ways to fill up lower brackets. ■

Did You Know?

Last year, the ratio of U.S. municipal bond upgrades-to-downgrades weakened to the lowest level in over 20 years. The ratio of upgrades-to-downgrades declined from 2.4-to-1 in 2008 to 0.7-to-1 in 2009.

Source: Moody's Investors Service

You and Your Company Can Avoid the Disguised Dividend Tax Trap

If you are the owner or part owner of a C corporation, you might think that your compensation plan is relatively straightforward. You pay yourself a salary to cover your living expenses during the year. At year end, if your company has made money, you pay yourself a bonus. Your company deducts the salary and bonus so it winds up with little or no net income and pays little or no corporate income tax.

In such a scenario, you might be in for a shock. The IRS could say that your compensation is unreasonable. Part of your compensation may be recast as a dividend, subject to both corporate and personal income taxes.

Example: Grace Moran owns 100% of ABC, a C corporation. She pays herself a salary of $10,000 a month, or $120,000 a year. In December 2010, Grace pays herself a $300,000 bonus. ABC reports no taxable income for 2010, and Grace pays personal income tax on her total income of $420,000.

The IRS examines ABC's corporate return and decides that Grace's $120,000 salary is reasonable compensation for her efforts. The other $300,000 is classified as a dividend, bringing ABC's corporate income up to $300,000 for the year. Counting state and federal taxes, ABC owes about $100,000 in corporate income tax. Grace, meanwhile, also has to pay personal income tax on both the $300,000 dividend and her $120,000 salary.

Sidestepping the snare

With careful planning, your C corporation can avoid this tax trap. Possible strategies include

- ✔ **creating a formal compensation plan**. Your corporate minutes can explain the plan and report its adoption. Such a plan might

call for owner-executives to receive a salary plus a bonus that's determined by financial goals, such as revenues, profits, and market share. If you worked for years with little compensation, helping your company to grow, your minutes might state that some of your compensation is a makeup for prior sacrifice.

- ✔ **using external comparisons.** Your compensation plan might refer to an industry study indicating that executives at other companies in your field are paid amounts comparable to those you are likely to receive. You might get such data from an industry association.
- ✔ **paying some corporate income tax.** In the previous example, Grace could pay herself a $200,000 or $250,000 bonus, rather than a $300,000 bonus. That would leave some money in the company subject to corporate income tax. On the first $75,000 of corporate income, your company will pay only 15% or 25% in federal corporate income tax.
- ✔ **paying some dividends**. Taking some profits as double-taxed dividends can indicate you are not "zeroing out" corporate income to avoid tax.
- ✔ **making an S corporation election.** Your company must meet several criteria (for example, it can have only one class of stock). But, if your company meets these criteria and makes the election, it will be an S corporation and, therefore, will not be subject to corporate income tax. ■

Trusted Advice

Bonuses That Look Like Dividends

- A closely held C corporation should avoid pro rata bonuses that look like dividends.
- Suppose Ann Walker owns 70% of XYZ Corporation, and Brad Taylor owns 30%. XYZ has net income of $250,000 in 2010.
- The coowners decide to leave $50,000 in the company. Of the remaining $200,000, XYZ pays a $140,000 (70%) bonus to Ann and a $60,000 (30%) bonus to Brad.
- The IRS could say that these "bonuses" look like a division of corporate profits. The bonuses might be recast as dividends, subject to both personal and corporate income tax.
- C corporations should adopt a performance-based plan for distributing executive bonuses.

How to Pass a Home to Your Children

The home where you live may be among your most valuable assets. In addition, you may own a second home that you use for vacations. If you would like to pass on either of those residences to your children or grandchildren, several ways exist to do so. Each method has advantages and disadvantages, so you should know your options before deciding how to proceed.

Straight sale

You can sell a home to your child or children. This method will provide you with cash, perhaps in your retirement. What's more, if you sell a home that you have been using as a principal residence for two years or longer, you can avoid paying tax on up to $250,000 of gain ($500,000 if you're married and filing a joint tax return).

With this strategy, your children will have to come up with the money for the purchase. Assuming they won't be able to manage an all-cash purchase, they'll have to qualify for a home loan from a third party. In today's real estate market, your children probably will need a good credit score and a substantial down payment.

Generally, this strategy will work best if your children are looking to buy a place, want the home you're willing to sell, and are financially able to manage the purchase price.

