GELMAN, ROSENBERG & FREEDMAN
CERTIFIED PUBLIC ACCOUNTANTS

2011 MID-YEAR TAX PLANNING LETTER

Dear Clients and Friends,

Now that we have reached the mid-point of 2011, it is once again time to talk about tax planning. Many people focus their tax planning strategies on the end of the tax year, when they make decisions such as whether to defer or accelerate income and what deductible expenses to pay before December 31. However, some savvy taxpayers plan their actions with sufficient lead time to take advantage of tax-saving opportunities.

Unlike the last couple of years, the first half of 2011 has produced little in the way of major tax legislation. But that does not mean tax planning opportunities are hard to find.

Your tax picture can change, sometimes dramatically, over the course of a year, and corresponding adjustments should be made. Otherwise, you may be paying too little or too much through tax withholding or estimated tax payments.

Income prospects may have changed since early in the year. For example, your business may have originally planned a profit, only to find that things have developed in a less rosy manner. Or better still, your business may be thriving more than anticipated. Either way, there are important tax consequences that should be reviewed.

Paying your income taxes

Federal and state governments operate on a pay-as-you-go payment pattern. Now is a good time to check your progress toward getting your taxes paid. You do not want to pay too little. Avoidable penalties apply if you do not pay enough tax throughout the year. If it looks as if you are going to be subject to an underpayment penalty, you may be able to reduce or eliminate the penalty by increasing your quarterly estimated tax payments.

If you are employed, having your employer withhold more from your pay can even eliminate penalties that accrued earlier in the year. There is a quirk in the penalty rules that treats withholding, even if it occurs late in the year, as if it had been taken evenly throughout the year.

You do not want to pay too much, either. Why give your money to the government too soon, when you can invest those funds until April 15, 2012? As long as you will not be subject to an underpayment penalty, you should hold on to your cash as long as possible. If it appears that you have been paying too much tax, cut back on your withholding or lower your remaining quarterly estimated tax payments.

If you can reduce the amount of tax you are currently paying to the government, consider putting some of that savings into a retirement plan.

Funding your retirement plans

Contributing to a tax-qualified retirement plan can reduce your current tax obligations and help you save for your retirement in a tax-efficient manner. Qualified plans provide tax deferral (or tax avoidance in the case of Roth IRAs) on earnings until distributions are made. It is the plan, not the contribution, that allows for earnings to grow tax-deferred or tax-free. So the sooner you make the contribution, the sooner your tax-deferred or tax-free earnings begin. If you already have a plan in place, consider funding it as soon as possible, rather than waiting until the last minute.

To qualify for a tax 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 can be set up through April 15, 2012. Establishing a new retirement plan requires thoughtful decision-making. It is not a good idea to cobble something together at the last minute.

Small employers (generally those with 100 or fewer employees) that set up a qualified retirement plan may be eligible for a tax credit up to $500 per year for three years. The credit is limited to 50 percent of the qualified startup costs.

The following contribution limits apply for the 2011 tax year:

- 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).

IRAs and Roth accounts – Individuals with earned income, including alimony, are generally eligible to contribute to traditional IRAs. Claiming a deduction for your contribution is another matter. That depends on your income and whether you or your spouse, if you are married, are covered by an employer-sponsored retirement plan.

- If neither you nor your spouse is covered by an employer's plan, you may deduct your contribution to your traditional IRA.
- At higher income levels, with modified adjusted gross income above $66,000 for singles and $110,000 for joint filers, no deduction is allowed if you (and your spouse if you are married) are covered by an employer's plan.
- If you are married and only one of you is covered by an employer's plan, the non-covered spouse may claim the deduction unless your joint modified adjusted gross income exceeds $179,000.

Many people find the long-term benefits of contributing to a Roth IRA or a Roth 401(k) outweigh the short-term financial benefits of tax-deductible contributions. While Roth contributions are not tax-deductible, none of the income earned in the Roth account will have tax consequences unless there are early distributions and penalties may apply. In addition, the Roth account is not subject to the required minimum distribution rules that apply when you reach age 70½.

