



## ***Year-End Tax Planning 2011***

Dear clients and friends,

Year-end tax planning is always a challenge, and this year is no exception.

No one likes to pay taxes any sooner than required. So, traditional year-end strategies tend to focus on deferring income from 2011 to future years and accelerating deductions from 2012 into 2011. In recent years, those strategies have been complicated by the uncertainty surrounding the potential for higher tax rates in the future.

Federal and state governments face budget deficits that tend to pressure elected officials to raise taxes. However, 2012 is an election year, so those facing re-election may try to postpone tax increases as long as possible.

The key to success in any year-end tax strategy involves considering at least two years – in this instance, 2011 and 2012 – at the same time. Unfortunately, this tactic requires you to predict a series of future events. Despite the difficulties involved, you will need to make educated guesses and reasonable assumptions. Remember, no tax strategy is cast in stone until the time for changing strategies has passed. Tax planning is a dynamic process.

Before going into more specific, detailed planning tips, here are some basic principles that can help guide your overall thinking:

- ❖ If you expect your tax rate will be higher in 2012, you may benefit from accelerating income into 2011 and deferring deductions into 2012.
- ❖ If you think your tax rate might be lower next year, consider deferring income to 2012 and accelerating deductions into 2011.

The second strategy is generally preferred when your tax rate in both years is expected to remain the same.

Remember, the focus is on your marginal tax rate. That is the highest rate at which your last, or marginal, dollar of income will be taxed. Even though overall tax rates may rise in the future, if your income will be substantially lower in 2012

Lyle & Associates CPA  
57 E. Washington Street, Chagrin Falls, OH 44022  
P: (440) 247-1178 | F: (440) 247-6719



than in 2011, your marginal tax rate may actually decrease because of our graduated tax bracket system.

Here are some additional guidelines:

- ❖ If you think your deductions might be restricted in 2012 because of current or future changes in the tax law, accelerate some deductible expenses into this year.
- ❖ If you could qualify for the standard deduction in either 2011 or 2012, consider shifting qualified expenditures into the year you expect to itemize your deductions – generally taking the standard deduction in one year and doubling up on itemized deductions in the other year results in greater tax savings.

Fewer deductions are allowed under the alternative minimum tax (AMT). So if you expect to pay the AMT in one year, you may want to shift non-AMT deductions into the non-AMT year.

In drafting this letter, we have focused on tax planning opportunities that involve actions you can take during the remainder of 2011. This letter certainly does not include every tax planning opportunity that may be available to you. In many cases, it is advised that you project your tax under various scenarios to determine the greatest tax savings. We would be pleased to meet with you to discuss all aspects of your tax situation.

We also recognize that not every year-end tax strategy will apply to every reader. As you review the list below, check those items that might apply to you. Then you can easily go back to address the more pertinent planning points that you want to follow up on.

## **Personal Tax Strategies**

### **Moving income or deductions between tax years**

**Salaries, bonuses, etc.** – If your employer is willing, compensation you earn in 2011 can sometimes be paid to you in early 2012. Your employer may even be entitled to its tax deduction in 2011. If you are self-employed and your business operates on the cash method, you can delay (within reason) sending out bills for

Lyle & Associates CPA  
57 E. Washington Street, Chagrin Falls, OH 44022  
P: (440) 247-1178 | F: (440) 247-6719



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2011 work until late in the year, so payment comes to you in 2012. Alternatively, you can offer a discount to a client who prepays if you are trying to increase 2011 income.

**Capital gains and losses** – You generally recognize gains and losses from securities sales on the trade date, not the settlement date. December trades will be 2011 transactions, while January trades will be reported in 2012. Sales at a loss can reduce other capital gains, and excess capital losses can be deducted to offset up to \$3,000 of other income.

Before you recognize a gain, check your holding period. Long-term capital gains from the sales of assets with a holding period greater than one year are eligible for a significantly lower tax rate – generally no more than 15 percent. It could even be as low as 0 percent – see "zero percent tax rate" discussion later in this letter. Short-term capital gains are taxed as high as 35 percent.

