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2010 Year-End Tax Planning Basics

For 2010, year-end tax planning is particularly challenging. That's because a great deal of uncertainty remains for both 2010 and 2011. Despite this, the window of opportunity for many tax-saving moves closes on December 31. So set aside time to evaluate your tax situation now, while there's still time to affect your bottom line for the 2010 tax year, and stay up-to-date on any late-breaking legislative changes.

Timing is everything

Year-end tax planning is as much about the 2011 tax year as it is about the 2010 tax year. There's an opportunity for tax savings when you can predict that your income tax rate will be lower in one year than in the other. If that's the case, some simple year-end moves can really pay off.

If you think your income tax rate will be lower next year, look for opportunities to defer income to 2011. For example, you may be able to defer a year-end bonus, or delay the collection of business debts, rents, and payments for services. Similarly, you may be able to accelerate deductions into 2010 by paying some deductible expenses such as medical expenses, interest, and state and local taxes before year-end. If you think you'll be paying tax at a *higher* rate next year, consider taking the opposite tack--possibly accelerating income into 2010 and postponing deductible expenses until 2011.

Tax rates scheduled to increase

For 2010, there are six federal income tax brackets: 10%, 15%, 25%, 28%, 33%, and 35%. Absent new legislation, there will be no 10% tax bracket in 2011, and the remaining bracket rates will return to their pre-2001 levels: 15%, 28%, 31%, 36%, and 39.6%.

Also, in 2011, the maximum tax rate that generally applies to long-term capital gain (and qualifying dividends) is scheduled to increase from its 2010 level.

AMT uncertainty complicates planning

If you're subject to the alternative minimum tax (AMT), traditional year-end maneuvers, like deferring income and accelerating deductions, can actually hurt you. The AMT--essentially a separate federal income tax system with its own rates and rules--effectively disallows a number of itemized deductions, making it a significant consideration when it comes to year-end moves. For example, if you're subject to the AMT in 2010, prepaying 2011 state and local taxes won't help your 2010 tax situation, but could hurt your 2011 bottom line.

Since 2001, a series of temporary AMT "fixes" bumped up AMT exemption amounts, forestalling a dramatic increase in the number of individuals ensnared by the tax. But the last such fix expired at the end of 2009. While it's likely that additional legislation will extend the fix to 2010 (and possibly 2011 as well), right now AMT exemption amounts for 2010 are at pre-2001 levels. Bottom line? If you think you might be subject to AMT in either 2010 or 2011, talk to a tax professional and pay close attention to what Congress does between now and the end of the year.

AMT triggers

You're more likely to be subject to the AMT if you claim a large number of personal exemptions, deductible medical expenses, state and local taxes, and miscellaneous itemized deductions. Other common triggers include home equity loan interest when proceeds aren't used to buy, build, or improve your home, and the exercise of incentive stock options.

AMT exemption amounts	2009	2010 and 2011
Married filing jointly	$70,950	$45,000
Single or head of household	$46,700	$33,750
Married filing separately	$35,475	$22,500

IRA and retirement plan contributions

Traditional IRAs (assuming that you qualify to make deductible contributions) and employer-sponsored retirement plans such as 401(k) plans allow you to contribute funds pretax, reducing your 2010 income. Contributions you make to a Roth IRA (assuming that you meet the income requirements) or a Roth 401(k) plan aren't deductible, so there's no tax benefit for 2010, but qualified Roth distributions are completely free from federal income tax--making these retirement savings vehicles very appealing.

For 2010, the maximum amount that you can contribute to a 401(k) plan is $16,500, and you can contribute up to $5,000 to

an IRA. If you're age 50 or older, you can contribute up to $22,000 to a 401(k) and up to $6,000 to an IRA. The window to make 2010 contributions to your employer plan closes at the end of the year, but you can generally make 2010 contributions to your IRA until April 15, 2011.

Still time for 2010 Roth conversions

There's still time to take advantage of the special rule that applies to Roth conversions in 2010: if you convert funds in a traditional IRA or an employer plan--like a 401(k)--to a Roth in 2010, half the income that results from the conversion can be reported on your 2011 federal income tax return and half on your 2012 return (you can instead report all of the resulting income on your 2010 return, if you choose). Whether a Roth conversion makes sense for you depends on a number of factors, including your marginal tax rate for 2010, 2011, and 2012. However, the ability to postpone tax on the resulting income to 2011 and 2012, combined with the flexibility of being able to wait until you file your 2010 federal income tax return to decide whether you want to do so, makes a Roth conversion a strategy worth considering before year-end.

"Bonus" depreciation and expensing

Good news if you're self-employed or a small-business owner: recent legislation extended special depreciation rules that were scheduled to expire at the end of last year, allowing an additional 50% first-year depreciation deduction for qualifying property purchased in 2010 for use in your business. Again, there's a short window of opportunity to take advantage of this, since, to qualify, property has to be acquired and placed in service on or before December 31, 2010.

In lieu of depreciation, IRC Section 179 deduction rules allow for the deduction, or "expensing," of the cost of qualifying property placed in service during the year. The maximum amount that can be expensed in 2010 and 2011 under Section 179 has been increased to $500,000 (double the maximum that applied in 2009). The $500,000 limit is reduced when the total cost of qualifying property placed in service during the year exceeds $2 million.

Also worth noting

- For 2010, itemized deductions and personal and dependency exemptions are not reduced for higher-income individuals, but (at least for now) that's going to change in 2011: these deductions will once again be subject to a phaseout based on adjusted gross income. This should be taken into account if you're considering timing income and deductions as part of your year-end planning.
- A 30% tax credit for energy-efficient improvements you make to your principal residence, or the cost of certain energy-efficient equipment you install (including furnaces, water heaters, and central air conditioning units) expires at the end of 2010. There's an aggregate credit cap of $1,500 for 2009 and 2010, so if you claimed the full $1,500 in 2009, you're out of luck for 2010. But if you haven't reached the maximum credit amount yet, consider timing qualifying expenditures to take advantage of the credit.
- When you reach age 70½, you're generally required to start taking required minimum distributions (RMDs) from any traditional IRAs or employer-sponsored retirement plans you own. RMD requirements, however, were suspended for 2009, so you may not have taken a withdrawal last year. RMD requirements are back for 2010, though, and the penalty is steep (50%) for failing to take an RMD by the date required--the end of the year for most individuals.

Talk to a professional

When it comes to year-end planning, there's always a lot to think about. And this year is more complicated than usual. A financial professional can help you evaluate your situation, keep you apprised of any last-minute legislative changes, and determine if any year-end moves make sense for you.

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