

CPA Client Bulletin

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

Higher Taxes Are Likely, But Perhaps Not for Everyone

May 2010



Many of the tax cuts passed during the George W. Bush administration are due to expire after 2010. Although some of them may be extended to future years, high income taxpayers may face higher rates starting in 2011. If you will be affected by higher tax rates, some planning can help you trim your tax bill.

Now and then

Under current law, there are six rates for federal income tax: 10%, 15%, 25%, 28%, 33%, and 35%. As your income increases, higher rates apply to your taxable income.

Special rates apply to long-term capital gains (profits on assets held for more than one year) and qualified dividends (most dividends received by investors). The maximum tax on both types of

income is now 15%, although some long-term gains on collectibles such as works of art and rare coins are taxed at 28%. A 25% rate may also apply to any previously-taken depreciations on the sale of long-term assets. Taxpayers in the 10% and 15% tax brackets owe 0% tax on most long-term gains and qualified dividends.

If Congress does not pass legislation this year, many people will face higher tax rates on ordinary income, qualified dividends, and long-term capital gains received in 2011. President Obama's budget proposal calls for increasing the 33% tax rate to 36% and the top federal income tax rate from 35% to 39.6%.

Under the President's proposal, these higher rates would affect single taxpayers with taxable income of more than \$200,000 "less the standard deduction and one personal exemption, indexed for inflation." The exact number under this formula probably would be around \$190,000. Similarly, the higher tax rates would affect married couples filing joint returns if their taxable income were higher than approximately \$230,000.

These numbers are for *taxable* income. Therefore, it's possible that even if your gross income were \$200,000 or more (\$250,000 or more on a joint return), you'd still only be in the third highest federal tax

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America Counts on CPAs

Tax Trend

Consider enhanced tax strategies in light of possible rate increases.

Trusted Advice

A Gift That Gives Back

- ❖ The gift tax is still in effect this year, even though the estate tax has lapsed. The annual gift tax exclusion is now \$13,000 per recipient per year.
- ❖ Therefore, if you intend for your lower-income parents to sell your assets in 2010 or 2011, to avoid capital gains tax, you might give them appreciated assets this year.
- ❖ A married couple can give up to \$26,000 worth of assets in 2010 to the husband's father, another \$26,000 to the wife's mother, and so on. Similar gifts can be made in 2011.
- ❖ If you give away appreciated assets held more than one year, your parents can sell them and owe 0% tax as long as they remain in the 10% or 15% income tax bracket.
- ❖ A married couple giving away appreciated assets won't owe gift tax and won't lose any part of their estate tax shelter.
- ❖ As long as each spouse makes gifts up to \$13,000 per recipient per year, the couple won't have to file a gift tax return.

bracket—28%—under this proposal.

The Obama administration suggests a similar approach to qualified dividends and long-term capital gains. Most taxpayers would continue to pay tax at 15% or 0%; however, those taxpayers with incomes in the proposed 36% or 39.6% tax brackets would owe 20% on qualified dividends and long-term capital gains.

Forecasting the future

Congress might not pass any tax law at all this year. And if it does pass a law, the new rules may not follow the administration's proposal. However, many observers believe that Congress will pass a tax increase to reduce the projected federal budget deficit. Such a tax increase probably will fall largely on high income families and individuals.

If you are likely to be affected, some broad principles can assist you in your tax planning. For example, beginning next year, you probably will owe more tax on all types of income. Therefore, you may want to increase your use of tax-advantaged vehicles, including employer sponsored retirement plans, tax-exempt municipal bonds, and 529 college savings plans. Our office can help you weigh the tax consequences of various choices for savings and investments.

You also may want to consider converting some or all of your traditional IRAs to Roth IRAs. You can pay tax on the conversion at 2010 rates. Five years after opening the account or at age 59½, which ever comes later, all withdrawals from your Roth IRA will be tax free, even if tax rates are much higher by then. For more information on the benefits of converting your traditional IRA to a Roth IRA, see the article "Good Reasons for Roth IRA Conversions"



in the February 2010 issue of *CPA Client Bulletin*.

