December 2011 Monthly Newsletter

It is possible, although doubtful, that Congress could enact sweeping tax reform that could have a major impact in 2012 and beyond. This fact is making tax planning extremely challenging this year. And even if there's no major tax legislation in the immediate future, Congress next year still will have to grapple with a host of thorny issues, such as whether to once again “patch” the alternative minimum tax (e.g., to avoid a drastic drop in post-2011 exemption amounts), and what to do about the post-2012 expiration of the Bush-era income tax cuts (including the current rate schedules, and low tax rates for long-term capital gains and qualified dividends), and the expiration of favorable estate and gift rules for estates of decedents dying, gifts made, or generation-skipping transfers made after Dec. 31, 2012.

Despite a lack of action by Congress, there are solid tax savings to be realized by taking advantage of tax breaks that are on the books for 2011 but may be gone next year unless they are extended by Congress. These include, for individuals: the option to deduct state and local sales and use taxes instead of state and local income taxes; the above-the-line deduction for qualified higher education expenses; and tax-free distributions by those age 70 1/2 or older from IRAs for charitable purposes. For businesses, tax breaks that are available through the end of this year but won't be around next year unless Congress acts include: 100% bonus first year depreciation for most new machinery, equipment and software; an extraordinarily high $500,000 expensing limitation (and within that dollar limit, $250,000 of expensing for qualified real property); and the research tax credit.

Year-End Tax Planning Moves for Individuals

- Fully fund your health savings account for 2011 even if you don’t become eligible to contribute to it until December of 2011. Contributions can be as high as $ 6,150 for family coverage and $ 3,050 for individual coverage.

- Increase the amount you set aside for next year in your employer's health flexible spending account (FSA) if you set aside too little for this year. Don't forget that you can no longer set aside amounts to get tax-free reimbursements for over-the-counter drugs, such as aspirin and antacids.

- Realize losses on stock while substantially preserving your investment position. There are several ways this can be done. For example, you can sell the original holding, then buy back the same securities at least 31 days later. It may be advisable for us to meet to discuss year-end trades you should consider making.

- Postpone income until 2012 and accelerate deductions into 2011 to lower your 2011 tax bill. This strategy may enable you to claim larger deductions, credits, and other tax breaks for 2011 that are phased out over varying levels of adjusted gross income (AGI). These include child tax credits, higher education tax credits, the above-the-line deduction for higher-education expenses, and deductions for student loan interest. Postponing income also is desirable for those taxpayers who anticipate being in a lower tax bracket next year due to changed financial circumstances. Note, however, that in some cases, it may pay to actually accelerate income into 2011. For example, this may be the case where a person's marginal tax rate is much lower this year than it will be next year.

- If you believe a Roth IRA is better than a traditional IRA, and want to remain in the market for the long term, consider converting traditional-IRA money invested in beaten-down stocks (or mutual funds) into a Roth IRA if eligible to do so. Keep in mind, however, that such a conversion will increase your adjusted gross income for 2011.

- It may be advantageous to try to arrange with your employer to defer a bonus that may be coming your way until 2012.

- Consider using a credit card to prepay expenses that can generate deductions for this year.

- If you expect to owe state and local income taxes when you file your return next year, consider asking your employer to increase withholding of state and local taxes (or pay estimated tax payments of state and local taxes) before year-end to pull the deduction of those taxes into 2011 if doing so won't create an alternative minimum tax (AMT) problem.

- Take an eligible rollover distribution from a qualified retirement plan before the end of 2011 if you are facing a penalty for underpayment of estimated tax and the increased withholding option is unavailable or won't sufficiently address the problem. Income tax will be withheld from the distribution and will be applied toward the taxes owed for 2011. You can then timely roll over the gross amount of the distribution, as increased by the amount of withheld tax, to a traditional IRA. No part of the distribution will be includible in income for 2011, but the withheld tax will be applied pro rata over the full 2011 tax year to reduce previous underpayments of estimated tax.

- 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 for medical expenses, are calculated in a more restrictive way for AMT purposes than for regular tax purposes. As a result, in some cases, deductions should not be accelerated.

- Accelerate big ticket purchases into 2011 in order to assure a deduction for sales taxes on the purchases if you will elect to claim a state and local general sales tax deduction instead of a state and local income tax deduction. Unless Congress acts, this election won't be available after 2011.

- 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.

