

2009-2010 TAX PLANNING GUIDE

YEAR-ROUND STRATEGIES TO MAKE THE TAX LAWS WORK FOR YOU

As you plan, so shall you save

In a year of generally bad economic news, the good news is that smart tax planning can help you mitigate losses and keep more of your hard-earned income. But to save the most, you'll need to start planning before year end — or sooner.

The following pages highlight recent tax law changes and provide an overview of tax breaks and planning strategies for individuals, families and business owners. You'll find helpful information about ways to save tax on investments and business income, as well as tax-smart ideas for funding education, saving for retirement and transferring wealth to your heirs.

You'll also realize how complicated tax planning has become, and how important it is to check with an advisor about the strategies that are best for you. Your best tax-saver may well be one we simply haven't had room to include here.

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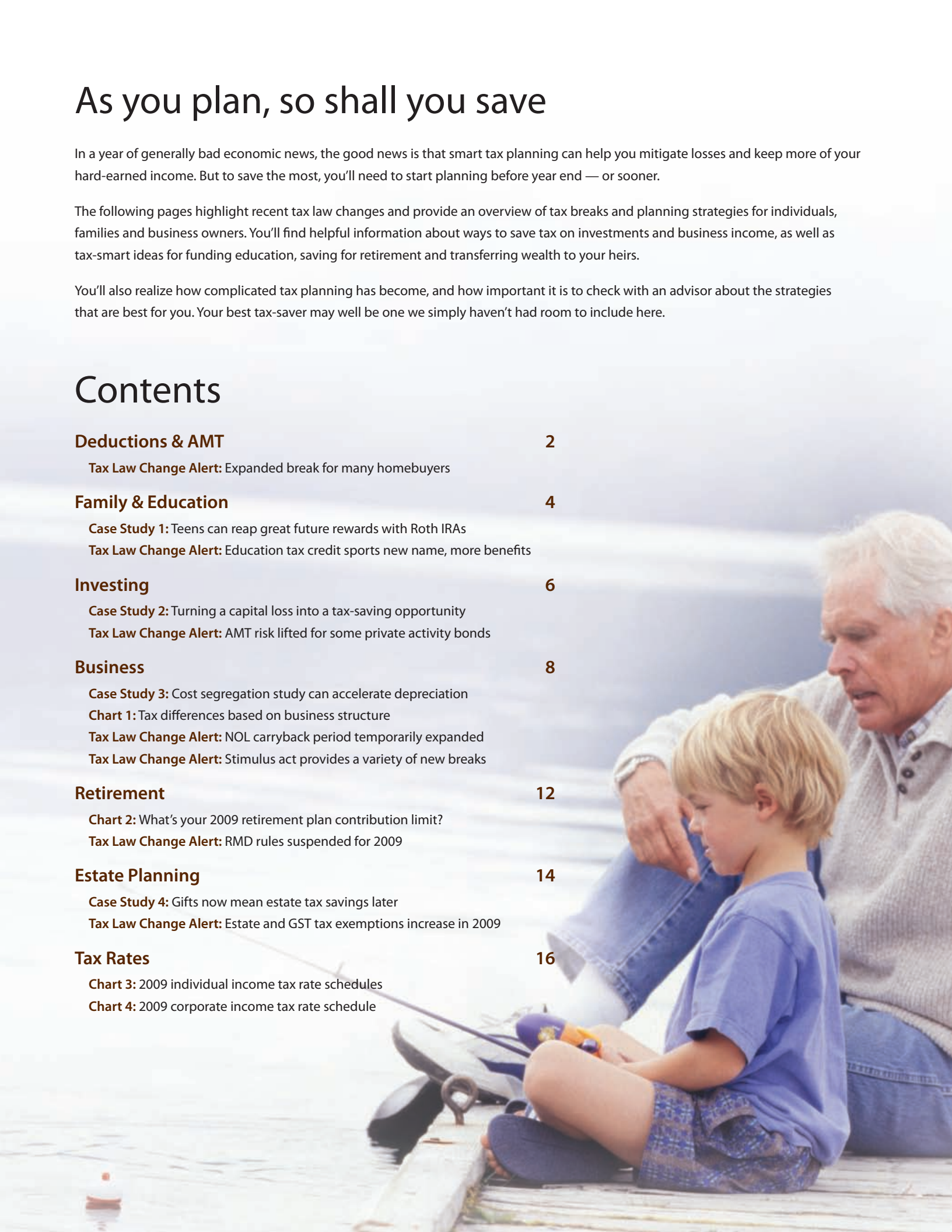
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Take two (or more) to alleviate tax pain

Generally, you'll want to use every tax break you can to reduce the ache of filing time. But in some cases, such as when you're subject to the alternative minimum tax (AMT), that's not the best remedy. Not sure what to do? Read below — then check with your advisor to see what's right for you.

Keep your eye on the AMT

Before taking steps to maximize deductions, consider the AMT — a separate tax system that limits some deductions and doesn't permit others, such as:

- State and local income tax deductions,
- Property tax deductions, and
- Miscellaneous itemized deductions subject to the 2% of adjusted gross income (AGI) floor, including investment advisory fees and employee business expenses.

You must pay the AMT if your AMT liability exceeds your regular tax liability. See Chart 3 on page 16 for AMT rates and exemptions, and work with your tax advisor to project whether you could be subject to the AMT this year or next. You may be able to time income and deductions to avoid the AMT, or at least reduce its impact.

Maximize home-related breaks

In the current economy, home-related tax breaks are more important than ever:

Property tax deductions. Before paying your bill early to accelerate the itemized deduction into 2009, review your AMT situation. If you end up subject to the AMT, you'll lose the deduction for the

prepayment. If you don't have enough other deductions to warrant itemizing (that is, your total itemized deductions are less than the applicable standard deduction), you can take an additional standard deduction of up to \$500 (\$1,000 for joint filers) for property tax paid.

Mortgage interest deduction. You generally can deduct interest on up to a combined total of \$1 million of mortgage debt related to your principal residence and a second residence. Points paid related to a principal residence also may be deductible.

Home equity debt interest deduction.

Interest on home equity debt used to improve your principal residence — and interest on home equity debt used for any purpose (debt limit of \$100,000) — may be deductible. So consider using home equity debt to pay off credit cards or auto loans, whose interest isn't deductible. But beware of the AMT: If the home equity debt isn't used for home improvements, the interest isn't deductible for AMT purposes.

Home sale gain exclusion. When you sell your principal residence, you can exclude up to \$250,000 (\$500,000 for joint filers) of gain if you meet certain tests. Losses aren't deductible. Because a second home is ineligible for the exclusion, consider converting it to rental use before selling. It will be considered a business asset, and you may be able to defer tax on any gain. (See

Tax Law Change Alert

Expanded break for many homebuyers

Who's affected: First-time homebuyers (defined as taxpayers who've had no ownership interest in a principal residence in the United States during the prior three-year period).

Key changes: Last year, a credit of up to \$7,500 on the purchase price of a principal residence was made available to qualified first-time homebuyers. The American Recovery and Reinvestment Act of 2009 extends its availability to qualifying purchases made before Dec. 1, 2009, and, for those made after Dec. 31, 2008, increases the maximum credit to \$8,000. Perhaps most significant, the act generally eliminates the repayment obligation for qualifying purchases after Dec. 31, 2008. The credit starts to phase out for joint filers with modified adjusted gross incomes exceeding \$150,000 (\$75,000 for single filers), and there are other limitations.

