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2010 Year-End Tax Planning

Weathering the Impending Tax Law Changes

Year-end tax planning for 2010 is unique. As we move into the final months of the year, uncertainty looms large concerning the status of tax rates and certain tax incentives. Without action from Congress, many tax rate cuts enacted at the beginning of the decade will expire. In addition, certain incentives recently enacted as part of the American Recovery and Reinvestment Act of 2009 (commonly known as the "Stimulus Bill") do not apply to tax years after 2010.

Although these benefits may be ending, proactive taxpayers may be able to mitigate the impact of the impending tax law changes through strategic tax planning. Certain tax planning opportunities are summarized below.

Increases in Tax Rates and Expiration of Special Incentives

The principal changes scheduled to take effect on January 1, 2011, are mentioned below.

Ordinary Income Tax Rates for Individuals to Increase

The highest ordinary income tax rate for individuals will increase from 35 percent to 39.6 percent. (The tax rate for corporations will remain unchanged at 35 percent).

Tax Rate on Dividends to Increase

Most corporate dividends (known as "qualified dividends") are taxed at a favorable 15 percent tax rate under present law. Effective January 1, 2011, all dividends will be taxed at ordinary income tax rates (*i.e.*, 39.6 percent for individuals in the highest tax bracket).

Long-Term Capital Gains Rates to Increase

The rate for long-term capital gains will increase from 15 percent to 20 percent.

Deferral of Cancellation of Debt Income to Expire

Under the Stimulus Bill, taxpayers may elect to defer

certain cancellation of debt income they realize in 2009 or 2010 and include such income ratably over the five-year period beginning with 2014. This temporary incentive expires on December 31, 2010.

Planning Opportunities

The current economic and tax climate in 2010 presents taxpayers with unique planning opportunities relating to the above tax law changes that likely will not be available next year. One or more of the opportunities listed below may be available depending on a taxpayer's situation.

Close Sale Transactions By Year End

Individuals and pass-through entities (including limited liability companies, partnerships and S corporations) who plan to sell their businesses (or engage in other taxable transactions) can avoid the scheduled tax rate increases by closing the sale in 2010. The reduced tax liability resulting from the lower tax rates may outweigh the benefit of tax deferral that would occur if the transaction closed in 2011. Likewise, if the transaction is otherwise eligible to be reported on the installment method (pursuant to which gain is generally recognized over the years in which payments are received by the taxpayer), the taxpayer may want to elect out of the installment treatment and recognize all of the gain in 2010. This strategy applies regardless of whether the disposition transaction results in capital gain or ordinary income because the rates for both categories will be higher in 2011.

Pay Corporate Dividends in 2010

Because the tax rate on corporate dividends is scheduled to increase substantially (from 15 percent to 39.6 percent for individuals in the highest tax bracket), a corporation should consider paying dividends to its shareholders prior to year end. If the corporation desires to retain the cash, it may be possible for the shareholders to loan the distributed amounts back to the corporation. Although the

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2010 dividend would be taxable to the shareholders (at a rate of 15 percent), future repayments of the loan principal by the corporation would constitute tax-free loan repayments rather than dividends taxable as ordinary income.

For example, assume ABC Corp. has individual shareholders and anticipates declaring a dividend of \$10 million in either 2011 or 2012, depending on when its existing need for such cash disappears. In anticipation of increased tax rates, ABC Corp. declares a dividend in 2010, and the shareholders purchase promissory notes issued by ABC Corp. worth \$10 million. Under this plan, the dividends would be taxed at the lower 15 percent dividend rate for 2010. Instead, if ABC Corp. waited until 2011 or 2012 to declare a dividend, the shareholders would pay tax at a 39.6 percent tax rate.

Implementation of this strategy requires a thorough analysis and proper structuring and documentation to ensure that the various state law and tax requirements are met.

Restructure Debt in 2010

Many taxpayers recently have been forced to renegotiate their debt instruments, which often results in cancellation of debt income that is subject to tax at ordinary income rates. A special election is currently available to many taxpayers that recognize cancellation of debt income in 2010. Under this election, the cancellation of debt income that occurs in 2010 is deferred and recognized ratably during the five years from 2014 to 2018. Please note that special rules apply to this election, including rules that could require a taxpayer to immediately recognize all of the income.

For example, assume XYZ Corp. originally borrowed \$50 million. As a result of current asset values and XYZ Corp.'s inability to pay, the lender agrees to cancel \$10 million of the debt and reduce the principal amount of the loan to \$40 million. XYZ Corp. may make an election to defer the \$10 million cancellation of debt income and recognize it ratably over a 5-year period beginning in 2014. If XYZ Corp. instead waited until 2011 to renegotiate the loan

under the same general terms, this election would not be available.

Locke Lord tax attorneys regularly monitor tax legislative proposals that affect our clients' tax liability. If you would like additional information or guidance on the matters discussed herein, please contact one of the authors of this article.

In addition, Locke Lord is hosting a CLE program entitled, "Unique Year-End Tax Planning: Opportunities for 2010," on September 22, 2010. For more information [click here](#).

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