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There's an old saying among tax professionals: "Never let the tax tail wag the economic dog." While that adage still holds true, tax considerations are more important than ever for 2010 and 2011.

New 2010 Tax Relief Act

On December 17, 2010, the President signed the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, generally called the 2010 Tax Relief Act. There are many provisions affecting both individuals and businesses, including many "extenders" — that is, laws that were scheduled to expire but that have been extended.

This article covers many of the highlights of that law:

Payroll tax cut: Beginning with their first paycheck in 2011, employees will get a 2% reduction in their Social Security tax. Self-employed individuals will get a similar reduction in their self-employment tax. The employer match of the Social Security tax is not reduced.

Individual tax rates: Rates, including the reduced rate on capital gain and dividends, were scheduled to go up in 2011, however the lower 2010 rates are extended through 2012.

Education benefits: The American Opportunity Tax Credit (a credit for certain college expenses) was scheduled to expire after 2010, but has been extended through 2012. The provisions phase out for single taxpayers with modified adjusted gross income of $80,000 to $90,000 and joint filers with modified adjusted gross income of $160,000 to $180,000.

Deductions: Certain deductions scheduled to expire after 2009 were extended, including the $250 teacher expense deduction, the itemized deduction for sales taxes, and the deduction for mortgage insurance premiums. Student loan interest deduction limits will remain at the 2010 levels which phase out ratably for single taxpayers with adjusted gross income between $60,000 and $70,000 and for married taxpayers with adjusted gross income between $120,000 and $150,000.

The IRA to charity deduction for charity: This is extended through 2011. Under this provision, an individual who is at least 70½ years old can request the IRA trustee make a direct transfer of IRA funds to a qualified charity. The amount distributed is not included as income and not deductible as a charitable contribution. For those wishing to make charitable contributions, this is a tax-efficient way to take a required minimum distribution. In addition, the new law will permit a distribution on or before January 31, 2011, to be treated as if made in 2010. This is an area where planning before the end of January 2011 would be a good idea.

Credit for non-business energy property: The tax credit of up to $1,500 for residential energy improvements (such as energy efficient windows) was set to expire after 2010. It was

extended through 2011. However, the new law reduces the maximum credit to $500, and there are further restrictions.

Bonus depreciation and §179 business expensing: Businesses will be able to expense 100% of certain equipment purchased after September 8, 2010, and before January 1, 2012. Restrictions apply.

Other business provisions: Certain business provisions were extended including:

- The Work Opportunity Credit;
- The Research Credit;
- Employer credit for child care assistance;
- Employer education assistance; and
- Enhanced transportation fringe benefits.

Not extended: Key provisions that were not extended include the Making Work Pay Credit (2010 is the last year) and the standard deduction for property taxes (2009 was the last year). Taxpayers who itemize can still deduct property taxes.

Estate and Gift tax: The estate tax exclusion was set at $5 million and the top tax rate at 35%. These amounts are good for 2011 and 2012, and unless extended will go back to a $1,000,000 exclusion and a 55% top tax rate in 2013. There is also a "portability" provision allowing a surviving spouse credit from any portion of the first deceased spouse's unused exclusion amount assuring a full $10 million exclusion for a couple who both die during 2011 and 2012. For an individual dying in 2010, there is a choice as to whether to use the 2011 or 2012 estate tax exclusion and rates or to use a complex 2010 provision that means no estate tax. Under the latest provision, there is an increased valuation of assets to fair market value limited to $1,300,000 of adjustments plus $3,000,000 of adjustments if assets go to a spouse. This may cause later capital gains taxes for the beneficiaries if assets are sold that were not given a full tax basis equal to fair market value when the decedent died. If you have a family member that this applies to, or are an executor for a decedent dying in 2010, this needs to be dealt with before filing the decedent's 2010 individual income tax return. The Gift Tax exclusion and Generation Skipping Transfer Tax exclusion are also $5 million for 2011 and 2012 providing a tremendous opportunity for gifting during these two years.

There are many interesting choices to make regarding all parts of this new law. These choices can reduce your tax liability substantially. Tax planning makes dollars and sense.

Roth conversions

Roth conversions have been getting a lot of recent publicity for two reasons. First, 2010 was the first year that anyone could do them without being restricted by income limitations. Second, if you did a Roth conversion in 2010, you may report the income in 2010 or defer and spread it 50/50 in 2011 and 2012. 2010 is the only year this special defer/spread provision was available.

Briefly, when you make a contribution to a "traditional" IRA, you get a deduction but when you take a distribution, the amount is taxable. When you contribute to a Roth IRA you don't get a deduction but distributions are tax free.

When you do a Roth conversion, it's treated as if you take a distribution from your traditional IRA (taxable) and contribute it to a Roth. As such, the amount converted is taxable but it and any earnings after the conversion are tax-free when distributed.

Tax tail: For 2011 and forward, consider doing a conversion if your tax bracket will be lower in the year of the conversion than in subsequent years.

