TAX TALK

Winter 2011

Twenty-five years ago, Congress overhauled the Tax Code in the Tax Reform Act of 1986. At that time, the 1986 Tax Reform Act was lauded for simplifying a Tax Code that had grown too complex. Since 1986, complexity has returned to the Tax Code, largely because Congress has enacted a host of temporary tax incentives with a variety of expiration dates. Today, many taxpayers are trying to navigate all of this complexity as they draft their 2011 year-end tax plans. This letter highlights some of the more widely-utilized 2011 year-end tax strategies for individuals and businesses.

Planning complications

Few tax laws have complicated tax planning as much as the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) A/K/A "The Bush Tax Cuts" and its progeny. EGTRRA was enacted as a temporary tax law. Its supporters predicted that a future Congress would make EGTRRA permanent. Indeed, some of EGTRRA's retirement savings provisions were made permanent in 2004. Other provisions, however, have been extended one or two years at a time. The most recent extension of EGTRRA was in the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (2010 Tax Relief Act). Many of the extended tax provisions are scheduled to expire at the end of 2011 or the end of 2012.

Uncertainty over the fate of the expiring tax provisions makes year-end 2011 tax planning a challenge for many individuals and businesses. Fortunately, we know that certain tax incentives will be available through the end of 2011 and others through the end of 2012. Additionally, some traditional year-end tax planning strategies are valuable even with all the uncertainty.

Please utilize this letter as a checklist for some year-end planning strategies for individuals and businesses. Every taxpayer's situation is different. Please contact our office so we can schedule a time to discuss your year-end tax planning in detail.

Individuals

Income/deduction shifting

Income and deduction shifting is a traditional year-end tax strategy that is worth a look at year-end 2011. However, one key complication is uncertainty over the individual income tax rates after 2012. We know that the individual income tax rates will be 10, 15, 25, 28, 33, and 35 percent for 2012. Under current law, the 10 percent rate is scheduled to expire after December 31, 2012 and the remaining rates are scheduled to revert to 15, 28, 31, 36, and 39.6 percent after December 31, 2012 (unless extended by Congress). As a result, some taxpayers may want to abandon the traditional strategy of shifting income into a future year and recognize income in 2011 or 2012 when the lower rates are available.

Capital gains/dividends

Reduced tax rates on qualified dividends and capital gains are scheduled to expire after December 31, 2012 (unless extended by Congress). Taxpayers need to carefully review when to recognize income from qualified capital gains and dividends to maximize their tax savings in 2011 or 2012.

AMT

For many individuals, year-end tax planning requires "doing the math" for regular federal tax liability and alternative minimum tax (AMT) liability and this year is no exception. Taxpayers may want to explore if certain deductions should be more evenly divided between 2011 and 2012 and which deductions may qualify, or will not be as valuable, for AMT purposes.

Gift tax exclusion

Many individuals overlook gift-making as a year-end tax strategy. Under current law, the annual gift tax exclusion per recipient on which no gift tax is due is $13,000 for 2011.

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Married couples may make combined tax-free gifts of $26,000 to each recipient. Use of a "lifetime" estate and gift tax exclusion should also be considered for larger gifts. Please contact us before making any large gifts to discuss tax planning opportunities.

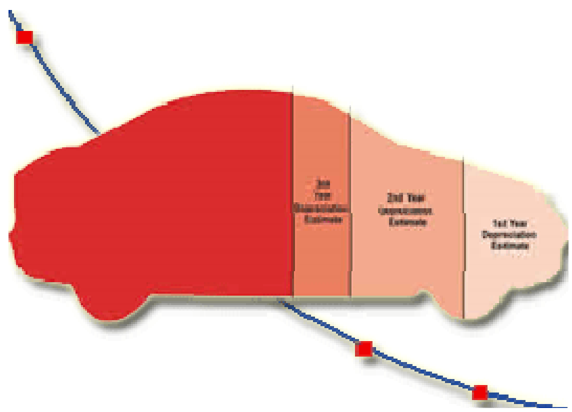
Energy improvements

In recent years, Congress has enacted a number of tax incentives to encourage homeowners to make energy efficient improvements to their primary residences. The Code Sec. 25C tax credit for certain nonbusiness energy property is scheduled to expire after December 31, 2011 (unless extended by Congress). The credit is complex; if you are considering installing energy efficient improvements such as windows, doors, heat pumps, and other items, please contact our office to determine if your purchase qualifies for the credit.