Planning tips: Even if you don't qualify, your adult children might. So if you've been thinking about making a gift to help them fund a down payment, now may be a great time to do it. In addition to benefiting from the credit, they also can take advantage of low housing prices and low interest rates. But be sure to first consider the gift tax consequences. (See page 14.)

“Evaluate tax-deferral strategies” on page 7.) Or you may be able to deduct a loss, but only to the extent attributable to a decline in value after the conversion.

Debt forgiveness exclusion. Homeowners who receive debt forgiveness in a foreclosure or a mortgage workout for a principal residence generally don't have to pay federal income taxes on that forgiveness.

Rental income exclusion. If you rent all or a portion of your primary residence or second home for less than 15 days, you don't have to report the income. But expenses associated with the rental aren't deductible.

Energy-related breaks. A wide variety of breaks designed to encourage energy efficiency and conservation are available, many of which have recently been expanded. Consult your tax advisor for details.

Save on health care

If your medical expenses exceed 7.5% of your AGI, you can deduct the excess amount. Eligible expenses include:

- Health insurance premiums,
- Medical and dental services, and
- Prescription drugs.

Consider “bunching” nonurgent medical procedures and other controllable expenses into one year to exceed the 7.5% floor. But keep in mind that for AMT purposes only medical expenses in excess of 10% of your AGI are deductible.

Also remember that expenses that are reimbursed (or reimbursable) by insurance or paid through an HSA or FSA aren't deductible:

HSA. If you're covered by qualified high-deductible health insurance, a Health Savings Account (HSA) allows 2009 contributions of pretax income (or deductible after-tax contributions) up to \$3,000 for self-only coverage (\$3,050 in 2010) and \$5,950 for family coverage (\$6,150 in 2010). Moreover, account

holders age 55 and older can contribute an additional \$1,000 to their HSAs in 2009.

HSAs bear interest or are invested and can grow tax-deferred similar to an IRA. Withdrawals for qualified medical expenses are tax free, and you can carry over a balance from year to year.

FSA. You can redirect pretax income to an employer-sponsored Flexible Spending Account (FSA) up to an employer-determined limit. The plan pays or reimburses you for medical expenses not covered by insurance. What you don't use by the end of the plan year, you generally lose. If you have an HSA, your FSA is limited to funding certain “permitted” expenses.

Give to your favorite charity

Donations to qualified charities are generally fully deductible. For large donations, discuss with your tax advisor which assets to give and the best ways to give them. For example:

Appreciated assets. Instead of donating cash, consider appreciated publicly traded securities. If you've held the shares more than one year, you can deduct the current fair market value. Plus you'll avoid capital gains tax. But beware: Gifts of appreciated assets are subject to tighter deduction limits. Excess contributions may be carried forward for up to five years.

CRTs. A charitable remainder trust (CRT) pays an annual amount to you for a given term. At the term's end, the trust's remaining assets pass to one or more charities. You receive an income tax deduction when you fund the trust. If you contribute appreciated assets, you also can avoid capital gains tax.

Consider sales tax deductions

You can take an itemized deduction for state and local *sales* taxes in lieu of state and local *income* taxes. You may benefit if you live in a state with no or low income tax or if you've purchased major items, such as cars or boats.

But another option may be available if you purchase a new car, light truck, motorcycle or motor home from Feb. 17, 2009, through Dec. 31, 2009: a new deduction for state and local sales or excise taxes paid on vehicle value up to \$49,500 that's available regardless of whether you itemize.

By taking the new deduction instead of the *itemized* sales tax deduction, you'll still be eligible to take the itemized state and local *income* tax deduction. But the new deduction starts to phase out for joint filers with AGIs exceeding \$250,000 (\$125,000 for other filers). ■





FAMILY & EDUCATION

Yes, kids are expensive — but they can lower your tax bill

When you're paying for shoes, food and schooling, from a financial standpoint children may seem more cost than benefit. Fortunately, tax breaks abound to help offset the costs of raising and educating them. But many aren't available to high- and even some middle-income taxpayers, so consult your tax advisor.

Take child-related tax breaks

Many tax breaks are available to families, including these favorites:

Tax credits. Tax credits reduce your tax bill dollar-for-dollar. So make sure you're taking every credit you're entitled to.

For each child under age 17 at the end of 2009, you may be able to claim a \$1,000 credit. For 2009, the credit starts to phase out when adjusted gross income (AGI) hits \$75,000 for single filers and \$110,000 for joint filers. The top of the phaseout range depends on filing status and number of children.

For children under age 13 (or other qualifying dependents), you may be eligible for a credit for child (or dependent) care expenses. The credit is either \$3,000 or \$6,000, depending on the number of children or dependents. The credit doesn't phase out altogether, but the minimum credit percentage of 20% applies to AGIs over \$43,000 for both single and joint filers.

If you adopt in 2009, you may be able to take a credit or use an employer adoption assistance program income exclusion; both are \$12,150 per eligible child. The credit starts to phase out when AGI hits \$182,180

and is phased out completely when AGI exceeds \$222,180.

FSA. You can redirect up to \$5,000 of pretax income to an employer-sponsored child and dependent care Flexible Spending Account (FSA). The plan then pays or reimburses you for child and dependent care expenses. You can't claim a tax credit for expenses reimbursed through an FSA.

Employing your children. If you own a business, you can hire your children and deduct their pay. They can earn as much as \$5,700 and pay zero federal income tax. Also, they can earn an additional \$5,000 without paying current tax if they contribute it to a traditional IRA. Your children must perform actual work and be paid in line with what you'd pay nonfamily employees.

Consider the "kiddie tax"

The kiddie tax applies to children age 18 and younger, as well as to full-time students under age 24 (unless the students provide more than half of their own support from earned income). For children subject to the kiddie tax, any unearned income beyond \$1,900 (for 2009) is taxed at their parents' marginal rate. Consult with your tax advisor about how recent changes to this tax may alter your tax and estate planning strategies.

Shifting income to an adult child who isn't subject to the kiddie tax but is in a lower tax bracket can still save your family tax dollars — especially if the child qualifies for the 0% long-term capital gains tax rate. (See "See if a loved one qualifies for the 0% rate" on page 7.)

Tax Law Change Alert

Education tax credit sports new name, more benefits

Who's affected: Taxpayers paying for college expenses in 2009 or 2010.

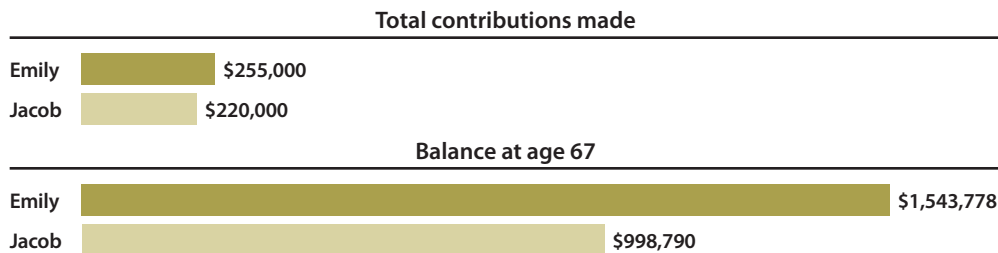
Key changes: The American Recovery and Reinvestment Act of 2009 introduced the American Opportunity education credit (an expanded version of what was previously known as the Hope credit). For 2009 and 2010, the credit covers 100% of the first \$2,000 of tuition and related expenses (including books) and 25% of the next \$2,000 of expenses. The maximum credit is \$2,500 per year for the first four years of postsecondary education. (The maximum Hope credit was \$1,800 and applied to only the first two years of postsecondary education.) The credit starts to phase out for joint filers with adjusted gross incomes (AGIs) over \$160,000 and for other filers with AGIs over \$80,000. And it's completely phased out at AGIs of \$180,000 for married couples and \$90,000 for single filers.

