

2010

TAX Planning Guide



PACIFIC LIFE

MKTG-327B

CONTENTS



WHAT'S NEW?	2
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FOR INDIVIDUAL TAXPAYERS

Getting Started	3
Will You Owe the AMT?	5
Family Matters	6
Minimizing Taxes on Your Investments	7
Going Green	9
Tax Help for Education Costs	10
Retirement Planning	12
Charitable Contributions	16
On the Home Front	18
Dealing with Deduction Floors	20

FOR BUSINESS TAXPAYERS

Reviewing Business Entity Choices	21
Start-up Strategies	24
Deduction Planning	26
Tax Credits	29
Sponsoring a Retirement Plan	30

CAN WE HELP?	32
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The uncertain economic climate has prompted many individuals and businesses to carefully examine their finances. Now more than ever, it makes good financial sense to do what you can to minimize your tax burden.

This *2010 Tax Planning Guide* suggests a number of strategies that can help lower your federal income-tax liability. As you read through it, please keep in mind that everyone's tax situation is different. Before implementing any of the strategies discussed in the guide, you will want to secure professional advice.

▶ WHAT'S NEW?

- The rules limiting itemized deductions and personal exemptions when adjusted gross income (AGI) exceeds certain thresholds do not apply in 2010.
- The 15% and 0% tax rates on long-term capital gains and qualified dividends are set to expire after 2010. In 2011, a 20% maximum capital gains rate generally will go into effect, and dividends will be treated as ordinary income — no special tax rate will apply to dividends.
- Regular individual income-tax rates are also scheduled to increase after 2010. Unless new legislation is enacted, the 10% rate will disappear and the top four pre-2001 tax rate brackets — 28%, 31%, 36%, and 39.6% — will be reinstated. The lowest bracket will be 15%.
- Starting in 2010, the income and filing status restrictions on converting a traditional individual retirement account (IRA) into a Roth IRA no longer apply.
- Businesses engaged in manufacturing, construction, and certain other domestic production activities may deduct 9% of qualified production activity income, up from 6% in 2009. (Other limitations apply.)
- Employers with 500 or fewer employees have a new retirement plan option beginning in 2010 called the DB(k) plan.



FOR INDIVIDUAL TAXPAYERS

GETTING STARTED

When you are planning for taxes, both the income and expense side of the equation deserve your attention. On the income side, you'll want to look for opportunities to generate tax-deferred, tax-free, or lower taxed income. On the expense side, be alert to potentially deductible expenses, as well as any expenses that may qualify for a tax credit. Sometimes, you can position yourself for a tax benefit by simply knowing the rules in advance.





Every year, you have a choice of claiming the standard deduction (a preset amount for your filing status) or deducting specific actual expenses called itemized deductions. You'll want to choose the option that results in the largest overall deduction.

Additionally, the tax code lists several expenses that may be deducted from your gross income in arriving at your adjusted gross income (AGI). These are called adjustments or above-the-line deductions. They are especially valuable deductions since several tax breaks depend on having AGI below specified amounts.

Unlike a tax deduction, which reduces the amount of your income that will be subject to tax, a tax credit directly reduces your tax liability. For example, a \$1,000 credit saves you \$1,000 of taxes.

The graduated income-tax rate schedules for individuals are shown in the table below. For planning purposes, focus on your marginal tax rate — the rate that applies to your last dollar of taxable income. You can use your marginal rate to estimate the tax effect of various planning strategies. If, for example, your marginal tax rate is 35%, a \$1,000 deduction would save you \$350 of tax.

▶ INDIVIDUAL TAX RATE SCHEDULES

Filing Status	Rate (%)	Taxable Income (\$) Brackets*
SINGLE 	10	0 – 8,375
	15	8,376 – 34,000
	25	34,001 – 82,400
	28	82,401 – 171,850
	33	171,851 – 373,650
	35	Over 373,650
HEAD OF HOUSEHOLD 	10	0 – 11,950
	15	11,951 – 45,550
	25	45,551 – 117,650
	28	117,651 – 190,550
	33	190,551 – 373,650
	35	Over 373,650
MARRIED Filing Jointly <i>(and surviving spouses)</i> 	10	0 – 16,750
	15	16,751 – 68,000
	25	68,001 – 137,300
	28	137,301 – 209,250
	33	209,251 – 373,650
	35	Over 373,650
MARRIED Filing Separately 	10	0 – 8,375
	15	8,376 – 34,000
	25	34,001 – 68,650
	28	68,651 – 104,625
	33	104,626 – 186,825
	35	Over 186,825

* These taxable income bracket amounts are the estimated tax brackets for 2010. As we go to press, the IRS has not announced the official 2010 inflation adjustments.

WILL YOU OWE THE AMT?

The alternative minimum tax (AMT) system adds another layer of complexity to your tax planning. Even if you've escaped it in the past, don't overlook the possibility that you'll have to pay additional taxes because of the AMT. The number of taxpayers who owe the AMT has been increasing over time.

Figuring the AMT is complicated because you must recompute your taxable income under special rules. Many deductions are not allowed. And certain income that is otherwise nontaxable must be included in AMT income. You will have to pay the AMT — in addition to your regular taxes — if your AMT income is more than the exemption amount for your filing status. The AMT rates are 26% and 28%, and the AMT exemptions phase out at higher levels of income.

If you are expecting a potential AMT problem, consider these planning points.