More incentives

More individual incentives scheduled to expire after December 31, 2011 include (not an exhaustive list):

- Employee-side payroll tax cut
- Above-the-line deduction for qualified tuition and related expenses
- Tax-free distributions from individual retirement plans for charitable purposes by individuals age 70 ½ and older
- Deduction for classroom expenses of qualified educators
- Parity for exclusion from income for employer-provided mass transit and parking benefits
- Premiums for mortgage insurance deductible as interest that is qualified residence interest
- Expansion of adoption credit and adoption assistance



Businesses

Business taxpayers, like all taxpayers this year, are confronted with uncertainty in year-end tax planning as 2011 ends. A number of business tax incentives are scheduled to expire after December 31, 2011 unless extended by Congress. These incentives include widely-popular and utilized ones, such as 100 percent bonus depreciation, enhanced small business expensing, real property expensing, and many more. Other provisions, such as the small business health insurance credit and the Code Sec. 199 domestic production activities deduction, while not expiring, appear to be under-utilized. As 2011 draws to a close, it is a valuable time to review some of these tax incentives and how they may be able to help your business' bottom line.

Bonus depreciation

Taxpayers are allowed to recover the cost of certain property used in a trade or business or for the production of income through annual depreciation deductions. The amount of the allowable depreciation deduction for a tax year is generally determined under the modified accelerated cost recovery system (MACRS), which assigns applicable recovery periods and depreciation methods to different types of property.

An additional first-year depreciation deduction equal to 100 percent of the adjusted basis of the property is available for qualified property acquired after September 8, 2010 and before January 1, 2012, and placed in service before January 1, 2012 (or before January 1, 2013 for certain longer-lived and transportation property). This additional depreciation deduction, known as "100 percent bonus depreciation" is temporary (unless extended by Congress). As a result, 2011 year-end tax planning should take into account 100 percent bonus depreciation as well as its scheduled drop to 50 percent for qualified property acquired after December 31, 2011 and before January 1, 2013 (or before January 1, 2014 for certain longer-lived and transportation property.

These dates are important in year-end planning. Let's look at an example. ABC Co. acquires a qualified asset on November 1, 2011 and places it in service on December 1, 2011. The 100 percent rate of bonus depreciation applies. However, if ABC Co. acquires a qualified asset on November 1, 2011 and places it in service on January 1, 2012, the 50 percent rate of bonus depreciation applies. The rules for determining the acquisition date of an asset are different for the 100 percent and 50 percent rates. Special rules apply to self-constructed property.

Taxpayers may elect out of bonus depreciation. An election out of 100 percent bonus depreciation in 2011 will spread the depreciation deductions for the cost of an asset into future years measured by the asset's depreciation period. Electing out of 100 percent bonus depreciation may be a valuable strategy for certain taxpayers. Our office can help you determine the best strategy for applying bonus depreciation.

Business vehicles

Special consideration should be paid to the interaction of 100 percent bonus depreciation and the so-called "luxury vehicle" caps. In Rev. Proc. 2011-26, the IRS set out a safe harbor method of accounting for businesses nominally entitled to 100 percent bonus depreciation but still limited by the maximum luxury vehicle depreciation caps ($11,060 for passenger autos for 2011 and $11,160 for light trucks in 2011). The effect of the safe harbor is generally to allow the taxpayer under the 100 percent bonus depreciation regime to claim exactly the same amount of depreciation during each year of the vehicle's recovery period as would have been allowed if a 50 percent bonus depreciation rate had originally applied. The safe harbor method may be used for qualifying new vehicles placed in service after September 8, 2010 and before January 1, 2012 for which a 100 percent bonus depreciation rate applies.

Code Sec. 179 expensing

Business taxpayers are allowed to expense up to a certain dollar amount in annual investment expenditures for qualified property. The maximum amount that can be expensed is reduced by the amount by which the taxpayer's cost of qualified property exceeds a certain investment limit. For tax years beginning in 2010 and 2011, the Code Sec. 179 dollar limit is $500,000 and the investment limit is $2 million. The dollar limit is scheduled to fall to $125,000 (indexed for inflation at $139,000) and the investment limit is scheduled to fall to $500,000 ($560,000 indexed for inflation) after 2011. As a result, business taxpayers contemplating qualified purchases should weigh the benefits of accelerating those purchases into 2011. Keep in mind that Code Sec. 179 expensing is also allowed for off-the-shelf computer software placed in service in tax years beginning before 2012.

Some targeted special expensing provisions are scheduled to expire after December 31, 2011 (unless extended by Congress). Expiring for qualified property placed in service after December 31, 2011 are special expensing rules for film and television production costs; brownfields remediation costs; and qualified advanced mine safety equipment.

Real property expensing

Real property generally is excluded from Code Sec. 179 expensing. However, tax legislation in 2010 provided that qualified leasehold property, qualified restaurant property, and qualified retail improvement property placed in service before January 1, 2012 are eligible for special expensing rules. However, the special expensing provision is temporary and is scheduled to expire after 2011 (unless extended by Congress).

