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Tax Planning for 2011

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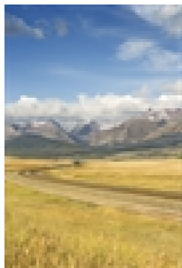
The Income Tax Planning Landscape: 2011



At this time last year, income tax planning was particularly challenging. Several tax deductions had already expired, and significant changes, including new, higher income tax rates, were scheduled to take effect at the end of the year. Legislation passed in mid-December, however, hit the "reset" button, reinstituting already-expired deductions, and extending major tax provisions--including lower rates--for an additional one to two years.

As a result of the December legislation, 2011 tax planning takes place in an environment characterized by something that was missing last year--a relative degree of certainty. That being said, here are some things to keep in mind as you consider your current tax situation.

Tax rates/calculation

- ***Federal income tax rates*** --The same six federal income tax rates that applied in 2010 will continue to apply in 2011 and 2012. So, depending on your taxable income, you'll fall into either the 10%, 15%, 25%, 28%, 33%, or 35% rate bracket. Remember, though, that all of your taxable income is not necessarily taxed at that rate--instead, the rate at which you pay tax generally increases as your income increases. For example, if you're a single individual with 2011 taxable income of $100,000, you fall into the 28% tax bracket. However, your first $8,500 of taxable income is taxed at 10%, your next $26,000 of taxable income is taxed at 15%, and your next $49,100 in taxable income is taxed at 25%. Only $16,400 of your taxable income is actually taxed at 28%.
- ***Rates for long-term capital gains and qualifying dividends*** --As in 2010, long-term capital gains and qualifying dividends continue to be taxed at a maximum rate of 15% through 2012; if your income (including any long-term capital gains and qualifying dividends) puts you in the 10% or 15% income tax brackets in 2011 and 2012, a special 0% rate will generally continue to apply.
- ***Alternative minimum tax (AMT)*** --While regular income tax rates and the maximum rates that apply to long-term capital gains and qualifying dividends were extended through 2012, the latest AMT "fix" (in the form of increased AMT exemption amounts) is effective only through 2011. So, if you think you may be subject to the AMT this year, the good news is that you know ahead of time what the relevant exemption amounts are ($74,450 for married individuals filing jointly, $48,450 for unmarried individuals, $37,225 for married individuals filing separately); the bad news is that the AMT situation for 2012 remains up in the air. You can probably expect another AMT fix later this year, but as it stands now, AMT exemption amounts will drop significantly in 2012, dramatically increasing the number of taxpayers ensnared by this parallel tax system.

Temporary payroll tax reduction

Available for 2009 and 2010, the Making Work Pay tax credit was a refundable tax credit equal to the lesser of 6.2% of earned income or $400 ($800 for married couples filing joint returns); the credit was phased out for those with higher incomes. The tax credit was not extended to 2011, but the December legislation created a new one-year 2% reduction in employee Social Security payroll taxes (the 2% reduction also applies to the self-employment tax paid by self-employed individuals).

So, if you're an employee, 4.2% of your 2011 wages (up to the 2011 taxable wage base of $106,800) is being withheld for your portion of the Social Security retirement component of FICA employment tax instead of the 6.2% that would normally be withheld. If you're self-employed, the 12.4% you would normally pay for the Social Security portion of your 2011 self-employment tax is reduced to 10.4%. So, if you earn $100,000 in wages, you'll have an extra $2,000 in take-home pay for 2011. Consider opportunities to take advantage of this extra income by, for example, increasing your retirement savings; applying the extra money toward a long-term goal could extend the benefit of this temporary tax reduction beyond 2011.

Other considerations

- ***IRA qualified charitable distributions*** --Unless Congress passes additional legislation, 2011 will be the last opportunity for individuals age 70½ or older to make qualified charitable distributions (QCDs) of up to $100,000 from an IRA directly to a qualified charity. These charitable distributions can be excluded from your income, and count toward satisfying any required minimum distributions (RMDs) that you would otherwise have to take from your IRA for 2011.
- ***Depreciation and IRC Section 179 expensing*** --If you're a business owner or self-employed individual, you're allowed a first-year depreciation deduction of 100% of the cost of qualifying property acquired and placed in service during 2011. The "bonus" first-year depreciation deduction drops to 50% for property acquired and placed in service during 2012. Additionally, the maximum amount that can be expensed under Internal Revenue Code (IRC) Section 179 for 2011 is $500,000; in 2012, the limit is currently scheduled to drop to $125,000.
- ***Small business stock*** --Generally, you can exclude 50% of any capital gain from the sale or exchange of qualified small business stock provided that you meet certain requirements, including a five-year holding period. For qualified small business stock issued and acquired in 2011, however, you'll be able to exclude 100% of any capital gain from income if the qualified stock is held for at least five years and all other requirements are met.
- ***Energy efficient improvements*** --Though not as generous as it has been the last two years, a credit is still available to individuals who make energy-efficient improvements to their homes. You may be entitled to a 10% credit for the purchase of qualified energy-efficient improvements, including a qualifying roof, windows, skylights, exterior doors, and insulation materials. Specific credit amounts may also be available for the purchase of specified energy-efficient property: $50 for an advanced main air circulating fan; $150 for a qualified furnace or hot water boiler; and $300 for other items, including qualified electric heat

pump water heaters and central air conditioning units. There's a lifetime credit cap of $500 ($200 for windows), however. So, if you've claimed the credit in the past--in one or more tax years after 2005--you're only entitled to the difference between the current cap and the total amount that you've claimed in the past. That includes any credit that you claimed in 2009 and 2010, when the aggregate limit on the credit was $1,500.

