Tax Planning Strategies

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2011-2012 Edition

CCH Editorial Staff Publication

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Planning Opportunities for Now and the Future

Tax planning is a process of reviewing various options for conducting business and personal transactions for the purpose of reducing your tax liability. It involves making decisions on the timing and method of completing transactions and the reporting of income, deductions, and credits. However, in order to make tax-planning decisions intelligently, you must have an accurate picture of your tax situation, not only for the current tax year, but also for future years. This includes not only your personal needs, but also economic conditions and trends, as well as tax law changes.

Over the past ten years, beginning with the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) (P.L. 107-16), numerous pieces of tax legislation have been enacted providing tax benefits to both individuals and businesses. This includes a reduction in the tax rates for ordinary income and capital gains, as well as the expansion of credits and deductions that may be available to you to help your reduce your tax liability. Just in the past year alone, there have been a number of pieces of legislation providing tax relief to various taxpayers.

For example, the Small Business Jobs Act of 2010 (P.L. 111-240) provided numerous tax incentives to small businesses to help stimulate job creation. This included an extension of bonus depreciation, as well as an extension and doubling of Code Sec. 179 expensing. It also provided for 100 percent gain exclusion for qualified small business stock and enhanced the deduction for start-up expenses. In addition, active participants in 401(k) and other qualified retirement plans were allowed to roll over existing balances to a designated Roth account under their plans.

The piece of legislation receiving the most news coverage in the past year was the the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (P.L. 111-312). The legislation extends all of the individual, capital gains, and dividend tax cuts from EGTRRA for all taxpayers for two years.

In addition, the legislation increased the alternative minimum tax (AMT) exemption amounts for individuals and extended the use of nonrefundable personal credits against AMT liability. It also continued to provide support for small businesses by boosting the 50-percent bonus depreciation to 100-percent for qualified investments made after September 8, 2010 and before January 1, 2012. For individuals, the 2010 Tax Relief Act reduced the employee-share of Social Security taxes from 6.2 percent to 4.2 percent for wages earned during 2011. Self-employed individuals pay only 10.4 percent on self-employment income.

EGTRRA gradually reduced the federal estate tax over a period of years and then abolished it for decedents dying in 2010. The pre-EGTRRA estate tax was scheduled to be revived after 2010. However, the 2010 Tax Relief Act revived the estate tax for decedents dying after 2009, but with a significantly lower rate or tax and higher applicable exclusion amount. Specifically, the maximum estate tax rate is 35 percent with an applicable exclusion amount of $5 million. This new estate tax regime is itself temporary and is scheduled to sunset on December 31, 2012.

Together with the revival of the estate tax, the 2010 Tax Relief Act eliminates the modified carryover basis rules and replaces them with the stepped up basis rules that had applied until 2010. Property with a stepped-up basis receives a basis equal to the property's fair market value on the date of the decedent's death (or on an alternate valuation date). Under a modified carryover basis that EGTRRA had put into place for 2010, the executor may increase the basis of estate property only by a total of $1.3 million, with other estate property taking a carryover basis equal to the lesser of the decedent's basis or the fair market value of the property on the decedent's death. An executor may increase the basis of assets passing to a surviving spouse by an additional $3 million (for a total of $4.3 million).

The 2010 Tax Relief Act gives estates of decedents dying in 2010 the option to elect not to come under the revived estate tax. The law gives those estates the option to elect to apply (1) the estate tax based on the new 35 percent top rate and $5 million applicable exclusion amount with stepped-up basis, or (2) no estate tax and modified carryover basis rules under EGTRRA. Any election would be revocable only with the consent of the IRS.

Many of the above tax benefits, as well as tax benefits provided in previous legislation, are temporary in nature and phased in and out over the past ten years. The result is a revolving door of changes that makes tax planning more difficult than ever before. In response, this publication provides information and insight to help you make the right planning decisions on a year-round basis. "Legislation Highlights" points out changes from recent tax legislation, while "Planning Alerts" and "Tax Tips" are provided throughout for additional practical information. In addition it provides references to the 2011 U.S. Master Tax Guide (MTG) to allow access to more detailed information and guidance.

With change comes opportunity, and all the changes made to the tax law have created an environment in which you can choose among a number of options to invest more and deduct more, all the while paying less in taxes. However, to best maximize tax savings, tax planning is essential to maximize many of these benefits whether you work with a professional advisor or planning on your own.

August 2011

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CHAPTER 1

Importance of Tax Planning

Introduction

Tax planning activities may often result in substantial tax savings. If you compute your federal income tax on a calendar-year basis, as most individuals do, your opportunity for tax planning generally ends on December 31. Thus, when you prepare your tax return two or three months after the close of the tax year, it is generally too late to do anything except file your return on the basis of what took place in the preceding year. There are some exceptions. For example, many individuals can make contributions after the end of the year to an individual retirement account (IRA) or a retirement plan if they are self-employed, and reduce their taxes for the prior year.

Tax planning primarily concerns the timing and the method by which your income is reported and your deductions and credits are claimed. The basic strategy for tax planning is to time your income so that it will be taxed at a lower rate and to time your deductible expenses so that they may be claimed in years when you are in a higher tax bracket. This usually means that, if you expect to be in a lower tax bracket in 2012 than in 2011, you should defer the receipt of income to 2012 and accelerate your deductions into 2011. Conversely, if you expect to be in a higher bracket in 2012, you should accelerate your income into 2011 and defer your deductions until 2012. The following is an example of how the timing of income strategy works using the tax rates for 2010 and 2011:

Suppose you and your spouse are both over age 60 and have been retired for several years. Your house is paid for and you have been living on investments, savings, and Social Security. You expect your taxable income for 2010 and 2011 to be $36,000 for each year. Near the end of 2010, you decide that you want to withdraw $50,000 from a traditional IRA in order to pay for major home improvements as well as paying off some of your high-interest credit card debt. Should you make the withdrawal in 2010 or wait until 2011?