

**A Special Report**  
**December 2<sup>nd</sup>, 2009**  
***2009 Year-End Tax Planning Report***

It seems like every year there are new tax laws that require us to pay close attention— and 2009 is no exception! Many tax law changes over the last few years have been very favorable for most taxpayers. What many people forget is that even if no new tax laws are passed, income taxes are still expected to increase in the near future! Why is that?

Unfortunately, many of the tax changes passed by Congress when George W. Bush first came into office were temporary, and scheduled to expire, or “sunset”, 10 years later. For example, unless Congress passes new legislation, the lower income tax rates that took effect in 2001 will expire in 2011, and the higher tax rates that existed pre-2001 will be reinstated. No action is necessary for the higher income tax rates to take place, many of which are expected to be reinstated on January 1<sup>st</sup>, 2011! Year-end tax planning may be more complicated than ever now that there are reasons to take gains *this year* to pay taxes at a potentially lower income tax rate than in 2011.

**Last Minute Tax Saving Ideas**

Most taxpayers aren't going to argue that these new laws are complex, with many of them containing hundreds and even thousands of pages of both rules and IRS “guidelines”. In too many cases, the effect is intimidation. Taxpayers and *even tax professionals* can get confused as to what deductions are allowed. Those who decide to play it safe often end up bypassing legitimate deductions. Let's take a look at the following tax saving ideas that can reap significant benefits:

1. **Compare the “Standard Deduction” vs. “Itemized Deductions”**. Nearly two-thirds of all taxpayers claim the basic “standard deduction” each year instead of itemizing their deductions, because the standard deduction is greater than all of their tax-deductible expenses. Prepare a tax projection to determine whether tax deductions should be accelerated from 2010 to 2009 or income should be deferred from 2009 to 2010, especially if you will be in a lower tax bracket in 2009. Some tax deductible expenses can be paid either this year or 2010. For example, state income tax, interest expense, and charitable contributions are usually deductible, but usually only if you itemize. If you don't have enough deductions to itemize in 2009, it may be best to pay these expenses in 2010 in order to hopefully qualify to itemize next year.
2. **Recheck your medical expenses**. You can deduct medical expenses in the event that they exceed 7.5% of your adjusted gross income (AGI). Most taxpayers do not qualify for this deduction because their actual medical expenses do not to meet this threshold. Therefore, it is often best to “bunch” your medical expenses in one year in order to qualify for this deduction at least for one of two tax years. For example, it might be best to consider paying for elective procedures or other medical expenses during 2009 if you are close to reaching the

threshold amount. If it appears that you will not be able to meet this limit during 2009, it may be best to postpone these elective procedures until 2010.

If your medical expenses exceed the 7.5% AGI limitation, review other medical expenses you can still pay (or pre-pay) during 2009. Below are medical expenses that are usually deductible and often overlooked. These expenses may be “accelerated” into 2009 if you’ve reached the deductibility threshold:

- Routine medical and dental exams.
- Surgery.
- Insurance premiums.
- Prescriptions, especially the “donut hole” on Medicare prescriptions.
- Long-term care insurance premiums, which are deductible based on the taxpayer’s age at the end of the tax year.

For 2009, the deduction limits are:

Up to age 40:	\$320
41-50:	\$600
51-60:	\$1,190
61-70:	\$3,180
71/+:	\$3,980

- It may also be possible to deduct medical expenses paid for your parent or children.
- Costs of certain home improvements for medical purposes to the extent that the cost exceeds the home’s increased value.
- The standard mileage rate for medical and moving expenses is now 24 cents per mile in 2009.

If you own your own business, and it is a “C-corporation”, you might want to establish a corporate medical reimbursement plan which is not limited to the 7.5% AGI limitation, and all medical expenses could be 100% deductible.

Just because you aren’t eligible to claim a dependency exemption for a parent or other relative doesn’t mean you must lose out on deducting medical expenses you paid for them. For example, let us assume that Bill pays more than half of his father’s expenses. However, his father’s income in this example is greater than \$3,650, which is the limit in 2009, and therefore Bill is unable to claim him as a dependent for this year. In this case, Bill can still include payments for medical expenses that he paid on his father’s behalf among his own medical expenses.

Please note: the threshold is 10% of your AGI when computing your alternative minimum tax.

3. **Avoid an underpayment penalty.** If a taxpayer does not pay sufficient federal income tax during the year, he or she could face a tax penalty for underpayment. This includes amounts paid through quarterly estimated tax payments and payroll withholding.

