

## Year end 2011 tax planning: Opportunities and challenges

As the end of the year approaches, it's always a good idea to review your tax situation and assess whether there are any actions you should take by Dec. 31 to reduce your tax bill. This year is no exception, and many opportunities are available that may significantly reduce your taxes. However, 2011 also presents some unique challenges.

### Businesses: Making the most of depreciation

For many businesses, their biggest 2011 tax-saving opportunity may be enhanced depreciation-related deductions that are scheduled to become less favorable in 2012:

**Bonus depreciation.** For qualified assets acquired and placed in service through Dec. 31, 2011, this additional first-year depreciation allowance is 100%. Among the assets that qualify are *new* tangible property with a recovery period of 20 years or less and off-the-shelf computer software.

With a few exceptions, bonus depreciation is scheduled to drop to 50% in 2012. You may want to purchase and place in service qualifying assets by Dec. 31 — not only to reduce your 2011 tax bill, but also to lock in the 100% deduction in case it's not extended.

**Section 179 expensing.** This election also allows a 100% deduction for the cost of acquiring qualified assets, but subject to different rules than bonus depreciation. On the plus side, *used* assets can qualify for Sec. 179 expensing. On the minus side, a couple of rules may make Sec. 179 expensing less beneficial to certain businesses:

- For 2011, expensing is subject to an annual limit of \$500,000, and this limit is phased out dollar for dollar if purchases exceed \$2 million for the year. So larger businesses may not benefit.
- The election can't reduce net income below zero. So for businesses that are having a bad year, it can't be used to create or increase a net operating loss for tax purposes.

The expensing and asset purchase limits are scheduled to drop to \$125,000 and \$500,000, respectively, in 2012 (though both amounts will be indexed for inflation). So, again, you may want to take action this year to lock in the higher limits.

These enhanced depreciation opportunities, however, bring with them a challenge: Determining whether the larger 2011 deductions will prove beneficial over the long term.

Taking bonus depreciation and/or Sec. 179 expensing deductions now means forgoing deductions that could otherwise be taken later, over a period of years under normal depreciation schedules. In some situations, future deductions could be more valuable. For example, tax rates for individuals are scheduled to go up in 2013, which means flow-through entities, such as partnerships, limited liability companies and S corporations, might save more by deferring the deductions.

## **Individuals: Income, expenses and AMT**

Traditional income tax planning calls for deferring income to the next year and accelerating expenses into the current year. This defers taxes to the next year, which generally is beneficial — as long as you'll be subject to the same (or a lower) marginal rate. Because the 2010 Tax Relief act extended lower rates through 2012, in 2011 you have the opportunity to take advantage of this traditional strategy (unless you expect to move into a higher tax *bracket* next year).

Potentially controllable income and expense items include:

- Bonuses or self-employment income,
- Retirement plan distributions,
- State and local income and real estate taxes,
- Mortgage interest, and
- Charitable contributions.

But this opportunity isn't without a challenge. Before taking action to time income and expenses, you must consider the alternative minimum tax (AMT). It's a separate tax system that limits some deductions and doesn't permit others, such as for state and local income and real estate taxes and miscellaneous itemized deductions. It also treats certain income items differently. You must calculate your tax liability under both the regular and the AMT systems, and pay the AMT if your AMT liability is higher.

So without proper planning, deferring income or accelerating deductions could trigger the AMT or increase AMT liability this year or next. Further complicating matters is the fact that, unlike the regular tax system, the AMT system isn't regularly adjusted for inflation. Instead, Congress must legislate any adjustments. Typically, it has done so in the form of a "patch." Such a patch is in effect for 2011 but not for 2012. This makes planning for the AMT — and thus properly timing your income and deductions — especially challenging this year.

There's another valuable opportunity related to timing income and expenses that you should consider if you're over age 70½: In 2011, you can make a direct distribution of up to \$100,000 in IRA assets to charity. The qualified charitable distribution (QCD) — commonly referred to as a "charitable rollover" — can be used to help satisfy your required minimum distribution (RMD). And, although you can't deduct your contribution, you'll owe no tax on the distributed funds.

A QCD may be especially beneficial if your charitable deduction could be phased out based on your income or if recognizing RMD income could cause other adverse tax consequences, such as increased taxes on Social Security benefits. Also keep in mind that the QCD provision is scheduled to expire after this year.

## **Don't forget about estate planning**

While estate planning won't necessarily affect your income tax bill, it's a good idea to also consider your estate planning goals as year end approaches. For example, the annual exclusion allows you to gift up to \$13,000 per year per recipient gift-tax-free without using up any of your

lifetime gift and estate tax exemptions. But unused exclusions don't carry forward. If Dec. 31 passes without your having made an annual exclusion gift to a particular family member, for example, you can't make double the gift under the exclusion the next year to make up for it.

Also consider the \$5 million lifetime gift tax exemption. Although action by Dec. 31, 2011, isn't required, action by Dec. 31, 2012, may well be. The exemption is scheduled to drop to \$1 million Jan. 1, 2013.

The \$5 million exemption presents an unprecedented opportunity to transfer substantial wealth to your loved ones tax-free. It may be especially valuable if you hold assets you expect to increase significantly in value. Making a gift now will remove not only the assets' current value from your taxable estate, but also all future appreciation on them.

But this opportunity comes with challenges related to the following:

***Step-up in basis.*** When you gift assets, your tax basis carries over to the recipient, which can lead to significant capital gains tax for the recipient if he or she sells the assets. If instead the recipient inherits the assets on your death, his or her basis generally will be stepped up to the current market value, reducing or even eliminating capital gains tax liability when the assets are sold. So before gifting assets, compare the potential income tax consequences with the expected gift and estate tax savings.

***Your own financial security.*** You need to ensure that making substantial gifts today won't compromise your own financial security or desired lifestyle. This requires looking at your overall financial situation and projecting your income sources and needs so you can determine how much you truly can afford to give away.

### **Achieve your tax planning goals**

We've discussed only a few of the 2011 tax planning opportunities and challenges. And it's possible that tax legislation could be signed into law between now and Jan. 1, 2012, that would extend expiring tax breaks or make other changes for 2012 that would affect your 2011 year end strategies. Further, changes in the economy, the markets or your personal situation could also have an impact.

So it's critical to review your tax situation now with your tax advisor and revisit it if anything changes. We would be pleased to help you determine what, if any, action you should take before year end to achieve your tax planning goals.