When selling to recognize a loss, do not run afoul of the wash-sale rules. A wash-sale occurs if you repurchase substantially identical assets with the 61-day period beginning 30 days prior to your loss sale and ending 30 days after the sale – even if the sale and repurchase occur in different years. A wash-sale will defer any current loss you thought you had.

When planning year-end stock sales, be sure to consider any capital loss carry-forward that may be available to you in 2011. Excess capital losses, above the \$3,000 deduction limit, are available to offset capital gains in future years.

**Installment sales** – Selling an asset at a gain and collecting the proceeds in future years may allow you to defer part of the income until the years in which you receive the payments. Before engaging in this strategy, consider the fact that you will be financing the sale yourself and may face the risk of collection problems. Also consider the possibility that capital gains tax rates could be higher in future years when you collect the payments because installment sales are taxed at the rates in effect the year the gains are recognized.

**Credit card payments** – Paying tax-deductible expenditures—including charitable contributions—with a credit card secures the deduction, even if you do not actually pay the credit card company until the following year. A pledge, or promise, to make the contribution is not good enough. You actually have to make the payment or charge it to your credit card.

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57 E. Washington Street, Chagrin Falls, OH 44022  
P: (440) 247-1178 | F: (440) 247-6719



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**Suspended passive activity losses** – If you own a passive activity with a suspended loss, and you do not expect sufficient passive income in 2011 to allow you to deduct the suspended loss, consider disposing of the activity before Dec. 31. If you dispose of a passive activity with a suspended loss, you can claim the deduction in the year of disposal without the need for passive income.

### **Other year-end strategies for individuals**

**Charitable contributions from IRAs** – The provision for making charitable contributions from an IRA is set to expire on Dec. 31, 2011. Normally when you make a charitable contribution from an IRA, it is treated as a distribution and included in your taxable income. You receive a charitable contribution deduction only if you itemize your deductions.

If you are age 70 1/2 or older, you can have charitable contributions made directly to a charity by your IRA custodian. There is no deduction for the contribution, but it also is not treated as a distribution and not included in your taxable income. This contribution is limited to \$100,000.

If you are planning to use this technique, check to determine the date by which the custodian of your IRA must be notified to effect the contribution prior to Dec. 31, 2011.

**Appreciated assets contributed to charity** – Consider fulfilling your charitable goals by contributing appreciated assets instead of cash. You can deduct the fair market value of long-term capital gain property contributed to charity and you avoid taxes on the appreciation.

**Tax credits for home improvements** – A tax credit for qualifying home improvements may be available for improvements placed in service during 2011, but not in 2012. The credit applies to energy-efficient improvements such as insulation, exterior windows, and heating and air conditioning systems. You will need to complete your purchase before Dec. 31 to qualify for the credit in 2011. The new energy efficiency tax credit is a 10 percent credit, up to a lifetime maximum of \$500. The prior cap had been up to \$1,500, so check to see whether you have claimed this credit in prior years. You may already have claimed the maximum credit allowable.

**Tax credits for alternative vehicles** – Several tax credits are available to purchasers of various types of motor vehicles that use fuel-saving or alternative-

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57 E. Washington Street, Chagrin Falls, OH 44022  
P: (440) 247-1178 | F: (440) 247-6719



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fuel technologies. The credits vary in amount by the type of credit and type of vehicle. Check with the manufacturer to see what tax credits may be available if you are considering the purchase of a new vehicle.

**Zero percent tax rate on capital gains and dividends** – This rate, if not applicable to you personally, may benefit your older children, aging parents or others. The maximum rate of tax on qualified dividends and most long-term capital gains is 15 percent. For those whose marginal income tax rate does not exceed 15 percent, the tax rate on these special types of income is reduced to zero. The zero percent rate applies to a single person with less than \$34,501 in taxable income for 2011 and married persons filing jointly with taxable income under \$69,001.

Many people with taxable income below these thresholds do not experience the types of income that qualify for the zero percent rate. And the kiddie tax rules (see next section) may prevent your children from qualifying. However, if you assist aging parents or others, you might consider gifting appreciated stock or other appreciated capital gain property to them if they are in the 10 or 15 percent tax brackets. They could then sell the investment and qualify for the zero percent tax rate on the gain.