- ▶ The interest on “private activity” municipal bonds generally is not tax exempt for AMT purposes. But the tax law makes an exception for private activity bonds issued (or, in certain cases, reissued) in 2009 and 2010. Before investing in private activity bonds, check their tax status.
- ▶ If your marginal tax rate is higher than the 28% maximum AMT rate, you may benefit from accelerating income into a tax year when you will pay AMT anyway. But consider the time value of money before doing so, since you will be paying taxes earlier.
- ▶ Also consider deferring late-year expenses that you can't deduct for AMT purposes to next year if you expect that you won't be subject to the AMT next year. Examples include investment fees and taxes.



FAMILY MATTERS

As the years pass, family situations tend to change — and that can have an impact on tax planning.

Dependent care credit. If you pay child-care expenses so that you (and your spouse) can work, look into claiming this credit. Your child must be under age 13. The credit is also available for the expenses of caring for a disabled spouse or other adult dependent while you work. The minimum credit rate is 20%, and up to \$3,000 of expenses (\$6,000 for the care of two or more individuals) can qualify for the credit.

- ▶ The expenses of sending a child to summer day camp can qualify as child-care expenses for credit purposes. No credit is allowed for the cost of an overnight camp.



Divorced parents. A child may be treated as the dependent of both divorced parents for certain medical-related tax deductions and exclusions. For example, the parent who pays a child's medical expenses is entitled to deduct them, even if the other parent claims the dependency exemption for the child.

Helping a parent. You may be able to claim a parent you are helping to support as your dependent. You are entitled to the dependency exemption if your parent's gross income, not counting nontaxable Social Security benefits, is no more than the exemption amount (estimated to be \$3,650 for 2010) and you provide more than half of your parent's total support. For purposes of this test, support includes both taxable and nontaxable Social Security benefits.

Hiring your child. Do you own a business? Giving your child a job could be a family tax saver. You'll be able to deduct your child's wages from your business income, reducing both your income taxes and your self-employment taxes. A dependent child may earn as much as \$5,700 in 2010 (estimated amount) income-tax free because of the standard deduction. Any wages your child earns over that amount probably would be taxed at the lowest 10% marginal tax rate. The 10% bracket for single filers is projected to extend to the first \$8,375 of taxable income in 2010.

Does your child have to file? Children who have job earnings or "unearned" income from savings and investments may have to file income-tax returns, even if they are dependents. In some situations, parents may be able to include a child's investment income on their own return. We can help you determine if a separate return is required for your child.

MINIMIZING TAXES ON YOUR INVESTMENTS

As an investor, you're focused on the returns your investments earn. When all is said and done, though, it's the amount you have left after taxes that matters most.

Capital gains rates. Net long-term capital gains are currently taxed at a maximum rate of 15%, and the rate is zero for net gains that would otherwise be taxed in the two lowest regular brackets. After 2010, these capital gains rates are slated to climb to 20% and 10%, respectively (18% and 8% with an eligible holding period of over five years).

▶ **Review your portfolio carefully to see if there are any appreciated investments you'd like to sell in 2010 before the rates go up.**

Real estate sales. If you are planning to sell an appreciated real estate investment in 2010 on the installment basis (i.e., the buyer will pay you part of the purchase price in 2010 and the remainder in one or more subsequent tax years), consider the possibility of reporting all your capital gain in 2010. You'll give up the opportunity to spread your capital gains taxes over the years you receive payment from the buyer, but you may pay less overall tax on your gain. (When you are projecting taxes

on the sale of depreciable property, keep in mind that the maximum rate on capital gains is 25% to the extent of prior depreciation.)

Capital losses. Nobody likes investment losses, but they can help you at tax time. You can use capital losses to offset capital gains on other transactions plus an additional \$3,000 of ordinary income (\$1,500 if married filing separately) annually. You may carry forward capital losses that you are not able to deduct because of these limitations to future tax years, subject to the same restrictions.

However, losses from a “wash sale” are *not* currently deductible. A wash sale is a loss-generating sale of securities that occurs within 30 days before or after the purchase of substantially identical securities.

▶ **Be cautious about the wash sale rules if you participate in a mutual fund or stock dividend reinvestment program. A sale of shares at a loss within 30 days of a purchase of shares through the dividend reinvestment program would be considered a wash sale.**

You should consider a mutual fund’s investment objectives, charges, expenses, and risks carefully before you invest. The fund’s prospectus, which can be obtained from your financial representative, contains this and other information about the fund. Read the prospectus carefully before you invest or send money. Shares, when redeemed, may be worth more or less than their original cost.

Tax-exempt bonds. Unlike interest on corporate or U.S. government bonds, municipal bond interest is generally exempt from federal income taxes. (As mentioned earlier, certain private activity bond interest is includable in AMT income.) You can use the table on the next page to compare tax-exempt and taxable yields in your tax bracket.

Qualified small business stock. You may qualify for substantial tax breaks if you invest in the stock of a fledgling corporation that meets the “qualified small business stock” (QSBS) requirements. Capital gain on QSBS held for more than five years is taxed at 28%, but only part of the gain has to be included in income. Generally, you may exclude 50% of your gain. For QSBS you acquire after February 17, 2009, and before January 1, 2011, the exclusion percentage is 75% (resulting in an effective

tax rate on the capital gain of just 7%, or 28% of the 25% of the gain that is taxable).