Assuming some variation of President Obama's plan becomes law, the gap between high income taxpayers and other taxpayers will increase in future years. This will make income shifting strategies more valuable. If you plan to sell appreciated assets, for example, you might first transfer them to your parents if they are in a lower tax bracket. They may be able to sell those assets and owe less tax than you would owe on a sale.

If passage is likely, our office can go over the details with you and develop suitable strategies. ■

Did You Know?

In 2009, nearly 24 million people received \$50 billion in benefits from the earned income tax credit. The average credit was more than \$2,000. Eligibility varies by income and family size. For example, to qualify for the credit, both 2010 earned income (money from working) and 2010 adjusted gross income (the amount reported on page 1 of your tax return) must be less than \$45,373 for married couples filing jointly, with two qualifying children.

Source: IRS

Make the Most of an IRA You Inherit

If you inherit an IRA, you have several choices of what to do with it. The right choice can help you enjoy penalty-free distributions, tax-deferred accumulation, or possibly tax-free income. An inherited IRA falls into one of four categories. You may be the beneficiary of a Roth IRA or a traditional IRA. Also, you may inherit an IRA from your spouse or someone other than your spouse.

Traditional IRA, from spouse

A traditional IRA usually is funded with pretax dollars—money that was never subject to income tax. Therefore, you'll probably owe income tax on some or all of the money you withdraw from a traditional IRA you inherit. You'll pay tax on withdrawals at your ordinary income tax rate. You won't owe a 10% penalty for early withdrawals, no matter how old you are, because the tax code provides IRA beneficiaries with an exception to this penalty.

If you don't need the money right away, you can extend the tax deferral. Surviving spouses have a unique opportunity: they can roll over an inherited IRA to their own IRA.

Example 1: Kim Snyder, age 51, inherits an IRA from her husband Matt. Kim can retitle the IRA in her own name and designate her own beneficiaries. Because Kim is not yet age 70½, she can defer required minimum distributions (RMDs) until she reaches that age.

This strategy will work well if Kim does not need the money from Matt's IRA now. She may let the account build for years, sheltered from income tax, until her RMDs begin. (Whenever RMDs begin, IRA beneficiaries owe a 50% penalty on insufficient distributions.)

However, suppose Kim needs the money in Matt's IRA right away. If she rolls the inherited IRA to her own IRA, she probably would owe income tax

plus a 10% early withdrawal penalty on any distributions before age 59½.

In this situation, Kim would be better off leaving the inherited IRA in Matt's name. That way she can withdraw the cash she needs without paying the 10% early withdrawal penalty. Once Kim reaches age 59½ and the penalty is not a problem for her, she can roll the IRA to her own name and designate beneficiaries.

Roth IRA, from spouse

Suppose Kim inherits a Roth IRA instead of a traditional IRA from her husband. Again, as a surviving spouse she can roll this account into her own Roth IRA. Not only will doing so allow Kim to designate her own beneficiaries, she'll be able to avoid RMDs as long as she lives. Although Kim must take RMDs from an inherited Roth IRA, a Roth IRA owner never has to take distributions from his or her own account. If Kim has ample assets, she can allow the Roth IRA she claims as her own to build indefinitely and untaxed—and eventually leave the account to her beneficiaries.

Is there a downside to rolling over a Roth IRA inherited from your spouse? Yes.

Example 2: Matt Snyder retires in 2009 and rolls over \$200,000 from his 401(k) to a Roth IRA. He pays income tax on \$200,000 of income. Matt dies in 2010 and leaves his Roth IRA to his wife Kim, who rolls that account to her own Roth IRA. In late 2010, Kim's Roth IRA is worth \$250,000.

