

# tax report

NOVEMBER 2009

## Borrowing from Your 401(k) Plan — the Good, the Bad, and the Ugly

The majority of 401(k) plans (86.3%) allow participants to take loans from their plan accounts.\* But *should* you borrow from your 401(k) savings if your plan allows it? Here are some points you'll want to consider before taking a plan loan.

### The Good

*Borrowing is usually a quick, easy process.* You can request a loan for any reason (although maximum loan amount limitations apply). While the plan may charge a fee in connection with the loan, the cost is typically modest.

*The loan won't affect your credit rating.* Unlike commercial lenders, 401(k) plans do not report loan activity to credit rating agencies.

*You can avoid paying interest to an outside lender.* The "interest" you pay on a 401(k) loan isn't going to anyone except yourself. It's really nothing more than additional money you are required to put into your plan account because you borrowed funds from it. And the "interest rate" on a plan loan may be low in comparison to the rates charged by credit card companies and other lenders.

*You take money off the table.* An opportunity cost is usually associated with 401(k) borrowing (i.e., the foregone investment returns on the borrowed amount). However, borrowing can turn out to be an "advantage" if returns are negative during the loan repayment period.

### The Bad

*Repayments are not pretax.* Unlike regular 401(k) salary deferrals, loan repayments will come out of your after-tax income. When the plan distributes the repaid amounts to you, they will be taxed again.

*You'll lose opportunities for investment growth.* Because the money you've borrowed won't be invested, you'll sacrifice any positive returns you might otherwise have earned.

### The Ugly

*The tax bite could be substantial if you miss payments.* Missing payments

will likely cause your loan to go into default and be taxed to you (at ordinary rates) as a deemed distribution. You may have to pay a 10% early distribution penalty on the amount in addition to income taxes.

*The plan may require you to pay off the loan quickly if your employment terminates, voluntarily or otherwise.* Many 401(k) plans call for repayment within 90 days of separation from the employer. Failure to repay within the required time frame causes the outstanding balance to become taxable, and the 10% penalty also would apply unless you qualify for an exception.

Like other financial decisions, you'll want to weigh the pros and cons in view of your personal situation before you commit to a 401(k) plan loan. ■

\* 51st Annual Survey of Profit Sharing and 401(k) Plans, Profit Sharing/401(k) Council of America, 2008

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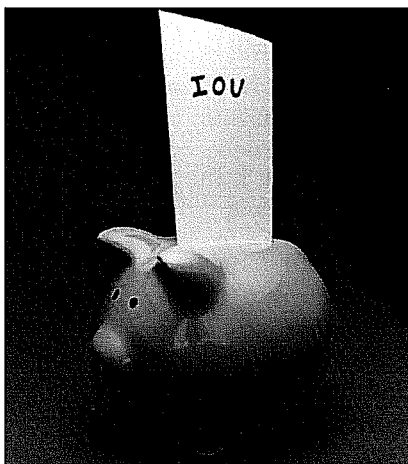
## Gains, Losses, and Your Taxes

Capital losses are fully deductible against capital gains and up to \$3,000 of ordinary income. Excess losses may be carried over and deducted in future years, subject to the same limitations. How can you use these rules to your advantage on this year's return?

**Put losses to work.** If you have capital losses on 2009 investment transactions or losses from earlier tax years that you are carrying forward to 2009, check your portfolio for appreciated securities you'd like to sell. Consider realizing enough capital gains to utilize your losses.

**Cut your losses.** If you have capital gains from 2009 transactions but not enough losses to offset them, review your portfolio for securities that are showing paper losses. If their future prospects don't look promising, consider taking at least enough losses that would offset your excess gains.

Keep in mind, however, that taxes are just one factor to weigh in making investment decisions.



## short takes

### Clock Is Ticking on Credit

Qualifying "first-time" homebuyers can benefit from a federal tax credit of up to \$8,000 (or 10% of the home's purchase price, if less). But time is running short. The credit is available only for purchases made before December 1, 2009.

### DB(k) Plans

The DB(k), a new type of retirement plan that combines features of a traditional pension plan and a 401(k) salary deferral plan, will become available to small businesses with no more than 500 employees starting in 2010.