- ▶ You may sidestep current tax on capital gain realized from the sale of QSBS you've held for more than six months by reinvesting the sale proceeds in QSBS within 60 days.

▶ COMPARING YIELDS

To Match the Tax-exempt Yield Below	In This Tax Bracket:			
	25%	28%	33%	35%
	You Need To Earn a Taxable Yield of:			
3.0%	4.0%	4.2%	4.5%	4.6%
3.5%	4.7%	4.9%	5.2%	5.4%
4.0%	5.3%	5.6%	6.0%	6.2%
4.5%	6.0%	6.3%	6.7%	6.9%
5.0%	6.7%	6.9%	7.5%	7.7%
5.5%	7.3%	7.6%	8.2%	8.5%
6.0%	8.0%	8.3%	9.0%	9.2%

The table does not consider the effect of state income taxes. Some states exempt interest received by state residents on in-state municipal bonds.

GOING GREEN

The government provides a number of tax incentives designed to spur taxpayer interest in energy conservation and green technology.

Nonbusiness energy property credit. You may benefit from a 30% tax credit for amounts you spend to make qualified energy-efficient improvements to your principal residence (subject to a combined \$1,500 credit limit for 2009 and 2010). Assuming they meet energy-efficiency standards, the following improvements can qualify for the credit:

- Insulation
- Exterior windows and skylights
- Exterior doors
- Roof (asphalt, metal)
- Central air conditioner
- Advanced main air circulating fan

- Water heater (natural gas, propane, oil, electric heat pump)
- Hot water boiler (natural gas, propane, oil)
- Electric heat pump

REEP credit. There is a separate 30% residential energy-efficient property (REEP) credit for installing solar electric and hot water systems, geothermal heat pumps, small wind turbines, and fuel cell systems. No dollar caps are placed on this credit.

Alternative motor vehicle credits. The purchase of an IRS-certified hybrid, plug-in electric, alternative fuel, or advanced lean-burn technology vehicle may qualify you for a tax credit. The availability and amount of the credit will depend on the type of vehicle you purchase and the specific make and model. Check before you buy.

TAX HELP FOR EDUCATION COSTS

Given the high cost of higher education, tax incentives are an important piece of the planning puzzle for anyone who is paying college expenses or setting aside money for future costs.



American Opportunity Tax Credit. This credit equals 100% of the first \$2,000 of qualifying higher education expenses and 25% of the next \$2,000 of expenses, up to a maximum credit of \$2,500 for each eligible student in your family. The credit is available for any of a student's first four years of college. Tuition payments and certain related expenses, including books and other required course materials, are eligible for the credit. It phases

out with AGI between \$80,000 and \$90,000 (between \$160,000 and \$180,000 for joint return filers). These phaseout ranges are the estimated inflation-adjusted ranges for 2010.

Lifetime Learning Credit. See if you can qualify for this credit if you don't meet the requirements for the American Opportunity Tax Credit. It's available for each year of post-secondary education, including graduate school and eligible job training. The maximum credit is \$2,000 (20% of up to \$10,000 of qualified tuition and related expenses) per taxpayer return. The estimated inflation-adjusted AGI phaseout ranges for the Lifetime Learning Credit are \$50,000-\$60,000 (\$100,000-\$120,000 on a joint return) for 2010. You may not claim both education credits for the same student's expenses, and neither credit is available to a married taxpayer filing separately.

529 Plans. Many states sponsor qualified tuition programs — prepaid tuition plans and college savings plans — that provide tax benefits under Section 529 of the federal tax code. You can't deduct contributions to a 529 plan on your federal return. However, you are not taxed on investment earnings while your money remains in the plan, and plan distributions to pay the account beneficiary's qualified higher education expenses are tax free.

The definition of qualified higher education expenses includes tuition, fees, books, supplies, equipment required for the beneficiary's enrollment or attendance, and expenses for special needs services. Room and board costs for a student who is enrolled at least half time also qualify (subject to a limit).

▶ For 2009 and 2010, the definition of qualified higher education expenses also includes certain computer technology, equipment, and related services (including Internet access) to be used by the beneficiary and the beneficiary's family during any of the years the beneficiary is enrolled. Computer software for sports and games does not qualify unless it is predominantly educational in nature.

▶ You are not limited to investing in your state's plan. However, certain plan benefits may not be available unless you meet specific requirements, such as state residency. Before you invest, find

out whether a particular plan has restrictions on the timing and use of plan distributions.

Before investing in a 529 plan, consider the investment objectives, risks, and charges and expenses associated with municipal fund securities. The issuer's official statement contains more information about municipal fund securities, and you should read it carefully before investing.

Coverdell ESA. An education savings account (ESA) offers federal tax benefits similar to a 529 plan. However, ESA contributions for a beneficiary are limited to \$2,000 annually, and this limit is slated to drop to \$500 after 2010. Also, ESA contributions are phased out for taxpayers with modified AGI between \$95,000 and \$110,000 (between \$190,000 and \$220,000 for joint filers).

▶ If you intend to tap into an existing ESA to pay a child's elementary or secondary school tuition or related costs, consider doing it in 2010. Unless Congress changes the law, withdrawals for qualified elementary and secondary school expenses will no longer be tax free after 2010.

