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Dear Tax Client:

As we write our annual letter, it appears Congress and the President have come to an agreement on extending most of the Bush-era reduced tax rates for individuals for another couple years. Unfortunately, we won't have all the details on exactly what tax breaks will be extended until it passes and the analysis comes out. We also had three major pieces of legislation that passed earlier this year that brought all kinds of changes to our tax laws, the first being the HIRE Act, then the Patient Protection and Affordable Health Care Act and finally the Small Business Jobs Act of 2010. Do you see a pattern here of trying to stimulate the economy?

The jury is still out on the Health Care Act, though, as it involves a fairly complicated phase-in of new laws over the next 8 years. We have highlighted below some of the provisions that are in effect currently. The immediate impact, however, is that many employers seem to be experiencing double-digit increases in premiums to cover employee health insurance. As we will see below, there is a tax credit that may help alleviate these increases, but it has its limitations. As usual, we will be taking update classes this next month to better understand the tax implications of this year's legislation as well as review all the federal laws to which California does not conform (too many!). Below are some of the highlights of the new tax legislation and key numbers as adjusted for inflation.

<u>HIRE Credits</u>: From March 18, 2010 through December 31, 2010, there is a payroll tax credit for the employer's 6.2% Social Security tax on wages paid to newly hired employees that had previously been unemployed for 60 days prior to date of hire. Starting with income tax returns filed in 2012, an additional credit of up to $1,000 can be claimed for newly hired employees that are retained for at least 52 consecutive weeks.

<u>Estate Tax and Basis</u>: The estate tax is repealed for 2010. However, the maximum step-up in basis that heirs to an estate may receive in 2010 is $1.3 million ($4.3 million for surviving spouses), so a new reporting form must be filed for 2010 estates that exceed $1.3 million in basis step-up to allocate it among the estate's assets. The estate tax is resurrected in 2011 for estates exceeding $1 million (unless the new legislation addresses this!).

<u>Self-Employed Health Insurance</u>: For 2010 only, the health insurance premiums of self-employed individuals will be deductible in determining earnings subject to the self-employment tax as well as income tax.

<u>Adoption Credit</u>: For 2010 and 2011, the adoption credit is increased to $13,170 and is now refundable.

Employer Health Insurance Credit: Starting in 2010 and expiring at the end of 2013, a maximum 35% credit (25% for non-profits) can be taken by small employers who cover at least 50% of their employee health insurance premiums. The credit starts to phase out, however, as the average full-time number of employees exceeds 10 and completely phases out with an average of 25 or more employees. The credit also starts to phase out once average annual employee compensation exceeds $25,000 and completely phases out with an average employee compensation of $50,000 or more. The exact calculation is very complicated!

Other Health Provisions: Starting in 2010, children under the age of 27 can now be covered under their parents' health plan and the premiums deducted by the employer or by the self-employed. There is also a new 10% tax on indoor tanning services. Starting in 2011, over-the-counter medications (excluding insulin) will no longer be considered eligible expenses for health savings or flexible spending accounts.

Home Buyer Credits: From January 1, 2009 until April 30, 2010, there is a refundable credit for qualified first-time home buyers purchasing a principal residence equal to 10% of the home's purchase price up to a maximum of $8,000. To qualify, the buyer(s) cannot have owned a principal residence within three years of the date of purchase. There are income limits as well as purchase price limits that apply to this credit. A second type of homebuyer credit, which is effective from November 6, 2009 to April 30, 2010, grants a maximum credit of $6,500 for those that are purchasing a new principal residence even though they have owned a principal residence in five of the last eight years. From May 1 to December 31, 2010, California is also offering a tax credit of 5% up to a maximum of $10,000 that is applied over 3 successive tax years (up to $3,333 per year) for first-time home buyers as well as those buying newly built homes (previously unoccupied) to be used as a primary residence.

Reduced Home Sale Exclusion: For sales after December 31, 2008, the $250,000 ($500,000 if married filing joint) exclusion of the gain on the sale of your primary residence will be reduced if there is any non-qualifying use occurring after December 31, 2008, such as rental or business use.

IRA and Pensions: In 2010, the maximum deduction for IRA contributions is $5,000, or $6,000 for those 50 and older. The salary deferral for pensions is between $11,500 and $22,000, depending on age and plan type.

IRA to Roth Conversions: In 2010, one can convert traditional IRA funds to a Roth IRA and elect to pay the tax on the conversion over the next two years. Half of the converted amount is included in income on the 2011 return and the other half on the 2012 return. The $100,000 AGI limit has been removed for 2010 to facilitate more conversions, and generate more tax revenues, of course. This move may be good for some, but not others.

