



Year-End Tax Considerations for 2011

As a shaky 2011 comes to a close, there is still time to bolster the bottom line by trimming your 2011 tax bill. Although there are significant tax debates going on at this time in Washington, there is very little chance that the tax brackets will change in 2012. Therefore, if you believe you will be in the same bracket both this year and next, it makes sense to hold down your 2011 tax bill by deferring income and utilizing any deductions you can in 2011. If you are a consultant, for example, delay your billings until late December. Reverse the strategy if you think you'll be in a higher tax bracket next year: Deductions are always more valuable against a higher tax rate.

Scheduled Tax Increases

Some tax increases are already scheduled for 2013, unless Congress acts in the interim to change them. These include:

- **Ordinary income:** Ordinary income tax rates will increase to their pre-2001 levels with a top rate of 39.6%.
- **Qualified dividends:** Maximum of 15% tax rate in 2011 and 2012 and can increase to a top rate of 39.6% starting in 2013 – talk about an increase!
- **Long-term capital gains:** The top rate on long-term capital gains will be 20%, up from 15% today.
- **Medicare tax:** There will be an additional Medicare payroll tax of 0.9% (without a cap) on wages and self-employment income over \$200,000 for single taxpayers and \$250,000 for married couples.
- A new **Medicare tax of up to 3.8%** will be imposed on the unearned income of high-income taxpayers (\$200,000 single/\$250,000 married), estates, and trusts (with some modification).
- **Itemized medical deductions:** The deduction floor increases to 10% of AGI; the floor remains at 7.5% until 2016 for taxpayers age 65 and older.

Potential Tax Increases

- **Overall Limits on Itemized Deductions:** This approach limits a high-income taxpayer's ability to fully utilize their itemized deductions for expenses such as home mortgage interest, estate and local property taxes and charitable contributions. Instead of allowing these taxpayers to claim the deductions based on their marginal tax bracket, they would be limited to 28%.
- **Millionaires Surtax:** There was recently a proposed 5.6% surtax on those with the highest income. Added to the other scheduled changes in tax rates, this would make for a substantial increase in the top marginal tax rate. For example, if the Bush tax cuts are allowed to expire, the tax on short-term capital gains will revert to 39.6% in 2013. When you add the Medicare surtax, the top short-term gain tax rate becomes 43.4%. If the "millionaires" tax at 5.6% is enacted, the top federal tax rate will be as high as 49% - 40% higher than the current 35% max tax rate!

Federal Income Tax Rates		
	2011 & 2012	Scheduled for 2013
Ordinary Taxable Income Rates	10%, 15%, 25%, 28%, 33%, 35%	15%, 25%, 31%, 36%, 39.6%
Long-Term Capital Gains Rate	0% rate (for 10/15% brackets); 15% rate (for other tax brackets)	10% (for 15% bracket); 20% rate (for other brackets)
Qualified Dividends Rate	0% rate (for 10/15% brackets); 15% rate (for other tax brackets)	Taxed as ordinary income.

Major Tax Code Overhaul Possible: The tax code after 2012 could be subject to major revisions as a result of the tax proposals set forth by most of the Presidential candidates. The winners of the elections in the fall of 2012 will likely suggest major changes to the tax code. One example is the plan suggested by some members of the debt super-committee which would lower incremental tax rates in general, making the top marginal rate 28%, but severely limit or eliminate many of the deductions.

Needless to say, how this all shapes up after the elections in the fall of 2012 will drastically alter tax planning for year-end 2012. It also has ramifications for making longer-term decisions in 2011. For example, taking out a mortgage loan may not make as much sense in the long-term if you cannot fully utilize the mortgage interest deduction. Another example would be the decision to depreciate asset acquisitions over a period of years or to use accelerated write off provisions. Future tax rates play a big role in which decision to make.

And of course the Roth IRA conversion decision will be largely effected by future tax rates – more on that later.

Capital Gains and Losses

Review your investment portfolio for a number of different tax saving opportunities. Start by reviewing the various sales of stocks, bonds and other investments that you have realized so far this year.

Next, review your remaining investments and determine whether these investments have an unrealized gain or loss. (**Unrealized** meaning you still own the investment, versus **realized**, which means you've actually sold the investment.)

You must know the **tax basis** of your investments, which is usually the cost of the investment when you originally bought it. However, some investments allow you to reinvest your dividends and/or capital gains. This means you are actually buying more shares and therefore the basis of this investment is determined by your original cost plus all these reinvestments. Unfortunately, many taxpayers aren't aware of the cost for reinvested shares when they sell their investment.

If your capital gains are larger than your losses, you might want to do some "loss harvesting." This means selling certain investments that will generate a loss - converting it from an unrealized loss to a realized loss. Remember that you can use an unlimited amount of capital losses to offset capital gains. You are limited to only \$3,000 of net capital losses that can offset against other income, such as interest, dividends and wages. Any remaining unused capital losses can be carried forward into future tax years.