Planning tips: If you don't qualify for this credit because your AGI is too high, your child might. Keep in mind that both the credit and a tax-free 529 plan or ESA distribution (see main article) can be taken as long as expenses paid with the nontaxable distribution aren't also used to claim the credit.

Case Study 1

Teens can reap great future rewards with Roth IRAs

Roth IRAs can be perfect for teenagers — just look at how much difference starting contributions early can make: Both Emily and Jacob contribute \$5,000 per year to their Roth IRAs through age 66. But Emily starts contributing when she gets her first job at age 16, while Jacob waits until age 23, after he's graduated from college and started his career. Emily's additional \$35,000 of early contributions result in a nest egg at full retirement age of 67 that's more than \$500,000 larger!



Note: This example is for illustrative purposes only and isn't a guarantee of future results. The figures presume \$5,000 is contributed at the end of each year over the ages indicated and a 6% rate of return. See page 13 for more information on Roth IRA contribution rules.

Go for education savings

If you're saving for a child's education, paying higher education expenses or paying off a student loan, you may be eligible for tax breaks:

529 plans. You can either secure current tuition rates with a prepaid tuition program or create tax-advantaged savings plans to fund college expenses. In addition:

- For federal purposes, contributions aren't deductible, but distributions used to pay qualified expenses — tuition, room, board, mandatory fees and books — are income tax free. (State treatment varies.)
- For 2009 and 2010, the definition of "qualified education expense" has been expanded to include computers, computer technology and Internet service.
- The plans typically offer higher contribution limits than ESAs (see next column), and there are no AGI limits for contributing.
- There's generally no beneficiary age limit for contributions or distributions.
- 529s provide estate planning benefits: By filing a gift tax return, you can use annual exclusions for five years and make a

\$65,000 contribution (or a \$130,000 joint contribution with your spouse) in 2009.

ESAs. Coverdell Education Savings Accounts (ESAs) offer more investment options than 529 plans, and they can fund expenses from kindergarten through college. Contributions aren't deductible, but distributions used to pay qualified education expenses are income tax free.

The annual ESA contribution limit is \$2,000 per beneficiary. That amount will be limited if you're a single filer with AGI between \$95,000 and \$110,000 or a joint filer with AGI between \$190,000 and \$220,000. The ability to contribute is eliminated if your AGI equals or exceeds the top of the applicable range.

Generally, contributions can be made only for the benefit of a child under age 18. Amounts left in an ESA when the beneficiary turns 30 must be distributed within 30 days, and any earnings will be subject to tax.

Education credits. When your children enter college, you may be able to claim the American Opportunity credit. (See the Tax Law Change Alert on page 4.)

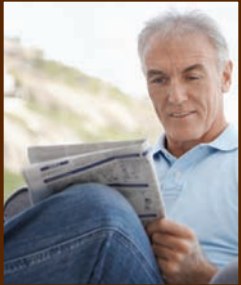
If you're paying postsecondary education expenses beyond the first four years,

check whether you're eligible for the Lifetime Learning credit (up to \$2,000 per tax return). If you're a single filer with AGI between \$50,000 and \$60,000 in 2009 or a joint filer with AGI between \$100,000 and \$120,000, the credit will be limited. If your AGI equals or exceeds the top of the applicable range, the credit isn't available to you. But your child may be eligible.

Both a credit and tax-free 529 plan or ESA distribution can be taken as long as expenses paid with the nontaxable distribution aren't used to claim the credit.

Education deduction. Eligible taxpayers can deduct up to \$4,000 of qualified higher education tuition and fees. The deduction is limited to \$2,000 for joint filers with AGIs of \$130,000 to \$160,000 (\$65,000 to \$80,000 for single filers) and is unavailable to taxpayers with higher AGIs.

Student loan interest deduction. If you're paying off student loans, you may be able to deduct up to \$2,500 of interest (per tax return). For 2009, this deduction is limited when AGI reaches \$60,000 for single filers and \$120,000 for joint filers. And it's completely phased out starting at AGIs of \$75,000 for single filers and \$150,000 for joint filers. ■



INVESTING

Tax planning can help mitigate losses

Investment tax planning usually focuses on how to reduce or defer capital gains. But the biggest tax challenge many investors face this year is how to deal with capital losses. Proper planning can help, though tax considerations shouldn't drive your overall investment strategy.

Be smart with losses

Losses aren't truly losses until they're realized — that is, until you sell the investment for less than what you paid for it. So while it's distressing to see an account statement that shows a large loss, the loss won't affect your current tax situation as long as you still own the investment.

Realized capital losses are netted against realized capital gains to determine capital gains tax liability. If net losses exceed net gains, you can deduct only \$3,000 of losses per year against ordinary income (such as wages, self-employment and business income, interest, dividends, and taxable

retirement plan distributions). You can carry forward excess losses to future years, but it could take a long time to fully absorb a large loss.

In the current market, you may not have enough gains to absorb losses. So think twice before selling an investment at a loss. After all, if you hold on to the investment, it may recover the lost value. In fact, a buy-and-hold strategy works well for many long-term investors because it can minimize the effects of market volatility.

Of course, an investment might continue to lose value. That's one reason why tax considerations shouldn't be the primary driver of investment decisions. If you're ready to

divest yourself of a poorly performing stock because, for example, you don't think its performance will improve or your investment objective or risk tolerance has changed, don't hesitate solely for tax reasons. Building up losses for future use could be beneficial if you have a large investment portfolio, real estate holdings or a closely held business that might generate substantial future gains.

Look at tax rates and timing

While time, not timing, is generally the key to long-term investment success, timing can have a dramatic impact on the tax consequences of investment activities. The 15% long-term capital gains rate is 20 percentage points lower than the highest regular income tax rate of 35% — and it generally applies to investments held for more than 12 months. Holding on to an investment until you've owned it more than a year may help substantially cut tax on any gain.

Timing also affects losses. First, short-term gains are netted with short-term losses and long-term gains with long-term losses. Then if, for example, you have a net short-term gain but a net long-term loss, you can use the long-term loss to offset the short-term gain. This can save more taxes because you're reducing or eliminating gain that would have been taxed at your higher ordinary rate.

Here are some other tax-saving strategies related to timing:

Avoid wash sales. The wash sale rule prevents you from taking a loss on a security

Tax Law Change Alert

AMT risk lifted for some private activity bonds

Who's affected: Bond investors vulnerable to the alternative minimum tax (AMT).

Key changes: The American Recovery and Reinvestment Act of 2009 excludes from the AMT any income from tax-exempt bonds issued in 2009 and 2010, along with 2009 and 2010 refundings of bonds issued after Dec. 31, 2003, and before Jan. 1, 2009. Previously, tax-exempt interest from certain private activity municipal bonds could trigger AMT liability.