Auto Mileage Rates: For 2010, the mileage rates per-mile are $0.50 for business use, $0.14 for charity work, and $0.165 for medical and moving expenses.

Depreciation: The Section 179 expensing election on the federal level increased to $500,000 for 2010 and 2011, but the California maximum expense election remains at $25,000. On federal returns for 2010, we have the return of the 50% bonus depreciation, which allows businesses to immediately deduct half of the cost of new qualifying personal property.

Education: For 2010, the HOPE credit has been replaced with the American Opportunity Credit, which is a maximum credit of $2,500 per student, based on 100% of the first $2,000 of tuition, books, supplies and necessary equipment plus 25% of the next $2,000. As an alternative, the Lifetime Learning Credit remains in effect indefinitely and provides up to a 20% credit for up to $10,000 in qualified tuition and fees. Both, however, are subject to income limitations.

Kiddie Tax: For 2010, dependent children under age 19, or under the age of 24 if a full-time student, with more than $1,900 in taxable investment income will pay tax on the excess at their parent's rates. Starting in 2010, California will conform to the IRS rules, but only if Prop 26 doesn't end up repealing the conforming legislation (see below).

Capital Gains and Dividends: For 2010, there is a 0% rate (yes, zero) for capital gains and qualified dividends included in taxable income of $34,000 or less when filing single and $68,000 or less when married filing a joint return.

Residential Energy Credits: For 2010, homeowners may qualify for a 30% credit up to a maximum of $1,500 on the purchase of qualifying energy-efficient improvements to their primary residences, such as adding insulation, energy-efficient exterior windows and doors, and energy-efficient heating and air conditioning systems. This credit does not apply to homes in the process of being built or to the installation costs of the improvement, and all equipment or materials installed must be new. A separate 30% credit that is not subject to a cap and that can be used for second or newly constructed homes applies to the purchase of solar hot water heaters or electrical equipment, geothermal heat pumps, or wind turbines.

Alternative Fuel Credit: A credit for purchasing hybrid vehicles is still in effect for 2010, though the amount depends on the make, model and date purchased. Credits on hybrid vehicles produced by some manufacturers, like Toyota, have already expired since the credit is limited to the sale of the first 60,000 units per manufacturer.

Plug-in Electric Drive Vehicle Credit: For 2010 and 2011, a new credit for buying qualified plug-in hybrid electric vehicles will start at $2,500 and cap at $15,000, based on the vehicle's battery capacity and gross weight. Only the first 200,000 of these vehicles sold by each manufacturer will receive the full credit before it starts to phase out. Qualifying vehicles must be newly purchased and derive its propulsion from a rechargeable battery with a 4 kilowatt-hour capacity, or 2.5 kilowatt-hour capacity for 2 or 3-wheeled vehicles. Golf carts do not qualify, however.

Charitable Contributions: For charitable contributions, last year's rules remain in effect: used clothing or household items must be in "good" condition to have charitable value, all items worth $5,000 or more require an appraisal, deductions for cash donations require a written receipt or a canceled check, but all cash donations of $250 or more require a written receipt.

CA Head-of-Household Credit: California now has a credit for qualifying taxpayers who are seniors filing as head-of-household or parents filing as single but who have joint custody of one or more children.

Foreign Bank and Financial Accounts: This law has been around awhile, but lately the IRS seems more determined to get full compliance. Anyone with a financial interest or signature authority over one or more accounts in a foreign country with an aggregate of more than

$10,000 in value at any time during the calendar year must file Form TDF 90-22.1 by the following June 30th.

Expiring Provisions: For 2010, there are a number of expired tax provisions that may or may not be renewed with the legislation being considered as of this writing. The expired provisions include the $250 teacher deduction, the additional property tax deduction for those that use the standard deduction, the first $2,400 unemployment benefits as tax free, the various sales tax deductions, the college tuition deduction, the allowable IRA contributions to charities, the higher estate tax exclusions, the higher AMT exemptions, the 15-year leasehold improvement depreciation, and many others.

California Conformity: California has always been at odds with federal tax laws, even more so lately, it seems. At the beginning of the year, though, the California legislature passed a conformity bill to align the state tax code with some of the provisions in the federal tax code. However, because there was a retroactive clause within Prop 26, which passed in November and now mandates a two-thirds vote for certain fees, the conformity bill will be nullified because it included such fees unless the legislature can renew it with a two-thirds vote this next session. Unfortunately, we may not know the resolution to this predicament until after the tax filing season, so the potential exists that a number of 2010 California returns will need to be amended if the legislature is unable to correct it.

Keep in mind that your own tax situation can be different from anyone else's. We would be happy to consult with you on how these changes might affect you specifically and help you plan to reduce your taxes before the year is over.

May your Holiday and New Year celebrations be joyous ones.

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