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2011 Year-End Tax Planning For Individuals

Dear Client:

Our tax system for the most part remains firmly based upon the calendar year. At year end, a snapshot of your income, deductions and credits is taken. Based on that data, your tax liability for the year is computed. Year-end tax strategies implemented before your tax liability is "set in stone," can therefore make a significant difference in what you owe for the 2011 tax year now drawing to a close.

Tax planning for year-end 2011 should use both traditional year-end strategies as well as those that react to situations unique to this year. Particularly important at year-end 2011 is the impact of certain tax benefits scheduled to end with 2011; a look ahead at possible sea-changes in the tax laws starting in 2013; and attention to new opportunities and pitfalls created during the past year through court cases and IRS rulings.

Income/deduction shifting

The traditional year-end strategy of income shifting applies to year-end 2011 but with an extra twist. Under traditional strategy, you time your income and deductions so that your taxable income is about even for 2011 and 2012 so your tax bracket does not spike in either 2011 or 2012. If you anticipate a higher tax bracket for 2012, you may want to accelerate income into 2011 and defer deductions into 2012. If you anticipate a leaner 2012, income might be delayed through deferred compensation arrangements, postponing year-end bonuses, maximizing deductible retirement contributions, and delaying year-end billings.

The twist for year-end 2011 is the uncertain future for tax rates after 2012. Many political observers forecast that higher-income taxpayers will be asked to pay more, either through higher tax rates or more limited deductions. That may suggest a strategy in which income is not deferred but is recognized now at lower tax rates still available in 2011 and 2012. Our office will keep you posted on developments.

Roth conversions

If you converted an individual retirement account (IRA) to a Roth IRA in 2010, you 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 that income into 2011 and 2012, do not forget to figure that income into your year-end planning for 2011.

If you initiated a Roth conversion earlier in 2011 and that Roth account has declined in value since then, you should consider a “Roth reconversion.” Reconverting your Roth IRA back to a regular IRA before year-end will allow you to avoid paying income tax on an account balance at its higher value.

Finally, if you have not yet made a Roth conversion, doing so at year-end 2011 might be an opportunity worth serious consideration. Variables include your present income tax bracket, how close you are to retirement, and your access to other funds both to pay the conversion tax and to delay distributions from your Roth account later. Our office can help you make the right decision.

AMT

Because the AMT was not indexed for inflation, and for other reasons, the AMT today encroaches on many moderate-income taxpayers, especially two-income married couples. With most of your income and deductions for 2011 more predictable as year-end approaches, now is a good time to compute whether you will be subject to the AMT for 2011 or 2012. Our office can 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.

Gains and losses

Our office can also help you time the recognition of capital gains and losses at year-end to minimize your net capital gains tax and maximize deductible capital losses. Many investors have excess capital losses from recent stock market declines that they may now "carry over" to offset capital gains that would otherwise be taxable.

Also of concern is whether the maximum tax rate for capital gains will rise from 15 percent to 20 percent or higher after year-end 2012 because of the scheduled expiration of the Bush-era tax cuts. Since long-term capital gains are only available on stocks and other capital assets held for more than one year, a capital asset must be bought on or before December 30, 2011 in order to be sold in 2012 and guarantee qualifying under the lower capital gains rates. We can help you coordinate your year-end trades with these tax variables in mind.

Finally, if you would like capital gains taxes at a zero percent rate, consider investing in "Section 1202" small business stock before year end. The 2010 Tax Relief Act allows the exclusion of 100 percent of the gain from the sale or exchange of qualified small business stock 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 percent tax-free gain closes on December 31, 2011.

Payroll taxes

All wage earners and self-employed individuals will experience a tax increase in 2012 unless Congress extends the current employee-side payroll tax cut. For calendar year 2011, the employee-share of OASDI taxes is reduced from 6.2 percent to 4.2 percent up the Social Security wage base of $106,800 (self-employed individuals receive a comparable benefit). President Obama has proposed to extend and enhance the payroll tax cut. The fate of the payroll tax cut will likely be decided by Congress late in 2011.

Life changes

Marriage, divorce, the birth of a child, death, a change in job or loss of a job, and retirement are just some of the life events that trigger a special urgency for year-end tax planning. If you have had a life change, please contact our office so we can review how that change will impact your federal tax liability. After December 31, 2011, it will be too late to alter most of your bottom-line tax liability for 2011.

Medical expenses

Effective January 1, 2011, the *Patient Protection and Affordable Care Act (PPACA)* provides that over-the-counter medications and drugs can no longer be reimbursed from a health flexible spending arrangement (health FSA) unless a prescription is obtained. The rule also applies to health reimbursement arrangements (HRAs), health savings accounts (HSAs), and Archer medical savings accounts (Archer MSAs), an important consideration for employees who are required to make a decision by year-end 2011 on how much to fund their accounts in 2012.

Tax extenders

A number of tax extenders are scheduled to expire after December 31, 2011. They include:

- the state and local sales tax deduction,
- the higher education tuition deduction, and
- the teacher’s classroom expense deduction.

Seniors age 70 1/2 and older should also consider making a charitable contribution directly from their IRAs up to $100,000 and paying no tax on the distribution. This tax break, especially advantageous to those who do not itemize deductions, is scheduled to end for distributions made in tax years beginning after December 31, 2011.

Casualty losses

Taxpayers in many states experienced natural disasters in 2011. A casualty loss can result from the damage, destruction or loss to your property from any sudden, unexpected or unusual event, such as a hurricane, earthquake, wildfire, or flood. Casualty losses are generally deductible in the year the casualty occurred, less ten percent of your adjusted gross income and a $100 per casualty deductible.

However, if you have a casualty loss from a federally declared disaster, you can elect to treat the loss as having occurred in the year immediately preceding the tax year in which the disaster happened, and you can deduct the loss on your return or amended return for that preceding tax year. The election gives taxpayers the opportunity to maximize their tax savings in the year in which the savings will be greatest.

Energy tax incentives

If you are considering replacing your roof, HVAC system, or windows and doors, doing so using energy-efficient materials before January 1, 2012 may generate tax savings. Through the end of 2011, a number of residential energy-efficiency improvements 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. Please call our office for details.

Gift/estate tax

The current estate tax through 2012 is set at a maximum 35 percent rate and a $5 million exemption amount. Many experts predict after 2012 that Congress will lower the exclusion to $3.5 million and raise the top rate to 45 percent. In light of this possibility, lifetime gift-giving, ideally on an annual basis, should continue to form part of a master estate plan. The annual gift tax exclusion per donee on which no gift tax is due is $13,000 for 2011 (and, again, for 2012), with $26,000 allowed to each donee by married couples. 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.

If you have any questions about the tax provisions and year-end planning techniques described in this letter, please contact our office.

Sincerely yours,

Carmody Meach & Choo LLP

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