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CLIENT UPDATE

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U.S. Economy

Business Investment won't storm back in 2010, despite recent indications of a pickup in the service sector as well as rising factory orders and production. At best a sliver of growth in business spending: 1% or so. Still, after falling by 17% this year, business investment that is flat should come as a welcome respite. Spending dropped off a cliff early this year, shrinking nearly 40% in the first quarter and an additional 11% in the second. We expect the second half to be down 6%.

Why no rebound after such a serious decline? Too many empty buildings, offices, stores, and warehouses mean no resurgence in construction investment. And little spending on software and equipment till consumers perk up.

Flat sales this holiday season are about the best retailers can hope for. Little to cheer about, but better than the 3% drop during last year's big sales period. There's reason to expect a prettier profits picture, though. Retail firms have been restraining orders all year, trying to avoid price and profit slashing. 2009 import container volume, much of which is consumer goods headed to stores, is down much more than lower sales can account for, indicating tighter inventories.

Sellers won't loosen the supply reins just because Santa's coming to town. In addition, unit sales are likely to head higher, despite flat dollar figures for sales, as consumers focus on lower priced products and store traffic starts to pick up.

Note that slim holiday inventories will keep suppliers on their toes. Brand owners are demanding lower minimum order requirements from vendors to match retailers' smaller requests for products. Suppliers are also being asked to be ready to ship additional products within days if retailers start to run short. Sourcing in Central America rather than Asia is more attractive as a result.

The Kiplinger Letter, September 11, 2009

Top 1% of Income Tax Filers Carried More Than 40% of Tax Burden

According to IRS statistics, the top 1% earned about 22.8% of all the income earned in the U.S. in 2007 (the latest year for statistics) and reported adjusted gross income (AGI) over \$410,096. They paid 40.4% of federal income taxes paid by all individuals. This is the first time that the top 1% paid more than 40% of all federal individual income taxes. This is more than the taxes paid by the bottom 95% of tax filers.

The top 0.1%, or 141,071 tax returns, accounted for almost 12% of AGI earned by individuals in 2007. These filers paid over 20% of all U.S. individual income tax for that year. The average taxable income for the 0.1% group was \$7.4 million, their average AGI was \$2,155,365, and their average income tax was \$1.6 million, which is an effective rate of 21.5%.

Despite the perception that the tax burden on the wealthiest individuals has declined because of Bush tax cuts, the tax burden on the wealthy has actually been growing over the years—up almost 20% on the top 1% of filers between 2001 and 2007.

J.K. Lasser's Monthly Tax Letter, September 2009

Deductions for Home Equity Loan Interest

If you borrowed against your home for business or investment purposes, a special election can save you taxes. Say you took out a second mortgage for \$75,000, used the funds to buy business equipment, and later tapped \$50,000 of home equity for personal expenses. Oops. The law allows deducting interest on no more than \$100,000 of home-equity debt, unless the money is used for home improvements. Don't worry. You can elect to treat the first \$75,000 you took out as business debt, not mortgage debt. The \$100,000 limit doesn't cover business or investment debt, and by making this election, you bring your home-equity borrowing below the cap, so all interest that you pay is tax-deductible.

Kiplinger's Personal Finance Adviser, September 2009

Internet Tech

Big businesses will shell out big bucks for custom internet names in the next few years, as hundred of new suffixes become available. Domain names such as .dupont, .amex, .green and .wine will supplement .com, .gov and others already in use. ICANN, the nonprofit that acts as the traffic controller on such matters, will try to award names to logical recipients, such as giving .realtor to the National Association of Realtors, for example. Owners can then dole out names within the domain as they see fit. The cost to lock up such a domain name: \$185,000.

The Kiplinger Letter, September 11, 2009

Energy

After years of wafer thin U.S. refinery capacity and periodic shortages, the opposite situation is likely to be true by the middle of the next decade. Why? A variety of government initiatives, from increased fuel efficiency standards for cars to mandatory use of renewable fuels, will succeed in cutting gasoline demand.

So little or no need for gasoline imports by the middle of the next decade. Foreign produced gasoline now accounts for one in every nine gallons used in the U.S. In fact, at slack times, U.S. refiners, which operate some of the world's most efficient and advanced fuel making plants, are likely to seek export markets for their product.

The shift should help keep a lid on prices. At present, most gasoline imports come from Europe, and the long ocean journey, then carriage by truck from port to storage facilities, adds to the cost, effectively setting a floor under U.S. prices. Some imports could still be required to meet demand at peak driving periods, typically late spring through July 4. But closer, cheaper sources, Caribbean and Canadian refineries, have enough capacity for that. No need to turn to Europe.

The Kiplinger Letter, September 11, 2009

No Penalty Break for Hardship Withdrawals from Retirement Account

When withdrawals are taken from IRAs and qualified retirement plans before age 59 ½, they are subject to a 10% early withdrawal penalty unless an exception to the penalty applies. In a recent case the Tax Court reiterated that there is no exception to the penalty for financial hardship.

The case involved a nurse in a VA hospital in Georgia who tapped into his government retirement plan (a plan that essentially is a 401(k) plan) when he went on leave because of mental health issues; he was diagnosed with post-traumatic stress disorder, depressive disorder, and bipolar type II, depressed.

Initially, he was put on light duty for one month but then was restricted to light duty for six months. He was accused of failing to perform his job adequately and was suspended from work without pay. He was later transferred but failed to report to the new work location. He then requested retirement because of disability and his classification under the Federal Employee Retirement System (FERS) was "disability retirement." While he was still employed, he took a \$158,310 financial hardship distribution from FERS as an in-service withdrawal. At this time, he was under age 59 ½. The IRS charged him with a 10% early withdrawal penalty. He argued that he did not owe the penalty because he took the distribution as a financial hardship; alternatively, he argued that he took the distribution when he was disabled.

The Tax Court rejected both arguments. The Tax Code (Section 72(t)(2)) does



not allow an exception for financial hardship. In this case, the taxpayer could not use the disability exception to the penalty because he did not meet its strict requirements. To be disabled for purposes of the exception to the penalty, an individual must be "unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration." What's more, it's up to the individual to furnish proof of disability.

In this case, while on disability from his nursing position with the VA, he continued to manage his family's farm in Minnesota and rental property in Georgia. One month after leaving the VA, he took a full-time nursing position with the State of Georgia. Thus, he engaged in substantial gainful activity and was not disabled.

J.K. Lasser's Monthly Tax Letter, September 2009

Roth IRAs Go Upscale

The handcuffs are about to come off high-income earners who want to convert traditional IRAs to Roth accounts. Until the end of this year, switches are permitted only for folks with adjusted gross income of \$100,000 or less—a limit that applies to both married couples and singles. On January 1, that restriction vanishes. The downside of a conversion is that you owe tax on the amount moved to the Roth. The upside? Roth withdrawals after age 59 ½ are tax-free, while regular IRA payouts are fully taxable in your top bracket. A conversion basically transforms future earnings from tax-deferred to tax-free status. To encourage 2010 conversions, Congress even offers extra time to pay the tab: Half the extra income can be reported on 2011 returns filed in 2012 and the rest on 2012 forms filed in 2013.

Kiplinger's Personal Finance Adviser, September 2009