A taxpayer that places qualified leasehold improvement property, qualified restaurant property or qualified retail improvement property in service in a tax year that begins in 2010 or 2011 may elect to treat the property as Code Sec. 179 property and expense up to $250,000 of the cost of the property. There are some important limitations. While qualified leasehold improvement property is eligible for bonus depreciation, qualified restaurant property and qualified retail improvement property are generally ineligible for bonus depreciation unless they meet the definition of qualified leasehold improvement property. Additionally, current law does not provide for a carryover of an unused real property expensing election for qualified property placed in service in 2011. If you are considering a real property improvement, please contact our office before the window of opportunity for this special expensing rule closes.

Work Opportunity Tax Credit (WOTC)

Employers that have taken advantage of the popular Work Opportunity Tax Credit (WOTC) in past years may be surprised to learn the credit is scheduled to expire after December 31, 2011 (unless extended by Congress). The WOTC is designed as an incentive to encourage employers to hire individuals from nine targeted groups, which have historically, experienced higher than average unemployment rates and other barriers to employment. The WOTC generally is 40 percent of the qualified worker's first-year wages up to $6,000 (with higher and lower amounts for certain groups). Under current law, the WOTC applies to wages paid to qualified individuals who begin work for the employer before January 1, 2012. Wages paid to qualified individuals who begin work for the employer after December 31, 2011 (under current law) are ineligible for the WOTC.

Payroll taxes

Employers should remind employees that effective January 1, 2012, the employee-share of OASDI taxes is scheduled to revert to 6.2 percent (unless the 2011 payroll tax holiday is extended by Congress). Under the 2011 payroll tax holiday, employees paid OASDI taxes at a rate of 4.2 percent rather than 6.2 percent. A similar benefit was provided to self-employed individuals. The employer-share of OASDI taxes for 2011, however, remains at 6.2 percent.

An employer's FUTA tax liability did change mid-year in 2011. The 0.2 percent FUTA surtax expired after June 30, 2011. As a result, the FUTA tax rate falls to 6.0 percent for the remaining six months of 2011 before any state unemployment tax credits are taken into account. The IRS has indicated it will provide guidance for employers. Our office will keep you posted on any developments.

Small business health insurance tax credit

According to the IRS, many small businesses are overlooking the Code Sec. 45R small employer health insurance tax credit. Small employers that provide health care coverage to their employees and that meet certain requirements ("qualified employers") generally are eligible for the Code Sec. 45R tax credit for health insurance premiums they pay for certain employees. The employer must have fewer than 25 full-time equivalent employees (FTEs) for the tax year; average annual wages of its employees for the year must be less than $50,000 per FTE; and the employer must pay the premiums under a qualifying arrangement. For tax years beginning in 2010 through 2013, the maximum credit is 35 percent of the employer's premium expenses that count towards the credit (25 percent for tax-exempt employers). If the number of FTEs exceeds 10 or if average annual wages exceed $25,000, the amount of the credit is reduced until it phases-out.

Code Sec. 199 deduction

Another under-used tax incentive, according to the IRS, is the Code Sec. 199 domestic production activities deduction. The Code Sec. 199 deduction generally allows taxpayers to receive a deduction based on qualified production activities income (QPAI) resulting from domestic production. The deduction effectively reduces the income tax rate on domestic production activities. Qualifying domestic production includes the manufacture of tangible personal property; the production of computer software, sound recordings and certain films; the production of electricity, natural gas, or water; and construction, engineering, and architectural services. One deterrent to greater use of the deduction is its complexity. Our office can help you navigate the deduction's rules and calculations.

Energy tax incentives

Energy tax incentives are a mixed bag for businesses. A number of tax credits for alcohol fuels and biodiesel/renewable diesel will expire after December 31, 2011 (unless extended by Congress). Tax credits for construction of new energy efficient homes and manufacture of energy efficient appliances will also expire after December 31, 2011 (unless extended by Congress). Other energy tax incentives, including the deduction for energy efficient commercial buildings, do expire until after 2013 or subsequent years.

Give us a call

All of the tax opportunities and considerations at this time of year can be a lot to remember, and the details of all these provisions can make it even more complicated. Fortunately, you won't have to remember all of them by yourself – that is why you hired us. The two most important pieces of tax advice for any year are to keep good records and ask questions. We look forward to hearing from you.

If you are projected to owe additional income tax, a tax projection can help determine which tax-minimizing strategies should be used before the end of the year to reduce or eliminate any tax due. If you are due a refund, we can ensure your tax return is filed as early as possible to allow you to receive your refund and enjoy your money more quickly.

If you need additional information on any of the above items or wish to speak with us directly about your tax picture for 2011, please do not hesitate to contact us at (212) 302-8970.

In addition if you feel that your friend or business associates could benefit from this newsletter, please feel free to pass it on to them.

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