

# 2011 Year-End Tax Planning Letter

## Dear Clients and Friends

The end of another year is in sight. With that in mind, this is a good time to review some year-end tax planning strategies that may help reduce your overall income tax burden.

For anyone who has had a change in circumstances during the year such as marriage or divorce, birth or death of a family member, acquisition or sale of a business, promotion or loss of a job or any other major event, year-end planning may take on increased importance.

Below are several ideas that we have grouped by type of taxpayer. Remember that these items may not all be relevant to your specific situation. Therefore, it is a good idea to check with us before taking any significant steps.

As we have indicated to you in prior communications, tax planning is concerned with the timing and method of reporting income and deductions. Year-end tax planning involves considering at least two years at the same time – this year and the next. The basic philosophy is to defer the payment of tax. Following are some basic principles that can help guide your overall thinking:

- If you expect your tax rate to be higher next year, it might make sense to accelerate income into this year and defer deductions into next year.
- If you think your tax rate might be lower next year, consider deferring income to next year and accelerating deductions into this year.
- If you expect to only qualify for the standard deduction in either year, consider shifting qualified expenditures and claiming itemized deductions to another year.
- If your deductions might be restricted next year due to the alternative minimum tax (AMT), capital loss rules, and/or passive activity loss rules, try to accelerate some into this year.

For 2011, as in previous years, the dreaded phase out rule that previously reduced write-offs for the most popular itemized deductions (including home mortgage interest, state and local taxes, and charitable donations) is gone. We'll talk more about this opportunity later. Current budget proposals include an inflation-adjusted phase out plan for 2011 and beyond.

As of right now, there have not been any major tax changes in 2011. With next year being an election year, it is doubtful any major tax laws will be placed into law till November 2012.

## **Individuals**

### **Tax Credits for Energy Efficient Home improvements**

The tax credit of up to \$1,500 from the qualifying home improvements is gone. However, you can still get a \$500 credit for improvements if you haven't claimed it in past years. It is the last chance to claim a tax credit for 10 percent of the cost of qualifying home improvements (non-business energy property credit), up to a maximum aggregate credit of \$500. The credit applies to energy-efficient improvements such as insulation, exterior windows including skylights, doors, heating and air conditioning systems, water heaters, and certain metal roofs. To qualify for the credit, you will need to complete your purchase on or before December 31, 2011. The credit is limited to \$500 cumulatively – not annually – so if you have claimed the credit in any of the previous years since 2006, the credit or the full amount will not be available in 2011.

Unlike 2010, the IRS placed a maximum credit limitation for windows (\$200), advanced main air circulating fan (\$50), qualified natural gas, propane, oil furnace, or hot water boiler (\$150), and any other item of energy-efficient building property (\$300).

### **Time Capital Gains and Losses**

Generally, gains and losses from securities sales are recognized on the trade date and not the settlement date. December trades will be 2011 transactions, even if the settlement date is in January 2012. Sales at a loss can reduce other capital gains, and a net loss of up to \$ 3,000 can be used to offset other ordinary income.

Holding period plays an important role in determining the type of a gain. The 15 percent maximum capital gain rate (Long-term capital gain) applies to the investments held for more than 12 months. Also, for 2011 it could be as low as 0 percent for a single with taxable income under \$34,500 and for married filing jointly with taxable income under \$69,000. On the other hand, investments held less than 12 months are considered as short-term gains or losses. Short-term gains are considered as ordinary income and are taxed at the taxpayer's marginal tax rate.

Long-term capital losses are used to offset long-term capital gains before they are used to offset short-term capital gains. Similarly, short-term losses must be used to offset short-term capital gains before they are used to offset long-term gains. A taxpayer should try to avoid having long-term capital losses offset long-term capital gains since those losses will be more valuable if they are used to offset short-term capital gains or ordinary income. To do this requires making sure that the long-term capital losses are not taken in the same year that the long-term capital gains are taken. However, this is not just a tax issue. As is the case with most tax planning involving capital gains and losses, investment

factors need to be considered. A taxpayer won't want to defer recognizing gain until the following year if there's too much risk that the value of the property will decline before it can be sold. Similarly, a taxpayer won't want to risk increasing the loss on property that he expects will continue to decline in value by deferring the sale of that property until the following year.

When selling to recognize a capital loss, do not run afoul of the wash sale rules. A wash sale occurs if you repurchase substantially identical assets within the 61 day period beginning 30 days prior to your loss sale and 30 days after the sale. A wash sale will wipe out any loss you thought you had.

### **Maximize Retirement Contributions**

The best way for most of us to reduce the IRS's take is to save for the future by contributing to tax-deferred retirement plans. The more money you funnel into an employer sponsored 401(k) or a similar 403(b) or 457 plan, the less the IRS and the state get to tax. If you have an employer sponsored employment plan and haven't yet contributed the maximum, consider bumping up your year-end contributions. The maximum that you can contribute in 2011 is \$16,500 or an additional \$5,500 in case you are 50 or older. An added benefit to these contributions is the employer's match, which would be a freebie towards your future income and may also qualify you for a tax credit in the current year.

