

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

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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 you 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 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.

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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.

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TABLE OF CONTENTS

CHAPTER 1: IMPORTANCE OF TAX PLANNING

Introduction.....	9
Using Tax Rate Differences	10
Alternative Minimum Tax.....	12

CHAPTER 2: INCOME SUBJECT TO TAX

Common Types of Taxable Income	15
Excluded Income	16
Taxation of Social Security Benefits.....	17
Shifting Income	18
Ways to Postpone Income.....	18
Ways to Accelerate Income	21
Taking Advantage of Flexible Spending Accounts	23
Avoiding the Risks of Incentive Stock Options	24

CHAPTER 3: MAKING YOUR DEDUCTIONS COUNT

Maximizing the Value of Your Deductions	28
Deducting Medical Expenses	32
Health and Medical Savings Accounts	34
Charitable Contributions	38
Deductions Related to Being a Homeowner	41
Miscellaneous Itemized Deductions	43
Moving Expenses	44
Protecting Your Business Expense Deductions	45
Accelerating Depreciation on Your Business Assets	46
Expensing Business Assets Under Code Sec. 179.....	48

CHAPTER 4: INVESTMENT DECISIONS

Capital Gains Tax Treatment.....	51
Dividend Income	52
Determining Your Holding Period	53
Offsetting Capital Gains with Capital Losses	55
Limitations on Capital Losses	56
Wash Sales	57
Mutual Funds: Recordkeeping Is Key.....	59
Shifting Capital Gains Tax Through Gifts	60
Sale of Principal Residence	61
Sale of Vacation Home.....	63
Qualified Small Business Stock.....	64
Small Business Investment Companies.....	66
Tax-Exempt Bonds	66
Additional Capital Gains Considerations	67

CHAPTER 5: RETIREMENT SAVINGS

Benefiting from IRAs	69
Traditional IRAs	70
Roth IRAs	72
Transfer of Assets to an IRA	73
Employer-Sponsored Plans	75
Deemed IRAs	76
Inherited Funds from Retirement Accounts	76
Withdrawing Savings Prior to Retirement	77
Hardship Distributions	79
Borrowing from Your Retirement Account	80
Retirement Savings Credit	81
Social Security Benefits	82

CHAPTER 6: EARLY RETIREMENT AND POST-RETIREMENT STRATEGIES

Planning for Early Retirement	83
Social Security Benefits	85
Retirement Accounts	87
Estimated Tax Liability	88
Medical Benefits	89
Housing	90
Asset Management and Protection	90
Incapacity	93

CHAPTER 7: ESTATE PLANNING—MINIMIZING ESTATE AND GIFT TAXES

Estate and Gift Tax Rates	96
Marital Deduction	97
Estate Tax Exclusion	97
Lifetime Gift Tax Exclusion	98
Annual Gift Tax Exclusion	98
Educational or Medical Expense Exclusion	99
Stepped-Up Basis Rule	99
State Death Taxes	101
Generation-Skipping Transfer Tax	101

CHAPTER 8: FAMILY STRATEGIES

Determining Your Filing Status	103
Splitting Income Among Family Members	105
The Kiddie Tax	105
Personal and Dependency Exemptions	107
Who Is Your Dependent?	107
Child Tax Credit	110
Child and Dependent Care Credit	111
Adoption Expenses	112
Tax Consequences of Divorce	113

CHAPTER 9: EDUCATION INCENTIVES

Education Tax Credits.....	117
Tuition and Fees Deduction.....	119
Coverdell Education Savings Accounts.....	120
Qualified Tuition Programs.....	122
IRA Education Expense Withdrawals.....	124
Student Loan Interest Deduction.....	125
Student Loan Cancellations.....	125
Business Deduction for Work-Related Education.....	126
Employer's Educational Assistance Program.....	127
Exclusion for U.S. Savings Bond Interest.....	127
Scholarships and Fellowships.....	129