Planning tips: Those who've hesitated to invest in private activity bonds because of the potential negative AMT consequences may want to reconsider them. Those holding private activity bonds that don't fall under the new provision, however, will still have to be wary of the AMT. (For more on the AMT, see page 2.)

Turning a capital loss into a tax-saving opportunity

Let's say your investments overall are down significantly and to date your net realized losses are \$15,000. Your portfolio includes \$30,000 of an oil company stock that was worth \$40,000 a year ago but that you paid only \$18,000 for. Even before the downturn you'd been thinking about selling it to diversify your portfolio, but you were concerned about the capital gains tax. Now might be a good time to sell the stock because your \$12,000 gain would essentially be tax free: The gain would absorb \$12,000 of losses, leaving you with a \$3,000 net loss that you could use to offset ordinary income.



if you buy a substantially identical security (or option to buy a security) within 30 days before or after you sell it — you can then recognize a loss only when you sell the replacement security. Fortunately, there are ways to avoid the wash sale rule. For example, you may buy a similar security or shares in a mutual fund that holds securities much like the ones you sold. Or, you can wait 31 days to repurchase the same security.

Swap your bonds. With a bond swap, you sell a bond, take a loss and then immediately buy another bond of similar quality from a different issuer. Generally, the wash sale rule (see above) doesn't apply because the bonds aren't considered substantially identical. Thus, you achieve a tax loss with virtually no change in economic position.

See if a loved one qualifies for the 0% rate. The long-term capital gains rate is 0% for gain that would be taxed at 10% or 15% based on the taxpayer's regular income tax rate. If you have adult children in one

of these brackets, consider transferring appreciated or dividend-producing assets to them so they can enjoy the 0% rate, which also applies to qualified dividends. But first make sure your child won't be subject to the kiddie tax. (See page 4.) Also, consider any gift tax consequences. (See page 14.)

Think about other rules

For some types of investments, special rules apply, so you have more tax consequences to think about than just gains and losses:

Bonds. The tax treatment of bond income varies:

- Interest on U.S. government bonds is taxable on federal returns but generally exempt on state and local returns.
- Interest on state and local government bonds is excludible on federal returns. If the bonds were issued in your home state, interest also may be excludible on your state return. (See the Tax Law Change Alert on page 6.)

- Corporate bond interest is fully taxable for federal and state purposes.
- Bonds (except U.S. savings bonds) with original issue discount (OID) build up "interest" as they rise toward maturity. You're generally considered to earn a portion of that interest annually — even though the bonds don't pay this interest annually — and you must pay tax on it. So, these bonds may be best suited for tax-deferred vehicles, such as IRAs (see page 12), or for investors with sufficient cash flow to absorb the tax.

Stock options. Before exercising (or postponing exercise of) options or selling stock purchased via an exercise, consult your tax advisor about the complicated rules that may substantially increase tax liability if you act hastily — or minimize it if you plan properly.

Evaluate tax-deferral strategies

With certain types of appreciated assets, it's possible to divest yourself of the investment but defer the tax liability. Such strategies may, however, be risky until there's more certainty about future capital gains rates. Rates are likely to increase but unlikely to do so until 2011. If rates go up, tax deferral could be costly. So tread carefully if you're considering a deferral strategy such as the following:

Installment sale. An installment sale allows you to defer gains on most assets other than publicly traded securities by spreading gain over several years as you receive payments. **Warning:** Ordinary gain, including certain depreciation recapture, is recognized in the year of sale, even if no cash is received.

Like-kind exchange. Also known as a Section 1031 exchange, a like-kind exchange allows you to exchange one real estate investment property for another and defer paying tax on any gain until you sell the replacement property. **Warning:** Restrictions and significant risks apply. ■



BUSINESS

Tough times call for tough-minded planning

In today's economy, minimizing your business's tax burden is more necessary than ever to keep cash flowing and profits from drying up. But there are a multitude of economic and business considerations you need to keep in mind along with your tax-saving objectives. So, to help you choose the best path, here are some strategies to check out with your advisor.

Appreciate depreciation

For assets with a useful life of more than one year, you generally must depreciate the cost over a period of years. In most cases you'll want to use the Modified Accelerated Cost Recovery System (MACRS), instead of the straight-line method, to get a larger deduction in the early years of an asset's life.

But if you make more than 40% of the year's asset purchases in the last quarter, you could be subject to the typically less favorable mid-quarter convention. Careful planning during the year can help you maximize depreciation deductions in the year of purchase.

Other depreciation-related breaks and strategies are also available:

Section 179 expensing election. The American Recovery and Reinvestment Act of 2009 (ARRA) extends the \$250,000 first-year Sec. 179 expensing amount through 2009. Business owners can use the Sec. 179 election to deduct (rather than depreciate over a number of years) the cost of purchasing such things as new equipment, furniture and off-the-shelf computer software.

You can claim the election only to offset net income, not to reduce it below zero.

Also, because this tax break is designed to benefit primarily smaller businesses, it begins to phase out dollar for dollar when total asset acquisitions for the tax year exceed \$800,000.

50% bonus depreciation. Also restored by ARRA, this provision offers a special allowance for certain property, generally if acquired and put into service in 2009. The special depreciation amount is equal to 50% of the property's adjusted basis. Eligible property includes:

- Tangible property with a recovery period of 20 years or less,
- Computer software,
- Water utility property, and
- Qualified leasehold improvement property.

Bonus depreciation isn't subject to any asset purchase limits, so businesses ineligible for Sec. 179 expensing can take advantage of it. And businesses that qualify for Sec. 179 expensing can take bonus depreciation on asset purchases in excess of the \$250,000 Sec. 179 limit. Of course, they'll also want to keep in mind the \$800,000 Sec. 179 phaseout threshold.

Leasehold and restaurant improvements. Accelerated depreciation for leasehold and restaurant improvements is available through 2009. It allows a shortened recovery period of 15 years — rather than 39 — for qualified leasehold and restaurant improvements. New this year, the provision also covers certain new construction for qualified restaurant property and improvements to retail space.

Tax Law Change Alert

NOL carryback period temporarily expanded

Who's affected: Small businesses with gross receipts of \$15 million or less.

Key changes: Generally, a net operating loss (NOL) may be carried back two years to generate a current tax refund. For 2008 (not 2009), the American Recovery and Reinvestment Act of 2009 (ARRA) allows you to elect to carry back an NOL resulting from a qualifying small business loss for up to five years. Any loss not absorbed in the carryback period is then carried forward for up to 20 years.

Planning tips: Carrying back an NOL and receiving a current tax refund may provide a needed influx of cash in tough times. But waiving the carryback period and carrying the entire loss forward may be beneficial if your marginal tax rate in the carryback years is unusually low, or if the alternative minimum tax (AMT) in prior years makes the carryback less beneficial. The election to waive the carryback period must be made by the due date of the tax return (plus extensions) for the year in which the NOL arose.

Cost segregation study. If you've recently purchased or built a building or are remodeling existing space, consider a cost segregation study:

- It identifies property components and related costs that can be depreciated over five or seven years using 200% of the straight-line rate, or over 15 years using 150% of the straight-line rate.
- You can depreciate the property much faster and dramatically increase your current deductions. (See Case Study 3.)
- Typical assets that qualify include decorative fixtures, security equipment, parking lots, landscaping, and architectural fees allocated to qualifying property.

