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December 10, 2010: Year End Tax Planning – There is Still Time to Get What You Want

New social acquaintances, hearing that I am a tax attorney, frequently comment that I must be extremely busy just before tax time. I find it surprising that the news that the end of the year is actually much more important shocks so many of them. However, for the majority of taxpayers, on top of everything else to think about at the end of the year, it is an important time for tax planning. While it may seem like the end of the year is too late for "planning," in reality there is usually still time to get what you want.

Our tax system is based on annual accounting periods or "tax years." While this concept started as administrative convenience, it forms a significant part of the landscape of tax planning. The majority of individuals use the calendar year for their tax year. Partnerships and S-corporations generally must use the tax year of their partners or shareholders, so they are frequently required to use the calendar year as well. C-corporations are freer to use a different fiscal years for their tax years, but generally must demonstrate a business purpose to do so. It is not normally possible to delay the end of the tax year to allow more time for tax planning. With few exceptions, changes to a taxpayer's tax year require IRS approval.[1] Even then, doing so does not delay the end of the current tax year, instead it frequently hastens it.[2] For calendar year taxpayers, December can be the most important month of the tax year. For taxpayers using other tax years, all of the same strategies still apply, just in a month other than December.

Due to the annual nature of our tax system, at the end of the tax year a difference of days can mean a difference of years paying the tax. Our tax system generally does not adjust for the time-value of money. This means that delaying income to a later year, or accelerating deductions and credits to an earlier year, is often good planning merely based on the interest or investment income that can be earned on the delayed

[1] I.R.C. § 442.

[2] Under I.R.C. § 443(a)(1) and Rev. Proc. 2002-39 §§ 4.06-.07, when changing tax years, taxpayers are required to use shortened tax years to effect the conversion. For example, if a calendar year taxpayer changes to a July 31 end of year after July of the current year, he finishes his current calendar year, and then has a short tax year from January to July, and only then has a full year August to July tax year.

tax cost. In addition, when tax law changes, as it frequently does, the opposite approach is sometimes also good planning. Accelerating income to an earlier year covered by expiring favorable law, such as a lower tax rate, can decrease the total tax cost enough to overcome the lost time value of money associated with waiting until a later year where the tax is less favorable. As discussed below, this year may present significant such opportunities based on increasing tax rates and decreasing deductions and credits.

Other than the tax year, the key to end of year tax planning is the recognition of income, deductions, or credits. Many individuals and some businesses use the "cash method" of tax accounting, realizing income when payment is received and deductions when payment is made. Other taxpayers use the "accrual method" of tax accounting, where income and deductions are realized "when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy."[3] There are certain special rules and exceptions, but in the majority of cases, these two accounting methods control the timing of recognition. However, before you start asking customers to hold onto their payments until after the first of the year, you should know about "constructive receipt." In such situations, the delayed payment is considered "constructively received" when it could have been paid if the taxpayer had so requested.[4]

While end of year tax planning can often include new transactions, there is also still time at the end of the tax year to correct or modify existing transactions. As a result of the annual nature of our tax system, agreements that are reversed or "rescinded" during the same tax year are erased for tax purposes as if nothing happened.[5] A rescinded contract can then be replaced by the desired agreement, which can often have retroactive effect through the year. If instead rescission occurs in a later tax year, then both the initial transaction and the rescission are taxable events in different tax years.[6] Usually this means that the taxpayer must pay taxes on the transaction and then wait some years for the offsetting tax benefits of rescission. An essential component of rescission is that both parties participating in the original transaction must participate in the rescission. In one case, a taxpayer's attempt to rescind a sale of Wal-Mart stock failed because he did not reacquire the stock from the same counterparty. The stock had been sold in a public stock exchange where it was not possible to identify and contact the counterparty. Repurchasing in the same public market was not sufficient.[7]

However, public securities are frequently involved in another common year-end tax planning technique: wash sales. Generally, the wash sale rule denies recognition of losses where the taxpayer reacquired or contracted to reacquire substantially identical property within 30 days before or after the sale.[8] This rule

[3] Treas. Reg. § 1.451-1(a). This is referred to as the "all events test."
[4] Treas. Reg. § 1.451-2(a) ("Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given.").
[5] Rev. Rul. 80-58 Situation 1.
[6] Rev. Rul. 80-58 Situation 2.
[7] *Hutcheson v. Commissioner*, TC Memo 1996-127.
[8] I.R.C. § 1091.

applies even though the sale and repurchase occur in different tax years. However, the wash sale rule applies only to loss sales and does not apply to gain sales.[9] So called "broken" loss wash sales that avoid the nonrecognition rule harvest losses on investments without significantly departing from the investment. Gain wash sales are an important part of planning for increases in tax rates, locking in lower rates on built-in gains. Both strategies may be important this year.

As mentioned above, changes in tax law can create planning opportunities. These changes frequently are effective starting with a new tax year, so are a natural part of the end of year tax plan. This year's planned expiration of the "Bush tax cuts" from the Economic Growth and Tax Relief Reconciliation Act of 2001[10] present a good example that has been well documented by the press. As a result of technical legislative budget rules, that act contains a sunset provision that expires the act's tax cuts for tax years beginning after December 31, 2010.[11] Some of the effects of that sunset provision are:

1. An across-the-board increase in tax rates for ordinary income, including the reinstatement of the 39.6% top tax rate (as compared to the 35% top current rate);[12]
2. Taxable dividends will cease to be taxed at lower capital gains rates and will instead be taxed as ordinary income under those increased rates;[13]
3. The estate, gift, and generation skipping transfer taxes that have phased out over the past 10 years and did not exist during 2010 will spring back into existence along with the "basis step-up at death" rule, eliminating the potential loss of basis with the loss of the basis establishing documentation;[14]
4. Itemized deductions will be subject to limitations that can eliminate up to 80% of itemized deductions for an individual with "adjusted gross income" over $100,000 (sometimes called the "Pease limitations");[15] and
5. A series of alternative fuels credits will expire, including credits related to hybrid vehicles[16].

There have been numerous attempts to extend these cuts, but none have been successful. There is a current proposal which would extend the sunset date by two years and reinstate the estate tax with a top rate of 35%.[17] Until the House version was amended last night, the extension did not apply above certain income levels. By the time we know the outcome, there may not be much time before the end of the year, so it is important to have alternate plans in place in advance which can be acted upon at the last moment.

So, as you think about the year's end with holiday plans and New Years' Eve parties, it is important to take some time to think about tax planning. While time is running out, there is still time to get what you want.

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[9] I.R.C. § 1091(a) ("In the case of any ***loss*** claimed to have been sustained from any sale or other disposition … [emph. added]").
[10] Pub. L. No. 107-16.
[11] Pub. L. No. 107-16 § 901(a).
[12] I.R.C. § 1(i).
[13] I.R.C. § 1(h)(11).
[14] I.R.C. §§ 2210 (estate and gift tax), 2664 (generation skipping transfer tax), and 1014(f) (step up at death rule).
[15] I.R.C. § 68.
[16] I.R.C. § 30B.
[17] H.R. 4853, as amended 12/9/2010.