If you look like you're faced with this underpayment penalty, one strategy is to adjust your income tax withholding. Withheld income taxes are treated as if you had paid them evenly throughout the year. So if you find you won't meet one of the exceptions for avoiding a penalty, extra tax withholding on other sources of income, such as IRA distributions or pension income, a year-end tax payment can make up for underpayments during the early part of the year. You may also try to increase the taxes deducted from year-end paychecks.

If you have a shortfall in tax withholding or payments, make sure you qualify for one of the tax law's "safe harbors" for exemption from underpayment penalties. You have 3 options:

1. Pay at least 90% of the current year's tax liability
  2. Pay at least 100% of your 2008 income tax liability (110% if your AGI for 2008 exceeded \$150,000)
  3. Pay installments under a special annualized basis. This option is available only if you receive significant income on a seasonal basis.
4. **Pay your fourth quarterly estimated tax payment to your state in 2009, even though it might not be due until January 15, 2010.** State income taxes are deductible in the year they are paid. Prepare your 2009 income tax projection, and it is possible that there still might be state income tax due for 2009 that will not have to be paid until April 15<sup>th</sup>, 2010. If it appears that there is a liability for 2009 state income taxes, it might be best to pay this state income tax during calendar-year 2009 in order to take the deduction this year. However, these taxes are *not* deductible for calculating the AMT and, if you are subject to AMT, it would be best to wait until 2010 in the hope that you might be able to take this deduction next year.

Please remember—estimated tax payments are usually based upon last year's income tax liability. In the event that your income has decreased this year, or deductible expenditures have increased during 2009, it may also be possible that the last quarterly estimated tax payment for either federal or state income taxes is not necessary. Prepare a tax projection to recheck this calculation. Otherwise, you may be making an interest-free loan to the government until you get your refund in the middle of next year!

5. **Compare state income taxes vs. state and local sales taxes.** You are able to deduct state and local sales taxes or the state income taxes, whichever is higher. There are a number of states that have no income tax and therefore state and local sales taxes will certainly be higher. However, it may be also worthwhile for taxpayers in states with low income tax rates to use the sales tax deduction if they have made any big purchases during the year. Few taxpayers keep track of sales taxes paid throughout the year, so you are permitted to deduct the actual sales tax paid or a standard amount listed in the IRS tax tables. This deduction was renewed recently for 2008 and 2009. If you intend to use this deduction and are planning to make a big-ticket purchase (such as a car or a boat) subject to sales tax, consider making it before the end of the year.

In June 2009, the Treasury Department announced as part of economic stimulus legislation that taxpayers who buy new cars in states without state sales taxes are entitled to deduct other fees or taxes imposed by the state or local government that are based on the vehicle's sales price or on a per-unit fee. That means car purchases made in states such as Alaska, Delaware, Hawaii, Montana, New Hampshire and Oregon can also qualify for the tax deduction. To qualify for this deduction, the vehicle must be purchased after February 16<sup>th</sup>, 2009 and before January 1<sup>st</sup>, 2010.

6. **Prepay property taxes.** It often makes sense for taxpayers who itemize their deductions to prepay state and local property taxes in the current year. This deduction can be claimed in addition to the standard deduction. However, it cannot exceed the lesser of \$1,000 (\$500 for single filers) or the taxes actually paid for the year. This tax break was initially available for 2008 only, but recent legislation extended it through 2009.
7. **Prepay January's mortgage payment.** If you make your January 2010 mortgage payment on your residence before the end of the year, you can deduct the interest portion of this payment on your 2009 income tax return.
8. **Convert non-deductible interest expense to deductible interest expense.** Unfortunately, you are generally not entitled to any tax benefit for interest paid on personal debts. (There is a limited exception for student loans.) However, you can deduct the full amount of interest paid up to \$1 million of "acquisition debt" used to buy, build or improve your principal residence. In addition, you can deduct the interest paid on up to \$100,000 of home equity debt, including a home equity line of credit. It does not matter how the proceeds are used, the interest will still be tax deductible. It might be best to convert a personal loan into a home equity loan. By doing so, you can deduct the interest on the home equity debt, even if you used the funds personally (up to the \$100,000 limit).

Home equity debt must be secured by your home, so use this year-end technique judiciously.

Remember to compare the after-tax interest rate that you will pay on the home equity loan vs. the interest rate on other loans. A low non-deductible interest rate loan might be worth keeping if its rate is lower than the net after-tax interest rate on a loan that qualifies for the tax deduction.

Deduct any points that you were not able to fully deduct that were paid for a mortgage that you had in prior years and you refinanced or sold the home in 2009. Any unamortized points are fully deductible this year.