Deducting student loan interest. Interest paid on personal loans is usually not tax deductible. But the tax law makes an exception for up to \$2,500 of annual interest paid on qualified higher education loans. To claim the interest deduction in 2010, your modified AGI can't be more than \$75,000 if you are single or \$150,000 if you are married. The deduction begins to phase out with AGI over \$60,000 (single) or \$120,000 (married). (The AGI figures are estimated.) Also, you must file a joint return if you are married.

▶ Eligible student loans aren't limited to those taken for undergraduate work — loans for graduate school and eligible post-graduate programs (e.g., an internship or residency program) also may satisfy the interest deduction requirements.

RETIREMENT PLANNING

The tax benefits associated with employer-sponsored retirement plans and individual retirement accounts (IRAs) can help you build your retirement savings.

Workplace plans. 401(k) plans, 403(b) plans, and SIMPLE plans all offer the opportunity for you to invest by contributing a portion of your pay to the plan. The tax benefits of plan participation include:

- Pretax contributions — the salary you contribute is not subject to income taxes until you receive distributions from the plan.
- Tax-deferred earnings — contributions are invested on a tax-deferred basis. Because the IRS does not share in your account earnings until you receive distributions, your investment can grow faster than it would if taxes were paid each year.

A 401(k) or 403(b) plan also may offer an after-tax Roth contribution option. With this option, you lose the benefit of pretax contributions, but you can receive qualified distributions from your Roth account tax free.



IRAs. Your annual IRA contributions — Roth and traditional — are limited to \$5,000 (\$6,000 if you are over age 50). The annual limit is subject to inflation adjustment.

A Roth IRA offers nondeductible contributions and potentially tax-free withdrawals after five years (1) once you are at least age 59½ or (2) to pay up to \$10,000 of first-time homebuying expenses or (3) on account of disability. Distributions to account beneficiaries after death are also tax free as long as the five-year requirement has been met.

To contribute to a Roth IRA for 2010, your modified AGI can't be more than \$120,000 if you are single, \$177,000 if you are married and file a joint return with your spouse, and \$10,000 if you are married filing a separate return. The allowable contribution is reduced with AGI over \$105,000 (single), \$167,000 (joint), and \$0 (separate). These AGI limits are the estimated inflation-adjusted amounts for 2010.

Contributions to a traditional IRA are tax deductible if you (and your spouse, if you are married) are not eligible to participate in an employer's retirement plan. With plan participation, certain income limits apply to deductions for IRA contributions. Ask us for the limits that apply to you.

- ▶ Another way to fund a Roth IRA is by converting a traditional IRA. Starting in 2010, there are no income or filing status restrictions on Roth IRA conversions.
- ▶ While a Roth conversion provides an opportunity for future tax-free earnings, it also triggers income taxes on previously tax-deferred amounts in your traditional IRA. Your current tax rate, as well as your expectations regarding future tax rates and the possibility of tax law changes, will be issues to consider as you weigh a possible conversion.
- ▶ The income from a 2010 conversion of a traditional IRA to a Roth IRA will *not* be taxed in 2010 but rather will be taxed over the next two tax years — one half in each of 2011 and 2012. Alternatively, you may elect to report all the income from the conversion on your 2010 return.

EXAMPLE

Several years ago, Chris rolled over a distribution from her employer's 401(k) plan to an IRA, paying no income taxes on the rollover. In 2010, when her IRA is worth \$100,000, Chris converts the account to a Roth IRA. Chris has a choice of (1) reporting \$50,000 of the conversion income on her 2011 return and the other \$50,000 on her 2012 return or (2) electing to include all of the \$100,000 of conversion income on her 2010 return.

Distributions. Withdrawing money from a tax-deferred plan or an IRA before age 59½ can result in a 10% tax penalty *in addition* to income taxes. However, the tax law provides a number of penalty exceptions.

- ▶ For example, you can take amounts from an IRA early without penalty to pay qualified higher education expenses or first-time home-buying expenses of up to \$10,000. (These

penalty exceptions do not apply to qualified plan distributions.)

▶ A little-known way to avoid the penalty is by taking a series of substantially equal periodic payments. The IRS has rules for calculating the payment amounts. At a minimum, you must take the payments at least annually for five years or until you reach age 59½, whichever comes later.



The tax law does not allow you to leave money in tax-deferred plans indefinitely. After you reach age 70½, you generally must begin taking annual “required minimum distributions” (RMDs) from your traditional IRAs and any employer-sponsored plans in which you participate. Note, however, that no RMDs are required for the 2009 tax year under a temporary one-year suspension. Also, your employer’s plan may permit you to delay the start of RMDs past age 70½ if you haven’t retired and are not a 5% owner of the company. And what about your Roth IRA? Minimum distributions are not required from Roth IRAs until after the account owner’s death.

- ▶ If you are a beneficiary of an IRA or plan account, consider your withdrawal options carefully. You may have an opportunity to delay income taxes by stretching out withdrawals over your life expectancy. Inherited plan assets also may be rolled into an IRA. (Requirements apply.)
- ▶ As the sole beneficiary of your spouse’s IRA, you would have the opportunity to retitle the account in your own name after your spouse’s death and be treated as the owner for tax purposes. This treatment may be advantageous if you want to delay RMDs until after you reach

age 70½. However, if you expect to take money from the IRA before age 59½, you may prefer to be treated as the IRA beneficiary so that the 10% penalty on early withdrawals will not apply.