The benefit of a cost segregation study may be limited in certain circumstances — for example, if the business is subject to the alternative minimum tax (AMT) or located in a state that doesn't follow federal depreciation rules.

Project your income

Projecting your business's income for this year and next will allow you to time income and deductions to your advantage. It's generally better to defer tax. So if you expect to be in the same or a lower tax bracket next year, consider:

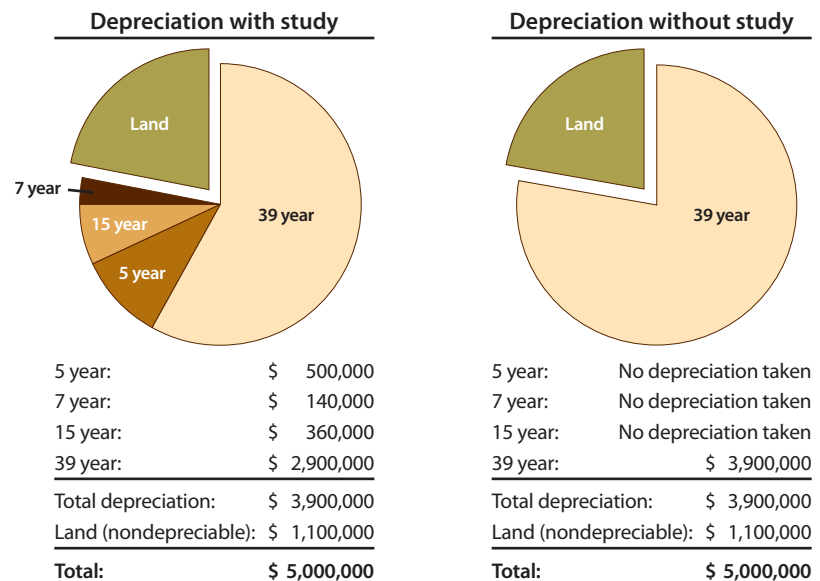
Deferring income to next year. If your business uses the cash method of accounting, you can defer billing for your products or services. Or, if you use the accrual method, you can delay shipping products or delivering services.

Accelerating deductions into the current year. If you're a cash-basis taxpayer, consider making an estimated state tax payment before Dec. 31, so you can deduct it this year rather than next, but consider the AMT consequences. Both cash- and accrual-basis taxpayers can charge expenses on a credit card and deduct them in the year charged, regardless of when paid.

Case Study 3

Cost segregation study can accelerate depreciation

Assume your business spends \$5 million to purchase land and a building, and the income tax bracket is 40% federal and state combined. A hypothetical example of the potential difference in resulting depreciation "lives" with vs. without a cost segregation study might be the following:



Every business and every building is different, and only a qualified team of professionals can help you evaluate whether your situation is a candidate for such a study.

Warning: Think twice about these strategies if you're experiencing a low-income year. Their negative impact on your cash flow may not be worth the potential tax benefit. And, if it's likely you'll be in a higher tax bracket next year, the opposite strategies (accelerating income and deferring deductions) may save you more tax.

Tap into tax credits

Tax credits reduce your business's tax liability dollar-for-dollar. So they're particularly valuable.

The Research and Development credit, available through 2009 but likely to be extended or made permanent, generally is equal to a portion of qualified research expenses. The credit is complicated to calculate, so consult your tax advisor.

The Work Opportunity credit, available through Aug. 31, 2011, benefits businesses hiring employees from certain disadvantaged groups, such as ex-felons, food stamp recipients and disabled veterans. ARRA expands the eligible groups to include unemployed veterans and disconnected youth, generally if hired in 2009 or 2010. The credit equals 40% of the first \$6,000 of wages paid to qualifying employees (\$12,000 for wages paid to qualified veterans).

Check out the manufacturers' deduction

The manufacturers' deduction, also called the Section 199 or domestic production activities deduction, for 2009 is 6% of the lesser of qualified production activities income or taxable income. In 2010, when

Stimulus act provides a variety of new breaks

Who's affected: Many businesses and their owners.

Key changes: The American Recovery and Reinvestment Act of 2009 (ARRA) expands and extends many tax breaks for businesses. But it also provides businesses with some new breaks.

The act reduces the estimated tax payment requirements for many small-business owners for 2009. To avoid penalties, taxpayers generally need to make sure their estimated payments or withholding equals at least 90% of their tax liability for the current year or 110% of the prior year's tax — 100% if their adjusted gross income (AGI) for the prior year was \$150,000 or less. Under ARRA, the 110% — or 100% — becomes 90% for qualifying business owners. Owners generally will qualify for the reduced payments if their AGI for 2008 was less than \$500,000 and if more than 50% of their 2008 gross income was generated from a "small business," which is defined as a business that, on average, had fewer than 500 employees during 2008.

In certain situations, ARRA also allows businesses to defer cancellation-of-debt income (CODI) generated from repurchasing business debt until calendar year 2014. They must then report the income ratably over the 2014 through 2018 tax years. Taxpayers generally must recognize CODI when they cancel — or repurchase — debt for an amount less than its adjusted issue price. CODI is the excess of the old debt's adjusted issue price over the repurchase price.

Finally, ARRA shortens the S corporation built-in gains period. Although a C corporation conversion to an S corporation isn't a taxable event, the S corporation normally must avoid recognizing built-in gains for 10 years to avoid tax on any built-in gains that existed at the time of the conversion. Under ARRA, for tax years beginning in 2009 and 2010, there generally will be no tax on an S corporation's net unrecognized built-in gain if the seventh tax year in the recognition period occurred before the 2009 and 2010 tax years.

Planning tips: Work with your tax advisor to ensure you take advantage of every ARRA benefit you're entitled to.

it's fully phased in, the deduction generally will be 9%. The deduction is further limited by W-2 wages paid by the taxpayer. Wages not allocable to domestic production gross receipts are excluded from W-2 wages for the purposes of the deduction.

The deduction is available to traditional manufacturers and to businesses engaged in activities such as construction, engineering, computer software production and agricultural processing. The deduction isn't allowed in determining net earnings from self-employment and generally can't reduce net income below zero. But it can be used against the AMT.

Look into auto tax breaks

Your business vehicle can save you taxes in a number of ways. However, you must

abide by strict recordkeeping rules and keep a contemporaneous log of business vs. personal miles. Vehicle expenses can be deducted using the mileage method (55 cents per business mile driven in 2009) or the actual method (total out-of-pocket expenses for fuel, insurance and repairs, plus depreciation).

If you own or lease hybrid and lean-burn-technology vehicles, you may be able to claim tax credits worth up to \$3,400 for cars and light trucks. Heavier vehicles also may be eligible for a credit.

Under Sec. 179 expensing, you can deduct up to \$25,000 of the purchase price of a new SUV or truck that weighs between 6,000 and 14,000 pounds. For passenger automobiles eligible under the 50% bonus

depreciation rules, the first-year limit on depreciation is increased by \$8,000.

Provide employee benefits

Including a variety of benefits in your compensation package can help you not only attract and retain the best employees, but also manage your tax liability:

Qualified deferred compensation plans.