9. **Consider all of the tax implications of charitable contributions.** (Please note: this strategy is only appropriate for those who do not need this money to fund their own retirement.) You deduct them in the year that you mail the check or hand over the money, *not* the year you make a pledge or give a note.

Your investment portfolio offers several tax saving opportunities for charitable contributions. One of these is making donations of appreciated stock. Identify investments with unrealized

capital gains. If you have owned the shares for more than a year, you can deduct the full value and avoid paying income tax on the appreciation. If you donate securities with an unrealized short-term capital gain, your deduction would be limited to only your cost basis in the securities. Remember—you must give the stock certificates “in kind”, and *directly* to the non-profit organization. They will then sell these shares without paying income tax.

Do not donate stock that has fallen in value because you lose the chance to claim a capital loss on your income tax return. In this case, sell the stock first, take the capital loss yourself, and then donate the proceeds.

The IRS has tightened the rules for substantiating charitable donations, and reporting requirements for non-cash contributions are subject to many new rules, depending on the value of the gift property. We suggest seeing your tax preparer to make sure that you are in full compliance with these new laws.

Clothes, books and household goods are now deductible only if they are in “good used condition”. Larger items such as a desk, computer, bookcase or appliance can also make an ideal donation to many non-profit organizations.

A recent tax-law change requires you to substantiate deductions for all monetary gifts to charity – even the spare change you throw into the collection plate at church! You must maintain proper records and whenever possible, obtain and retain a bank statement, receipt, or written communication from the charity when you make the donation. The written communication must show the charity’s name, the date of the contribution and the donation amount. As long as you keep these records, you should be able to withstand an IRS challenge.

If you charge a donation by credit card in 2009, you can still claim a current deduction for the gift during this year, even if you don’t actually pay off the amount until 2010.

There are various expenses that are also deductible as a charitable contributions. You can deduct incidental, un-reimbursed, out-of-pocket expenses related to volunteer work. This could include such things as postage, the cost of stationery and other business supplies, telephone charges, the purchase price and cleaning bills for required volunteer uniforms that are worn only for that purpose, and even the ingredients used to make something for a bake sale. Transportation costs to and from volunteer commitments can also be deducted. You can deduct either a flat rate of \$.14 per mile, to which parking fees and tolls may be added, or the actual vehicle operating costs.

10. **Make contributions to your charity directly from your IRA.** (Please note: this strategy is only appropriate for those who do not need this money to fund their own retirement.) If you are age 70 ½ or over, you can transfer up to \$100,000 directly from your IRA to a qualified charity income tax-free. This contribution counts towards your RMD, allowing you to reduce or even eliminate the tax that would normally be due (at ordinary income tax rates) on your RMD. Since the withdrawal will not be taxed to you, you won’t have extra income that could cause you to lose itemized deductions or personal exemptions. In addition, the payout won’t trigger additional taxes on social security benefits. Keep in mind that the money must go

directly from the IRA to the charity or the transaction will be taxable. Please remember there is no income tax deduction allowed for the donation – you never paid taxes on the contributed funds anyway!

Remember that 2009 is a very unusual year because you do not have to make an RMD for this year anyway. However, if you are over 70½ you are still eligible to make a charitable contribution directly from your IRA.

Both spouses can make these contributions, but the money must come from each one's separate IRA. Please also notify your tax preparer, because the 1099-R that is generated by the IRA custodian often does not indicate that this was a qualified charitable distribution. In addition to this, make sure that you receive an acknowledgment of the donation from the charity.

11. **Pay (or pre-pay) college tuition expenses.** Depending on your circumstances, you are allowed an above-the-line deduction for college tuition expenses.

The maximum amount of deductible college costs for 2009 varies between \$2,000 and \$4,000 per year, and the deductibility depends on your income. If you have yet to spend these amounts, you may be able to max out these deductions by pre-paying the 2010 winter quarter or spring semester in December 2009.

12. **Employ different strategies for negative taxable income.** If your deductible expenses exceed your income, causing negative taxable income, your tax strategies could include the following:

- ♦ Reduce your income tax deductions:
  - pay medical expenses next year,
  - defer or reduce charitable contributions until 2010
  - pay state and property taxes in 2010.
- ♦ Increase your taxable income, and at least bring it up to \$0. For example, if you have a negative taxable income of \$15,000, your income tax is \$0. If you bring up your negative taxable income from a negative \$15,000 up to \$0, your tax is still \$0. One of the best ways to accomplish this is to convert part of your traditional IRA into a Roth IRA. For example, if you converted \$15,000 from a traditional IRA into a Roth IRA, this is considered taxable income, but this would merely increase your negative taxable income up to zero, and therefore, this Roth IRA conversion is income tax-free! Since it's going into a Roth IRA, its earnings will be income tax-free! However, you could end up with a small amount of state taxes.

