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Executive Newsletter

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2011 Year-End Tax Planning Update

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It's that time again. The end of each year is always an important time to think about the available tax saving opportunities. We've included our assessment of whether there will be an increase in tax rates for the coming year. We suggest you think about whether you need to project your taxable income for 2011 and take other action(s) before year-end. For example, you might need to increase your withholding to avoid underpayment penalties. Also, you may want to increase your retirement plan contributions before year-end to take advantage of the income tax deferral, especially if any additional company matching is available.

Doing some analysis now will also allow you to determine whether you can and should defer or accelerate income this year.

Below is a summary of a few key changes for 2011 and some suggestions. We are available to help you with year-end planning, and starting sooner is always advisable.

1. Individuals

What's New For 2011:

- The 6.2% tax rate for the employee part of Social Security payroll tax drops to 4.2%.
- There's no phase out of the first 3% of limitation on itemized deductions for high earners and no phase-out of the personal exemption.
- The tax credit for energy saving home improvements has been reduced to 10% with a maximum credit of $500 which is also subject to other new caps. However, the earlier 30% credit continues for alternative energy systems such as solar water heaters.
- The tax deductions for state and local sales taxes instead of income taxes have been extended. This can be beneficial to residents in states with no state income taxes.
- The $8,000 first time homebuyer's credit ends.
- Flexible Spending Accounts, Health Savings Accounts and Health Reimbursement Arrangements can no longer reimburse workers tax-free for nonprescription over the counter drugs.

Ways to manage income:

- **Defer or accelerate collections** if you are self-employed if you expect next year's income to be the same or to increase.
- **Defer or accelerate compensation and bonuses.** Your employer can still accrue and deduct payments in a prior year (2011) as long as the bonuses are paid by March 15th of the following year (2012).
- **Restricted Stock:** If you receive restricted stock, you can elect to treat the lower value stock today as vested and pay the presumably lower tax in 2011 by filing a statement with the IRS within 30 days after you receive the stock.

- **Make withdrawals from retirement plans** if you are over age 59½.
- **Installment sales:** Defer or Accelerate payments on installment notes.
- **Settle any lawsuits** to accelerate settlement payments and closure.
- **Convert traditional retirement plans to Roth retirement plans.**
- **Exercise non-qualified stock options if the exercise price is low.**

Ways to manage deductions:

- **Accelerate or defer purchases which result in sales tax deductions.** This will assure a deduction for sales taxes on the purchases if you elect to claim a state and local general sales tax deduction instead of a state and local income tax deduction.
- **Bunch Miscellaneous Deductions.** Miscellaneous deductions are only allowable in excess of 2% of your adjusted gross income (AGI). You may be able to save taxes this year and next by applying a bunching strategy to "miscellaneous" itemized deductions, medical expenses and other itemized deductions. For example, payments to extend subscriptions can be accelerated or delayed.
- **Accelerate or defer payment of contested taxes and estimated tax payments.** You may want to defer state tax payments so they can be used as deductions against federal taxable income. However, see below regarding alternative minimum tax.
- **Accelerate or defer casualty losses.** An insurance or damage claim can be a write off.
- **Accelerate or defer charitable contributions** to get a tax benefit at the higher rates.
- **Accelerate or defer business expenses** to get a tax benefit at higher rates.
- **Dispose of passive investments.** In general, passive losses cannot be deducted until the asset or passive activity is disposed. By disposing of a passive activity you can time the tax deduction and take losses when rates are higher.

Manage Alternative Minimum Tax:

The alternative minimum tax (AMT) affects tax planning. You should estimate the effect of any year-end planning moves on the alternative minimum tax (AMT) for 2011 keeping in mind that many tax breaks allowed for purposes of calculating regular taxes are disallowed for AMT purposes. These include:

- The deduction for state property taxes on your residence.
  State income taxes (or state sales tax if you elect this deduction option).
- Miscellaneous itemized deductions, and personal exemption deductions.
- Other deductions such as medical expenses.
- If your employer grants you a qualified incentive stock option (ISO) to purchase its stock, you are generally not taxed until you dispose of the stock. However, if you exercise the ISO you may have to add the difference between the fair market value of the stock on the exercise date and the option price to your alternative minimum taxable income.

Review your investment portfolio:

- **Manage capital gains and losses.** Consider the timing of taking gains and using losses in conjunction with changes in rates.
- **Take gains on appreciated stock.** Consider the option of selling a security to realize the gain or loss. If you realize losses, you must wait 30 days before making the purchase or the loss will be disallowed under the "wash sale" rules.

Project tax benefits from making charitable donations:

- **Consider deducting cash or property.** You can deduct up to 50% of your adjusted gross income (AGI) for cash contributions and up to 30% of your AGI for contributions of long-term appreciated securities using the fair market value of those securities. Consider whether the contribution will provide the best benefit in 2011 or 2012. The deduction limits for gifts to private foundations are limited to 30% of AGI for cash contributions and 20% for gifts of stock. Note that when you give away long term capital gain property you can deduct the fair market value but when you give away short term capital gain property you can only deduct the cost basis.
- **Consider making gifts through a donor advised fund (DAF).** This will allow you to take a deduction at the higher level while still being able to direct the fund to a particular charity.
- **Make Charitable Gifts from your IRA.** If you are age 70½ or older, own IRAs (or Roth IRAs), and are thinking of making a charitable gift, consider arranging for the gift to be made directly by the IRA trustee. Such a transfer, if made before year-end, can achieve important tax savings.

