JEFFREY A BERNSTEIN, CPA/PFS
P.O. BOX 766
HAWLEYVILLE, CONNECTICUT 06440-0766
PHONE: (203) 426-6140 FAX: (203) 426-6145
e-mail: jeffrey@bernsteincpa.net

2011 YEAR-END, 2012 AND 2013 INCOME TAX PLANNING FOR INDIVIDUALS

Although the end of 2011 approaches, coordinating tax planning for 2011 year-end must also look to see the future tax changes that are on the horizon for 2013 and to see whether all the tax breaks that are available for 2011 will be allowed for 2012. Tax planning is particularly challenging this year given the growing national debate over comprehensive tax reform, the rapid pace of recent tax law changes, and the extensive list of current tax breaks that are scheduled to ***expire at the end of 2011.***

The *traditional* year-end tax planning strategies attempt to postpone income and accelerate income that help lower your taxable income now and postpone the payment of your taxes to later years. Since many tax breaks are currently scheduled to ***expire after 2011*** (and others ***after 2012***), it is extremely important that you act timely to obtain maximum benefits! **Tax Tip.** Even though the weak economy has caused a drop in the income of many individuals, this decrease in income may actually produce additional tax benefits. If your income is down for 2011 as compared to recent years, you may be eligible for deductions and credits that you did not get in previous years because your income exceeded the phase-out thresholds. So, ***please pay close attention to the income thresholds*** for the various deductions and credits, which we ***highlight prominently*** in each section.

Caution! Tax planning strategies suggested in this letter may subject you to an unexpected alternative minimum tax (AMT). For example, many deductions are not allowed for AMT purposes, such as: personal exemptions, the standard deduction, state and local income taxes, and real estate taxes. Also, AMT can be triggered by taking large capital gains, having high levels of dividend income, or exercising incentive stock options. You cannot properly evaluate a particular planning strategy without calculating your overall tax liability (including the AMT and any state income tax) with and without that strategy.

SIGNIFICANT TAX BREAKS EXPIRING AFTER 2011

A host of current tax breaks for individual taxpayers are scheduled to expire at the ***end of 2011***, unless Congress takes action to extend these provisions. **Caution!** Although Congress has traditionally extended a majority of expiring tax breaks in the past, there is no guarantee that Congress will do so in the future. **Tax Tip.** Regardless of how Congress ultimately addresses these expiring tax breaks, there are real tax savings available if you take advantage of these provisions **before the end of 2011.** The following are some of the more popular tax breaks that we have enjoyed over the past several years, but are ***currently scheduled to expire after 2011*****:**

1) school teachers' deduction (up to $250) for certain school supplies;
2) election to deduct state and local sales tax;
3) deduction (up to $4,000) for qualified higher education expenses;
4) tax-free transfers from IRAs to charities for those at least age 70½,
5) 2% Social Security tax holiday;

6) increased AMT exemptions; and
7) credit for energy-efficient improvements to your principal residence. (**Caution!** This 30% credit of up to $1,500 cumulative for 2009 and 2010 dropped to a maximum life-time credit of $500 for installations during 2011).

Two Percent Social Security Tax Holiday For "2011 Only." For **2011 only,** there is *a **2%*** reduction in Social Security taxes for both employees and self-employed individuals. Therefore, **if you are an employee,** your take-home pay for 2011 is generally being increased by 2% of each dollar of compensation that you earn. However, since Social Security taxes apply only to the first $106,800 of compensation in 2011, your maximum savings will generally be $2,136 (i.e., $106,800 x 2%). Likewise, if you are self-employed, your Social Security taxes are reduced by 2% of your self-employment income for 2011 (up to $106,800). Therefore, if your self-employment income is $106,800 or more, your self-employment taxes will be reduced by $2,136. **Tax Tip!** Accelerating 2012 compensation or self-employed income ***into 2011*** will save you 2% on your Social Security tax to the extent the income acceleration does not cause you to exceed the $106,800 earned income cap.

Tax-Free IRA Payments To Charities If You Are At Least 70½. For the past several years, we have had a popular (but *temporary*) rule that allows taxpayers, who have reached age 70½, to have their IRA trustee contribute up to $100,000 from their IRAs directly to a qualified charity, and exclude the distribution from income. **Planning Alert!** To qualify, the check from your IRA must be made out "directly" to your designated charity. Since this tax break is currently scheduled to **expire after 2011,** you should make arrangements for the transfer with your IRA trustee ***well before the end of 2011*** if you want to take advantage of this provision.