Social Security. A portion of your Social Security retirement benefits will be subject to tax if your “provisional income” for the year is more than \$25,000 (\$32,000 on a joint return). You will be taxed on up to 85% of your benefits if your provisional income is more than \$34,000 (\$44,000 if married filing jointly). Provisional income is defined as your AGI with certain modifications, plus one half of your Social Security benefits for the year. You also have to include otherwise tax-exempt municipal bond interest in your provisional income.

CHARITABLE CONTRIBUTIONS



Your contributions to qualified organizations are generally tax deductible as an itemized deduction. If you plan to make a large donation, be mindful that the amount you may deduct each year is limited by a percentage-of-income ceiling. The applicable percentage depends on the type of property you contribute and the type of charity that receives your contribution. We can provide details.

Records. You must have records to support your deduction. For cash contributions of *any amount*, you must have a written receipt from the charity or a bank record showing the name of the charity, the date of the contribution, and the amount. You will also need a record of your non-cash contributions, and, if they exceed \$500, you'll have to file a special form with your tax return. You may need an appraisal for larger gifts.

Stock contributions. Contributing publicly traded stock you've held longer than one year avoids capital gains tax

on any price appreciation, while allowing you to deduct the stock's full market value on the date of your gift. You don't get the same tax break for contributions of appreciated stock you've held one year or less — your deduction for the contribution will be limited to your basis in the stock (generally, your cost).

For stock that has declined in value, you'll obtain a better tax result by selling the shares and contributing the proceeds than you will by donating the shares outright. The reason: You'll be able to deduct a capital loss as well as your contribution.

Volunteers. If you do volunteer work, you may be entitled to deduct various unreimbursed expenses as charitable contributions. Potentially deductible expenses include the cost of gas and oil used in driving your car while performing services for the organization (or you may use a standard mileage rate to figure the cost), supplies, and uniforms. If you travel overnight on behalf of an organization, you generally may deduct your unreimbursed travel, transportation, lodging, and meal expenses.

When you receive a benefit. Figuring the amount of your tax deduction can be tricky when you make a contribution to a qualified organization and receive a benefit in return. In this situation, your deduction is limited to the amount over and above the value of the benefit you receive.

EXAMPLE

Don pays \$100 for a ticket to a dinner held for the benefit of a charity, and the dinner's fair market value is \$40. Don's deduction is limited to \$60 — the difference between the amount he paid for the ticket and the value of the dinner.

- ▶ Under a special rule, you may deduct as a charitable contribution 80% of payments made to a college or university in exchange for the right to buy tickets to an athletic event at the school. If you receive tickets in return, you can't deduct the price of the tickets, but 80% of the remaining amount you pay is deductible.
- ▶ You may be able to deduct membership fees or dues you pay to a *qualified* organization.

Generally, only the amount that is more than the value of the benefits you receive is deductible. However, if your annual payment to the organization is \$75 or less, you may disregard the value of rights or privileges that you use frequently while you are a member, such as free or discounted parking and discounted admission to the organization's facilities or events. (This exception doesn't apply to athletic ticket benefits, discussed previously.)

ON THE HOME FRONT

Maintaining your household probably takes a large share of your income every year. You'll want to be sure you capitalize on any tax benefits available to you.

Mortgage interest and taxes. You may deduct interest paid on up to \$1 million of debt incurred to acquire your principal and/or a second residence, as well as interest paid on up to \$100,000 of home equity debt, as an itemized deduction. The home equity interest deduction is available even if you don't spend the money on your home. You also may include the real estate taxes you pay on your property in your itemized deductions.

Refinancing your home mortgage. Your lender may charge you points (prepaid interest) in connection with a mortgage refinancing. Generally, you may deduct the points over the new loan's term as an itemized deduction. But you may deduct points currently to the extent you spend the refinancing proceeds on improvements to your principal residence. If you refinance a second time, you may deduct the balance of the points on your first refinancing, assuming you are switching lenders. If you refinance again with the same lender, any points remaining from the first refinancing are deductible over the new loan's term.

Home rentals. Renting your personal residence for fewer than 15 days during the year can provide a source of tax-free income. However, this tax break extends only so far — expenses associated with the rental of your residence, such as advertising and utilities, are not deductible. When you rent your home for 15 days or more during the year, your rental income is taxable, but, in this

situation, rental expenses are tax deductible (within certain tax law limitations).

Office in the home. If you own a home-based business or professional practice, you may be able to deduct various expenses related to using your home for business purposes, such as electricity, heating/cooling, homeowners or renters insurance, and trash removal.



Deductions for an office in the home generally are available only if you use the space regularly and exclusively for business. The IRS won't allow a deduction if the office occasionally doubles as a den or guest room — even if you use the space strictly for business during the workday.

Homeowners who claim a home office deduction face a potential tax downside. When the home is sold, any gain realized on the sale will be taxable up to the amount of the depreciation deductions that were allowed with respect to the home office for periods after May 6, 1997. (The capital gain exclusion, discussed next, will not apply to that portion of the gain.)

Selling your home. Despite recent declines in home prices, you may be fortunate enough to earn a profit when you sell your principal residence. Up to \$250,000 of gain (\$500,000 for joint filers) on the sale of a principal residence is not subject to tax if you meet tax law requirements. Generally, you may claim this exclusion only once every two years, and you must have owned the home and used it as your principal residence for at least two of the five years immediately before the sale.

- ▶ The maximum \$250,000/\$500,000 gain exclusion is prorated if you sell your home before meeting these requirements because of a change in employment, for health reasons, or because of certain other unforeseen circumstances.

