2011 Year-End Tax Planning Considerations

With about one month left in the year, we encourage all of our clients to take a few minutes to consider what tax planning may be beneficial prior to the end of the year. Although Congress continues to squabble, there are certainly more than a few things that can be considered to neutralize your taxes for 2011.

Income tax planning calls for deferring income to the next year and accelerating expenses into the current year. This pushes taxes into next year. This is generally beneficial if you'll be subject to the same (or a lower) marginal rate. The 2010 Tax Relief Act extended lower rates through 2012. As such, in 2011 you'll have the opportunity to take advantage of this strategy (unless you move into a higher tax *bracket* next year).
*Potentially controllable income and expense items include:

1. Bonuses
2. Consulting or self-employment income
3. Retirement plan distributions
4. State and local income and real estate taxes
5. Mortgage interest
6. Charitable contributions

*The **qualified charitable distribution (QCD) can satisfy required minimum distributions** (RMD) from an IRA or 401(k) plan. While you can't deduct your contribution, you'll owe no tax on the distributed funds. The QCD provision is scheduled to expire after this year. This tax break is especially advantageous to those who do not itemize deductions.

***Consider the alternative minimum tax** (AMT). You must calculate tax liability under both the regular and the AMT systems, and pay the AMT if your AMT liability is higher. Without proper planning, deferring income or accelerating deductions could trigger the AMT or increase AMT liability this year or next. Further complicating matters is the fact that, unlike the regular tax system, the AMT system isn't regularly adjusted for inflation. Because the alternative minimum tax (AMT) is not indexed for inflation, it encroaches on many moderate-income taxpayers, especially two-income married couples. It's a good idea to consult a tax professional to explore whether certain deductions should be more evenly divided between 2011 and 2012 and which deductions will qualify, or will not be as valuable, for AMT purposes.

*Consider **donating appreciated property to charity** so you can deduct the full value without paying capital gains taxes. But don't donate depreciated property. If an asset has depreciated, sell it first and give the proceeds to charity so you can take the capital loss and a charitable deduction.

*__Bunch itemized deductions.__ Many expenses can be deducted only if they exceed a certain percentage of your adjusted gross income (AGI). Bunching itemized deductible expenses into one year can help you get over these AGI floors. Consider scheduling your non-urgent medical procedures all in one year to clear the 7.5% AGI floor for medical expenses. To overcome the 2% AGI floor for miscellaneous expenses, bunch your pass-through business professional fees such as legal advice and tax planning, plus any unreimbursed business expenses such as travel and vehicle costs.

***Maximize"above-the-line" deductions.** Above-the-line deductions are especially valuable since they reduce your AGI, and AGI is used to test eligibility for many tax benefits. Common above-the-line deductions include traditional Individual Retirement Account (IRA) and Health Savings Account (HSA) contributions, moving expenses, self-employed health insurance costs, alimony payments and any bank penalties you may have had to pay for early account withdrawals.

*A number of tax extenders are scheduled to expire after December 31, 2011. They include: (1) State and local sales tax deduction (if planning on buying a high ticket item such as a vehicle it may pay to accelerate that purchase into 2011 to deduct the sales tax) (2) higher education tuition deduction, and (3) teacher's classroom expense deduction.

*Through the end of 2011 take advantage of **residential energy-efficiency improvements which qualify for a tax credit**. These include qualified windows and doors, insulation products, HVAC systems and roofing. The "lifetime" credit amount for 2011, however, is $500 and no more than $200 of the credit amount can be attributed to exterior windows and skylights.

*The **annual exclusion allows gifting up to $13,000 per year per recipient gift-tax-free** without using up any of your lifetime gift and estate tax exemptions. Making a gift at year-end 2011 to take advantage of this annual, per-donee exclusion should be considered by anyone with even modest wealth. Gifts can still be split between a husband and wife to increase the total amount gifted to one individual to $26,000. If husband and wife split gifts to a son and daughter in law, then the total amount can increase to $52,000 in one year without affecting the $5 million gift/estate tax exclusion.

* **Tuition payments** to an educational institution for the benefit of your children or grandchildren are excluded from gift tax. This is also true of **medical payments paid directly to a hospital** or doctor for someone else's benefit.