Eligibility to contribute to a Roth IRA depends on the amount of your income. No contribution is allowed if your modified adjusted gross income for 2011 exceeds $122,000 for singles and $179,000 for joint filers. You can make a direct rollover from your traditional IRA or other qualified retirement plan into a Roth IRA. However, you must pay tax on the rollover amount. There is no longer an income limit associated with Roth rollovers.

Defined benefit plans – If you own a business, you may be able to avail yourself of a defined benefit type of retirement plan. These plans often allow higher retirement contributions than other types of plans. The higher retirement benefit must be weighed against the additional cost of providing comparable retirement benefits for your employees.

Charitable contributions from IRAs

Until December 31, 2011, those over age 70½ are able to make charitable contributions from their IRA without the need to include the distribution in income. Making these contributions directly is generally advantageous because this method will not raise your income for limits on itemized deductions such as medical and miscellaneous deductions.

Investing in small business stock

If you purchase qualified small business stock after September 27, 2010, and before January 1, 2012, and hold it for more than five years, your entire gain is tax free. Qualified small business stock purchased before September 28, 2010, may qualify for partial exclusion of gain. The company that issues the stock must meet technical qualification rules. In addition, you must be the original owner of the stock, acquiring the stock by purchase or as compensation for services.

Once the stock is qualified, you can transfer it by gift or inheritance, and the new owner may still obtain the tax exclusion.

If you are considering an investment in qualified small business stock, you should consult your tax adviser to be sure the technical qualifications are met. And you will want to complete the acquisition by December 31, 2011.

Cashing in on tax credits

Energy credit – If you have home-improvement plans such as replacing your furnace, water heater, windows and doors or adding insulation, consider getting the job done before December 31, 2011, to take advantage of the energy credit, which could reduce your tax bill by as much as $500. Note that energy credits you claimed in the past may reduce or eliminate your credit available for 2011.

Adoption credit – The maximum adoption credit for 2011 is $13,360 subject to income limitations, and it is refundable. This means that, if the credit exceeds your tax bill, you get cash back from the government. By 2012, the credit is expected to be lower and nonrefundable. Because adoptions can take some time to complete, you may want to start the process soon so that your expenses will fall in 2011 rather than in 2012.

Establishing a health plan for your employees

If you are not currently providing health coverage for your employees, a tax credit for small businesses may make the cost of purchasing this coverage more affordable. For tax years 2011 through 2013, the maximum credit is 35 percent of the premiums paid by the employer.

To earn the credit, the employer generally must contribute at least 50 percent of the total premium. The full credit is available for employers with 10 or fewer full-time equivalent employees (FTEs) and average annual wages less than $25,000. Partial credits are available on a sliding scale to businesses with fewer than 25 FTEs and average annual wages less than $50,000.

Hiring new employees

The Work Opportunity Tax Credit is available to employers who hire certified members of specified targeted groups. The credit can range up to 40 percent of the first $6,000 of qualified wages paid during the first year of employment, for a maximum credit of $2,400 per qualified employee. Under current law, the credit is available only for employees hired by December 31, 2011.

If you own a business and have children, consider putting them to work during summer vacation or after school. You will be able to deduct their wages, as long as you make their pay commensurate with what you would pay to a nonfamily employee for the same services. For 2011, they can earn as much as $5,800 and pay zero income tax. If they earn $10,800 and contribute $5,000 to a traditional IRA, they will also pay zero income tax.

Writing off capital expenditures

Generous tax write-off rules apply to most non-real estate assets acquired and placed in service during 2011. The expensing election limit under Section 179 is set at $500,000 if the total amount of qualified asset purchases does not exceed $2 million. The deduction is available for most business equipment, furniture and off-the-shelf computer software. There are limits to the Section 179 deduction, including the fact that it cannot cause a net loss. But the 100 percent bonus depreciation election, also available through the end of 2011, has no such no-loss restriction.

The key to qualifying for these enhanced deductions is that the qualifying asset must be placed in service by December 31, 2011. Just ordering or paying for the asset is not enough. It must actually be in use in your business by the end of the year. Considering the time it may take to identify the appropriate equipment, obtain competitive bids, order the product, have it assembled and shipped, and then get it installed and operational, now may the time to begin the acquisition process.

