

## Tax Planning Alert for Individuals

**November, 2011**

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Year-round tax planning has never been more important with the prospects of the Bush tax cuts scheduled to expire at the end of 2012 and federal and state budget deficits' impact on future tax legislation. Frequent monitoring of your tax situation, not just at year-end, is essential. This Alert highlights some important tax planning opportunities.

FGMK can assist you in determining the best course of action for your tax plan and can help you to implement the plan.

### **Income/deduction shifting**

Income shifting always applies to year-end decisions and for 2011 this requires further thought. Based on usual year end planning strategies, you time income and deductions so that your taxable income is about even for 2011 and 2012 so your tax bracket is not higher in either 2011 or 2012. If you anticipate a higher tax bracket for 2012, you may want to accelerate income into 2011 and defer deductions into 2012. If you anticipate less income in 2012, income might be delayed through deferred compensation arrangements, postponing bonuses, maximizing deductible retirement contributions and delaying business billings.

For year-end 2011 planning, the complication is the uncertain future for tax rates after 2012. Many observers forecast that higher-income taxpayers will be asked to pay more, through higher tax rates or more reduced deductions. This may indicate the advantage of a strategy in which income is not deferred but is recognized now at lower tax rates still available in 2011 and 2012. The following exhibit summarizes the scheduled tax changes in 2013 based on current law. The exhibit includes the additional taxes set to go into effect in 2013 as provided by the Health Care Act. If no action is taken by Congress the tax rates reflected in the chart for 2013 will go into effect.

The possibility of an income tax increase in 2013 and the scheduled additional tax on investment income (from the Health Care Act) impacts planning now. The ability to accelerate income and capital gains to 2011 and 2012 should be reviewed.

With the possibility that the tax rate on qualified dividends could increase to the maximum tax rates from the present 15% rate, consideration should be given to paying dividends from closely held C corporations and possibly S corporations in 2011 and/or 2012.

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## Overview of tax rates for individuals from 2011-2013

	<u>2011 and 2012</u>	<u>2013</u>
<b>Marginal tax brackets</b>	35.0%	39.6%
	33.0%	36.0%
	28.0%	31.0%
	25.0%	28.0%
	15.0%	15.0%
	10.0%	15.0%
<b>Long-term capital gains</b>	15.0%	20.0%
<b>Qualified dividends</b>	15.0%	39.6%
<b>Health Care Act taxes:</b>		
Surtax on investment income	N/A	3.8% surtax on investment income of single taxpayers with AGI over \$200,000 (\$250,000 for joint filers)
Increase in Medicare tax	N/A	0.9% increase in employee portion of Medicare tax over earned income of \$200,000 (\$250,000 for joint filers)

Notes:

- Payroll tax: 2% cut in employee Social Security tax is eliminated after 2011.
- Itemized deductions and personal exemptions: AGI phase-outs are restored in 2013.
- AMT exemption:
  - 2011 & 2012 - \$48,450 Single; \$74,450 Married
  - 2013 - \$33,750 Single; \$45,000 Married

## **Gains and losses**

Timing of capital gains and losses is critical to minimize your net capital gains tax and maximize deductible capital losses. Also consideration should be given to the type of capital gain rates that apply. There are short term capital gains that can be taxed at the maximum ordinary income tax rates that apply to you; and there are long term capital gain rates (for assets sold after a holding period of one year) of 10%, 15%, 25% and 28%. Understanding the types of capital gain rates that apply to you will enable you to make the best use of capital losses.

Also of concern is whether the maximum tax rate for capital gains will rise from 15% to 20% or higher after year-end 2012 because of the scheduled expiration of the Bush-era tax cuts, the Health Care Act or future legislation. Consideration should be given to taking capital gains before possible higher capital gain tax rates apply in the near future.

Should you wish to make charitable donations, you should consider donating appreciated securities (held more than 1 year) rather than donating cash and eliminate any tax on the appreciation.

## **Roth IRAs - conversions and contributions**

Roth IRAs (Roth individual retirement accounts) as the name would indicate are a type of IRA but which grows completely tax-free and produces future tax-free distributions (with certain limitations). An IRA can be converted to a Roth IRA to gain the future tax-free advantages of a Roth IRA. Upon conversion, the IRA value is taxable income. If you converted an IRA in 2010, you had the choice to recognize all of the conversion income in 2010 or defer that income, half into 2011 and half into 2012. If you elected to defer that income into 2011 and 2012, that income needs to be considered in your 2011 and 2012 tax planning. If your converted Roth IRA declined in value you are allowed to re-characterize back to an IRA. A recharacterization is a reconversion of your Roth IRA back to a regular IRA and allows you to avoid paying income tax on an account balance at its higher value. If you "recharacterized" a 2010 Roth conversion in 2011 after filing your 2010 federal tax return you will need to amend your 2010 federal tax return to disclose the recharacterization. If you initiated a Roth conversion earlier in 2011 and that Roth account has declined in value since then, you should consider recharacterizing the 2011 Roth conversion.

If you have not yet made a Roth conversion, doing so at year-end 2011 might be an opportunity worth serious consideration. Variables include your present income tax bracket, how close you are to retirement, and your access to other funds both to pay the conversion tax and to delay distributions from your Roth account later.