*__Consider the $5 million lifetime gift tax exemption__. The current estate tax through 2012 is set at a maximum 35% rate. Although action by Dec. 31, 2011, isn't required, action by Dec. 31, *2012,* may well be. The exemption is scheduled to drop to $1 million on Jan. 1, 2013. In light of this possibility, lifetime gift-giving, ideally on an annual basis, should continue to form part of a broader plan. The $5 million exemption is an unprecedented opportunity to transfer significant wealth to your heirs free of estate or gift taxes. It may be especially valuable if you hold assets you expect to increase significantly in value. Making a gift now will remove not only the assets' current value from your taxable estate, but also all future appreciation on them.

When gifting assets, your tax basis carries over to the recipient, which can lead to significant capital gains tax for the recipient if they sell the assets. If instead the recipient inherits the assets on your death, his or her basis generally will be stepped up to the current market value, reducing or even eliminating capital gains tax liability when the assets are sold.

*The **"kiddie tax,"** which requires a portion of a child's unearned income to be taxed at the parents' marginal rate, has been expanded to apply to full-time students under the age of 24 whose earned income does not represent at least one-half of their support. As such, **be careful when transferring income-producing assets to your kids**.

***Maximize contributions to a retirement account**. Contributions reduce current year taxable income and you don't pay taxes until you take the money out at retirement. Due to the government's perception that there is no inflation, they have capped the amount that an individual can put into a 401k or IRA for 2011. An individual can defer salary of $16,500 into a 401k and the age 50 or older "catch up provision" will remain at $5,500. Additionally, IRA (traditional or Roth) contributions are limited to $5,000 with a $1,000 catch up if age 50 or older.

***Roth IRA Conversions**: If you converted an individual retirement account (IRA) to a Roth IRA in 2010, taxpayers were given an option: recognize all income in 2010 or defer that income, half into 2011 and half into 2012. If you elected to defer income into 2011 and 2012, don't forget to figure that income into your year-end planning for 2011.

If you have not yet made a Roth conversion, doing so by year-end 2011 might be an opportunity. The $100,000 AGI limit on these rollovers was recently lifted, so even high-income taxpayers can convert. Although you will be required to pay tax on the converted amount, it is an effective hedge against future income tax bracket increases.

*Roth IRA's are not subject to RMDs and the ultimate rate paid on distribution will be zero.

*Clients who turned 70½ in 2011 are subject to required minimum distributions for the first time in their life. You should **consider whether to take first time RMD distributions in 2011** rather than wait until the first-year extension date of April 1, 2012. Delaying until then means two distributions in 2012 -- the delayed 2011 RMD and the normally required RMD for 2012.

*The **maximum tax rate for capital gains may rise from 15% to 20% or higher after year-end 2012** because of the scheduled expiration of the Bush-era tax cuts. As such, you may consider accelerating the recognition of capital gains before higher rates go into effect.

*Tax rates for individuals are scheduled to go up in 2013, which means **flow-through entities**, such as partnerships, limited liability companies and S corporations, **might save more by deferring the deductions**.

*The 2010 Tax Relief Act allows the **exclusion of 100% of the gain from the sale or exchange of qualified small business stock (Section 1202)** acquired by an individual after September 27, 2010, and before January 1, 2012, and held for more than five years. The window of opportunity to invest in stock that will yield 100% tax-free gain closes on December 31, 2011.

For many businesses, their biggest 2011 tax-saving opportunity may be enhanced depreciation-related deductions that are scheduled to become less favorable in 2012. For qualified assets acquired and placed in service through Dec. 31, 2011, this additional first-year depreciation allowance is 100%. Among the assets that qualify are *new* tangible property with a recovery period of 20 years or less and off-the-shelf computer software. With a few exceptions, bonus depreciation is scheduled to drop to 50% in 2012.

We hope this information is helpful. For clarification on these or other tax related issues, ***give your CPA a call***. More details can be found on the Web sites of CCH (cch.com), RIA (ria.thomson.com/News/federal.asp) and the IRS (www.irs.gov).

Sincerely,

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