The Financial Navigator - December Newsletter

Happy holidays to all. As we near the end of 2010 we face much uncertainty concerning next year's tax rates. Congress is hard at work trying to determine whether the 'Bush' tax cuts will be extended for all, just the middle class, or whether taxes for all will be increased. With only three weeks left in the year the bottom-line is you need to be prepared to act because if Congress finalizes the tax package at the last minute you will only have until December 31st to react. Below are some ideas that may prove helpful, if you have any questions on the information below please feel free to give me a call.

Sincerely,

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2010 End of Year Tax Planning

Year-end tax planning always makes sense, but this year it's especially critical because Congress still has no agreement on what 2011 income, capital gains, dividend, and estate tax rates will be, nor whether the alternative minimum tax (AMT) will hit the middle class, which was never its original purpose. Despite the large unknowns year-end planning is both possible and important; just be prepared to act with little notice.

Capital Gains and Losses

As of today rates on capital gains are scheduled to increase to 20% for most tax payers on January 1. If Congress extends the current 15% capital gains rate into next year and you have any losses in a taxable investment account it could make sense use $3,000 of these losses this year to offset ordinary income, with the excess losses carried forward for use in future years. The assets must be actually sold, and held in taxable accounts, as opposed to IRAs and other tax-sheltered retirement plans.

Capital losses also may be matched dollar-for-dollar against capital gains. For example, if you have $5,000 of long-term losses on some investments, theses losses could be used to eliminate up to $2,000 of capital gains on other investments, after taking the $3,000 deduction against your ordinary income. Beware of the tax code's 'wash sale' rule which applies to investment loses; the Internal Revenue Service says a 'wash sale' occurs when you sell or trade a stock at a loss and buy the same stock, or something 'substantially identical' within 30 days of the sale. (That means within 30 days before or after the sale.) If you violate the rule, you can't deduct your loss.

However, if Congress lets the tax increases go into effect, it may make sense to hold off on taking losses until January, when their value will be greater as they would be offsetting higher income and capital gains tax rates.

Lock in 15% Capital Gains Tax Rate

If you are bullish on an investment with gains, it may make sense to sell it to soak up losses, or to just lock in the 15% capital gains tax rate, especially if rates increase in 2011. Then you can always purchase the identical investment right back as the 'wash sale' rule only applies to losses. This may be a wise strategy since the current top capital-gains tax rate of 15% is the lowest in decades. As mentioned you can always buy the investment back which resets the basis in the investment. The only capital at risk would be the commissions you pay on the sell and buy orders, which would be minimal in comparison to potential hundreds or thousands of dollars in tax savings.

Roth IRA Conversions

In 2010 all tax payers, regardless of income, can convert existing IRAs to Roth IRAs. An additional advantage to a conversion in 2010 is you will be allowed delay the recognition of income due to the conversion and spread it ratably over the two-year period of 2011 and 2012. However, as mentioned above, stay tuned on the impending tax increases, depending on whether your rate increases or not may dictate when you want to recognize the income; in 2010 or spread over 2011-2012.

There are significant benefits to Roth IRAs as contributions and earnings grow tax deferred until needed in retirement, and withdrawals are tax-free once you are in retirement. But remember, the conversion must take place prior to the end of the year in order to take advantage of the option of paying the tax in 2011-2012. Most custodians and brokerage firms are expecting a last minute rush of conversions, so to ensure your conversion gets counted in 2010 it is advisable that you start the process in early December.

Flexible-Spending Accounts

You must spend these funds before year end or else forfeit them unless your plan has a grace period. The list of reimbursable expenses is wider than many realize, extending to contact-lens solution and acupuncture. (See IRS Publication 502.) However, be warned, because of a change in the law as part of the health care reform, no reimbursements are permitted for purchases of over-the counter medicines after Dec. 31, 2010 without a doctor's prescription, regardless of plan rules. Not many doctors are going to spend time writing out prescriptions for routine meds, so most of us will lose the ability to use flexible spending accounts for over the counter medications. It may make sense to stock up on over the counter meds now and ensure you use all of the funds in your flexible spending account.

Check withholdings

If extra cash would come in handy for the holidays, see if you have had too much withheld from your paycheck for 2010 and make a last-minute adjustment. About three out of four taxpayers received refunds last year, and the average payback was nearly $3,000. That is a considerable sum to park with Uncle Sam interest free.

Energy Credit

The Residential Energy Property Credit expires Dec. 31. Taxpayers who spend as much as $5,000 get a credit for up to $1,500 of energy-efficient home improvements such as hot-water heaters, insulation and even certain shades, but they must be installed by year end.

Charitable Contributions

To qualify for a 2010 deduction, make donations by Dec. 31. The charity doesn't have to have cashed a check or sent you notification by then, but the gift has to be in the mail or otherwise beyond your control by year end. (If you are worried, get proof of mailing.) If tax rates rise next year, should you wait to donate until Jan. 1, when the value of deductions would be greater? It is hard to say, because if rates rise, limits on itemized deductions, phased out during the Bush administration, may return as well. Donations of property such as old clothes or household items must be in "good used condition." Taxpayers who keep total noncash donations to $500 or less don't have to fill out IRS Form 8283. But a donation of a household item worth $500 or more may require an appraisal.

401(k) Plans

Consider maxing out your 401(k) to reduce your taxable income in 2010, contributions to company retirement-savings plans like 401(k)s are due by Dec. 31. For 2010 the limit per employee is $16,500, with an extra $5,500 allowed to those 50 and older.

Required IRA distributions

Congress suspended required payouts for 2009, but this year they're back for regular IRA owners over 70 ½ or those who have inherited accounts, ensure you take them by December 31st to avoid the 50% penalty.

Gifts

Any taxpayer may give any other taxpayer up to $13,000 a year free of tax. Using this provision, a couple with three children and six grandchildren could move $234,000 a year from their estates. Property and securities may be given as well as cash, but the asset's cost basis carries over.

If you have any questions on this topics, or need some help with other financial issues you are facing give me a call at (603) 373-8793.