**Kiddie tax rules** – For 2011, all children under age 19 and dependent full-time students under 24 will have their unearned income in excess of \$1,900 taxed at their parents' marginal tax rate. Unearned income includes interest, dividends and capital gains.

Shifting investments to a child's account was once a popular college savings strategy, especially when the child was in a lower tax bracket. Now, a good alternative may be investing in a Section 529 college savings plan or an education IRA, in which funds grow tax-free and subsequent withdrawals are tax-free for qualified secondary education expenses.

**Income tax prepayments** – If your estimated tax payments and withholding are not high enough to avoid penalties, increase payments. Even better, if you receive wages, IRA distributions, annuity payments or other payments from which you can have money withheld, have the additional taxes withheld. You are more likely to avoid penalties by increasing withholding than by increasing your last estimated tax payment because withholding is deemed to be ratable throughout the year.

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If you have a fourth quarter state estimated tax payment due Jan. 15, 2012, consider making the payment late in December if you need additional itemized deductions in 2011. Remember, state income taxes are not deductible if you are subject to the AMT.

**The alternative minimum tax** – An increasing number of middle-income earners, especially retirees, are subject to the AMT. High itemized deductions (other than charitable contributions), high personal exemptions and large capital gains, among other items, can trigger the AMT. New retirees often run afoul of the AMT because they experience lower income while their itemized deductions remain high.

Before implementing any year-end tax strategy, be sure to consider the impact of the AMT.

**Your retirement plans** – To qualify for a deduction in 2011, your retirement plan generally must be in place before the end of the year. Exceptions are IRA and SEP (simplified employee pension) plans, which must be funded by April 15, 2012.

The following limits apply for 2011:

- ❖ Participants in a 401(k) plan can defer up to \$16,500 (\$22,000 for ages 50 or older)
- ❖ The IRA contribution limit is \$5,000 (\$6,000 for ages 50 and older)
- ❖ SIMPLE IRA participants can defer up to \$11,500 (\$14,000 for age 50 and older)
- ❖ Self-employed individuals can contribute 20 percent of their self-employment income up to \$49,000.

**Roth IRA conversion** – Roth IRAs have a number of advantages over traditional IRAs, including no tax when the money is withdrawn. You may wish to consider a conversion from a traditional IRA to a Roth IRA, but the conversion results in taxable income. Even so, you may consider a conversion during 2011 if you expect that the benefits of tax-free withdrawals in the future are greater than the current tax you will pay. This can be a somewhat difficult decision to make, so you may wish to consult your CPA or financial adviser.

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P: (440) 247-1178 | F: (440) 247-6719



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There is no longer an income limitation prohibiting high earners from converting. Anyone with a traditional IRA can make the conversion. And if you are expecting a business loss or have high itemized deductions in 2011 that could offset the income effect of the conversion, your tax consequences may be minimized.

**Saver's credit** – If you or your working children contribute to a retirement plan at work (e.g., 401(k) or 403(b), 457, SEP IRA, SIMPLE) or a traditional IRA, and your income is less than \$56,500 for married couples or \$28,250 for singles, you may qualify for the saver's credit. You must be at least 18 years of age, not a full-time student and not claimed as a dependent on someone else's tax return. Depending on your income, the tax credit ranges from 10 percent of your contribution to as high as 50 percent of your contribution up to a maximum credit of \$1,000. Even if you do not qualify for this credit, it may be available to your older children.

## **Business Tax Strategies**

**Retirement plans for your business** – Starting a small business retirement savings plan can be easier than you think. In addition, a retirement plan has significant tax advantages: Employer contributions are deductible from the employer's income, employee contributions are not taxed until distributed to the employee (for plans other than Roths) and investments in the program grow tax-deferred. Further, the tax law offers a small incentive of a \$500 per year tax credit for the first three years of a new SEP, SIMPLE or other retirement plan to cover the initial setup expenses.

**Depreciation** – Certain enhancements to business depreciation provisions are scheduled to expire Dec. 31, 2011, although President Obama has proposed an extension through 2012.

