

WINTER 2009

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More on Converting to Roth IRAs

From our last newsletter, you know you can convert your traditional IRA (and, plan terms allowing, your 401(k)) into a Roth IRA in 2010. Should you? The answer, which relies on a number of assumptions, is not clear-cut.

We've run a number of test cases to demonstrate how some of the relevant considerations impact the projected financial results of a Roth conversion. Our benchmark case assumes the individual:

- is age 45 at the time he or she is considering converting to a Roth IRA,
- will begin taking distributions at age 65,
- will receive equal annual distributions for 20 years,
- will earn a before-tax rate of return on investments of 6%,
- has a current marginal income tax bracket of 35%,
- will have an income tax bracket in distribution years of 35%,
- has an IRA balance which is 50% taxable (i.e., there have been some after-tax contributions),
- will pay taxes from the IRA funds, and
- has an estate that will not owe estate taxes.

In this benchmark scenario, converting to a Roth IRA provided 22.5% more after-tax income than not converting. We then changed one variable at a time to see what impact the change would have on the projected results:

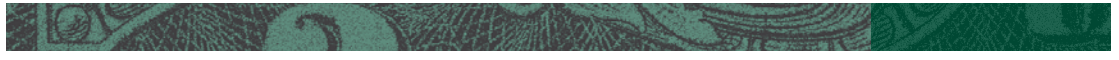
- **Marginal Tax Rates:** If we assume that the marginal tax rate in distribution years declines to 20%, but all other factors in our benchmark case remain the same, converting provides just 1.4% more income than not converting.
- **Source of Funds to Pay the Tax on Conversion:** Paying the tax from non-IRA assets vs. IRA assets results in a conversion providing 26.5% more income than not converting.
- **Basis in IRAs:** In our benchmark case, where 50% of the IRA balance is taxable, converting to a Roth provided a 22.5% higher return than not converting. Where none of the IRA balance is taxable, that percentage is 44%. Where all of the IRA balance is taxable, and all other assumptions are unchanged, converting provides no benefit.

Our analysis in this article examines a benchmark scenario and changes just one factor in each example. When multiple factors change, the results may offset or amplify benefits or detriments of converting to a Roth IRA. The analysis also assumes an "all-or-nothing" approach. In many cases, converting some, but not all of an IRA may maximize benefits or hedge against assumptions that are not realized.

Following are some additional factors which may enter into decisions about whether to convert:

- **State Income Taxes:** Would distributions in retirement be exempt from state income tax, but a conversion be subject to state income tax? This could happen if you currently live in a state with an income tax, but will move to a state with no income tax in retirement. Even if you're currently a resident of Kentucky and plan to stay here in retirement, converting can result in loss of the annual approximate \$41,000 pension exclusion other than in the conversion year.
- **Benefits of Longer Deferral:** If you expect a longer deferral period, perhaps because you are relatively young now and don't expect to need these funds until after retirement, or if you don't expect to need the IRA to fund your lifestyle throughout your life and plan to leave the account to your heirs, a current conversion is likely to be beneficial.
- **Estate Tax Considerations:** Do you believe that you will not need the funds in the IRA

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Roth IRAs *continued from page 1*

during your life and that there will be estate tax due at your death? If so, that favors a conversion since estate tax is due on the unpaid income tax that is embedded in the traditional IRA, and distributions from Roth IRAs aren't required until after you die.

- **Charitable Intentions:** Do you want to leave funds to charity at your death? If so, you may make your favorite charity or charities a beneficiary of your traditional IRA, and no taxes will ever be due on the distributions—this favors not converting.

If you decide a Roth IRA fits into your financial future and you haven't made a nondeductible contribution to a regular IRA for 2009, considering doing so (you have until 4/15/2010 to do so for 2009). Consider also converting a 401(k) where permitted by the plan. You may also make future nondeductible contributions to a regular IRA and convert those annually.

Please let us know if we may help you assess whether a conversion is advisable in your case.

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Year-End Tax Planning Tips

With 2009 soon ending, you may want to consider some of these year-end tax savings opportunities:

Accelerate taxable income into 2009? As you no doubt know, higher tax rates are anticipated. However, no one knows when such changes, assuming they occur, will happen. No action will be required for many rates to increase after 2010 (the capital gains rate is scheduled to go to 20% from 15%, qualified dividends lose their favorable capital gains rate, and ordinary income rates revert to pre-2001 levels—top rate of 39.6%).

