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Do your recent investment decisions have near-term tax implications?

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Most investors who followed sound financial advice saw double-digit gains in their portfolios in 2009, a big change from the losses many experienced in 2008. But what to do about those gains isn't the only thing making tax season this year a little more complicated. Changes in tax law impacting retirement accounts and increasing tax-related enforcement policies have created special considerations, especially for higher-income filers.

While there's no way to know what might trigger an audit of your return, there are some precautions you can take.

What You Should Know:

1. **Reconsider IRA Deductions in Light of Conversion Opportunities**
   Most investors know they have until April 15th to make regular IRA contributions that can be deducted on their 2009 tax return. However, if you are planning to take advantage of the new law allowing higher-income individuals to convert to a Roth IRA in 2010, you should also know the tax benefit of that deduction could be short lived:

   - If you claim a deduction for your 2009 IRA contribution, and then convert that amount to a Roth IRA in 2010, the contribution amount will be treated as taxable income upon conversion.
   - Before making deductible IRA contributions this year, you should first determine if the short-term tax benefits outweigh the future tax owed on that amount if and when you convert to a Roth IRA.

2. **Past Losses Can Offset Last Year's Gains**
   In 2008, investors learned the hard way that capital losses can be used to offset capital gains dollar-for-dollar, but that excess losses can only offset up to $3,000 of other income. After 2009, you should also remember the inverse of that–excess losses from past years can be carried forward to offset the gains you may have realized in 2009. ▶

- Even if you didn't realize any gains in 2009, you can still use $3,000 of your loss from 2008 to offset other income in 2009.
- The rest of your losses from 2008 will carry forward indefinitely to either offset future capital gains or to be used against $3,000 of other income each year.
- Note that you cannot use realized losses in tax-deferred accounts to offset gains in taxable accounts.

3. Be Aware of Rising Tax Audits

The IRS audited more than 1.4 million Americans in 2009, the highest number in 10 years. And the government plans to spend $8.2 billion in tax enforcement initiatives in 2011, a nearly 10% increase over 2009. This rising rate is important for higher-income filers to be aware of as their returns can be more complicated and thus more susceptible to audit. In fact, the IRS has reported that audits of individuals earning more than $200,000 climbed 11% in 2009, and audits of those making more than $1 million rose nearly 30% from 2008.

While there's no way to know what might trigger an audit of your return, there are some precautions you can take to reduce its likelihood or be prepared in the event it occurs.

- If you're self-employed and claiming business expenses, make sure your records are accurate. You need to keep detailed and consistent records of income and expenses with all the proper documentation. It's a good idea to maintain a separate bank account for the business and to consult an attorney or accountant before tax time.
- The government crackdown on offshore bank accounts means taxpayers with foreign accounts should disclose them on their tax returns and be sure to include any income from that bank account on their tax return. Foreign bank deposits that exceed $10,000 at any point during the year must be reported on Form TD F 90-22.1
- Wealthy filers should triple-check everything for omissions and inaccurate numbers, particularly regarding items that are easy for the IRS to verify, such as items reported on W-2s, 1099s, etc.

What You Should Do Now:

A Financial Advisor who understands your unique situation can help you navigate many of the special considerations related to your investment portfolio this tax season. If your 2009 tax return will include any of the items addressed above, we encourage you to consider hiring a professional tax advisor to help review or prepare and file your return. ■

** Robert W. Baird does not offer tax or legal advice.*