Economic dog: Despite their publicity, Roth conversions aren't for everyone. Don't do one if your tax rate is higher now than you believe it will be when you take distributions (generally, during retirement when you may have little other income). Remember the time value of money: paying tax now versus paying it later — or not at all — if you pass on the income to your children at your death.

Health care reform

The Health Care Acts included many tax provisions. Of greatest concern are the two new additional Medicare taxes. One will impose an additional 0.9% tax on earned income (salaries, wages, self-employment) in excess of certain threshold amounts and the second will impose an additional 3.8% tax on "investment" income in excess of approximately the same threshold amounts. The threshold amounts, generally, are $250,000 for joint returns and $200,000 for individuals.

Tax tail: Although the new taxes do not go into effect until 2013, there are actions you can take now that may lessen the impact when 2013 arrives.

Economic dog: The new taxes only affect higher-income individuals.

These are just a few of the important issues you must consider. And, the earlier you start planning, the more opportunity you have to implement the best strategy to reduce your taxes now and in the future.

CALIFORNIA SALES TAX

Individuals

The state of California is getting aggressive about collecting all the taxes the law allows – no matter how small.

If you purchase merchandise from a vendor located outside the state or the country, you may owe California use tax. This includes purchases you make over the internet. When your tax returns are prepared, you will be asked if you made purchases outside of California because you can pay the use tax for non-business purchases with your individual California income tax return.

Use tax is like sales tax but you pay it directly to the state, rather than to the retailer. The rule of thumb is: You owe use tax if what you bought would have been subject to sales tax if you purchased it at a local store in California and if you did not pay California sales tax. You generally owe California use tax when you use, store, or consume – in California – tangible personal property purchased from an out-of-state vendor. If the vendor does not collect the California tax on the purchase or if the Vendor does collect the sales tax of the State where the vendor is located in an amount less than the California sales tax rates, then the purchaser must

pay the use tax directly to California. If you don't report and pay your use tax in a timely manner, such as with your income tax return, the state will assess penalties and interest.

What is and is not subject to sales and use tax can be complicated. There are numerous exceptions to the rules, but here are some common ways that people make out-of-state purchases that are subject to use tax:

- Internet purchases;
- Certain foreign purchases;
- Shopping channel purchases; and
- Telephone and Mail order purchases out of state.

These are some common examples of items subject to use tax:

- Clothing;
- CDs and books;
- Computers, cameras and other electronic equipment;
- Toys;
- Household items such as small appliances;
- Makeup;
- Over-the-counter medications;
- Collectibles;
- Jewelry;
- Sports equipment, and
- Computer programs shipped on a disc.

Items that are exempt from sales tax are also exempt from use tax. Here are a few examples:

- Music and other media purchases for your iPod or MP3 player that is transferred directly over the Internet;
- Software that is transferred over the Internet and nothing is mailed to you;
- Prescription drugs;
- Newspapers, magazines, and other periodicals;
- Most food items;
- Purchases where the seller added California sales tax to your purchase, and
- The first $800 in property hand carried back from a foreign country.

What if another state's sales tax was paid?

If you were required to pay, and did pay, another state's sales tax on the purchase, you may take a credit against the California use tax due. So, for example, if you paid 7% sales tax to another state, you are only required to pay the difference between the 7% and the rate in your district.

How do you pay the use tax?

As an individual, if you do not have rental and/or self-employment income in excess of $100,000, you may either:

- Pay the use tax on your California income tax return; or
- Complete Form BOE-401-DS, Individual Use Tax Return.

Businesses

Many businesses that do not currently hold a seller's permit must register with the Board of Equalization (BOE), and report and pay, by April 15, any use tax due from purchases made in the preceding year. California has been aggressively pursuing this since the beginning of 2010, and most businesses or owners of rental property with gross receipts over $100,000 have been contacted by the BOE and told to register.

Use tax applies to purchases from out-of-state vendors that are not required to collect tax on their sales. If you purchased property that would have been subject to sales tax if purchased in a local store in California, it is subject to use tax if purchased over the Internet or out of California and brought into the state to be used, stored, or consumed here.

The registration process

The BOE sends letters to taxpayers with at least $100,000 in business gross receipts who are not already registered with the BOE, and do not hold a seller's permit. If you receive one of these letters, you will be asked to verify your contact information, and then the BOE will register you.

Once you are registered, the BOE will send you an account number and login information so that you can e-file your returns. You must e-file annually by April 15th covering the prior year, the same as your income tax returns. However, the BOE does not grant filing and payment extensions.

If you receive one of these letters, you must respond, or you may be subject to penalties.

You will need to maintain and retain records in a form that will allow to report use tax purchases accurately.

If you have any questions or concerns either related to your personal situation about what is covered in this newsletter or any other matters, please contact our office at 415-457-4411 to schedule a telephone or office appointment.

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