Considering this uncertainty, should you accelerate income into 2009 or defer deductions from 2009? Only one thing seems certain: rates won't be lower for higher-income individuals in the foreseeable future.

Capital Losses. If you took gains this year as the stock market experienced a partial recovery from the ultra-tough market of 2008, consider whether you should sell to realize losses left in your portfolio. Recognize, too, that you may have capital loss carryovers from 2008.

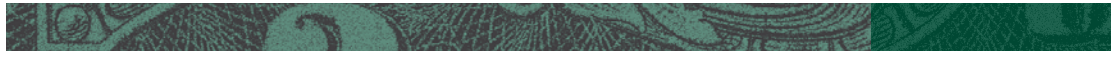
First-Year Depreciation. The cost of most business equipment and furniture must be capitalized and depreciated over five to seven years. However, a special tax break is available to most small businesses. The Section 179 deduction permits immediate write-offs for up to \$250,000 of 2009 qualifying additions. If you haven't yet made 2009 equipment or furniture purchases up to this amount, consider accelerating next year's planned purchases into this year to fully utilize this provision. The equipment, which may be new or used, must be "placed in service" by year end for the deduction to be available. These rules also apply to breeding or racing horses and to breeding cattle. Note that there are limits on the availability of the Section 179 deduction, the applicability of which you should ascertain before acting. Chief among these are that the deduction is only available to the extent of net business income, and the deduction is phased out dollar-for-dollar when qualifying property additions exceed \$800,000 in the year.

To the extent Section 179 deductions are not available for capital expenditures, bonus depreciation may be. For qualifying capital expenditures, 50% of cost can be deducted in the year assets are placed in service, and normal first-year depreciation is allowed on the other 50%. Qualifying capital expenditures must have a cost recovery period of 20 years or less or be certain leasehold improvement property. In general, the business must acquire the property during 2009, and the property's original use must have begun with the acquirer.

Note that bonus depreciation is scheduled to expire after 2009, and, as noted elsewhere in this newsletter, the limit on Section 179 depreciation is being greatly reduced.

S Corporation and Partnership Losses. If your S Corporation will generate a tax loss this year, consider whether you have enough basis in the stock (or in loans you've made to the corporation) to take the full loss. If you don't, additional investments should be considered. Similar considerations can arise in some situations with partnerships expecting tax losses.

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Year-End Tax Planning *continued from page 2*

Self-Employed Retirement Plans. If you have self-employment income and don't have a retirement plan in place to shelter any of it, you may qualify to use a Self-Employed Retirement Plan. Even though the plan does not need to be funded until the due date for filing your income tax return, the plan must be established by year-end in order to deduct contributions for 2009.

Charitable Contributions. Consider "prepaying" contributions you would have made next year. Always consider funding charitable gifts with appreciated marketable securities, resulting in gains being untaxed. You may also charge charitable contributions on your credit card; contributions posted to your account before year-end are deductible this year, even if you do not pay the charges until next year.

Annual Gifting. You may give your children and others up to \$13,000 in 2009 without gift tax consequences. This annual exclusion is a per person amount, and there is no carryover of any unused exclusion. Consider making year-end gifts to fully utilize the annual exclusion.

Tax Developments for 2010

FICA Base - Annual compensation to which Social Security applies remains \$106,800 for 2010. The Medicare tax continues to apply to all compensation.

Social Security Benefits - Individuals who have not attained full retirement age will begin to lose Social Security benefits if they have earned income exceeding \$14,160 in 2010, the same amount that applied in 2009.

Adjustments for Retirement Accounts - The maximum annual addition to a defined contribution plan remains \$49,000 for 2010. The maximum amounts that individuals can elect to contribute to employer-sponsored plans and IRAs remain the same for 2010 as shown below, as do the "catchup" contributions for individuals who are age 50 or older by the end of the tax year.