These include pension, profit-sharing, SEP and 401(k) plans, as well as SIMPLEs. You can enjoy a tax deduction for your contributions to employees' accounts, and the plans offer tax-deferred savings benefits for employees. (For more on the benefits to employees, see page 12.)

HSAs and FSAs. If you provide employees with qualified high-deductible health insurance, you can also offer them Health Savings Accounts (HSAs). Regardless of the type of health insurance you provide, you also can offer Flexible Spending Accounts (FSAs). (See page 3.)

Fringe benefits. Some fringe benefits, such as group term-life insurance (up to \$50,000), health insurance, parking and employee discounts, aren't included in employee income. Yet the employer still receives a deduction and typically avoids payroll tax as well.

NQDC. Nonqualified deferred compensation (NQDC) plans generally aren't subject to nondiscrimination rules, so they can be used to provide substantial benefits to key employees. The employer generally doesn't get a deduction for NQDC plan contributions until the employee recognizes the income. This is unlike a qualified plan, such as a 401(k), in which the employer normally deducts the contribution in the year it's made, even though the employee doesn't typically recognize income until he or she withdraws the funds.

Look at business structure

Income taxation and owner liability are the main factors that differentiate one business

structure from another. Many businesses choose entities that combine flow-through taxation with limited liability, namely limited liability companies (LLCs) and S corporations. (See Chart 1 to compare the tax treatment for pass-through entities vs. C corporations.) Sometimes it makes sense to change business structures, but there may be unwelcome tax consequences, so be sure to consult your tax advisor.

Some tax differences between structures may provide planning opportunities, such as those related to salary vs. distributions:

S corporations. To reduce their employment tax, shareholder-employees may want to keep their salaries relatively low and increase their distributions of company income (which generally isn't taxed at the corporate level). **Warning:** The IRS expects shareholder-employees to take a reasonable wage each year. What's considered "reasonable" is determined by the specific facts and circumstances.

C corporations. Shareholder-employees may prefer to take more income as salary (which is deductible at the corporate level) because the overall tax paid by both the corporation and the shareholder-employee may be less.

Make a tax-smart exit

All business owners should create an exit strategy to sell their companies or to pass

Chart 1
Tax differences based on business structure

Pass-through entity	C corporation
One level of taxation: The business's income flows through to the owners.	Two levels of taxation: The business is taxed on income, and then shareholders are taxed on any dividends they receive.
Losses flow through to the owners. Owners may realize current tax savings by taking any losses individually. However, there may be limitations due to basis.	Losses remain at the corporate level and are carried forward to offset future corporate-level income.
Top individual tax rate is 35%.	Top corporate tax rate is generally 35% ¹ . Income distributed as dividends is taxed a second time, generally at 15%.

¹ See Chart 4 on page 16 for exceptions.

them on to their children, other family members or key employees. Potential tax consequences are one of the many factors to consider if you're selling the business:

Asset vs. stock sale. With a corporation, sellers typically prefer a stock sale for the capital gains treatment and to avoid double taxation. Buyers generally want an asset sale to maximize future depreciation write-offs.

Taxable sale vs. tax-deferred transfer. A transfer of ownership of a corporation can be tax-deferred if made solely in exchange for stock or securities of the recipient corporation in a qualifying reorganization, but the transaction must comply with strict rules. Although it's generally better to postpone tax, there are some advantages to a taxable sale:

- The seller doesn't have to worry about the quality of buyer stock or other business risks that might come with a tax-deferred transfer.
- The buyer benefits by receiving a stepped-up basis in its acquisition's assets and not having to deal with the seller as a continuing equity owner, as it would in a tax-deferred transfer.
- The parties don't have to meet the technical requirements of a tax-deferred transfer.

Installment sale. If a taxable sale is chosen, the transaction may be structured as an installment sale, due to the buyer's lack of sufficient cash or the seller's desire to spread the gain over a number of years. Installment sales are also useful when the buyer pays a contingent amount based on the business's performance. But an installment sale can backfire. For example:

- Depreciation recapture must be reported as gain in the year of sale, no matter how much cash the seller receives.
- If tax rates increase in the future, the overall tax could wind up being more on an installment sale than on a cash sale. (Remember, the favorable 15% rate on long-term capital gains is scheduled to end Dec. 31, 2010.)

Tax breaks for the self-employed

If you're self-employed, you can deduct 100% of health insurance costs for yourself, your spouse and your dependents. This above-the-line deduction is limited to the net income you've earned from your trade or business. Half of the self-employment tax you pay on your self-employment income and all contributions you make to a retirement plan and HSA for yourself are also deducted above-the-line. And you may be able to deduct home office expenses against your self-employment income. ■





RETIREMENT

It's not just the money you save, it's the tax

Whether you're about to retire or decades away from it, you need to decide whether you want a tax-deferred plan or a plan that offers tax-free distributions — or both. Whatever you choose, follow IRS rules to avoid penalties and other negative consequences.

Defer to your employer's plan

Because of the tax advantages, contributing to an employer-sponsored retirement plan, such as a 401(k), 403(b), 457, SARSEP or SIMPLE, is usually the best first step in retirement planning:

- Contributions are generally pretax, so they reduce your taxable income.
- Plan assets can grow tax-deferred — meaning you pay no income tax until you take distributions.
- Your employer may match some or all of your contributions — also on a pretax basis.

Chart 2 shows the 2009 limit for employee contributions to 401(k), 403(b), 457 and SARSEP plans. If you're age 50 or older, you may be able to make an additional "catch-up" contribution. If your employer offers a match, contribute at least the amount necessary to get the maximum employer match and avoid missing out on that free money.

Unfortunately, many employers (if their plan allows) are suspending matching contributions this year to reduce costs in our troubled economy. If yours is among them, don't use that as an excuse to suspend your own contributions. Doing so will only

exacerbate the negative impact on your retirement nest egg — plus your taxable 2009 income will increase compared to what it would be if you had contributed to the plan.

If your employer provides a SIMPLE, it's required to make contributions (though not necessarily annually). But the employee contribution limits are lower than for other employer-sponsored plans. (Also see Chart 2.)

In certain situations, other tax-deferred savings options may be available:

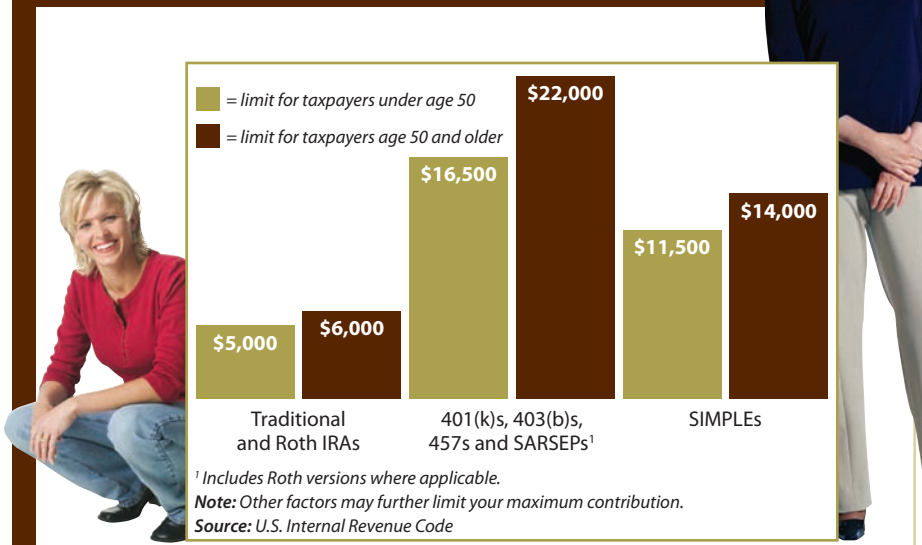
If you're a business owner or self-employed.