### Education Expenses Were Not Deductible

In two recent cases, the Tax Court denied taxpayers' deductions for education expenses related to obtaining doctoral degrees because the degrees qualified the taxpayers to work in *new* trades or businesses. The cost of education undertaken to maintain or improve skills required in a taxpayer's *current* business or employment may be deductible. Since these rules can be tricky, please talk with us if you have questions about your expenses.

*The general information in this publication is not intended to be nor should it be treated as tax, legal, or accounting advice. Additional issues could exist that would affect the tax treatment of a specific transaction and, therefore, taxpayers should seek advice from an independent tax advisor based on their particular circumstances before acting on any information presented. This information is not intended to be nor can it be used by any taxpayer for the purpose of avoiding tax penalties.*

## Selling Rental Real Estate

As with any significant transaction, the sale of rental real estate will have income-tax consequences you'll want to understand ahead of time. Although much will depend on the details of your specific situation, here are some key concepts to keep in mind.

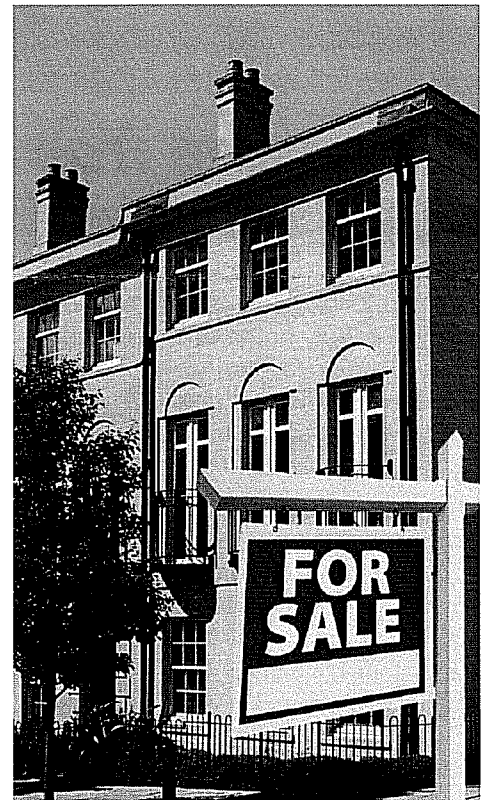
### Gain or Loss?

Figuring gain or loss for tax purposes involves comparing the amount realized on the sale to your "adjusted basis" in the property. Generally, your adjusted basis is equal to the amount you paid for the property, *plus* the cost of any improvements you made and *minus* depreciation deductions.

The tax law requires you to net your gains and losses from the sale of rental and business property held longer than one year against each other. If the result is a *net gain*, it generally will be taxed as long-term capital gain, except to the extent that special rules regarding prior depreciation and losses can result in less favorable treatment. If the netting process results in a *net loss*, you may deduct it in full against your ordinary income.

### Potential Tax Benefit

You may have losses from renting the property that you weren't allowed to deduct in previous years because of the "passive loss" rules. Those suspended losses generally will be deductible in the year you sell your rental property. ■



## Safeguarding Financial Records

If your home or business were to sustain damage from a fire, flood, or some other natural disaster, would your financial records be safe? Would you have the documentation you need for insurance claim and tax deduction purposes? Here are some ways to help ensure that you're protected.

**Create a backup set.** Bank statements and other financial records that you access online can be downloaded and saved on your computer. If you have paper documents, you may want to scan them into your computer and save them along with your other electronic records on an external hard drive or burn them onto a CD. Then keep the backup set —

either in electronic or hard-copy form — in a different location than the original.

**Take pictures.** Document the contents of your home and business through either photos or video. All equipment, buildings, vehicles, and personal items should be included. Make sure you record the date the pictures were taken. A visual record will make it easier to prove the market value of items for insurance and casualty loss claims.

