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A PROFESSIONAL CORPORATION OF CERTIFIED PUBLIC ACCOUNTANTS

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Dear Clients and Friends,

Thanks to legislation passed at the end of 2010, there is temporary stability in the tax law. Most of the rules in effect in 2010 were extended through December 2012. That gives taxpayers a two-year respite from major changes to the tax code and the opportunity to do effective short-term tax planning.

With an economy that is still struggling, a federal deficit that is staggering, and a Presidential election on the horizon, it's relatively clear that 2013 will bring some major changes. That's when the current tax rules are scheduled to expire, more of the health care reform law is scheduled to take effect, and automatic spending cuts will go into effect if Congress has not yet passed legislation to cut the deficit.

Tax increases are likely to be included in the big changes that lie ahead. That makes tax planning for this year and next more critical than ever. This *Letter* is being sent to remind you that now is the ideal time to identify actions you can take before year-end to cut your 2011 taxes. It's also the right time to look ahead and plan for the coming tax changes. Please call if you have questions or if you would like to get together to discuss your tax planning options. And please share this *Letter* with friends or associates who might be interested in this information.

Consider final steps to cut your tax bill

As 2011 winds down there's less uncertainty about the short-term outlook for tax law than we had at the end of last year. With this temporary clarity comes the opportunity to create a sound tax-saving plan – and the time to put your plan into action. Here are several strategies to consider.

■ Reap tax benefits with retirement savings

When it comes to retirement saving, rule number one is to contribute the maximum amount allowed every year.

For 2011, the IRA contribution limit is \$5,000, and those 50 and older can contribute \$6,000. Participants in a 401(k) plan can contribute as much as \$16,500 (\$22,000 if 50 or older).

Did you know you can make IRA contributions for your spouse when you're working and your spouse is not? For 2011, the maximum spousal IRA contribution is the lesser of \$5,000 or your combined earned income. You can add an additional \$1,000 when your spouse is over age 50.

If you're self-employed, establishing a retirement plan such as a SEP or a SIMPLE means a current-year tax deduction in addition to tax-deferred growth. For 2011, you can contribute 25% of your salary to a SEP plan, up to a maximum contribution of \$49,000. The maximum SIMPLE contribution is \$11,500, plus an additional \$2,500 as a catch-up contribution if you're over age 50. A federal tax credit may also be available – up to \$500 for each of the first three years of your new plan. Remember, credits reduce your tax bill dollar for dollar.

■ Roth conversions affect taxes

Roth conversions were included in tax planning last year, in part due to the one-time opportunity to defer paying federal income tax on the conversion. If you made the deferral election, remember you'll report half the income on this year's return. Current or prior-year net operating losses, unused tax credits, and deductions that lower your adjusted gross income can help reduce the resulting tax bill.

Haven't converted to a Roth yet? You still have time to decide if a full or partial Roth conversion makes sense for you this year. A potential tax-reducing suggestion: Transfer investments from your traditional IRA to a Roth during a market dip. You'll capture after-conversion growth without owing additional tax.

Are you already taking required withdrawals from your retirement accounts? Then you know required minimum distributions from traditional IRAs increase your adjusted gross income (AGI). In turn, your AGI affects how much of your social security benefits are taxable. One option for reducing the impact is to take only the minimum from your traditional IRA. Use nontaxable Roth distributions or capital gain/loss harvesting in taxable accounts to supplement your income.

Alternatively, during 2011 you can make a qualified charitable distribution from your traditional IRA of up to \$100,000. The donation counts toward your required distribution, yet has no effect on your AGI.

■ Reduce AGI to qualify for tax breaks

Reducing your adjusted gross income could increase eligibility for income-limited deductions and credits.

The standard deduction for 2011 is \$11,600 when you're married filing jointly (\$5,800 when you're single). When your itemized deductions; that is, expenses you pay for medical care, mortgage interest, taxes, charitable contributions, casualty losses, and miscellaneous deductions, are close to that amount, advance payments could save you tax dollars. For example, you can choose to make your final estimated state income tax payment in December instead of January. Since itemized deductions are no longer limited by your income, timing the payment of expenses might be more beneficial than you expect.

There's another reason to double-check deductions: your alternative minimum tax (AMT) exposure. Certain expenses, including state taxes and medical costs, are reduced or eliminated under AMT rules. The AMT calculation also eliminates the standard deduction. In some cases, you may save money if you claim itemized deductions even if they total less than your standard deduction.

■ Review support provided for relatives

While planning to maximize deductions, remember to take into account the financial support you provide for relatives. Potential tax breaks include dependency exemptions, head-of-household filing status, medical deductions, and the dependent care tax credit. Generally, you'll need to provide over half of your relative's living expenses.

What if you don't provide more than 50% of support for your relative? You could enter into an arrangement with other family members who provide help, or you could shift assets you would dispose of anyway to pay for the support. You would then be shifting the related income and tax to your relative.

Here's an illustration of asset and income shifting. Instead of selling stock at a gain and using the proceeds to pay for a parent's living expenses, gift the stock to your parent and let him or her make the sale. Long-term gains could qualify for a zero-percent tax rate if your parent is in the lower tax brackets.

■ Assess equipment needs for your business

For business owners, this year offers what may be a last-chance opportunity for an enhanced deduction: 100% bonus depreciation is scheduled to expire December 31. The increased Section 179 expensing of up to \$500,000 is also slated to shrink after the end of the year.