- If you are a homeowner, make energy saving improvements to the residence, such as putting in extra insulation or installing energy saving windows, or an energy efficient heater or air conditioner. You may qualify for a tax credit if the assets are installed in your home before 2012.

- Unless Congress extends it, the up-to-$4,000 above-the-line deduction for qualified higher education expenses will not be available after 2011. Thus, consider prepaying eligible expenses if doing so will increase your deduction for qualified higher education expenses. Generally, the deduction is allowed for qualified education expenses paid in 2011 in connection with enrollment at an institution of higher education during 2011 or for an academic period beginning in 2011 or in the first 3 months of 2012.

- You may want to pay contested taxes to be able to deduct them this year while continuing to contest them next year.

- You may want to settle an insurance or damage claim in order to maximize your casualty loss deduction this year.

- Purchase qualified small business stock (QSBS) before the end of this year. There is no tax on gain from the sale of such stock if it is (1) purchased after September 27, 2010 and before January 1, 2012, and (2) held for more than five years. In addition, such sales won't cause AMT preference problems. To qualify for these breaks, the stock must be issued by a regular (C) corporation with total gross assets of $50 million or less, and a number of other technical requirements must be met. Our office can fill you in on the details.

- If you are age 70-1/2 or older, own 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. • Take required minimum distributions (RMDs) from your IRA or 401(k) plan (or other employer-sponsored retired plan) if you have reached age 70-1/2. Failure to take a required withdrawal can result in a penalty of 50% of the amount of the RMD not withdrawn. If you turned age 70-1/2 in 2011, you can delay the first required distribution to 2012, but if you do, you will have to take a double distribution in 2012—the amount required for 2011 plus the amount required for 2012. Think twice before delaying 2011 distributions to 2012—bunching income into 2012 might push you into a higher tax bracket or have a detrimental impact on various income tax deductions that are reduced at higher income levels. However, it could be beneficial to take both distributions in 2012 if you will be in a substantially lower bracket that year, for example, because you plan to retire late this year.

- In the spirit of the holiday season, you could make gifts sheltered by the annual gift tax exclusion before the end of the year and thereby save gift and estate taxes. You can give $13,000 in 2011 to each of an unlimited number of individuals but you can't carry over unused exclusions from one year to the next. The transfers also may save family income taxes where income-earning property is given to family members in lower income tax brackets who are not subject to the kiddie tax.

Year-End Tax-Planning Moves for Businesses & Business Owners

- Businesses contemplating capital expenditures should consider making expenditures that qualify for 100% bonus first year depreciation if bought and placed in service this year. This 100% first-year write-off generally won't be available next year unless Congress acts to extend it. Thus, enterprises planning to purchase new depreciable property this year or the next should try to accelerate their buying plans, if doing so makes sound business sense.

- Heavy SUV's are also included in the 100% bonus depreciation deduction, subject to certain qualifications. Heavy SUV's are those built on a truck chassis and weighing more than 6,000 pounds, making them exempt from the luxury-auto dollar caps. The SUV must also be otherwise qualified property and business use must be greater than 50%.

- Businesses should also consider making expenditures that qualify for the business property expensing option. For tax years beginning in 2011, the expensing limit is $500,000 and the investment ceiling limit is $2,000,000. And a limited amount of expensing may be claimed for qualified real property. However, unless Congress changes the rules, for tax years beginning in 2012, the dollar limit will drop to $139,000, the beginning-of-phaseout amount will drop to $560,000, and expensing won't be available for qualified real property. The generous dollar ceilings that apply this year mean that many small and medium sized businesses that make timely purchases will be able to currently deduct most if not all their outlays for machinery and equipment. What's more, the expensing deduction is not prorated for the time that the asset is in service during the year. This opens up significant year-end planning opportunities.

- Nail down a work opportunity tax credit (WOTC) by hiring qualifying workers (such as certain veterans) before the end of 2011. Under current law, the WOTC won't be available for workers hired after this year.

- Make qualified research expenses before the end of 2011 to claim a research credit, which won't be available for post-2011 expenditures unless Congress extends the credit.

- If you are self-employed and haven't done so yet, set up a self-employed retirement plan.

- Depending on your particular situation, you may also want to consider deferring a debt-cancellation event until 2012, and disposing of a passive activity to allow you to deduct suspended losses.

- Losses generated by partnerships or S corporations are only deductible if you have basis in the entity. Consider increasing your basis in the entity so you can deduct a loss from it for this year.