- ❖ **Section 179** – A \$500,000 expensing election limit applies to qualifying property purchased and placed in service during 2011. As a result, many businesses will receive an immediate tax write-off for the cost of most new and used tangible personal property. Unless Congress acts to further extend the higher limit, it will drop to about \$134,000 in 2012.

Companies that purchase more than \$2 million of qualifying property during 2011 have their deduction amount reduced, dollar-for-dollar, for

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57 E. Washington Street, Chagrin Falls, OH 44022  
P: (440) 247-1178 | F: (440) 247-6719



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purchases in excess of \$2 million. So the deduction is not available to those companies that purchase and place in service more than \$2.5 million of qualifying property during 2011. The deduction is also not available to the extent it increases or results in a net operating loss (the taxable income limit).

Businesses that use a fiscal year as their tax accounting year should note that the deduction limit applies to property purchased and placed in service during their tax year beginning in 2011.

Qualifying assets generally include machinery, equipment and other personal property acquisitions. In addition, the definition of qualified property is temporarily extended to include certain real property such as qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property.

- ❖ **Bonus depreciation** – Property that does not qualify for an immediate tax write-off under the expensing election may qualify for an increased first-year depreciation deduction under bonus depreciation rules. Unlike the Section 179 deduction, there are no restrictions on the amount of qualifying property and there is no taxable income limit. The deduction is 100 percent of the cost for property purchased and placed in service during 2011. Unless Congress acts to extend the bonus depreciation rules (now proposed by the President), they will not be available for 2012.

To qualify for bonus depreciation, the property must be new. Used property does not qualify. In addition, the property must:

- Have an applicable MACRS recovery period of 20 years or less,
- Be water utility property or computer software not covered by the Section 197 amortization rules, or
- Be qualified leasehold improvement property.

**Cost segregation** – Buildings and other real estate generally do not qualify for bonus depreciation or the expensing election. However, a cost-segregation study may be able to identify qualifying property within the overall project, which can often significantly increase your deduction.



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**Health insurance tax credit** – To encourage smaller businesses to offer medical insurance coverage for their employees, the law offers a tax credit to offset all or part of the cost. If your business qualifies as a small employer, meaning fewer than 25 employees and average annual wages of less than \$50,000, you are eligible for a credit of up to 35 percent of nonelective contributions you make on behalf of your employees for medical insurance premiums. The credit varies based on the numbers of employees and average compensation. Very small employers with 10 or fewer employees and average wages of less than \$25,000 are eligible for the entire 35 percent credit.

**Credit for hiring new employees** – Businesses that hire workers who are members of certain target groups, such as disabled veterans, food stamp recipients and ex-felons, can claim a credit up to 40 percent of the first \$6,000 of wages paid to each such employee.

**Losses from pass-through entities** – Economic pressures are causing many historically profitable businesses to experience operating losses. If you are an owner of a pass-through business entity operating as a partnership, LLC, S corporation or trust, and the business will incur a loss in 2011, you may need to plan ahead to be sure you can take advantage of that loss on your personal tax return.

**If your business activity is "passive"** – generally a rental real estate activity or a business in which you do not materially participate. You may not be able to deduct the loss unless you also have passive income. Even if you are actively involved in the business, your loss may not be deductible if you do not have "basis." These rules can be complicated, and you should consult with your tax adviser. But there are steps you can take prior to the end of the tax year that may turn these nondeductible losses into deductions:

- ❖ Work more hours in the business to increase material participation.
- ❖ Invest more in the business.
- ❖ Otherwise increase your basis.

**Paying corporate dividends** – Profits of traditional C corporations (those that have not elected S corporation pass-through status) are taxed twice: once when earned by the corporation and again when distributed as a dividend to the shareholders. Many have seen the current 15 percent tax rate on qualified dividends as an opportunity to pay out accumulated earnings at relatively low tax

Lyle & Associates CPA  
57 E. Washington Street, Chagrin Falls, OH 44022  
P: (440) 247-1178 | F: (440) 247-6719



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rates. It is likely that the tax rate on dividends will increase in the future, so you may wish to discuss with your tax adviser the possibility of distributing profits to lock in the current 15 percent rate.