Please note that if you sell an investment with a loss and then buy it right back, the IRS disallows the deduction. This is known as the "wash sale" rule that says you have to wait at least 31 days before buying back the same security in order to be able to claim the original loss as a deduction. What you can do instead

is to buy a *similar* security to immediately replace the one you sold, perhaps a stock in the same sector. This strategy allows you to maintain your general market position while unlocking a tax break.

If you own an investment that you believe is worthless, sell it to someone other than a related party for a minimal amount, say \$1, to show that it is, in fact, worthless. The IRS often disallows a loss of 100% because they argue that the investment usually has at least *some* value.

Reporting your capital gains for 2011 is going to be more complicated. You will have to use two forms (Form 8949 and Schedule D) thanks to basis recording rules that went into effect for securities bought after 2010 and sold in 2011 and later. All sales will be listed on the 8949, and the totals will be carried to Schedule D. Separate 8949's must be filed for sales where the basis is recorded by the broker, for sales where the tax basis isn't reported and for any disposition where no 1099-B is received reporting the gross proceeds. This way, the IRS will be able to cross-check the basis information it receives with the seller's tax returns.

Zero Percent Tax on Long-Term Capital Gains

If you are in the 10% or 15% tax bracket, the tax rate for long-term capital gains is **zero** percent! In order to qualify for this tax break, your 2011 taxable income cannot exceed \$34,500 for singles and \$69,000 for married joint filers. The zero percent capital gains rate is set to expire at the end of 2012.

However, the 0% rate only applies until your income breaks through the 15% bracket. Let's say a married couple with a taxable income of \$50,000 sells an investment for a long-term capital gain of \$30,000. The first \$19,000 of gains is tax-free, but a 15% capital gains tax rate applies to the \$11,000 balance.

For those eligible for the 0% capital gains rate, it might be appropriate to sell some of your appreciated stock to take advantage of this tax strategy. Sell just enough so your profit pushes your income to the top of the 15% bracket. Then buy new shares in the same company; the shares will have a higher cost basis than the shares you sold. The capital gains tax you pay when you eventually sell these shares in the future will be based on a gain above this new value. This allows you to take advantage of the 0% tax rate now, so when the 0% rate goes away you won't have to pay taxes on the appreciation that occurred when you first bought the stock.

Please note that you do not have to wait the 31 days before you can buy the stock back when there is a gain. You only have to wait if there is a loss.

You may have acquired shares of the same stock at different times and different prices. You may be able to reduce a gain or increase a deductible loss if you identify the particular shares to be sold at the time of the transaction. Otherwise, you are bound by the tax law rules.

Be careful - you can't "go back in time" if you subsequently discover you would have fared better had you identified different shares when you had the chance. If you don't specify which shares you are selling at the time of the sale, the tax law treats the shares you acquired first as the first ones sold. In other words, it uses a **FIFO** (First-In, First-Out) method. This may not produce an optimal result.

Step-Up in Basis Rules

Another important but often overlooked item is when a taxpayer acquires an asset through an inheritance. The recipient of an inherited asset usually receives a "step-up" in basis on the investment, which means that the

new cost basis is the fair market value as of the date of death, which is often much greater than the original basis that the decedent had in this investment.

Remember that if someone gifts you an appreciated asset while they are alive, then the recipient's basis is the same as the basis of the giver. However, as mentioned above, if you inherit an appreciated asset, the basis gets increased to the fair market value as of the date of death and you are not taxed on the gain - at least up to the fair market value as of the date of death.

Roth IRA Conversions

The recent turbulence in the investment markets may make a Roth IRA conversion in 2011 a good choice. If your IRA or retirement plan investments have dropped significantly and in the future will recover significantly, consider converting part of your Traditional IRA to a Roth IRA. ***The lower the stock market at the time of conversion, the more tax-free appreciation when the market rebounds.*** Only convert an amount that you won't need for many years or would like to leave to your estate. There is little point in paying tax on a conversion if you're going to tap the Roth quickly.



Determining how much to convert requires some analysis. If you convert too much, higher taxes on the conversion income will mitigate some of the long term advantages. A better plan may be to convert a smaller amount each year to keep the tax effects down.

If all other things are equal and the investment markets are the same in 2012, even if only in January, for example, it may be better to do Roth IRA conversions in 2012. The recharacterization deadline for 2012 conversion is October 15, 2013. This extra year should allow you to see how the political elections in November of 2012 turn out and the how the tax laws will be changed in the future. This information is needed to gain more confidence in the long-term advantage of the Roth IRA conversions.