Face the alternative minimum tax (AMT) head-on

The alternative minimum tax (AMT) – often called a “stealth tax” – snares unsuspecting or uninformed taxpayers each year. With a better understanding of the rules, you may be able to avoid or reduce adverse tax consequences.

Overview: The AMT is a separate tax system that runs parallel to the regular income tax system. This complex calculation includes additions for “tax preference items” and reductions for personal exemptions and certain tax deductions. There are five basic steps to computing the AMT.

1. Determine your taxable income for regular income tax purposes.

2. Make the technical AMT adjustments required by law.

3. Subtract a special “exemption amount” based on tax filing status ($48,450 for single filers, $74,450 for joint filers, and $37,225 for married filing separately). These exemption amounts are reduced for high-income taxpayers.

4. Apply the AMT rate to the result. The rate is 26% on the first $175,000 of AMT income and 28% for amounts above $175,000.

5. Compare your AMT liability to your regular tax liability. You pay whichever tax is greater.

Best approach: Estimate your AMT exposure before year-end. Depending on your situation, it may make sense to avoid tax preference items or postpone certain deductions. Caution: This is a complex area of the tax law, so contact our office if you need more information or planning guidance.

Tax tips for year-end charitable giving

As the year draws to a close, you may decide to donate cash or property to one or more worthy causes. Besides the satisfaction of helping others, there’s another reward for your benevolence: a tax deduction on your 2011 return. But keep the following points in mind:

- For starters, you may only deduct contributions made to a legitimate tax-exempt charitable organization. Note that a qualified charity cannot be established to benefit a specific individual or family.

- Generally, your deduction is limited to 50% of adjusted gross income (AGI) for the year (30% of AGI for contributions to certain charities and private foundations). Any excess may be carried over for up to five years. The deduction for gifts of property have other AGI limits.

- The tax law imposes strict substantiation requirements. No deduction is allowed for monetary gifts unless you maintain a bank record or written communication from the charity indicating your name and the amount and date of donation. For contributions of $250 or more, you must obtain a contemporaneous written acknowledgement from the charity. If you donate property valued above $500, you must provide a written description with your return. Independent appraisals are required for property donations above $5,000.

- Typically, you may deduct the fair market value of gifts of property owned longer than one year. Any appreciation in value remains untaxed. For instance, if you donate property valued at $5,000 that you acquired five years ago for $1,000, you can deduct $5,000. But the property must be used by the charity to further its tax-exempt purpose.

- For 2011, individuals age 70½ or older can transfer up to $100,000 from an IRA directly to a charity without paying any tax on the distribution. The downside is that the transfer doesn’t qualify for the charitable deduction.

- Finally, you can secure deductions late in the year by donating to charity by credit card. As long as the charge is posted in December, you can deduct it on your 2011 return, even if you don’t pay the credit card until 2012.

New law signed by President Obama on November 21, 2011

On November 21, 2011, President Obama signed the *Three Percent Withholding Repeal and Job Creation Act* into law. This new law repeals three percent withholding on certain payments to government contractors. The law, H.R. 674, was amended to include the *Vow to Hire Heroes Act* which provides tax credits to employers who hire unemployed veterans.

The law creates the “Returning Heroes Tax Credit” and the “Wounded Warriors Tax Credit.” Employers may qualify for a credit of up to $5,600 for hiring a veteran who has been looking for employment for more than six months. A credit of up to $2,400 applies for veterans who have been unemployed for more than four weeks but less than six months. Employers who hire an unemployed veteran with service-connected disabilities who has been looking for work for more than six months may be eligible for a tax credit of up to $9,600.

The credits apply to new hires after November 21, 2011, through December 31, 2012. For more information about the new law, contact our office.

New worker classification program offered by the IRS

Companies that have had worker classification issues are being offered a settlement program by the IRS. The program, labeled the "Voluntary Worker Classification Settlement Program," will let employers who previously misclassified employees as independent contractors make a minimal payment to settle the tax dispute.

The program will give eligible employers substantial relief from federal payroll taxes they may have owed for past periods. Employers must agree to pay just over 1% of wages paid to reclassified workers for the past year and to treat these workers as employees going forward.

Happy Holidays,

Thank you for the opportunity to serve you this past year. Your business is appreciated, and your referrals are welcome. Please mention our name to friends and business associates who may need our services.

Warmest wishes for a happy holiday season and a prosperous 2012.

Stephenson and Warner, Inc.