**Update regularly.** Maintaining your records shouldn't be a one-time event. To ensure that you'll have the appropriate information if and when you need it, routinely update your files and keep them in a secure location. ■

# A Time for Giving

As you're making out your holiday gift list, you may want to plan some charitable gifts as well. With the recent recession, many charitable organizations need help more than ever. One way you can make a significant gift to your favorite charity and maximize tax savings for you and your family is through a charitable trust or other planned giving vehicle. The following are some popular gift strategies you may want to consider.

## Charitable Lead Trusts

If you are making regular gifts to a favorite charity — or would like to make regular gifts — consider using a charitable lead trust for those gifts. A charitable lead trust pays a specified amount to the charity of your choice for a specific period. At the end of that period, the trust assets pass to the person you've named as the trust's remainder beneficiary — your child or grandchild, for example. Both the charity and your heirs benefit.

The current low-interest-rate environment may make a charitable lead trust particularly attractive. The value of certain types of gifts is determined using an applicable federal rate, or "AFR," from tables issued by the IRS. The AFR can change monthly. Lower rates can reduce gift and estate taxes on the assets that eventually pass from the trust to your family or other heirs, allowing them to receive more of those assets. Depending on how you design your charitable lead trust, you may achieve income-tax benefits as well.

## Charitable Remainder Trusts

These irrevocable trusts pay income at least annually to you, you and your spouse, or to another noncharitable beneficiary for life or a term of up to 20 years. At the end of the trust term, the charitable beneficiary you've named receives the assets remaining in the trust. Charitable remainder *annuity* trusts pay a fixed dollar amount annually. Charitable remainder *unitrusts* pay a variable amount annually, equal to a fixed percentage of the value of the trust's assets, recalculated each year.

You can take a charitable income-tax deduction in the year of the contribution for the present value of the charity's remainder interest (subject to limits). Note that a lower AFR will reduce the value of your charitable gift and mean a lower up-front income-tax deduction. However, making gifts of assets that you expect to appreciate may help you avoid future capital gains tax, and the value of the gifted assets is removed from your estate for gift- and estate-tax purposes.

## Charitable Gift Annuities

With this arrangement, you and the charity essentially enter into a contract under which you give cash or other property in exchange for fixed annuity payments. The transaction is, in essence, part gift and part purchase. You are allowed a charitable income-tax deduction (within limits) for the difference between the value of the contribution and the value of the annuity.

While lower interest rates reduce the value of your charitable contribution and, consequently, your income-tax deduction for the gift, low interest rates can make a charitable gift annuity attractive for another reason. For older donors, a charitable gift annuity is likely to provide significantly higher payouts than they can gain from other fixed income investments such as certificates of deposit.

While more complex than outright gifts, planned gifts can offer substantial benefits. Let us know if you'd like to review your situation and explore the various planning options in more depth. ■

## Calendar of Filing Dates



### NOVEMBER

- 2 Employers:** File Form 941, Employer's Quarterly Federal Tax Return, for the third quarter of 2009.
- 10 Employers:** Deferred due date for Form 941, if timely deposits were made.

### DECEMBER

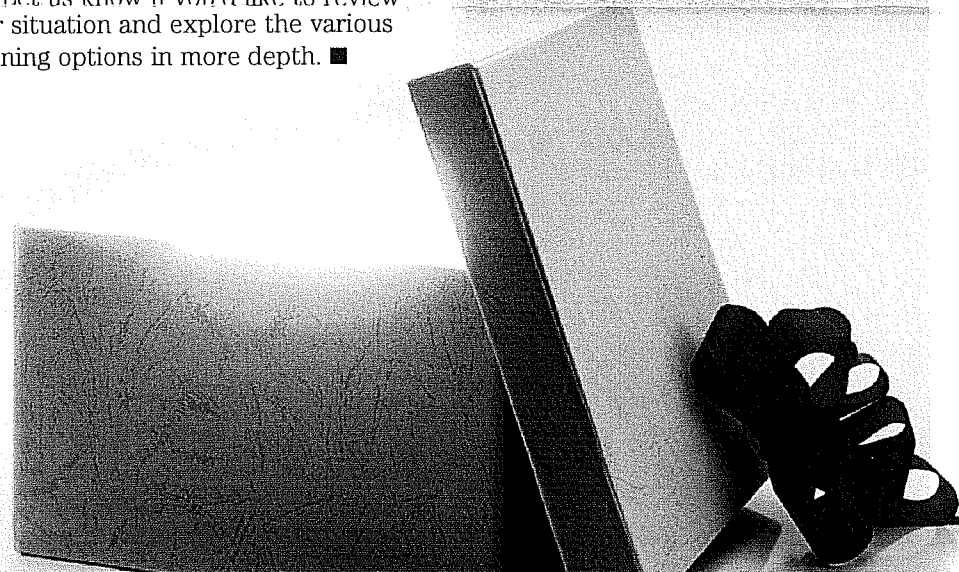
- 15 Corporations:** Pay fourth installment of 2009 estimated tax.