DEALING WITH DEDUCTION FLOORS

Two categories of itemized deductions are limited by income-based “floors.” Unreimbursed medical expenses are deductible only to the extent they, in total, are more than 7.5% of your AGI. Similarly, a 2%-of-AGI floor applies to miscellaneous itemized deductions. As a result, your deduction for expenses in this category is limited to the amount exceeding 2% of your AGI.

Medical expenses. Like many taxpayers, you may assume you won’t qualify for a medical expense deduction because of the 7.5% floor. However, health insurance premiums, prescriptions, co-pays, deductibles, and other out-of-pocket health-care costs you pay can add up quickly. It’s worth a quick check to find out. If you travel to obtain medical treatment, don’t forget to add in your eligible travel costs. The IRS provides a flat mileage rate you can use if you travel by car, or you may include your actual gas and oil expenses.

Miscellaneous itemized deductions. Among other items, this category includes unreimbursed employee business expenses and various expenses related to your investments. Your business travel, entertainment, and auto expenses are potentially deductible if you are not reimbursed for them. These expenses are also deductible if your employer provides you with an expense allowance under a nonaccountable plan and includes the amount in your taxable wages on Form W-2.

The costs of resumé preparation, transportation to job interviews, and other expenses of hunting for a new job are also potentially deductible. To qualify for a deduction, you can’t be looking for your first job or switching careers. Also, the deduction is not available if a “substantial period” has elapsed between your last job and the start of your search for a new one.

- ▶ **Keep track of your medical and miscellaneous expenses during the year. When it looks as though you are close to a floor, see if you can pay expenses before the end of the year to push your total over the floor and gain a deduction for the excess.**



FOR BUSINESS TAXPAYERS

REVIEWING BUSINESS ENTITY CHOICES

Even if you have been in business for some time, you may benefit from reviewing the various forms of business to make sure that your current structure continues to meet your needs from both a non-tax and a tax point of view. Some key tax considerations are highlighted below.

Corporation. Unless a “Subchapter S” election is made, a corporation uses the corporate tax rate schedule on the next page to figure the federal income taxes due on its taxable income. When corporate income is distributed to shareholders as dividends, the corporation receives no deduction for the payments, and the income is taxed again to the shareholders.

- ▶ For the last several years, individual shareholders have enjoyed a relatively low 15% tax rate on qualified dividends. However, this favorable treatment expires after 2010, and dividends will once again be taxed at ordinary rates. As a result, corporations that are in a situation to do so may want to consider distributing dividends in 2010 while shareholders can take advantage of the 15% rate.
- ▶ A corporation may deduct reasonable amounts of compensation paid to shareholders employed by the company. By paying out corporate earnings in the form of tax-deductible

compensation, double taxation of the earnings is avoided.

► Leasing business property or equipment to your corporation is another way to draw out corporate earnings on a tax-deductible basis. Your corporation deducts the rent expense, and you declare the rent as income.

► CORPORATE TAX RATES

Taxable Income	Rate
Up to \$50,000	15%
\$50,001 – \$75,000	25%
\$75,001 – \$100,000	34%
\$100,001 – \$335,000	39%
\$335,001 – \$10 million	34%
Over \$10 million – \$15 million	35%
Over \$15 million – \$18,333,333	38%
Over \$18,333,333	35%

The IRS may assess an “accumulated earnings penalty” on a regular corporation that retains more earnings and profits than are necessary to meet reasonable business requirements. The penalty is designed to encourage corporations to pay taxable dividends to shareholders.

► For 2010, the penalty is 15% of “accumulated taxable income.”

► A corporation may accumulate up to \$250,000 (\$150,000 for certain service corporations) without penalty because of an accumulated earnings credit. Corporations should document the reasons for additional accumulations — the anticipated purchase of a new facility or equipment, for example — in the corporate minutes.

Like individual taxpayers, regular corporations may be subject to the alternative minimum tax. The corporate AMT rate is 20%, and an exemption of up to \$40,000 is available. However, the \$40,000 exemption is phased out for corporations with AMT income between \$150,000 and \$310,000.

A corporation is exempt from the AMT if it qualifies as a “small” corporation. A small corporation is one that has average annual gross receipts of no more than \$7.5 million for all three-year periods beginning after 1993 and ending before the current year. For a corporation’s first three-year period (or portion of a period), a \$5 million average gross receipts threshold applies.

S corporation. Making an S election for a corporation can avoid the problem of double taxation. Subject to certain exceptions, an S corporation does not pay corporate income taxes at the federal level. Instead, the corporation’s income, losses, deductions, and credits are allocated or “passed through” to its shareholders for inclusion on their tax returns. As a result, the corporate income is taxed only once, to the shareholders.

EXAMPLE

Miguel owns 60% of the stock in an S corporation and Stacy owns the other 40%. For its 2010 tax year, the S corporation has taxable income of \$100,000. The corporation pays no federal income tax on the \$100,000 of income. Instead, Miguel includes \$60,000 of the income on his personal return and Stacy includes \$40,000 on her return.

Limited liability company (LLC). An LLC can have one owner, or the company can have co-owners, called “members.” An LLC’s income is taxed to the owners individually. An LLC has more freedom in allocating income and deductions among the owners than an S corporation, which must make such allocations according to ownership percentages.