## **Estate & Gift Tax Planning Strategies**

**Estate planning** – The estate and gift tax exemption amount for 2011 is \$5 million – essentially \$10 million for a married couple. Even if your estate is below the taxable threshold, it is important to have a will. Make sure your will distributes your assets in the appropriate manner. Again, there is uncertainty in the future about where the estate tax exemption and tax rates will end up. And with all of the recent changes, it is a good idea to review your plan to ensure it is up to date. Because the estate and gift tax exemptions were recently reunified, now may be an excellent time to make gifts to take advantage of the \$5/\$10 million lifetime exemption. Making large gifts under the exemption amount not only removes the value of these gifts from your estate but also future appreciation of the gifted assets without estate tax consequences. Your tax adviser has many techniques to accomplish these transfers.

With states looking for additional revenue to balance their budgets, state inheritance taxes are receiving increased attention. Many states have had changes in their inheritance laws. Be sure your estate plan minimizes inheritance taxes in your state of residence and in any states in which you own property.

**Gift tax** – The annual gift tax exclusion for 2011 remains at \$13,000 per person. If you are married, you can gift up to \$26,000 per donee, per year, by using the gift-splitting rules, without any federal gift tax ramifications. Gifting is a good way to reduce your taxable estate and may be important in a good estate plan. For example, if you and your spouse have two children, with gift-splitting, you can give each child \$26,000 in late December and another \$26,000 in early January. If your children are married and/or you have grandchildren, the opportunity increases accordingly.

## **Conclusion**

Lyle & Associates CPA  
57 E. Washington Street, Chagrin Falls, OH 44022  
P: (440) 247-1178 | F: (440) 247-6719



When Congress dealt with the so-called Bush tax cuts at the end of 2010, the effect was to delay a decision for another two years. These provisions, originally enacted in 2001, reduced marginal tax rates for all taxpayers, provided relief from the marriage penalty, increased child tax credits, expanded education-related tax benefits and phased out the estate tax.

These laws, including the recently enacted estate tax changes, are now set to expire, or sunset, on Dec. 31, 2012. If Congress does not act, most of these tax benefits will disappear, and taxes will automatically increase to pre-2001 levels on Jan. 1, 2013.

Without congressional action to extend or change these provisions:

- ❖ The highest marginal income tax rate will increase from 35 percent to 39.6 percent.
- ❖ The capital gains rate will increase from 15 percent to 28 percent.
- ❖ The highest tax rate on qualifying dividends will go up from 15 percent to 39.6 percent.
- ❖ The estate tax exemption will drop to \$1 million.
- ❖ The top estate tax rate will rise to 55 percent.
- ❖ The Section 179 expense election limit will drop to \$25,000.

Some future tax changes have already been enacted but have yet to take effect:

- ❖ Effective Jan, 1, 2013, a new Medicare Hospital Insurance (HI) tax applies to high income individual taxpayers. The tax is 0.9 percent of earned income in excess of \$200,000 for single filers and \$250,000 for couples filing joint returns. An additional tax at the rate of 3.8 percent applies to investment income for the same individuals. Investment income includes dividends, annuities, royalties and rents and others. Now may be a good time to talk with your tax adviser about some longer-term strategies for avoiding this tax – realizing capital gains sooner, investing in municipal bonds, increasing retirement contributions, etc.
- ❖ Also for 2013, the threshold for the itemized deduction for unreimbursed medical expenses is increased to 10 percent of adjusted gross income from the current 7.5 percent. If you have a choice regarding incurring



unreimbursed medical costs, you may want to plan for these unreimbursed procedures in 2011 or 2012 to maximize your tax benefit. There is a break for older taxpayers. If an individual or spouse is age 65 or older, the threshold remains at 7.5 percent of adjusted gross income through 2016.

Although we have covered a number of topics in this letter, we undoubtedly did not address every issue relating to your specific situation. Please consult with your tax adviser before implementing any of these tax planning strategies.