### JANUARY

- 15 Individuals:** Pay last installment of 2009 estimated tax with Form 1040-ES. Or file 2009 income-tax return and make full payment of any balance due by February 1, 2010.

### FEBRUARY

- 1 Employers:** Distribute copies of Form W-2 for 2009 to employees.
- 1 Businesses:** Distribute Forms 1099 (or other information statements) to recipients of certain payments made in 2009. See us for more details.
- 1 Employers:** File Form 941, Employer's Quarterly Federal Tax Return; quarterly deposit due.
- 1 Employers:** File Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return, for 2009.



## Employee Discounts

Letting your employees buy company products or services at a discounted price can be an attractive, relatively inexpensive fringe benefit. Your employees can receive the discounts tax free if your discount program satisfies certain requirements.

### Maximum Amount

Product discounts may not exceed your company's gross profit percentage (determined under specific rules). For services, the limit is 20% of the selling price.

### Same Line of Business

Offer discounts only to employees working in the same line of business. For example, let's say you own a bicycle shop and a bakery. You should limit discounts on bike shop products to employees of the bike shop and discounts on baked goods to bakery employees.

### "Qualified" Property and Services

Tax-free treatment is available only for "qualified" property and services. Commercial or residential real estate and personal property held for investment (e.g., securities, commodities, and currency) are not qualified property.

### Program Can't Be Discriminatory

Make the discounts available on substantially the same terms to a reasonable classification of employees that does not discriminate in favor of your highly compensated employees. Otherwise, discounts received by highly compensated employees will be taxable. ■

## A Roth Opportunity

Good news for individuals who'd like to convert a traditional IRA to a Roth IRA but haven't been able to do so because of the tax law's \$100,000 income cap. Beginning in 2010, the cap is eliminated. Also, married taxpayers filing separately will be able to convert their traditional IRAs to Roth IRAs. Currently, they are not allowed to. As a result, more high earners will have the opportunity to take advantage of a Roth IRA.



### Why Convert?

With a traditional IRA, income taxes are generally due on both deductible contributions and all investment earnings when they are withdrawn from the account. Also, once you reach age 70½, you must begin taking annual minimum distributions from traditional IRAs.

With a Roth IRA, all contributions are nondeductible and, thus, not subject to income tax when withdrawn (since they've already been taxed). Once you've held a Roth IRA for five years and you're over the age of 59½ (and in certain other circumstances), you can withdraw earnings tax free. And you don't *have* to withdraw money from a Roth IRA unless you want to, since there are no mandatory minimum distribution requirements.

There's a tradeoff, though, when you convert a traditional IRA to a Roth IRA. You'll incur a federal income-tax liability on the taxable portion of the traditional IRA in the year that it's converted.

### For a Limited Time Only

But, if you convert your traditional IRA to a Roth IRA in 2010, you won't have to pay taxes on the conversion immediately. Unless you elect otherwise, half of the taxable amount of your IRA will be included in your 2011 income and the remainder in your 2012 income.

This tax break may not benefit everyone. After 2010, unless Congress acts, the tax brackets above the 15% bracket are scheduled to revert to their higher pre-2001 rates. Instead of the current 25%, 28%, 33%, and 35% brackets, the top four brackets will be 28%, 31%, 36%, and 39.6%. Consequently, you may pay less in tax if you elect to pay it in 2010. ■