Partnership. A partnership, by definition, has more than one owner. Partnerships do not pay federal income taxes at the entity level but must file an annual informational return with the IRS. Among other matters, the partnership agreement addresses how business profits and losses will be divided among the partners.

Sole proprietorship. The business income and expenses of a sole proprietor are reported on Schedule C, an attachment to the individual income-tax return. Net earnings from the business are taxed directly to the owner.

- ▶ A married couple who jointly own and operate an unincorporated business and file a joint income-tax return may elect “qualified joint venture” treatment. Making this election eliminates the requirement to file annual partnership returns for the business. Instead, the couple divides the income and expenses of the business and each reports these amounts on the appropriate form, such as Schedule C.
- ▶ To minimize self-employment taxes, plan to take as many deductions as possible on Schedule C. For example, professional fees should be claimed on Schedule C to the extent the expenses are business related.



START-UP STRATEGIES

In the midst of all the activity that accompanies starting a business, tax matters can be easily overlooked. Here are some pointers that will be of interest to you if you are planning to start a business.

Start-up expenses. You'll want to keep track of the expenses you incur in launching the business, such as pre-opening advertising, travel and survey fees, consulting fees, and wages. With the appropriate election, up to \$5,000 of start-up expenses will be deductible in the year your business begins, and any additional expenses can be deducted over a period of 180 months. Absent the election, start-up expenses must be capitalized. Note that the \$5,000 limit is reduced dollar-for-dollar once total start-up costs exceed \$50,000.

EXAMPLE

Before they opened their new restaurant in March 2010, the Smiths spent \$8,000 on start-up costs. The Smiths elect to write off \$5,000 of those expenses on their 2010 return. They may deduct the remaining \$3,000 of expenses over a period of 180 months, at a rate of \$16.67 per month ($\$3,000 \div 180$), starting in March. Their total 2010 deduction for the expenses is \$5,166.70 ($\$16.67 \times 10 \text{ months} = \166.70 ; $\$5,000 + \$166.70 = \$5,166.70$).

Organizational expenses. A new corporation may make a similar election for costs incurred in setting up the company. Examples include legal and accounting fees for establishing the corporation, state incorporation fees, the cost of drafting the corporation's by-laws, and director and shareholder meeting expenses.

Section 1244 stock. You are going into business to make money, not to lose it. Still, if you are incorporating a new business, you should consider taking the precautionary measure of qualifying the stock your corporation issues as "Section 1244" stock. This will require meeting certain tax law requirements. In addition, you should maintain certain records concerning the stock.

What's the benefit? Section 1244 treatment will enable you to deduct any future losses on your stock as ordinary losses, up to an annual maximum of \$50,000 (\$100,000 on a joint return). Ordinary loss treatment is generally preferable to capital loss treatment, since your annual deduction for capital losses is limited to the amount of your capital gains plus an additional \$3,000 (\$1,500 for married-separate filers).

DEDUCTION PLANNING

Much of your business tax planning effort may center on ensuring that potential deductions are not overlooked. Timing issues also may be important in ensuring that you gain the maximum benefit from your deductions.

Bad debts. Monitor your company's accounts receivable and determine if any amounts are uncollectible and can be written off as bad debts. But note: Businesses that use the cash method of accounting may not deduct bad debts, since they do not report sales revenue for tax purposes until they receive payment.

Depreciation. The ability to recover a portion of amounts spent on machinery, equipment, buildings, and other assets through depreciation deductions is a significant tax benefit, especially for capital-intensive businesses. Properly segregating fixed asset costs is essential, since the period over which an asset can be depreciated and the amount deductible in each year varies with the category to which the asset is assigned.

▶ DEPRECIATION UNDER THE MODIFIED ACCELERATED COST RECOVERY SYSTEM

Property Class	Assets Included*
3-year	Tractor units for over-the-road use
5-year	Automobiles, trucks, computers, copiers and other office machinery
7-year	Office furniture and fixtures, agricultural machinery and equipment
10-year	Vessels, barges, and tugs
15-year	Certain land improvements
20-year	Farm buildings (other than certain single-purpose structures)
25-year	Water utility property
Residential rental property (27.5-year)	Apartment buildings, single-family rental properties
Nonresidential real property (39-year)	Office buildings, stores, warehouses

* The lists of property included in each class are not all-inclusive.



- ▶ The depreciation period for commercial buildings and their structural components is 39 years. However, it may be possible to segregate certain building-related costs and depreciate them more quickly than the building itself.
- ▶ With non-real-estate assets, a business generally can deduct a full half-year's worth of depreciation in the first year, regardless of the date the asset is placed in service. However, when more than 40% of such assets are placed in service during the last quarter of the tax year, depreciation is figured using a "mid-quarter convention." In many cases, use of the mid-quarter convention will result in a lower overall depreciation deduction that year. So try to time asset purchases to your best advantage.

Section 179 deduction. Don't overlook the possibility of deducting up to \$134,000 of your 2010 business asset purchases instead of depreciating them. You can make this election for most non-real-estate assets. Note that the Section 179 expensing limit is reduced dollar for dollar as asset purchases rise from \$530,000 to \$664,000, and the deduction can't exceed taxable income from active trades or businesses. (These Section 179 dollar limits are the estimated inflation-adjusted amounts.)

- ▶ Under a special provision, you may qualify to expense amounts spent to make a commercial building energy efficient. Specific energy and power cost reduction targets must be met. There is an overall ceiling on this deduction of \$1.80 per building square foot.