Apart from the contributions in the employer sponsored retirement plans which should be funded by the year-end, some individuals may qualify to make additional contributions to IRA and SEP (simplified employee pension) plans after year-end (April 15, 2012) or to an extended due date of your return in case of a SEP. The maximum you can contribute in IRAs is \$5,000 (or \$6,000 if you are 50 or older). In case of SEP, the maximum contributions can be up to \$49,000. Please contact us early next year if you are interested and to find out if you qualify to make these additional contributions.

### **Roth IRA conversion**

There are several advantages that ROTH IRAs have over traditional IRAs, but a conversion from a traditional IRA and qualified plans to a ROTH IRA results in taxable income. Even so, there are some reasons that you might want to consider converting part or all of your traditional IRA accounts to ROTH IRAs in 2011.

If your traditional IRA has lost substantial value, consider converting it to a ROTH IRA this year because the tax on conversion is based on the fair market value. Because that has dropped in 2011, the tax cost of the conversion will be lower.

The benefit of converting an IRA to a ROTH IRA is the ability to grow the investment with tax-free earnings and later withdraw the money without paying the tax. The flip side is re-characterizing a ROTH IRA back to a traditional IRA if the ROTH has lost significant value since making the conversion to a ROTH. If the IRA was converted to a

ROTH IRA in 2011, it can be recharacterized in the same tax year. You have until the extended due date of your 2011 tax return (Oct. 15, 2012) to do this.

### **Charitable contributions**

Consider contributing appreciated securities instead of cash. You can deduct the fair market value of long-term capital gain property contributed to charity, even though your basis in that security might be significantly less. Not only do you get a higher deduction, but you also avoid taxes on the gain that would have been recognized if you sold it and donated the proceeds. However, if you're determined to get rid of securities that have declined in value since you bought them, don't gift those – instead sell them first to realize the loss, then gift the proceeds. By doing so, you can take the deduction for the gift and at the same time reduce your ordinary income by claiming the loss.

### **Credit card payments**

Using credit card to pay the tax deductible expenditures, including charitable contributions, before year-end secures you a deduction, even if you do not actually pay the credit card company until the following year.

You need to consider the convenience fees charged by the credit card companies. Although those fees may be deductible the fees can be significant..

### **Few other tips to reduce your 2011 adjusted gross income (AGI)**

Numerous tax breaks (tax credits, deductions, and other tax benefits) are reduced or eliminated if a taxpayer's adjusted gross income (AGI), or modified AGI (MAGI), exceeds specified thresholds. As year-end nears, taxpayers who do not anticipate being subject to higher rates next year should consider reducing their 2011 AGI by deferring taxable income into 2012, or by accelerating deductions, if doing so will keep their income level for the current year below the relevant phase-out thresholds (or will mitigate the effect of phase outs).

Not all steps listed below will be available or desirable for every individual, but many whose income without planning would be in the range of a threshold may be able to use one or more of the following strategies to keep AGI below the applicable level:

- *Convert taxable interest to tax-exempt interest.* This will be especially practical where an individual will recognize little or no gain on the disposition of a taxable investment, such as when shifting funds in a taxable money market account to tax-exempt fund. The tax-exempt interest will not be included in AGI (except in determining the taxability of social security benefits), and for some individuals, the after-tax amount received from tax-exempt interest will be at least as much as the after-tax amount received from taxable interest. That's especially true if the tax-exempt interest is exempt from state or local income taxes as well as federal income tax.

- *Convert taxable interest to tax-deferred interest or income.* Shifting some funds to US Series EE bonds or inflation-indexed US Series I savings bonds will help you to not recognize any interest earned on these bonds in the current year. The interest earned on these bonds isn't taxed until the bonds mature or are redeemed, unless the taxpayer elects otherwise. Another possibility would be to shift funds from investments that produce currently taxable income to beaten-down growth stocks, which pay little or no dividends and give the individual the ability to control when any gain on the stocks will eventually be realized by timing their sale to suit his tax goals.
- *Pay off debts.* If an individual has both income-generating investments and debts on which he is paying interest, he should consider selling part of his investments and using the proceeds to pay off the debt. In addition to reducing AGI, this may increase the individual's net income because the reduction in interest payments often is greater than the reduction in the income received on the investment.
- *Increase contributions to Health savings account (HSA).* Individuals who are covered by a qualifying high deductible health plan (and are generally not covered by any other health plan that is not a qualifying high deductible health plan) may make deductible contributions to an HSA. For 2011, assuming a full year coverage, the maximum contribution for self-only coverage is \$3,050, and for family coverage is \$6,150 (a catch-up contribution of \$1,000 for 55 or older). Distributions from an HSA to pay for qualified medical expenses are not taxable. These contributions in excess of medical needs can be withdrawn from the HSA and used for any purpose without penalty (but subject to tax) once the individual reaches age 65.
- *Pay up to \$2,500 of student loan interest.* A taxpayer should consider deducting up to this amount even if less than that amount is required to be paid in that tax year. Any voluntary interest payments up to \$ 2,500 are deductible in the year paid.
- *Defer receipt of year-end bonuses.* An employee who believes a bonus may be coming his way may request that his or her employer delay payment of any bonus until early in the following year.