Synchronize these two tax benefits with your asset purchase plan before year-end to make the most of 2011 deductions. For instance, you can apply the Section 179 deduction to used property, while bonus depreciation is available only for new assets you buy and place in service in 2011. One caution: Some states do not follow federal bonus depreciation rules.

■ Choose strategies that fit your situation

Other strategies for reducing your 2011 federal income tax bill include maximizing losses by increasing your participation in passive activities, taking steps to write off worthless securities and bad debts, and harvesting capital losses.

Be aware that Congress might pass legislation before year-end that would require adjustments to your tax plan. Contact us for guidance in identifying the tax strategies that best fit your situation.

More tax-savers to consider as year-end approaches

- Estimate your tax liability for 2011. Adjust your final quarterly voucher or your withholding to avoid underpayment penalties. Check estimated payments for your C corporation for the same reason.
- Consider prepaying college tuition you'll owe for the first semester of 2012. Expenses paid for you, your spouse, or your dependents will count on your 2011 return if you qualify for education tax credits. Breaks include the American Opportunity Credit, which can reduce your tax bill by up to \$2,500 and is partially refundable.
- Gather tax identification numbers your business will need to issue year-end reporting statements. Though two reporting requirements were repealed (the one for rental property owners and the one for payments to corporations), the old rules live on. In addition, penalties for failure to file have increased.
- Consider setting up a newly available SIMPLE cafeteria plan for your business. The plus: pre-tax employee benefits without the need for discrimination testing.
- Hire your child under the age of 18 to do legitimate work in your business. You get a business tax deduction, and your child can earn up to \$5,800 without paying income tax. Bonus: When your business is a sole proprietorship, you don't have to pay FICA taxes. Double bonus: The kiddie tax does not apply to wages.
- Start a retirement account for your working child. Boost the tax savings you get from paying your child to work in your business by gifting the child money for a deductible, traditional IRA contribution. The maximum basic contribution for 2011 is \$5,000.
- Claim the last of the residential energy credit. Install certain energy efficient property in your home, such as insulation, doors, and windows, and get a federal tax credit of up to \$500. That's the aggregate total credit, including amounts you claimed in prior years. The credit is scheduled to expire after December 2011.

- Get the documentation you'll need for all your 2011 charitable contributions, or you risk losing your deduction. Even gifts under \$250 require a bank record or a receipt from the charity.

Unlock the secret to tax rate planning

Do you know your marginal tax rate? More importantly, do you know your real tax rate? They are not the same, and knowing the difference can be critical to effective tax planning.

The U.S. individual income tax system is based on six tiers of rates: 10%, 15%, 25%, 28%, 33%, and 35%. A common misconception is that a taxpayer falls into just one of these brackets. But actually if someone's income is high enough, their tax bill could be affected by all six. This is because the tax system is graduated, meaning the first taxable dollars are taxed at the lowest rates first, then move up the scale until the marginal rate is reached. Your marginal rate is the rate you will pay on your next dollar of taxable income. Your real tax rate (also called your effective tax rate) is the actual percent of tax you pay on your taxable income.

For example, the 10% rate is assessed on taxable income from \$1 to \$8,500 (if filing as single in 2011). The 15% bracket covers income from \$8,501 to \$34,500. If your taxable income is \$30,000, your marginal (i.e., top tier) tax rate is 15%, but your real tax rate will be less because the first \$8,500 of income is taxed at 10%.

Other factors affect your rate

There are other factors that can affect real tax rate. Personal exemptions and itemized or standard deductions can lower taxable income and thereby lower one's overall rate. Conversely, unearned income such as interest and dividends might raise a taxpayer to a higher bracket. And some types of income are taxed differently from earned income. Long-term capital gains are taxed at 15% unless your ordinary income tax bracket is 10% or 15%, in which case long-term capital gains are not taxed at all.

Here's the point

Knowing where your income is in relation to the six brackets can make a big difference in keeping your real tax rate as low as possible.

Say for example your taxable income is sitting at \$83,600, which is the top of the single 25% tax bracket. The next dollar you earn above that figure (up to \$174,400) will be taxed at your marginal rate of 28%. So if the timing of a future receipt of income is within your control, such as from a pending business contract, consider deferring the income to next year. Another strategy might be to reduce taxable interest income by keeping money in a tax-exempt investment instead of a taxable one.

Or consider moving savings into Series EE savings bonds, where tax on the interest is deferred. You might also invest in longer-term CDs which pay interest in the next tax year. Or defer taking short-term capital gains until next year.

On the other hand if your income is just above a certain tax bracket, your strategy might be to look for deductions that will bring your income back down into the lower bracket. Options include such steps as contributing the maximum allowed to your 401(k) plan, your SEP, or your SIMPLE retirement plan. Another possibility is making a deductible IRA contribution for you and your spouse.

With the economy causing many household incomes to vary significantly from year to year, watching your marginal tax bracket is more important than ever. Contact our office today if you would like more information or a complete analysis of where you stand.

NOTE: This newsletter is issued to provide you with information about minimizing your taxes. Do not apply this general information to your specific situation without additional details. Be aware that the tax laws contain varying effective dates and numerous limitations and exceptions that cannot be summarized easily. For details and guidance in applying the tax rules to your individual circumstances, please contact us.