Year-End Tax Planning

As the end of the year approaches, it's time to consider strategies that can help you reduce your tax bill. But most tax tips, suggestions, and strategies are of little practical help without a good understanding of your current tax situation. This is particularly true for year-end planning. You can't know where to go next if you don't know where you are now.

So take a break from the usual fall chores and pull out last year's tax return, along with your current pay stubs and account statements. Doing a few quick projections will help you estimate your present tax situation and identify any glaring issues you'll need to address while there's still time.

When it comes to withholding, don't shortchange yourself

If you project that you'll owe a substantial amount when you file this year's income tax return, ask your employer to increase your federal income tax withholding amounts. If you have both wage and consulting income and are making estimated tax payments, there's an added benefit to doing this: Even though the additional withholding may need to come from your last few paychecks, it's generally treated as having been withheld evenly throughout the year. This may help you avoid paying an estimated tax penalty due to underwithholding.

Of course, if you've significantly overpaid your taxes and estimate you'll be receiving a large refund, you can reduce your withholding accordingly, putting money back in your pocket this year instead of waiting for your refund check to come next year.

Will you suffer the alternative?

Originally intended to prevent the very rich from using "loopholes" to avoid paying taxes, the alternative minimum tax (AMT) snags more and more middle-income taxpayers every year, since (unlike regular income tax) it doesn't keep pace with inflation. The AMT is governed by a separate set of rules that exist in parallel to those for the regular income tax system. These rules disallow certain deductions and personal exemptions that you are allowed to include in computing your regular income tax liability, and treat specific items, such as incentive stock options, differently. As a result, AMT liability may be triggered by such items as:

- Large numbers of personal exemptions
- Large deductible medical expenses
- Large deductions for state, local, personal property, and real estate taxes
- Home equity loan interest where the financing isn't used to buy, build, or improve your home
- Exercising a large incentive stock option
- Large amounts of miscellaneous itemized deductions such as unreimbursed employee business expenses

So when you sit down to project your taxes, calculate your regular income tax on Form 1040, and then consider your potential AMT liability using Form 6251. If it appears you'll be subject to the AMT, you'll need to take a very different planning approach during the last few months of the year. Even some of the most basic year-end tax planning strategies can have unintended consequences under AMT rules. For example, accelerating certain deductions into this year may prove counterproductive since AMT rules may require you to add them back into your income. See a tax professional for information on your specific tax situation.

Timing is everything

The last few months of the year may be the time to consider delaying or accelerating income and deductions, taking into consideration the impact on both this year's taxes and next. If you expect to be in a different tax bracket next

year, doing so may help you minimize your tax liability. For instance, if you expect to be in a lower tax bracket next year, you might want to postpone income from this year to next so that you will pay tax on it next year instead. At the same time, you may want to accelerate your deductions in order to pay less tax this year.

To delay income to the following year, you might be able to:

- Defer year-end bonuses
- Defer the sale of capital gain property (or take installment payments rather than a lump-sum payment)
- Postpone receipt of distributions (other than required minimum distributions) from retirement accounts

To accelerate deductions into this year:

- Consider paying medical expenses in December rather than January, if doing so will allow you to qualify for the medical expense deduction
- Prepay deductible interest
- Make alimony payments early
- Make next year's charitable contributions this year

The gifts that give back

If you itemize your deductions, consider donating money or property to charity before the end of the current tax year in order to increase the amount you can deduct on your taxes. As an aside, now is also a good time to consider making noncharitable gifts. In 2011, you may give up to $13,000 ($26,000 for a married couple) to as many individuals as you want without incurring any federal gift tax consequences. If you gift an appreciated asset, you won't have to pay tax on the gain; any tax is deferred until the recipient of your gift disposes of the property.

Postpone the inevitable

To reduce your taxable income this year, consider maximizing pretax contributions to an employer-sponsored retirement plan such as a 401(k). You won't be taxed on the contributions you make now, and you may be in a lower tax bracket when you do eventually withdraw the funds and report the income.

If you qualify, you might also consider making either a tax-deductible contribution to a traditional IRA or an after-tax contribution to a Roth IRA. In the first instance, a current income tax deduction effectively defers income--and its taxation--to future years; in the second, while there's no current tax deduction allowed, qualifying distributions you take later will be tax free. You'll generally have until the due date of your federal income tax return to make these contributions.

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