The Qualified Tuition Deduction. If you pay for *qualified* higher education tuition and fees for yourself, your spouse, or your dependents, you may qualify for an education expense deduction. This maximum $4,000 deduction is available whether or not you itemize. You are allowed the maximum $4,000 deduction only if your adjusted gross income ("AGI") does not exceed $130,000 on a joint return ($65,000 if single). If your AGI is between $130,000 and $160,000 ($65,000 and $80,000 if you're single) your maximum deduction drops to $2,000. **Caution!** If your AGI exceeds $160,000 (if joint) or $80,000 (if single) by even $1, the entire deduction is lost.

CONSIDER FUTURE TAX RATES BEFORE DEFERRING INCOME

Classic year-end tax planning typically includes strategies that lower your current taxable income and postpone the payment of taxes to later years. A traditional technique to accomplish both of these goals is to defer the current recognition of taxable income to later years. However, as you consider any tax strategy that would defer taxable income beyond 2011, please keep in mind that individual tax rates are scheduled to increase ***after 2012.***

Currently Scheduled Tax Rate Increases. Over the past several months, there are several proposals for tax increases on higher-income taxpayers as part of deficit reduction proposals. Because of the political uncertainty of these proposals, it is impossible to predict with any certainty what the tax rates will be in the future. However, the existing individual income tax rates for all income levels are currently scheduled to remain in place ***through 2012.*** Consequently, the current 10% through 35% tax brackets for ordinary income, and the maximum 15% tax rate for long-term capital gains and qualified dividends **continue through 2012. CAUTION!** Starting ***in 2013***, absent Congressional action, the top individual income tax rates will generally increase to: **1)** 39.6% for ordinary income; **2)** 39.6% for qualified dividends; and **3)** 20% for long-term capital gains. **Planning Alert!** In addition, starting ***in 2013,*** the *Health Care Act* imposes a **new Medicare Surtax of 3.8% on the *investment incom***e (e.g., interest, dividends, capital gains, rental profits) of higher-income individuals, and a **Medicare Surtax of .9% on the *earned incom***e (e.g., W-2 income, self-employment income) of higher-income individuals.

POSTPONING TAXABLE INCOME

Since currently scheduled tax rate increases do not occur **until 2013,** it continues to be a good idea to defer income into 2012 if you believe that your marginal tax rate for 2012 will be equal to or less than your 2011 marginal tax rate. Also, deferring income into 2012 could increase various credits and deductions for 2011 that would otherwise be phased out as your adjusted gross income increases.

Self-Employed Business Income. If you are self-employed and use the cash method of accounting, consider delaying year-end billings to defer income until 2012. **Planning Alert!** If you have already received the check in 2011, deferring the deposit does not defer the income. Also, you may not want to defer billing if you believe this will increase your risk of not getting paid.

IRA Owners Who Attain Age 70½ During 2011. If you reached age 70½ at any time during 2011, although you may take your first required distribution from a traditional IRA before the end of 2011, you are allowed to take the first payment as late as **April 1, 2012,** without penalty. **CAUTION!** If you wait until 2012 to take your first payment, you will still be required to take your second required minimum distribution no later than December 31, 2012, which will cause you to take two payments in 2012. This "bunching" of the first two annual payments into one tax year (2012) could cause your income to be taxed in a higher tax bracket and, therefore, result in more overall tax than if you received the first required payment in 2011.

Rollovers By Surviving Spouses. If an individual ***over age 70½*** died during 2011 and the beneficiary of the decedent's IRA or qualified plan is the surviving spouse, and the *surviving spouse* ***is over 59½,*** the *surviving spouse* should consider rolling the decedent's qualified plan or IRA amount into his or her name **on or before December 31, 2011.** If the decedent's retirement account is rolled into an IRA in the surviving spouse's name **before 2012,** then **1)** provided the surviving spouse has not reached age 70½, no distributions are required in 2012, and **2)** if the surviving spouse is at least 70½, the required minimum distribution in 2012 will be determined using the Uniform Lifetime Distribution Table that results in a smaller annual required payout. **Therefore, converting the account into the surviving spouse's name on or before December 31, 2011, could substantially reduce the amount of the required minimum distribution for 2012 where the decedent was at least 70½.**