The tax rules regarding Roth IRAs can be very complicated and confusing. The best plan may be to convert some in 2011 and some in 2012. Please call us if you would like to review these details in person.

Estate and Gift Tax Opportunities

The estate and gift tax exclusion amount - the amount a person can pass by gift or bequest without paying federal tax - has gone up **to \$5 million**. Now a married couple can pass up to \$10 million tax-free to their heirs. Unfortunately, this law is only good through **December 31, 2012**. Please remember that it is a good idea to save taxes, but not impoverish yourself. Don't let the tax tail wag the estate planning dog - you should always maintain enough assets to be comfortable.

After 2012 the \$5 million exemption for gift and estate taxes is scheduled to decrease to \$1 million, while the maximum estate tax rate is slated to soar from 35% to 55%! In addition, the portability of estate tax exemptions between spouses is set to expire after next year. This rule provides that after the death of one spouse, the survivor can claim any unused exemption and make larger tax-free lifetime gifts or bequeath more assets free of estate tax.

Don't ignore **annual exclusion** gifts. You and your spouse can each give **\$13,000 per calendar year (\$26,000 per couple)** to as many individuals as you like without reducing your lifetime gift tax exemptions. It may be smart to make a gift before the end of the year depending on your circumstances. Gifts to medical or educational providers are not included in the \$13,000 limit - there is no limit on qualified gifts made directly to a school or medical facility if the check is made payable to the institution.

Determine which asset is best to gift. It is usually best to gift high-basis assets or cash, especially if the taxpayer is in poor health. In most cases, it is best not to give low-basis assets because gifted assets will not receive a step-up in basis when the taxpayer passes.

Before making sizable gifts to children or other family members, keep in mind that these gifts may backfire in some cases. For example, gifts can make a student ineligible for college financial aid and the earnings from the gift could make a senior's Social Security benefits subject to new or increased tax.

Retirement Plans

There are several increases on retirement plan contributions starting in 2012. The maximum 401(k) contribution rises to \$17,000 in 2012, up \$500 over this year. Individuals born before 1963 can also put in as much as \$22,500. The contribution limits apply to 403(b) and 457 plans as well. Plan contributions can be based on up to \$250,000 of salary next year. The pay-in limitation for defined contribution plans increased to \$50,000 in 2012 which is a \$1,000 increase.

There is no change in the pay-in limits for IRAs and Roth IRAs. The limits remain at \$5,000, plus \$1,000 more for anyone who was born in 1962 or earlier.

Social Security

The Social Security wage base will increase in 2012 to \$110,100, a \$3,300 increase over this year's figure and the first jump since 2009. The wage base did not go up in 2010 and 2011 because the law bars any increase in the cap in years when there is no cost of living height for Social Security beneficiaries.

Tax rates are in limbo. For 2011, the rate on employees was reduced by two percentage points to 4.2%, while the rate paid by employers stayed at 6.2%. However, this cut is set to expire after December 31, 2011. It is very possible that Congress will extend the break for 2012. Please note that Medicare tax is not affected by this, and still remains 1.45% on all wages in 2012.

Currently, Social Security benefits are scheduled to go up 3.6% in 2012 - the first hike in 2 years. The earnings limits will also increase. Individuals who turn 66 in 2012 will not lose any benefits if they earn \$38,880 or less before they reach that age. Individuals between 62 and 66 by the end of 2012 can make up to \$14,640 before they lose any benefits. There is no earnings cap once a beneficiary turns 66.

Charitable Giving



For the sixth year in a row, taxpayers age 70 ½ and older can transfer up to \$100,000 directly from their IRA over to a charity. You can satisfy all or part of your Required Minimum Distribution (RMD) with your IRA-to-charity maneuver. This popular break is scheduled to end at the end of 2011, although it is very possible it might be extended.

You don't pay income tax on the distribution, but you also cannot deduct the charitable donation. However, non-itemizers, who don't get to write-off this charitable donation anyway, can benefit. By transferring IRA funds directly to a charity, they can reduce their Adjusted Gross Income (AGI). By keeping AGI down they could qualify to deduct medical expenses that otherwise would fail to exceed 7.5% of their AGI or reduce the amount of the Social Security benefits that are taxed.

However, some taxpayers may want to postpone giving until 2012. It is best to take a close look at your expected donations for 2011 and 2012. If you think you are better off taking the standard deduction this year and itemizing in 2012, write the checks to the charity after December 31, 2011.

Please also note that many people receive solicitations from organizations that are no longer tax-exempt; there are over 275,000 groups that lost their tax-exempt status this year. Please check out the non-profit at Charity Navigator (www.charitynavigator.org).

This is a great time of year to clean out your garage but you can only write off these donations to a charitable organization only if you itemize your deductions. Valuing donations can be difficult. You can find estimated values for your donated clothing at: turbotax.intuit.com/personal-taxes/itsdeductible.