You may be eligible for a plan that would allow much larger contributions. Depending on the plan, you might not have to make 2009 contributions, or even set up the plan, before year end. Check with your tax advisor for details.

If your employer doesn't offer a retirement plan.

Consider a traditional IRA. You can likely deduct your contributions, though your deduction may be limited based on your adjusted gross income (AGI) if your spouse participates in an employer-sponsored plan. You can make 2009 contributions as late as April 15, 2010.

Chart 2
What's your 2009 retirement plan contribution limit?



Consider tax-free opportunities

A potential downside of tax-deferred saving is that you'll have to pay taxes when you make withdrawals at retirement. Two retirement plan options allow tax-free distributions; the tradeoff is that contributions to these plans don't reduce your current-year taxable income:

1. Roth IRAs. In addition to tax-free distributions, an important benefit is that, unlike other retirement plans, Roth IRAs don't require you to take distributions during your lifetime. This can provide income tax and estate planning advantages.

But Roth IRAs are subject to the same relatively low annual contribution limit as traditional IRAs — the lesser of your compensation for the year or \$5,000 (\$6,000 if you're age 50 or over by the end of the year), reduced by annual contributions to a traditional IRA. Your Roth IRA contribution may be further limited based on your AGI.

If you have a traditional IRA, consider whether you might benefit from converting it to a Roth IRA. You must generally pay tax on the conversion, but you can enjoy tax-free distributions in the future. 2009 may be a good year to do so, because asset values are likely low and thus the tax cost of a conversion would be lower.

But you can make the conversion only if your 2009 AGI is \$100,000 or less. This limit is scheduled to be eliminated beginning in 2010, so if your AGI is too high this year, start thinking about whether you should convert next year.

2. Roth 401(k)s and Roth 403(b)s. If you participate in a 401(k) or 403(b) plan and the plan allows it, you may designate some or all of your contributions as Roth contributions. (Employer matches, however, aren't eligible to be treated as Roth contributions.) There are no AGI limits on designating Roth 401(k) contributions, so

Tax Law Change Alert

RMD rules suspended for 2009

Who's affected: Seniors and others who otherwise would have to take required minimum distributions (RMDs) from their retirement plans in 2009.

Key changes: The Worker, Retiree and Employer Recovery Act of 2008 (WRERA) suspends the RMD excise tax for 2009 for IRAs (including inherited IRAs) and defined contribution plans, including 401(k), 403(b) and 457 plans. Normally, once you reach age 70½ (or inherit an IRA), you must take annual RMDs. If you don't comply, you can owe a penalty equal to 50% of the amount you should have withdrawn but didn't.

The new law gives taxpayers otherwise subject to the RMD rules the option to keep funds in their plans for another year without incurring a tax penalty — providing time for their investments to perhaps recoup recent losses. Many seniors have been particularly hard hit, because those having to take RMDs in 2008 had to base their withdrawals on Dec. 31, 2007, values — which in many cases were considerably higher than current ones. This provision applies regardless of the retirement plan's account balance or whether the plan has incurred any losses.

Planning tips: If you're subject to the RMD rules, consider whether you can benefit from reducing or skipping your 2009 distribution. Your tax advisor can help you crunch the numbers to determine the wisest course of action.

these plans may be especially beneficial for taxpayers who are ineligible to contribute to Roth IRAs because of their AGIs.

Watch out for early distributions

If you're facing severe financial challenges this year, it may be tempting to make withdrawals from your retirement plans. But this generally should be a last resort. With a few exceptions, retirement plan distributions made before age 59½ are subject to a 10% penalty, in addition to income tax.

That means that, if you're in the top tax bracket of 35%, you can lose close to half of your withdrawal to taxes and penalties. Even if you're in a lower bracket, you'll lose a substantial amount to taxes and penalties. Additionally, you'll lose all the potential future growth on the amount you've withdrawn.

If you must make an early withdrawal and you have a Roth account, you may be better off withdrawing from that. You can withdraw up to your contribution amount free of tax and penalty. Another option to consider if your employer-sponsored plan allows it is a plan loan. You'll have to

pay it back with interest, but you won't be subject to current tax or penalty. Keep in mind that, with both these options, you'll still be losing out on the potential for tax-advantaged growth on those assets.

Early distribution rules are also important to be aware of if you change jobs and receive a lump-sum distribution from your employer's retirement plan. To avoid the early-withdrawal penalty and other negative income tax consequences, request a direct rollover of your retirement plan assets to either your IRA or your new employer's retirement plan.

If the funds from the old plan are instead paid to you, you'll need to make an indirect rollover to your IRA or new plan within 60 days to avoid the tax and potential penalty on those funds. **Warning:** Be careful to roll over the *gross* amount of the distribution. The check you receive from your old plan may be net of federal income tax withholding. If you don't roll over the gross amount, you'll likely be subject to income tax, and potentially the 10% penalty, on the difference. ■



ESTATE PLANNING

Make sure your heirs inherit your wealth

Yes, death and taxes are inevitable. But that doesn't mean they have to go together. By taking advantage of all the exemptions, deductions and estate planning strategies available, you can leave the legacy you desire to your loved ones, not Uncle Sam.

Take steps to cut taxes

The top gift and estate tax rates and the generation-skipping transfer (GST) tax rate are currently 45%. As of this writing, the estate and GST taxes are scheduled to be repealed for 2010 only, while the gift tax is set to remain in place that year, albeit at a lower rate.

However, it's expected that the repeal will be repealed, and rates might remain at 2009 levels. (Check with your tax advisor for the latest information.) So taking steps to minimize these taxes is as important as ever. Fortunately, some exemptions, exclusions and deductions are available to help you do just that:

Gift and estate tax exemptions. During your lifetime, the gift tax exemption allows you to transfer up to \$1 million of taxable gifts without paying gift tax. At death, transfers up to the estate tax exemption amount minus any gift tax exemption used can be made free of estate tax. For 2009, the estate tax exemption amount is \$3.5 million. (See the Tax Law Change Alert.)

Annual gift tax exclusion. You can exclude certain gifts of up to \$13,000 per recipient each year (\$26,000 per recipient if your spouse elects to split the gift with you,

or you're giving community property) without using up any of your gift tax exemption. If you gift more than \$13,000 during the year to one person, you must file a gift tax return, even if no tax is due.

Unlimited marital deduction. Your estate generally can deduct the value of all assets that pass from you to your spouse at your death, provided your spouse is a U.S. citizen.

GST tax exemption. The GST tax applies to transfers (both during life and at death) made to people two generations or more below you, such as grandchildren. For 2009, the GST tax exemption is \$3.5 million. (See the Tax Law Change Alert.)

Charitable deduction. There's no limit on this deduction. If you bequeath your entire estate to charity, no estate tax will be due. (For more on charitable giving, see "Give to your favorite charity" on page 3.)

Warning: State gift and estate tax laws vary, so state tax could be due even when there's no federal liability.