CHAPTER 10: ESTIMATED TAX

Safe Harbors.....	131
High-Income Taxpayers.....	132
Avoiding the Penalties.....	132

CHAPTER 11: BUSINESS PLANNING

Determining Whether to Start or Buy a Business.....	135
Types of Business Organizations.....	137
Choosing the Right Business Organization.....	139
Tax Year Considerations.....	140
Accounting Methods.....	140
Financing.....	141
Start-Up Costs.....	141
Acquiring Assets.....	143
Managing and Maintaining a Workforce.....	144
Retirement Planning as Business Owner.....	145

CHAPTER 12: TAX STRATEGIES FOR THE SELF-EMPLOYED

Medical Expenses.....	147
Deducting Automobile Expenses.....	148
Buying or Leasing an Automobile.....	152
Travel Away from Home.....	154
Meals and Entertainment.....	155
Home Office.....	156
Retirement Plans.....	159
Self-Employment Tax.....	162
Employee v. Independent Contractor.....	164

APPENDICES

Appendix A: Tax Planning Checklist.....	165
Appendix B: Tax Calendar.....	168
Appendix C: Income Tax Rates.....	169
Appendix D: Deductions Checklist.....	171
INDEX.....	177

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Taxation of Social Security Benefits.....	17
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Ways to Accelerate Income	21
Taking Advantage of Flexible Spending Accounts.....	23
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Accelerating Depreciation on Your Business Assets	46
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Dividend Income	52
Determining Your Holding Period	53
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Limitations on Capital Losses	56
Wash Sales	57
Mutual Funds: Recordkeeping Is Key.....	59
Shifting Capital Gains Tax Through Gifts.....	60
Sale of Principal Residence	61
Sale of Vacation Home	63
Qualified Small Business Stock	64
Small Business Investment Companies.....	66
Tax-Exempt Bonds	66
Additional Capital Gains Considerations	67

CHAPTER 5: RETIREMENT SAVINGS

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Traditional IRAs.....	70
Roth IRAs.....	72
Transfer of Assets to an IRA.....	73
Employer-Sponsored Plans.....	75
Deemed IRAs.....	76
Inherited Funds from Retirement Accounts.....	76
Withdrawing Savings Prior to Retirement.....	77
Hardship Distributions.....	79
Borrowing from Your Retirement Account.....	80
Retirement Savings Credit.....	81
Social Security Benefits.....	82

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Medical Benefits.....	89
Housing.....	90
Asset Management and Protection.....	90
Incapacity.....	93

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Estate and Gift Tax Rates.....	96
Marital Deduction.....	97
Estate Tax Exclusion.....	97
Lifetime Gift Tax Exclusion.....	98
Annual Gift Tax Exclusion.....	98
Educational or Medical Expense Exclusion.....	99
Stepped-Up Basis Rule.....	99
State Death Taxes.....	101
Generation-Skipping Transfer Tax.....	101

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Determining Your Filing Status.....	103
Splitting Income Among Family Members.....	105
The Kiddie Tax.....	105
Personal and Dependency Exemptions.....	107
Who Is Your Dependent?.....	107
Child Tax Credit.....	110
Child and Dependent Care Credit.....	111
Adoption Expenses.....	112
Tax Consequences of Divorce.....	113

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Education Tax Credits.....	117
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Acquiring Assets.....	143
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Retirement Planning as Business Owner.....	145

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Medical Expenses.....	147
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Buying or Leasing an Automobile.....	152
Travel Away from Home.....	154
Meals and Entertainment.....	155
Home Office.....	156
Retirement Plans.....	159
Self-Employment Tax.....	162
Employee v. Independent Contractor.....	164

APPENDICES

Appendix A: Tax Planning Checklist.....	165
Appendix B: Tax Calendar.....	168
Appendix C: Income Tax Rates.....	169
Appendix D: Deductions Checklist.....	171
INDEX.....	177

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?