If Kim withdraws all \$250,000 right away, she will owe income tax on \$50,000 worth of earnings because the Roth IRA will not have passed the five-year mark. Kim also will owe a 10% penalty on the full amount withdrawn (\$25,000) because she is not yet 59½.

Trusted Advice

Make the Most of Multiple Beneficiaries

- ❖ You may be among multiple beneficiaries of an IRA.
- ❖ Generally, all the beneficiaries must take required minimum distributions (RMDs) based on the shortest life expectancy among the beneficiaries. This deprives younger beneficiaries of some potential tax deferral.
- ❖ To provide each beneficiary with maximum potential tax deferral, the IRA can be divided into separate accounts for each individual beneficiary. If these separate accounts are established by December 31 in the year following the IRA owner's death, each individual beneficiary can take RMDs based on his or her own life expectancy.
- ❖ If the multiple beneficiaries include a nonindividual such as a charity, distributions may have to be accelerated and tax deferral may be lost.
- ❖ One solution is to pay the charity in full before September 30 of the year after the IRA owner's death. Then separate accounts can be established by December 31 and the individual beneficiaries can take RMDs based on their own life expectancy.

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However, Kim can take a withdrawal of up to \$200,000 from this Roth IRA at any time, free of income tax, as a return of the initial investment. She'll owe income tax on withdrawals over \$200,000 and the 10% penalty on all withdrawals until the Roth IRA meets the five-year and age 59½ requirements.

What if Kim keeps the inherited Roth IRA in Matt's name? She can take income tax free withdrawals of up to \$200,000 at any time and income tax free withdrawals of any amounts in 2014 and later years because the Roth IRA will have met the five-year requirement. In addition, Kim can withdraw any amount at any time without paying the 10% early withdrawal penalty because the tax code provides an exception for inherited IRAs. These withdrawals are, however, subject to the RMD rules.

Traditional IRA, from nonspouse

As a nonspouse IRA beneficiary, you can't roll over the account to your own name. You can take all the money from the account and pay income tax on the pretax money

you withdraw. Alternatively, you can transfer the account to an inherited IRA, as explained in the following example.

Example 3: Charles Baxter inherits an IRA from his mother, Alice. He transfers the account to an IRA in the name of "Alice Baxter (deceased) for the benefit of (f/b/o) Charles Baxter."

Then Charles can take distributions as he wishes and pay the resulting income tax. Each year, no matter how old he is, Charles must take at least the RMD from this account, based on his official life expectancy. Life expectancy tables can be found in IRS Publication 590, *Individual Retirement Arrangements (IRAs)*. If Charles withdraws less than the RMD amount, he'll owe a 50% tax on the shortfall.

Roth IRA, from nonspouse

Again, you can either take the cash or transfer the account to an inherited Roth IRA in the name of the deceased IRA

owner, for your benefit. You are subject to the RMD rules, determined by your life expectancy. All distributions will be tax free as long as the original Roth owner opened the account at least five years earlier. If you take out less than the RMD amount, you will owe a 50% penalty on the shortfall.



If you inherit any type of IRA from anyone, you probably will have the opportunity to stretch out distributions over many years, profiting from tax deferred or tax-free wealth accumulation inside the account. Missteps can deprive you of this chance to build wealth. Our office can guide you around the pitfalls of dealing with an inherited IRA. ■

TAX CALENDAR

MAY 2010

May 10

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the first quarter of 2009. This due date applies only if you deposited the tax for the quarter in full and on time.

May 17

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

JUNE 2010

June 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 second installment of your 2010 estimated tax.

If you are a U.S. citizen or resident alien living and working (or on military duty) outside the United States and Puerto Rico, file Form 1040 and pay any tax, interest, and penalties due for 2009. If you want additional time to file your return, file Form 4868 to obtain four additional months to file. Then, file Form 1040 by October 15.

Corporations. Deposit the second installment of estimated tax for 2010.

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