## **Businesses**

On September 27, 2010 the President signed into law the “Small Business Jobs Act of 2010” which includes a wide-ranging assortment of tax breaks and incentives for businesses. It extended the life of expiring provisions we’re familiar with and added some new deductions that we’ve not seen before. Here’s a brief overview of the tax changes in the new Act and other year-end business tax planning ideas.

### **Enhanced small business expensing (Section 179 expensing)**

To help small businesses quickly recover the cost of capital outlays, small business taxpayers can elect to write off these expenditures in the year they are made instead of recovering them through depreciation. Under the old rules, taxpayers could generally expense up to \$250,000 of qualifying property – generally, machinery, equipment, and software – placed in service during the tax year. This annual limit was reduced by the amount by which the cost of property placed in service exceeded \$800,000. Under the Small Business Jobs Act, for tax years beginning in 2010 and 2011, the \$250,000 limit is increased to \$500,000 and the investment limit to \$2,000,000.

A new provision is also added to allow up to \$250,000 of Section 179 expensing of qualified real property. Qualified real property includes qualified leasehold improvements, restaurant, and retail improvement property.

### **Extension of 100% bonus first-year depreciation**

Before the Small Business Jobs Act, Congress already allowed businesses to more rapidly deduct capital expenditures of most new tangible personal property placed in service in 2008, 2009, or 2010 (before September 9, 2010) by permitting the first-year write-off of 50% of the cost. The new Act extends the first-year 100% write-off to apply to qualifying property placed in service in 2011 or after September 8, 2010. This 100% write-off generally won’t be available next year unless Congress acts to extend it.

### **Boosted deduction for start-up expenditures**

The Small Business Jobs Act allows taxpayers to deduct up to \$10,000 in trade or business start-up expenditures for 2011. The amount that a business can deduct is reduced by which start-up expenditures exceed \$60,000. Previously, the limit of these deductions was capped at \$5,000, subject to a \$50,000 phase-out threshold.

### **100% exclusion of gain from the sale of small business stock**

Ordinarily, individuals can exclude 50% of their gain on the sale of qualified small business stock (QSBS) held for at least five years. This percentage exclusion was temporarily increased to 75% for stock acquired after February 17, 2009 and before January 1, 2011. Under the Small Business Jobs Act, the amount of exclusion is temporarily increased yet again, to 100% of the gain from the sale of qualifying small

business stock that is acquired after September 27, 2010 and before January 1, 2012 and held for more than five years. In addition, the Act also eliminates the alternative minimum tax (AMT) preference item attributable to such sales.

### **Five-year carry back of general business credit**

Generally, small business's unused general business credits can be carried back to the previous year and the remaining amount can be carried forward for 20 years. Under Small Business Jobs Act, for the first tax year of the taxpayer beginning in 2010, eligible small businesses can carry back unused general business credits for five years instead of just one and can be carried forward to 24 years instead of 20 years. Eligible small businesses are sole proprietorships, partnerships, and non-publicly traded corporations with \$50 million or less in average annual gross receipts for the prior three years. Further, general business credits are not subject to AMT.

### **Health insurance tax credits to certain small employers**

The recently enacted health reform legislation provides small employers with a tax credit for non-elective contributions to purchase health insurance for their employees. To qualify, a business must offer health insurance to its employees as part of their compensation and contribute at least half the total premium cost. The business must have no more than 25 full-time equivalents (FTEs), and the employees must have annual full time wages that average no more than \$50,000. However, the full amount of credit is available only to an employer with 10 or fewer FTEs and whose employees have average annual full time equivalent wages of not more than \$25,000. The credit can offset employer's regular tax or its alternative minimum tax (AMT) liability.

Self-employed individuals, including partners and sole proprietors, two percent shareholders of an S corporation, and five percent owners of the employer are not treated as employees for purposes of this credit.

### **Deductibility of health insurance for the purpose of calculating self-employment tax**

The Small Business Jobs Act allows business owners to deduct the cost of health insurance incurred in 2011 for themselves and their family members in calculating their 2011 self-employment tax.

### **Cell phones no longer listed property**

This means that cell phones can be deducted or depreciated like other business property, without onerous recordkeeping requirements.

As noted earlier, there are many other considerations in tax planning that are not addressed here, but our intent is that you use this as a primer for your year-end planning. Starting now can make the process less stressful and leave you with some time to take necessary steps before year-end. If you think you may be affected by tax increases in the future, please call us to discuss it. While the typical tax planning normally suggests the deferral of income and accelerating deductions, your situation may dictate a different strategy. If you know that your income will be higher in 2012 than it was in 2011, you may want to accelerate income and defer deductions into 2011. You might also adopt the same strategy if you believe that the current administration will increase taxes in 2012.

Sincerely,

*Friedman, Lewitt & Assoc.*