Planning your estate and gifts

Do not make the common mistake of thinking that Congress has settled the estate tax debate. It is true that effective January 1, 2011, Congress raised the exclusion so that the tax applies only to estates valued at greater than $5 million. And it is also true that Congress made the estate tax exclusion “portable.” So if the combined estates of you and your spouse do not exceed $10 million, you may avoid the estate tax without the necessity of having a trust that includes language creating a “bypass trust” or other such provisions.

But the estate tax situation is far from settled. The new estate tax law was enacted as part of the same legislation that extended the so-called Bush-era tax cuts for two years. The new estate tax law has the same two-year expiration date. In other words, absent congressional intervention in the interim, on January 1, 2013, federal estate, gift and generation-skipping taxes will revert to a lower exclusion amount ($1 million) and higher rates (up to 55 percent) as would have occurred on January 1, 2011.

The annual gift tax exclusion for 2011 remains at $13,000 per person. Therefore, if you are married, you can gift up to $26,000 per donee 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 an important element of your estate plan. In addition, the earlier in the year you gift income-earning assets such as cash, stock, etc., the lower your taxable income.

As noted above, effective January 1, 2011, Congress enacted a number of changes in the law applying to estates and gifts. Unexpectedly, Congress reunified the estate and gift transfer tax exclusion amount. This means that, not only do you have a $5 million exclusion for your taxable estate, that same exclusion can be used instead during your lifetime to make large gifts without tax consequences. Because this increased exclusion amount is scheduled to expire after 2012, it may be very prudent tax planning to go ahead and use the increased gift exclusion during your lifetime. Failure to do so may result in a permanently missed opportunity.

Many people executed their current will and estate plan without consideration of the increased exclusion amount and the portability feature of the new estate tax law. That means a review is in order to make sure your assets will be handled in the most tax-efficient manner.

Disclosing offshore assets

If you had a financial interest in, or signature authority over, at least one financial account located outside of the United States during 2010, and the aggregate value of all your foreign financial accounts exceeded $10,000 at any time during the calendar year, you must file Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts*, commonly known as FBAR. This report was due by June 30, 2011.

If you were required to file FBARs for prior years but did not do so, criminal and civil penalties can apply. Generally, the civil penalty for willfully failing to file an FBAR can be as high as the greater of $100,000 or 50 percent of the total balance of the foreign account, per violation. Fraud penalties can be as high as 75 percent.

The IRS has announced a program for those with undisclosed income from unreported foreign accounts for the 2003 through 2010 period. Those complying with the terms of the program must pay back taxes and interest, plus an accuracy or delinquency penalty. There is also an additional penalty of 25 percent of the amount in the foreign bank accounts in the year with the highest aggregate account or asset value.

However, those who come forward on a timely basis will not face criminal prosecution. In some cases, the 25 percent penalty is reduced to 12.5 percent or 5 percent. The voluntary disclosure period ends August 31, 2011.

CONCLUSION

Tax planning is an ongoing process. Toward the end of the year, the tendency is to focus on tax strategies that can be executed quickly because of the short period of time remaining.

In this letter, we have focused on year-end strategies that may take a little more time to implement. And we have highlighted those strategies whose effectiveness may be reduced or eliminated after the year 2011 comes to a close.

No one can predict the future. And predicting future actions of Congress is particularly hazardous. Congress can – and all too often does – change the tax law on literally a moment's notice.

One final thought: Saving taxes is generally a good strategy. But making a bad business, investment or personal decision just to save some tax dollars is *never* a good strategy. Just ask some of the people who hastily closed on a home purchase last year to take advantage of the government's offer of a homebuyer tax credit – and who now find themselves with negative equity.

Although we have covered a number of topics in this letter, we undoubtedly did not address every issue relating to your specific situation. Our tax advisers are here to help and guide you through the complex maze that is our U.S. tax system.

Sincerely,

Walter H. Deyhle, CPA, CFP, ABV

The technical information in this letter is necessarily brief. No final conclusion on these topics should be drawn without further review and consultation. Please be advised that, based on current IRS rules and standards, the information contained herein is not intended to be used, nor can it be used for the avoidance of any penalty assessed by the IRS.

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