Start giving now

One way to reduce your taxable estate is to start giving away assets now. Consider maximizing your annual exclusion gifts (see Case Study 4) and perhaps also using part or all of your \$1 million gift tax exemption. Here are some additional strategies for tax-smart giving:

Choose gifts wisely. Take into account both estate and income tax consequences and the economic aspects of any gifts you'd like to make. For example, to minimize *your estate tax*, gift property with the greatest future

Tax Law Change Alert

Estate and GST tax exemptions increase in 2009

Who's affected: Anyone concerned about estate and generation-skipping transfer (GST) taxes.

Key changes: Under 2001 tax legislation, the estate and GST tax exemptions have both gone up to \$3.5 million for 2009 from \$2 million in 2008. As of this writing, after the estate and GST tax repeal scheduled for 2010 (see main article), the exemptions are set to drop significantly for 2011, though legislation this year might extend (and perhaps increase) the \$3.5 million exemptions.

Planning tips: Don't take a wait-and-see attitude about reviewing your estate plan; review it now. Depending on how your plan is set up, it may require updates to avoid unexpected and undesirable results. Plus, with proper planning, you can make the most of the increased exemptions.

Case Study 4

Gifts now mean estate tax savings later

The annual gift tax exclusion can be a powerful tool. Just look at how much a married couple giving to two children and their spouses and four grandchildren can remove from their estates tax-free: \$208,000.



\$26,000 each =
\$130,000



\$26,000 each =
\$78,000



appreciation potential. In fact, an upside of the down economy is that reduced asset values can allow you to transfer more shares at a lower tax cost, removing more potential future appreciation from your estate.

To minimize *your beneficiary's income tax*, gift property that hasn't already appreciated significantly since you've owned it.

And if you want to minimize *your own income tax*, don't gift property that has declined in value. Instead sell the property so you can take the tax loss and then gift the sale proceeds.

Plan gifts to grandchildren carefully.

Annual exclusion gifts are generally exempt from the GST tax, so they also help you preserve your GST tax exemption for other transfers. For gifts that don't qualify for the exclusion to be completely tax free, you must apply both your GST tax exemption and your gift tax exemption.

So, for example, if you already made an annual exclusion gift to your grandson for the year and you want to give him an additional \$30,000 to help him make a down payment on his first home, you'll

have to use \$30,000 of your GST tax exemption plus \$30,000 of your gift tax exemption to avoid any tax on the transfer.

Gift interests in your business. If you own a business, you can leverage your gift tax exclusions and exemption by gifting ownership interests, which may be eligible for valuation discounts. So, for example, if the discounts total 30%, you can gift an ownership interest equal to as much as \$18,571 tax free because the discounted value doesn't exceed the \$13,000 annual exclusion in 2009. But the IRS may challenge the value; a professional appraisal is strongly recommended.

Also, as of this writing legislation has been proposed that would eliminate discounts for family transfers. So if you're considering such gifts, you may want to make them now. But first check with your tax advisor for the latest information.

Gift FLP interests. If you don't own a business but you'd like to benefit from valuation discounts, you can set up a family limited partnership (FLP). You fund the FLP and then gift limited partnership interests. Again, there's some uncertainty whether discounts for such transfers will remain available. Also,

the IRS is scrutinizing FLPs, so make sure you set up and operate yours properly.

Pay tuition and medical expenses. You may pay these expenses for a loved one without the payment being treated as a taxable gift, as long as the payment is made directly to the provider.

Consider trusts and insurance

Trusts can provide significant tax savings while preserving some control over what happens to the transferred assets. Here are some trusts you may want to consider:

- A credit shelter (or bypass) trust can help minimize estate tax by taking advantage of both spouses' estate tax exemptions.
- A qualified domestic trust (QDOT) can allow a non-U.S.-citizen spouse to benefit from the unlimited marital deduction.
- A qualified terminable interest property (QTIP) trust is good for benefiting first a surviving spouse and then children from a prior marriage.
- A qualified personal residence trust (QPRT) allows you to give your home to your children today — removing it from your taxable estate at a reduced tax cost (provided you survive the trust's term) — while you retain the right to live in it for the trust's term.
- A grantor-retained annuity trust (GRAT) works similarly to a QPRT but allows you to transfer other assets; you receive payments from the trust for a certain period.
- A GST or dynasty trust can help you leverage your GST tax exemption.

Along with protecting your family's financial future, life insurance can be used to pay estate taxes, equalize assets passing to children who aren't involved in a family business, or pass leveraged funds to heirs free of estate tax. Proceeds are generally income tax free to the beneficiary. And with proper planning, you can ensure proceeds are not included in your taxable estate. ■

TAX RATES

Chart 3
2009 individual income tax rate schedules

Regular tax brackets				
Tax rate	Single	Head of household	Married filing jointly or surviving spouse	Married filing separately
10%	\$ 0 – \$ 8,350	\$ 0 – \$ 11,950	\$ 0 – \$ 16,700	\$ 0 – \$ 8,350
15%	\$ 8,350 – \$ 33,950	\$ 11,950 – \$ 45,500	\$ 16,700 – \$ 67,900	\$ 8,350 – \$ 33,950
25%	\$ 33,950 – \$ 82,250	\$ 45,500 – \$ 117,450	\$ 67,900 – \$ 137,050	\$ 33,950 – \$ 68,525
28%	\$ 82,250 – \$ 171,550	\$ 117,450 – \$ 190,200	\$ 137,050 – \$ 208,850	\$ 68,525 – \$ 104,425
33%	\$ 171,550 – \$ 372,950	\$ 190,200 – \$ 372,950	\$ 208,850 – \$ 372,950	\$ 104,425 – \$ 186,475
35%	Over \$ 372,950	Over \$ 372,950	Over \$ 372,950	Over \$ 186,475

AMT brackets				
Tax rate	Single	Head of household	Married filing jointly or surviving spouse	Married filing separately
26%	\$ 0 – \$ 175,000	\$ 0 – \$ 175,000	\$ 0 – \$ 175,000	\$ 0 – \$ 87,500
28%	Over \$ 175,000	Over \$ 175,000	Over \$ 175,000	Over \$ 87,500

AMT exemption				
	Single	Head of household	Married filing jointly or surviving spouse	Married filing separately
Exemption	\$ 46,700	\$ 46,700	\$ 70,950	\$ 35,475
Phaseout ¹	\$ 112,500 – \$ 299,300	\$ 112,500 – \$ 299,300	\$ 150,000 – \$ 433,800	\$ 75,000 – \$ 216,900

¹ The alternative minimum tax (AMT) income ranges over which the exemption phases out and only a partial exemption is available. The exemption is completely phased out if AMT income exceeds the top of the applicable range.

Note: Consult your tax advisor for AMT rates and exemptions for children subject to the kiddie tax.

Source: U.S. Internal Revenue Code

Chart 4
2009 corporate income tax rate schedule

Tax rate	Tax bracket
15%	\$ 0 – \$ 50,000
25%	\$ 50,001 – \$ 75,000
34%	\$ 75,001 – \$ 100,000
39%	\$ 100,001 – \$ 335,000
34%	\$ 335,001 – \$10,000,000
35%	\$10,000,001 – \$15,000,000
38%	\$15,000,001 – \$18,333,333
35%	Over \$18,333,333

Note: Personal service corporations are taxed at a flat 35% rate.

Source: U.S. Internal Revenue Code



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