TAKING ADVANTAGE OF DEDUCTIONS

Accelerating "Above-The-Line" Deductions Into 2011. As a cash method taxpayer, you can generally accelerate a 2012 deduction into 2011 by "paying" it in 2011. Accelerating an **"above-the-line"** deduction (e.g., IRA or Health Savings Account (HSA) deduction, health insurance premiums for self-employed individuals, qualified student loan interest, qualified tuition deduction, qualified moving expenses, deductible alimony) into 2011 may allow you to reduce your "adjusted gross income" (AGI) below the thresholds needed to qualify for many other tax benefits (e.g., child credit, education credits, adoption credit, ability to contribute to a deductible IRA, etc). However, ***"*itemized"** deductions (i.e., below-the-line deductions) do **not** reduce your "adjusted gross income" and, therefore, will not affect your 2011 deductions and credits that are reduced as your income increases. *Itemized deductions* generally include charitable contributions, state and local income and property taxes, medical expenses, unreimbursed employee travel expenses, and home mortgage interest. **Tax Tip.** "Payment" typically occurs in 2011 if a check is delivered to the post office, if your electronic payment is debited to your account, or if an item is charged on a *third-party credit card* (e.g., Visa, Mastercard, Discover, American Express) in 2011. **Be careful,** if you post-date the check to 2012 or if your check is rejected, no payment has been made in 2011. **Planning Alert!** The IRS says that prepayments of expenses applicable to periods beyond 12 months after the payment will not be deductible in 2011.

Accelerating "Itemized" Deductions Into 2011. If your itemized deductions fail to exceed your standard deduction in most years, you are not receiving maximum benefit for your itemized deductions. You could possibly reduce your taxes over the long term by bunching the payment of your itemized deductions in alternate tax years. This may produce tax savings by allowing you to itemize deductions in the years when your expenses are bunched, and use the standard deduction in other years. **Tax Tip.** The easiest deductions to shift from 2012 to 2011 are *charitable contributions*, *state*

and local taxes, and your January, 2012 home *mortgage interest payment*. For 2011, the standard deduction is $11,600 on a joint return and $5,800 for single individuals. If you are blind or age 65, you get an additional standard deduction of $1,150 if you're married ($1,450 if single). **Watch Out For AMT!** Certain itemized deductions are not allowed in computing your alternative minimum tax (AMT), such as state and local taxes (including state income taxes) and unreimbursed employee business expenses. Before you accelerate 2012 itemized deductions into 2011, to be safe, we should first do a "with and without" computation so we can determine the AMT impact of this strategy.

Charitable Contributions. A charitable contribution deduction is allowed for 2011 if the check is mailed **on or before December 31, 2011,** or the contribution is made by a credit card charge in 2011. **Tax Alert!** Deductions for charitable contributions are allowed only if you have proper documentation for the contribution (i.e., generally a receipt containing the information required by the IRS). In addition, for contributions of property in excess of $5,000 IRS requires a qualified appraisal.

Maximizing Home Mortgage Interest Deduction. You can increase your home mortgage interest deduction by paying your January, 2012 payment **on or before December 31, 2011.** Typically, the January mortgage payment includes interest that was accrued in December and, therefore, is deductible if paid in December. **Planning Alert!** Make sure that you send in your January, 2012 mortgage payment early enough in December for your lender to actually receive it before year-end. That way, your lender will be sure to reflect that last payment on your 2011 Form 1098, and we can avoid a matching problem on your 2011 return.

State And Local Taxes. Consider paying your sate and local income taxes (fourth quarter estimate and balance due for 2011) and any property taxes for 2011 **prior to January 1, 2012.** **Planning Alert!** State and local income and property taxes are not deductible for AMT purposes. Consequently, you should not employ this tactic without carefully calculating the alternative minimum tax impact.

YEAR-END TAX PLANNING FOR INVESTORS

Planning With Capital Gains And Losses. Generally, the current maximum long-term capital gains rate of 15% **is scheduled to continue through 2012.** Also **through 2012,** lower-income taxpayers who have long-term capital gains that would otherwise be included in the 15% or lower ordinary income tax bracket, are taxed at a zero percent rate. **Tax Tip.** Timing your year-end sales of stocks, bonds, or other securities may save you taxes. **After fully evaluating the economic factors**, the following are time-tested, year-end tax planning ideas for sales of capital assets. **Planning Alert!** Always consider the economics of a sale or exchange **first!**

- **Timing Your Capital Gains And Losses.** If you have already recognized capital gains in 2011, you should consider selling securities that have declined in value **prior to January 1, 2012.** These losses will be deductible on your 2011 return to the extent of your recognized capital gains, plus $3,000. **CAUTION!** If within 30 days before or after the sale of loss securities, you acquire the same securities, the loss will not be allowed currently because of the "wash sale" rule. **Tax Tip.** There is *no* wash sale rule for *gains*. Thus, if you decide to sell stock at a gain in order to take advantage of a zero capital gains rate, or to absorb capital losses, you may acquire the same securities within 30 days without impacting the recognition of the gain.

