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Your April 15, 2011 Tax Return: It's Not Too Late to Plan

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There are eight weeks left in 2010. Then April 15, 2011, the due date for personal income tax returns, looms ahead. Is it too late now to take steps to significantly reduce your income tax liability?

Newsletters and the popular press contain many recommendations related to the expected differences between 2010 and 2011 tax rates: the top federal bracket on ordinary income in 2010 is 35 percent and will go to 39.6 percent in 2011; the capital gains tax rates are zero percent and 15 percent in 2010, going to 10 percent and 20 percent in 2011. Therefore, taxpayers are advised to accelerate ordinary income, e.g., bond interest, annuity income, traditional IRA income, and compensation into 2010 if they expect to be in a higher bracket in the future. Similarly, taxpayers are advised to sell appreciated property and recognize the taxable gain in 2010. Of course, the impact of the recent elections on tax rates is unknown.

Individual taxpayers should also consider: oil and gain investments, because intangible drilling costs provide a large immediate income tax deduction (up to 85 percent of the initial investment); loss harvesting using the "similar stock" strategy or a cashless collar to avoid the "wash sale" rule; and converting from a traditional to a Roth IRA so that future distributions are tax free.

However, there are at least three deductions worth considering that have the potential to make a large difference in your April 15, 2011, return.

The safest, most flexible deduction in the Internal Revenue Code, available to the owner of a closely held business, is a contribution to a tax qualified employee retirement plan. Not an IRA. And if you wish a large deduction, not $45,000, but $245,000 or even $545,000, it must be a defined benefit pension plan. Every closely held business is a candidate to adopt a defined benefit pension plan. Why don't more do so? Here are some of the usual objections.

First, "it is expensive to maintain." Not true. For a corporation with two owners and four employees, the cost of a third party administrator is in the range of $2,500 to $4,500 per year. That is cost-effective for a deduction that might be 100 times as much. Second, "it is too expensive to cover the rank and file employees." This is usually untrue. Defined benefit pension plans permissibly discriminate in favor of three types of people: those who are older, make more money and remain employed the longest. The owner-employee is likely to fall into all three categories. Third, "a [defined benefit pension plan] has an inflexible deduction structure." This is completely untrue. A deduction of $400,000 in the first year might, if the business cannot afford as much in the second year, be followed by a $40,000 deduction. There are many ways to modify the deductions required in a defined benefit pension plan. The list of objections - and responses - goes on. The key point is that if you have a closely held business and do not completely investigate this option, you are missing the chance for a large, safe deduction.

SPECIAL REPORT

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Thursday, May 12, 2011

Discipline
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Zoning, Planning and Use
The Curse of Chavez Ravine
Are the Dodgers' financial problems a case of delayed retribution for how Dodger Stadium came about? By **Gideon Kanner** of Loyola Law School

International
The Benefits of Bilateral Investment Treaties When Investing in China
Bilateral investment treaties operate as "free insurance" with its minimal costs and direct benefits. By **Allan Marson**, **Grant Hanessian**, and **Michiel Kloes** of Baker & McKenzie

Construction
What to Do With a Busted Project
Distressed real estate projects are getting a shot of much needed adrenaline from preferred equity. By **Anita F. Sabine** of O'Melveny & Myers LLP

Letter to the Editor
America Is a Fair Country
Leon Snaid responds to "Death of Osama bin Laden: Could There Have Been a Trial?"

Criminal
Panel Lawyers Could Be Curtailed
A committee of federal judges is considering whether to create a new "alternate" public defender's office in the Central District of California that would be independent of the existing institution.

Judge Bars Gang Injunction Enforcement
A federal judge has approved an unusual permanent injunction against the Orange County district attorney, barring him from enforcing a gang injunction won in state court against 48 people.

After defined benefit pension plans, consider a premium to an insurance company for a property and casualty policy. For small employers, this often takes the form of a payment to an association captive insurance company. A captive is an insurance company owned by a trade, industry or service group for the benefit of its members. This type of insurance company can insure risks not covered by existing policies, e.g., the deductibles on existing policies; coverage in excess of current policy limits; coverage for loss of key customers or key employees; loss of income due to change in legislation. These policies typically come with return of premium features, so if there are no claims, the premiums - less expenses - will be recoverable, typically in five years. At worst, this becomes an income deferral. An example of the best possible outcome was a client whose home was destroyed in the most recent Malibu fire, that received $2 million back from the captive as a tax-free casualty payment. Some employers can set up their own captive insurance companies. Vermont, with 900 captives, and Delaware, with a capitalization requirement of as little as $250,000, are popular jurisdictions. A captive can be established for as little as $60,000. It can also be owned by an irrevocable heirs' trust so as to potentially shift wealth to future generations.

Finally, a group of charitable structures can create large deductions. One is comparatively simple: transfer to charity now the right to your residence upon your death. For a 65 and a 62 year old with $1 million of equity, that will create a $626,000 current income tax deduction which, in a combined state and federal bracket of 45 percent, would save $282,000. The deduction can be used against up to 50 percent of adjusted gross income in the current year, and any excess can be carried forward for up to five additional years. Another example is a charitable remainder annuity trust. Assume the same 65 and 62 year old contribute $100,000 to a 20 year charitable remainder annuity trust. They retain a $5,000 distribution for themselves each year for 20 years and, at the end of the 20-year term, whatever is left goes to charity. The donors are entitled to a $21,000 income tax deduction, saving them $10,000 in income tax.

The last example is a grantor charitable lead annuity trust. Assume the same couple contributes $100,000 into a 10-year charitable lead annuity trust that distributes $6,000 per year to their favorite charity. At the end of the 10 years, the $100,000 comes back to the donors. The charitable deduction will be almost $54,000, saving them $24,000 in income tax. The donors will be taxed on the trust's income during the 10-year period, so the investments should generate as little taxable income as possible. However, this can be a terrific year-end income tax deduction.

In conclusion, although the end of the year is rapidly approaching, there is still time to carefully consider structures that will significantly reduce the tax you will need to pay on April 15, 2011.

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Judicial Profile
Making Her Mark
A framed reproduction of Botticelli's Calumny of Apelles hangs in U.S. Magistrate Judge Jennifer L. Thurston's chambers. The colorful painting, rich in allegory, depicts Slander dragging Innocence - the victim of false accusations by Envy,

Intellectual Property
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Despite some recent unfavorable court rulings, a Nevada company appears to be doubling down on its bet that suing hundreds of defendants for infringing the copyright of a Las Vegas newspaper is a winning strategy.

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