Send cash donations to your favorite charity by December 31, 2011 and be sure to hold on to your cancelled check or credit card receipt as proof of your donation. If you contribute \$250 or more, you'll also need an acknowledgment from the charity.

If you plan to make a significant gift to charity this year, consider giving appreciated stocks or other investments that you've owned for more than one year. Doing so boosts the savings on your tax return. Your charitable contribution deduction is the fair market value of the securities on the date of the gift, not the amount you paid on the asset, and you never have to pay tax on the profit!

Try not to donate any stock that has lost value. If you do, you can't claim the loss. In this case, sell the stock with a loss first, then donate the proceeds and take both the charitable contribution deduction and the capital loss.

Miscellaneous Year-End Strategies

Consider preparing a tax projection for 2011 (and possibly 2012 too) to try to determine which tax bracket you are in. It is also possible that you might have a negative taxable income. This happens when your deductions and exemptions are greater than your income, as is often the case with seniors who receive tax-free Social Security income. If you do have a negative taxable income, your tax is obviously zero. It is a good strategy to increase your income at least up to zero taxable income, because the tax on zero taxable income is still zero!

One of the best ways to do this is to do a partial Roth IRA conversion up to the amount that it brings your negative taxable income up to zero. You may want to convert even more, but remember that your tax would certainly go up above the zero rate. However, it might still be lower than the tax you might have to pay on your RMDs on your traditional IRAs in the future.

Please remember that you are eligible to take a standard deduction or if your itemized deductions are greater, then itemize these expenses instead. Unfortunately, many taxpayers don't have enough itemized deductions in order to reduce their taxes and they often miss the threshold by only a small amount each year. Therefore, it may be best to "bunch" your deductions every other year, taking the standard deduction in the alternate years. If you are trying to bunch your deduction in 2011, you may want to consider accelerating some of these deductions before the end of the year:

1. Make your January 2012 mortgage payment on your residence before the end of this year, which enables you to deduct the interest portion in 2011.
2. Max out state or sales taxes. Taxpayers who itemize deductions can choose between writing-off their state income taxes or their sales taxes in 2011. In most cases, income taxes will provide the bigger tax break. But if you live in a state with no income tax, or you buy a big ticket item such as a car or boat by December 31, 2011, you may be better off deducting sales taxes. If you are thinking about purchasing a new car, for example, you might want to do that before the end of the year in order to take advantage of deducting the sales tax.
3. Prepay the state income taxes that are due in January as part of your estimated tax payments or the estimated amount of state income tax due on April 15, 2012.
4. Pay all parts of your property taxes in 2011 rather than spreading them over the next 12 months.

These taxes do not count toward the Alternative Minimum Tax (AMT). If you are in the AMT, delay these payments, if possible, into 2012 and perhaps you might be able to use that deduction next year.

If you face an estimated tax shortfall for 2011, have the extra tax withheld on an IRA distribution. Withheld taxes are treated as if you paid them evenly to the IRS throughout the year. This can make up for any previous underpayments, which could save you penalties.

College Tuition Tax Credits

The popular American Opportunity Tax Credit, worth up to \$2,500 to offset college expenses, was scheduled to expire at the end of 2010 and has been extended through 2012. The full credit, which reduces your tax bill dollar for dollar, is available to individuals with incomes of up to \$80,000 and married couples with joint incomes of up to \$160,000. The credit, which can be claimed for all 4 years of undergraduate education, phases out above these income levels.

There are other tax breaks which include qualified tax-free distributions for Coverdell Education Savings Accounts, which can be used to fund elementary and secondary school expenses in addition to college costs. Maximum contribution levels have been dropped to a maximum of \$500 per year starting in 2011.

What You Should Do Now

There are many other additional tax reduction strategies that will vary depending on your financial picture. We encourage you to come in so that we can review your particular situation and hopefully take advantage of the particular rules that apply to you. If you want personal attention for income tax planning, I urge you to schedule to meet with whoever prepares your tax return. If you are not currently an income tax preparation client and are considering using our firm for tax preparation, I would recommend setting up a meeting with one of our preparers before year-end.

If you have been meaning to come in to see us because there is a problem with your wills and trusts (i.e., you don't have one) or you are feeling uneasy about your investments or were wondering if a Roth IRA conversion is appropriate for you, I would urge you to come in soon. For clients considering life insurance (I like guaranteed universal life that has low premiums and a high face value), I would urge you to see us for an independent analysis.

I wish you and your family a joyful holiday season and a healthy, prosperous new year.

Warmest personal regards,



Ronald A. Papa, President

P.S. If you need to see either me or your tax preparer, please don't put it off. Simply call Sharyn at 781-556-1038; she will be happy to schedule an appointment for you.

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