NOL deductions. Your business may carry back a net operating loss (NOL) to offset taxable income for the two preceding tax years. Carrying back an NOL allows a business to secure a refund of taxes paid for those years.



If not completely absorbed, the balance of the NOL may be carried forward for up to 20 years. Instead of carrying an NOL back to previous tax years, a business may elect to carry its NOL forward. This election is worth considering if a company expects to generate a large profit — and a high tax bill — the next year.

▶ As an S corporation shareholder, you may deduct your allocable share of the corporation's net operating loss — provided you have sufficient "basis" in your S corporation stock and in any loans you have made to the corporation. If you need to increase your basis to gain a tax deduction for an NOL, consider loaning the company money before year-end. However, personally guaranteeing a bank or other third-party loan to the corporation will not increase your basis because you do not make an actual economic outlay.

Domestic production activities. Manufacturers, construction contractors, software companies, engineering and architectural firms, and other businesses involved in U.S. production activities may be eligible to deduct 9% of their qualified production activities income or, if less, 9% of their taxable income (determined without regard to the deduction). The deduction is limited to 50% of W-2 wages allocable to domestic production gross receipts.

Timing. From a cash flow standpoint, deducting an expense in the current year and actually paying it in the next tax year can be advantageous.

- ▶ Bonuses, vacation pay, and charitable contributions may be deductible in the current year if paid within the first 2½ months of the following tax year. These strategies are not available to cash-method businesses, and various restrictions and requirements apply.
- ▶ Companies that sponsor profit sharing plans have until the extended due date of their tax return (a possible 8½ months after year-end for a calendar-year corporation) to make a deductible contribution for the previous tax year.

TAX CREDITS

A number of tax credits are available to business taxpayers.

Energy credits. Installing solar energy property, small wind turbines, geothermal heat pumps, and other types of energy-efficient property for business use can result in a tax credit. The property must meet official quality and performance standards, and other requirements apply.



Alternative motor vehicles. Credits are available for the purchase of qualifying new fuel cell, advanced lean-burn technology, alternative fuel, and hybrid vehicles for business use.

Work opportunity credit. This credit is available for hiring employees who are members of certain targeted groups. In general, the credit is 40% of a qualifying employee's first-year wages, up to a maximum of \$6,000, for a maximum credit of \$2,400 per employee. (Different rules apply in certain situations.) The credit reduces the employer's wage deduction dollar for dollar.

Tip credit. A food and beverage establishment can get credit for its share of Social Security taxes paid on

cash tips in excess of the amount treated as wages for purposes of satisfying minimum wage requirements.

Retirement plan startup. The credit is 50% of administrative and retirement-related education expenses for the first three plan years (maximum annual credit of \$500).

Other credits. A variety of other special credits are available to businesses, including the low-income housing credit, the disabled access credit, and the credit for employer-provided child care. Be sure to investigate all of the credits that may be available to your business as you plan your 2010 taxes.

SPONSORING A RETIREMENT PLAN

Retirement plans are not only a sought-after employee benefit, they also offer business owners a valuable opportunity to reduce their tax burden. Subject to tax law limits, contributions to a qualified retirement plan for yourself and any eligible employees are tax deductible. Plan investment earnings are tax deferred, and benefits are not taxed until distributed.



401(k) plans. Participants defer a portion of their pay to individual plan accounts on a pretax basis. The sponsoring employer may make matching contributions but isn't required to do so. In addition to pretax contributions, a 401(k) plan may offer a Roth contribution option. If you are self-employed and do not have employees, you might consider establishing a "solo" 401(k) plan.

Profit sharing plans. Flexibility is one of the key advantages of a profit sharing plan. Whether your company will contribute for a given year — and how much — can be left to its discretion. (Annual contribution limits apply.) If desired, a profit sharing plan may incorporate a 401(k) salary deferral feature, which would give participating employees the ability to save money in the plan through payroll deduction.

Simplified Employee Pension (SEP) plans. As the name implies, a SEP plan is relatively easy to establish and administer. The business funds the plan with tax-deductible contributions to SEP-IRAs set up for the plan participants. (Only pre-1997 SEP plans may accept employee contributions.) The annual employer contribution is discretionary.

SIMPLE plans. Like SEP plans, SIMPLE plans are relatively easy to set up and maintain. Eligible employees have the opportunity to make payroll contributions to the plan on a pretax basis, and the employer is required to make matching or nonelective contributions for employees annually based on a matching formula or percentage that meets minimum tax law requirements. A SIMPLE plan can be established as a SIMPLE 401(k) or a SIMPLE IRA.

Defined benefit plans. Benefits are provided in the form of a traditional pension, typically based on average pay and length of service. Although defined contribution plans, such as those described above, are more commonly used today, a defined benefit plan can be ideal for older owners who desire faster accumulation of benefits. Another avenue you might explore is a hybrid plan (e.g., a cash balance plan) that has features of both a defined contribution and a defined benefit plan.

DB(k) plans. If your business has 500 or fewer employees, a DB(k) plan is yet another option to consider. First available in 2010, a DB(k) plan allows elements of a defined benefit plan and a 401(k) arrangement to be combined in a single plan.

▶ CAN WE HELP?

We hope the strategies presented in this *Tax Planning Guide* will be helpful to you in your 2010 tax planning. Please let us know if you would like planning assistance or more information about the broad range of services we offer.



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