YEAR	IRAs		SIMPLE Plans		Other Employer Plans	
	Annual Contribution	Catch-Up Contribution	Elective Deferral	Catch-Up Contribution	Elective Deferral	Catch-Up Contribution
2010/2009	\$5,000	\$1,000	\$11,500	\$2,500	\$16,500	\$5,500

The maximum amount of compensation that can be considered as the base for retirement plan contributions remains \$245,000 in 2010.

Nanny Tax Threshold - Payments to a household employee will not be subject to reporting or FICA taxes if less than \$1,700 for 2010, the same as 2009.

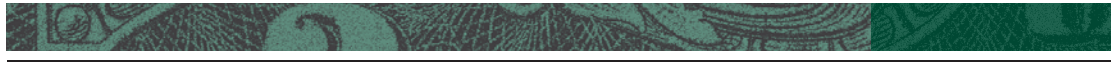
Gift Taxes - The annual exclusion for gifts per donee remains \$13,000 for 2010. The amount of taxable gifts above which gift taxes will be payable remains \$1,000,000 for 2010.

Standard Automobile Mileage Rates - The standard rates per mile for deducting automobile expenses are adjusted as follows:

	2009	2010
Business	\$.55	.50
Charity work	.14	.14
Medical	.24	.165

Section 179 Deduction - Unless Congress acts, the maximum Section 179 deduction for 2010 is \$134,000, down from \$250,000, and the limit on qualifying property additions declines from a 2009 phase-out range of \$800,000 - \$1,050,000 to a 2010 phase-out range of \$530,000 - \$664,000.

Estate Tax - As we write this, no estate tax applies to deaths occurring in 2010. Many observers believe this won't happen, but that the amount exempt from tax will remain \$3,500,000, with a 45% tax rate, at least through 2010.



S Corporation Shareholder-Employees Take Note

Most S Corporation shareholders, those who directly or, through related persons, indirectly own more than 2% of the corporation's stock, are subject to special rules if they also are employees of the corporation and receive employee fringe benefits. If the S Corporation provides these shareholder-employees with health, disability, or group-term life insurance (these being among the most common fringe benefits provided), the value (usually the cost) of these benefits is to be reported as taxable income on the shareholder-employee's W-2 form. However, the fringe benefit amount includible in taxable income is not included in FICA wages.

The cost of medical insurance included in W-2 taxable income is treated as self-employed medical insurance paid by the shareholder-employee, potentially being fully deductible on the shareholder's return and, thus, offsetting the income included in the W-2.

We strongly encourage S Corporations to follow the practice described. Failure to do so may result in IRS disallowing the S Corporation's deduction, resulting in unnecessary taxes. Please be sure that whoever is administering your payroll is aware of these rules.

Please contact us if you have questions about or need assistance with this issue.

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DDF Seminar Focuses on Process Improvement for Law Firms

As the economy continues to struggle, firms are reaching the point where further cuts may mean providing fewer services to clients. Process improvement techniques can help identify waste and non-value-added activities, enabling firms to streamline operations while continuing to add value and not cutting service to clients. Dean Dorton Ford is holding two complimentary seminars in January to introduce process improvement tools and techniques to law firms – January 13 in Lexington, and January 20 in Louisville. For more information, please contact me.

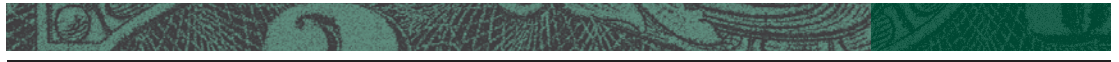
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Expanding Our Resources

Our firm has joined Leading Edge Alliance (LEA), one of the largest international associations of independently owned accounting and consulting firms. Our association with LEA allows us to share knowledge, resources, and creative solutions that add value to the services we provide to our clients. We chose LEA because it fits well with our core values. LEA brings together firms that anticipate new opportunities, strive to be innovative, and have demonstrated a strong commitment to excellence.

LEA membership includes 145 independent firms in over 90 countries. With LEA, we have access to the size and scope of a large international firm while offering our clients the continuity, consistency, and strong personal relationships of a much smaller firm.

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What We Learned...

We believe we learned a lot from our recent process of updating and upgrading our website. Highlights include:

Content Management Systems (CMS) – Rather than relying on a web programmer to help keep site content fresh, we chose to build our site on a technology that offers an easy-to-use CMS. The CMS allows greater flexibility for us to keep current information posted and to purge old content. Keeping content fresh is important for presenting the most useful information and for enhancing your site's position with search engines. If your site content never changes, the search engines stop visiting your site, resulting in your rank being lowered in user searches.