- **Making The Most Of Capital Losses.** Many investors still have substantial loss carry forwards coming into 2011. If your stock sales to date have created a *net* capital loss exceeding $3,000, consider selling enough appreciated securities **before the end of 2011** to decrease your net capital loss to $3,000. Stocks that you think have reached their peak would be good candidates. All else being equal, you should sell the short-term gain (held 12 months or less) securities first. This will allow your *net* capital loss (in excess of $3,000) to offset your short-term capital gain, while preserving your favorable long-term capital gain treatment for later years.

MISCELLANEOUS YEAR-END TAX PLANNING OPPORTUNITIES

As you develop your 2011 and 2012 tax year-end planning strategies, don't overlook the following tax savings opportunities:

"American Opportunity Education Tax Credit" (Formerly "Hope Credit"). **For 2009 through 2012,** you may qualify for the ***"American Opportunity Tax Credit"*** for qualifying college tuition and course materials for yourself, your spouse, and your dependent children. The maximum credit for each student is $2,500, and is allowed for up to *four* years (i.e., generally, freshman through senior years). The credit phases out as your modified adjusted gross income increases **from $160,000 to $180,000 for those filing joint returns** and from **$80,000 to $90,000 for single filers.** **Planning Alert!** To get the full $2,500 credit for 2011, you must pay qualifying expenses of at least $4,000 for the student **by December 31, 2011.** For example, if you paid tuition and books of $2,500 for the fall, 2011 semester for a college freshman, you would need to pay tuition of at least $1,500 for the spring, 2012 semester by **December 31, 2011,** to get the full credit of $2,500 for 2011.

The Lifetime Learning Credit. The *Lifetime Learning tax credit* equals 20% of the first $10,000 of qualified higher education tuition and fees. The credit phases out ratably as your modified adjusted gross income increases from **$102,000 to $122,000** on a joint return (**$51,000 to $61,000** on a single return). The Lifetime Learning credit is for an unlimited number of years and can be used for graduate or professional degrees (as well as undergraduate education). However, the Lifetime Learning credit **limitation of $2,000 is per tax return, not per student.** If your income **is more than $122,000 ($61,000 on a single return),** you do not qualify for the Lifetime Learning credit.

Maximize Tax-Favored Medical Benefits For Children Under Age 27. **Effective March 30, 2010,** an employer-provided health plan may provide tax-free reimbursements to an employee's child **who is under age 27** *at the end of the tax year*. This exclusion applies even if the taxpayer cannot claim the child as a dependent for tax purposes. Previously, an employer could only reimburse "tax free" the medical expenses of an employee, the employee's spouse, and the employee's dependents. **Tax Tip.** If your employer's health insurance plan is currently covering your child who will turn age 27 in 2012, accelerating discretionary medical expenses for that child from **2012 to 2011** will allow your employer's 2011 reimbursements to be tax-free.

In addition, if you are self-employed, you may take an "above-the-line" deduction (i.e., unrestricted by the limitations on "itemized deductions") for health insurance premiums that you pay for your child who is **under age 27** at the **end of the year,** even if the child is not your "dependent" for tax purposes.

Planning With The "Kiddie Tax." A child will have his or her unearned income (e.g., interest, dividends, and capital gains) in excess of the *threshold amount* ($1,900 for 2011), taxed at the *parents' tax rate* if: **1)**The child **has not attained age 18** by the *close of the tax year*; **OR 2)** The child is **age 19 through 23** by the *close of the tax year* AND the child is a full-time student. **Tax Tip.** Since a child's *earned income* is not taxed at the parents' tax rates, parents may save taxes by employing a child in the parent's business and paying the child *reasonable* compensation. The child's earnings won't be subject to tax at the parent's rates under the kiddie tax rules and the earnings should be deductible by the business.

Note! The information contained in this letter represents a general overview of tax developments and should not be relied upon without an independent, professional analysis of how any of these provisions may apply to a specific situation.

Circular 230 Disclaimer: Any tax advice contained in the body of this material was not intended or written to be used, and cannot be used, by the recipient for the purpose of **1)** avoiding penalties that may be imposed under the Internal Revenue Code or applicable state or local tax law provisions, or **2)** promoting, marketing, or recommending to another party any transaction or matter addressed herein.