13. **Pay more than 50% of a parent's support in order to claim an exemption for him/her.** Believe it or not, even a gift as low as \$51 can create a \$3,650 exemption! Parents cannot be a dependent if their gross incomes are more than the exemption amount. For 2009, each exemption is \$3,650. Remember – gross income for this purpose does not include tax-free Social Security benefits, insurance proceeds, inheritances or gifts.

Keep an eye on your parent's earned and investment income to make sure you will qualify for this additional deduction. As their income starts to approach \$3,650, it might make sense to have your parent postpone income until 2010, or make investments that will produce tax-free income.

It is also important to watch out for the half-support rule. Money that a parent receives from Social Security may be saved, or used to buy Christmas presents for grandchildren, while money from the adult child is used to pay for food and rent. Remember – you can always give a parent a few dollars more to make sure the half-support mark is met.

Please note that personal and dependency exemptions are phased out for higher income taxpayers. For 2009, this phase out begins at \$205,200 for joint filers, and \$106,800 for single filers.

If your parent qualifies as a dependent but support is split between you and one or more siblings, you can establish a "multiple-support agreement" and as long as you pay at least 10% or more of the support cap, you can take the exemption for the parent. Remember that every other supporter who pays more than 10% of the total must sign IRS form 2120, waiving any rights to the deductions. These forms must be attached to your return and mailed in with the rest of your forms. Remember – supporters may take turns claiming the exemption over the years.

Additionally, in 2010 there will be some Roth IRA opportunities. Therefore, we've included a section on this important topic.

### **Roth IRA Conversion**

To Roth or not to Roth – that is the question!

It may be a good idea to convert part, or all of a traditional IRA to a Roth IRA in order to receive tax-free investment returns in future years, and escape minimum distribution requirements. Conversions are subject to ordinary income tax in the year of the "conversion". If a Roth IRA conversion takes place in 2010, the taxpayer may spread paying the taxes over the following two years – 2010 and 2011. You do not have to convert 100% of your IRA into a Roth. You can make a partial conversion; the amount usually depends on both your current income tax bracket and your estimated future tax bracket.

The ability to convert from an IRA to a Roth IRA depends on your Adjusted Gross Income (AGI), which must be less than \$100,000. Unfortunately, many taxpayers who would like to convert are not eligible. However, *this AGI limitation goes away in 2010*, so if you're currently ineligible it may be a good idea to start planning for this possibility in the near future.

If you do convert, you are allowed to change your mind and reverse the conversion (also known as recharacterization) in the future (but only one reversal per year). For example, if you find out later

that you exceeded eligibility limits, or that your account value has dropped, you can reverse the conversion at a lower tax cost. In fact, you can do this as late as October 15<sup>th</sup>, 2010.

The tax rules regarding Roth IRAs can be very complicated and confusing. For example, a Roth IRA distribution can only be qualified if you've had the account for at least five years and the distribution is made after you've reached age 59 ½. Otherwise, early withdrawals could result in a 10% federal income tax penalty. These conversion decisions are complex, so please call us if you would like to review these details in person.

### **Summary**

In conclusion, upper-income earners are bearing a record share of the income tax burden. The top 1% of filers paid 39.9% of all Federal Income Tax, which is up from 39.4% in the previous year, according to IRS data for 2006, the most recent year available. The minimum AGI level needed to be in the top 1% rose to a new high - \$388,800. Note that the bottom 50% of all filers paid just 3% of the total income tax bill that year.

Every taxpayer is different, and it is best to review your specific situation in order to determine what strategies would be best for you. We encourage you to meet with your tax preparer in order to prepare an income tax projection for 2009, and possibly for the years beyond as well. This year and next, there are many new tax strategies that should be reviewed in detail, and for some deductions or strategies, it is necessary to first determine whether or not you are even eligible.

If you need any additional information from us to provide to your tax preparer, please give us a call immediately. We also urge you to contact your tax preparer as soon as possible because, as you know, with one blink of your eyes it will be 2010 already. Don't wait until the last minute to talk to your tax preparer when it might be impossible to get an appointment; instead, call today and make an appointment for the first part of December. Remember—if you make a date, things happen!

**If you'd like a copy of this article sent to someone else who would benefit from this information, please contact Joyce at Jay R. Penney, L.L.C., at (480) 596-6600 or [joyce@jaypenney.com](mailto:joyce@jaypenney.com).**

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