Search Engine Optimization (SEO) – While updated content helps raise your rank with search engines, it is only part of the process. Each of a multitude of sites is competing for high rankings in searches. To remain highly ranked, your site must employ a strategy to keep it competitive. SEO is a continual process that requires an in-depth knowledge of search engine methodology. We have partnered with an external expert to provide ongoing SEO services for our site.

We found other interesting functionalities, including BLOG facilitation, automated news (RSS) feeds, eNewsletters, pay-per-click campaigns, and walk-out videos.

Visit our new site at www.ddfky.com frequently. We are continually working to improve content and functionality to provide valuable information and resources. If you have any questions regarding our website project or the topics discussed above, please contact me.

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Did You Know...

For fiscal year 2008-09, which ended on September 30, the U.S. government funded only 60% of its expenditures from taxes and other federal revenue and a whopping 40% from borrowings. In other words, the federal government spent about 67% more than its revenues last year. We all know that the federal government incurred a huge deficit, but this may give it added perspective.

Federal revenues were down 17% and federal spending was up 18% from the year before. Thankfully, low interest rates on government borrowings caused net interest payments to decline by \$10 billion from the prior year, so the deficit could have been much larger.

Home Buyer Tax Credit Extended and Expanded

The **first-time homebuyer** tax credit, set to expire after November 30, 2009, has been extended by recent legislation to April 30, 2010. And, if a buyer enters into a binding purchase contract by April 30, 2010, the buyer has until June 30, 2010, to close to qualify for the credit. As before, the credit is 10% of the purchase price, subject to a cap of \$8,000, and it does not have to be repaid as long as the buyer continues to own and use the property as the buyer's principal residence for at least 36 months.

A significant provision of the legislation expands the reach of available tax credits for homebuyers to cover **"long-time residents"**—those who have owned and used the same home as their principal residence for at least five consecutive years during the eight-year period ending on the date of purchase of the new principal residence. The credit in this situation also is 10% during the new home's cost, but with a cap of \$6,500. The new home's closing date must be after November 6, 2009.

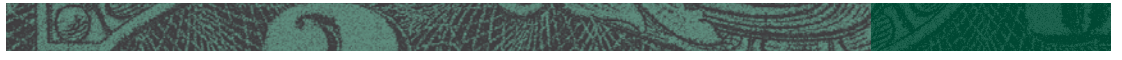
Some new restrictions apply in the cases of both first-time homebuyers and long-time residents:

- No credit is available if the home costs more than \$800,000.
- One who is a dependent of another cannot claim the credit.
- The buyer must be at least age 18 on the purchase date.

For qualifying homes purchased after November 6, 2009, income limits (as measured by "modified adjusted gross income") still apply, but they have been increased to \$125,000 (from \$75,000) for single filers and to \$225,000 (from \$150,000) for joint filers.

For qualifying purchases in 2010, buyers have the option of claiming the credit on their 2009 or 2010 tax return.

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People News

Kyle Bouelle has joined us after graduating from Morehead State University, where he majored in accounting.

Megan Mason recently earned her degree from Eastern Kentucky University and is starting her professional career with DDF.

Jason Mitchell, Brittany Browning, and Lee Livingood have joined us after earning their Master of Science in Accounting degrees from the University of Kentucky. Jason also has a Bachelor of Arts degree in Psychology from UK.

Jennifer Bathon has been elected to the Board of Directors of Lexington Youth Soccer Association and is serving a two-year term as treasurer.

Rachel Brown has accepted a Board of Directors position with the International Book Project in Lexington.

Lisa Wilson is teaching classes in financial literacy to middle-school students for Junior Achievement.

Paula Hanson recently spoke at a Women Leading Kentucky program on the topic "What's a Board To Do."

Congratulations to **Brittany Browning, Haley Jones, Lee Livingood, Erin McClain, and Jason Mitchell**, each of whom recently were successful in completing the CPA examination.

The matters discussed in these articles provide general information only. You should consult with us about your specific situation before undertaking action based on such general information.