Further contributions can be made to Roth IRAs, however, income limits apply. Contributions are disallowed over the income limits. If your income exceeds the income limits thereby eliminating your ability to make a Roth contribution, you should consider making a nondeductible IRA contribution and convert it to a Roth IRA (caution must be taken if other IRAs exist).

## **Alternative Minimum Tax (“AMT”)**

The AMT is an additional federal tax that could increase your overall tax above the regular income tax. The AMT has a different set of rules from the regular tax for certain income, deductions and exemptions. The AMT, over the years, has affected more and more taxpayers, many of whom were not the original target of the AMT. Nonetheless, it exists and must be considered in your tax planning. For example care must be taken to ensure that a tax deduction you thought you were getting for regular tax purposes isn't given back in your AMT or if so that it does not come as a surprise

## **Life changes**

Marriage, divorce, the birth of a child, death, a change in job or loss of a job, and retirement are just some of the life events that trigger a special urgency for tax planning. If you have had a life change, please contact FGMK so we can review how that change will impact your tax liability.

## **Medical expenses**

Effective January 1, 2011, the *Patient Protection and Affordable Care Act (PPACA)* provides that over-the-counter medications and drugs can no longer be reimbursed from a health flexible spending arrangement (health FSA) unless a prescription is obtained. The rule also applies to health reimbursement arrangements (HRAs), health savings accounts (HSAs), and Archer medical savings accounts (Archer MSAs), an important consideration for employees who are required to make a decision by year-end 2011 on how much to fund their accounts in 2012.

## **Expiring tax provisions**

Several tax provisions scheduled to expire after December 31, 2011 include:

- 100% bonus depreciation (50% bonus is still available in 2012)
- the state and local sales tax deduction,
- the higher education tuition deduction,
- the teacher's classroom expense deduction
- Charitable contributions from IRAs (as discussed further below)

## **Charitable contributions from IRAs**

Taxpayers age 70 1/2 and older generally must take minimum required distributions from the IRAs and pay tax on such distributions. If you are in that situation and are considering charitable donations you should review making charitable contributions directly from your IRAs up to \$100,000 and thereby avoid paying tax on the distribution (though you give up the donation deduction). The direct contribution from the IRA can be valuable for a number of reasons, such as, it does not increase gross income, which could affect other items on your tax return, if you already have an unused donation

carryforward, or if you receive a local senior real estate tax freeze that is based on your taxable income, to name a few.

This provision is set to expire for tax years beginning after December 31, 2011.

### **Casualty losses**

Taxpayers in many states experienced natural disasters in 2011. A casualty loss can result from the damage, destruction or loss to your property from any sudden, unexpected or unusual event, such as a hurricane, earthquake, wildfire or flood. Casualty losses are generally deductible in the year the casualty occurred, less 10% of your adjusted gross income and a \$100 per casualty deductible.

However, if you have a casualty loss from a federally declared disaster, you can elect to treat the loss as having occurred in the year immediately preceding the tax year in which the disaster happened, and you can deduct the loss on your return or amended return for that preceding tax year. The election gives taxpayers the opportunity to maximize their tax savings in the year in which the savings will be greatest.

### **Energy tax incentives**

If you are considering replacing your roof, HVAC system, or windows and doors, doing so using energy-efficient materials before January 1, 2012 may generate tax savings. Through the end of 2011, a number of residential energy-efficiency improvements qualify for a tax credit. These include qualified windows and doors, insulation products, HVAC systems, and roofing. The "lifetime" credit amount for 2011, however, is \$500 and no more than \$200 of the credit amount can be attributed to exterior windows and skylights. Please call FG MK for details.

### **Gift/Estate tax**

The current estate and gift tax through 2012 is set at a maximum 35% rate and a \$5 million exemption amount. Many experts predict after 2012 that Congress will lower the exclusion and raise the top rate. In light of this possibility, wealthy individuals should consider gifting up to \$5 million before the end of 2012 in case the exemption amount is lowered. In addition, lifetime gift-giving on an annual basis should continue to form part of a master estate plan. The annual gift tax exclusion per donee on which no gift tax is due is \$13,000 for 2011 (and, again, for 2012), with \$26,000 allowed to each donee by married couples. Making a gift at year-end 2011 to take advantage of this annual, per-donee exclusion should be considered by anyone with even modest wealth.

In addition, the currently low interest rates make certain estate shifting techniques particularly attractive. For example, self-funded annuities (or Grantor Retained Annuity Trusts, sales to defective grantor trusts, gifts of residences while retaining current use (Qualified Personal Residence Trusts), inter-family loans and partnership freezes can be utilized to transfer assets to heirs at lower values due to low interest rates.

### **Illinois taxes**

Beginning January 1, 2011 the Illinois individual income tax rate was raised from 3% to 5% through 2014. This rate increase will affect your estimated tax payments and

requires proper planning. Beginning in 2015, the Illinois tax rate is scheduled to decrease to 3.75%, and decrease again in 2025 to 3.25%.

With the substantial increase in the Illinois tax rates, consideration should be given for investment income planning opportunities. Municipal bonds, while tax free for federal tax, there are some IL municipal bonds that are tax free in Illinois as well. Furthermore, dividends paid by certain companies are tax-free to Illinois residents.

The information provided in this alert is not necessarily specific to your tax situation. We should discuss your circumstances before taking any action. If you have any questions about the tax provisions and planning techniques described in this letter, please contact **FGMK**. Our tax professionals can assist you with tax-effective and proactive planning.

***FGMK, LLC***

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