Sale and leaseback

You also can sell your house to a child and then lease it back from him or her.

Example: Lynn Collins is a widow who lives in the house where she has spent most of her adult life. She sells the home to her son, Owen, for the market price of $300,000; Lynn reports a $200,000 gain because her basis, in this example, is $100,000. Lynn then agrees to rent the home from Owen at the market price, which is $1,800 a month in her area.

With this arrangement, Lynn gets to stay in the house where she has lived for many years, and she receives tax free cash for retirement spending. Owen can treat the home as investment property and take deductions to offset the tax on cash he receives as rental income. When Lynn no longer can live in the house, Owen

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will have all the choices of a property owner: rent it, sell it, or move in. Moreover, the house will not be owned by Lynn at her death, so its value will not be subject to state or federal estate tax.

Again, this strategy requires your child or children to be able to qualify for a home purchase. The rental income and the tax advantages of property ownership will reduce the buyer's financial strain, but you must be able to deal with a tenant-landlord relationship between family members.

Giving it away

If you don't need the cash from selling your home, you can give it to a child or children. Real estate prices are depressed now, so the gift probably will have a low value, for gift tax purposes. This way, the home (and any future recovery in value) will not be included in your taxable estate.

As another approach, you can give away fractional interests each year. In 2010, for instance, a married couple can give each recipient up to $26,000 worth of assets, with no gift tax consequences. If Flo and Frank Parker, for example, own a vacation home valued at $260,000, they can give their son Greg and daughter Gwen each a 10% interest this year. After several years, Flo and Frank might be able to give away all of the ownership of their vacation home without reducing their estate tax exemption. However, this method requires periodic appraisals and ongoing paperwork.

Later, not sooner

Yet another approach is to retain ownership of your home until your death and then leave it to the next generation. This is simple and requires no financial commitment by your children. It is likely your children will get a "step-up in basis," meaning that they can sell the house after they inherit it and owe no capital gains tax on any appreciation during your lifetime.

With this tactic, though, you give up the chance of receiving tax-free cash from a home sale.

Trust tactics

You may want to give or bequeath a home to your children, but are hesitant about making an outright gift or bequest. If a recipient has special needs or is in an unhappy marriage, a valuable asset could be mishandled or lost in a divorce settlement. For such situations, you may prefer to transfer the home into a trust during your lifetime or at your death. A qualified personal residence trust is designed to allow you to make a lifetime transfer while reducing the impact of gift tax.

One thing to note, using a trust can be expensive and may require special language to permit the $250,000 or $500,000 capital gain exclusion if the home is sold.

Multiple choice

You can choose among these techniques when deciding how to pass a house to one child. If you have multiple children, your decision may be more complicated. With multiple coowners, some formal arrangement might be desirable to ensure that costs and responsibilities are shared. If you decide to have one of your children own the home, you may wish that your other children receive other assets. Whatever your situation, our office can help you make the appropriate arrangements. ■

TAX CALENDAR

SEPTEMBER 2010

September 15

Individuals. If you are not paying your 2010 income tax through withholding (or will not pay enough tax during the year that way), pay the third installment of your 2010 estimated tax. Use Form 1040-ES.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in August if the monthly rule applies.

Corporations. File a 2009 calendar year income tax return (Form 1120) and pay any tax, interest, and penalties due. This due date applies only if you timely requested an automatic six-month extension.

Deposit the third installment of estimated income tax for 2010. Use the worksheet Form 1120-W to help estimate tax for the year.

S corporations. File a 2009 calendar year income tax return (Form 1120S) and pay any tax due. This due date applies only if you timely requested an automatic six-month extension. Provide each shareholder with a copy of Schedule K-1 (Form 1120S) or a substitute Schedule K-1.

Partnerships. If you were given an additional five-month extension, file a 2009 calendar year tax return (Form 1065). Provide each partner with a copy of Schedule K-1 (Form 1065) or a substitute Schedule K-1.

OCTOBER 2010

October 15

Individuals. If you have an automatic six-month extension to file your income tax return for 2009, file Form 1040, 1040A, or 1040EZ and pay any tax, interest, or penalties due.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in September if the monthly rule applies.

Electing large partnerships. If you were given an additional six-month extension, file a 2009 calendar year tax return (Form 1065-B).

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