2. Estate Planning

What's New for 2011:

- The estate tax returns with a maximum rate of 35% and an exclusion of $5 million.
- The lifetime gift tax exemption also rises to $5 million. The annual gift tax exclusion stays at $13,000. Up to $136,000 in gifts to an alien spouse are excludable.
- The Generation Skipping Tax (GST) returns with an exemption amount of $5 million while the rate is 35%.

Ways to manage tax:

- **Make annual exclusion gifts and pay medical and tuition expenses**. You can save gift and estate taxes by making gifts sheltered by the annual gift tax exclusion before the end of the year. You can give $13,000 in 2011 to an unlimited number of individuals, but you can't carry over unused exclusions from one year to the next. In addition to the annual exclusions, you can also make certain medical and tuition expense payments for others without using up your lifetime gift exemption.
- **Use Special Trusts for tuition payments.** Trusts can be used to avoid federal income tax when the fund is used for paying education expenses of beneficiaries under the age of 21.
- **Use a GRAT.** Consider a grantor retained annuity trust to retain certain rights to property and avoid gift taxes.

3. Businesses

What's New for 2011:

- Electronic funds transfers are required to make all federal deposits, such as deposits of employment tax, excise tax and corporate income tax.
  The R&D credit was extended.
- Self employed persons get the same Social Security break by the reduction in self-employment tax from 15.3% to 13.3%.
- The Section 179 expensing limit has increased to $500,000.

- Businesses of any size can claim 100% bonus depreciation on qualified new assets placed in service.
- A self employed person can no longer deduct health insurance costs in determining self-employment income subject to self-employment taxes, but the person still qualifies for a deduction when calculating taxable income.

Ways to manage tax:

- **Partnerships and S Corporations - basis:** If you own an interest in a partnership or S corporation you may need to increase your tax basis in the entity in order to deduct the losses incurred during the year.
- **Take write-offs on capital purchases**. Small businesses should consider making expenditures that qualify for the business property expensing option, which is up to $500,000. Also, the new law makes certain real property eligible for expensing. In addition, businesses are allowed to write off 100% of the cost of capital expenditures first year depreciation and may be allowed to write off 100% if a proposed bill currently pending is passed by Congress. For example, 100% of the cost of tangible property used in the trade or business can be deducted.
- **Set up self-employment retirement plans.** If you are self-employed and haven't done so yet, consider setting up a self-employed retirement plan before year-end.
- **Maximize retirement plan contributions.** This includes your employer provided retirement plans and any deductible IRA contributions.
- **Tax credits against AMT:** General business credits of eligible small businesses aren't subject to alternative minimum tax credit limitations. This allows eligible small businesses to use all types of general business credits to offset their AMT. In addition, these credits can be carried back five years. Consider energy saving investments and research expenses that may qualify for credits.
- **Rollover Gains:** If you exchange property for like-kind property, e.g. real estate, you may be able to defer recognition of gain.

Executive Gifts of Cars to Charity

We've all heard about getting the "maximum" charitable deduction when you give away your used vehicle to a local charity. This may not be a good strategy as the following facts demonstrate.

Assume you acquired a vehicle for $100,000 and now after ten years, you've racked up a lot of mileage so the blue book value is only $10,000.

If you give your car to a charity, a flatbed truck will haul away your beloved machine to be sold at an auction. The selling price at auction may be as low as 50% of what you'd get by selling the car yourself. Instead, you may want to employ your son or daughter to do the selling and pay them a commission, and then give the cash to the charity. This alternative would yield more for you and more for charity.

If instead, you give away your car to charity, the maximum charitable deduction you can claim is the fair market value of the car. Due to past abuses in this area, the current rules limit this to the actual amount the charity receives from the sale at auction. The charity may get $10,000 at an auction, but more likely, your car will only sell for $5-6,000 maximum. The tax deduction for $6,000 is only worth $2,400, using the 40% tax rate.

If your car is used in a business, the argument changes even more dramatically against a gift of the vehicle. Depreciation rules for luxury cars are limited, and may have only reduced the tax basis of the car by $2,500 (estimate) per year. Tax basis is the original cost less the total depreciation you've claimed over the years of use. After 10 years, the car's tax basis will still be in the $70,000 range.

If you sell your car for $10,000, you can report a $60,000 ordinary loss on your tax return assuming the car is used 100% in your business. The $60,000 loss will yield a tax savings of $24,000, assuming a 40% federal and state combined tax rate. You'll also have the $10,000 cash.

Moreover, the deduction for a year end gift is uncertain because the charity will not be able to inform you until the vehicle is sold in the following year which may be close to, if not, past April 15. The charity will provide you with **Form 1098-C** for the year you made the gift to attach to your return.

Clearly, selling your car to a third party and then making a cash donation to the charity would be more beneficial to all parties, except the IRS!

See Both IRS Publication 526, Charitable Deductions, and Publication 561, "Determining the Value of Donated Property," for details.

Outlook for Higher Rates for 2012

Our recommendations to accelerate or defer income or expenses assume that 2012 tax rates will remain the same. Given that 2012 is an election year, it is not likely that we'll see any increase in the top tax rates of 35% for ordinary income when taxable income hits $379,150 and 15% for capital gains. The $5 million estate and gift tax exclusion will likely be reviewed or adjusted for inflation given the battle of these changes that seemed to have occurred only last month, not 12 months ago. There will also be growing pressure on discrete changes, e.g. changing the tax rate on the "carry" for hedge fund managers from 15% to 35%.

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