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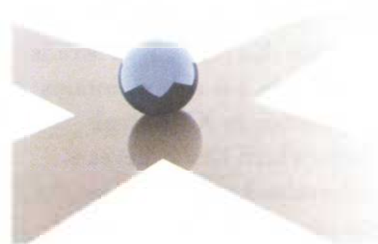
CPA

Client Tax Letter

Tax Saving and Planning Strategies *from your* Trusted Business Advisor℠

October/November/ December 2011

A Year of Uncertainty?



Officially, year-end tax planning is fairly straightforward in 2011. At year-end 2010, Congress extended many of the income tax laws that were in place at the time. Some laws were changed, especially in the estate planning area. For the most part, the tax law passed at the end of last year is effective for two years: 2011 and 2012. Therefore, you may expect to plan for year-end 2011 and for 2012 with some certainty.

As this issue is written, however, the news from Washington is far from certain. President Obama and Congressional leaders are attempting to resolve federal budget and debt issues. Tax changes are possible, and such changes may affect year-end planning in 2011. Our office will keep you informed about any changes that become law and how they might impact your year-end tax planning. In the meantime, here is an overview of the current situation:

Income tax

In 2011, federal income tax rates range from 10% to 35%. The same tax rates will be in effect for 2012. Therefore, standard tax planning calls for deferring income to 2012, where possible, and accelerating tax deductions to 2011. With this strategy, you'll defer tax payments and benefit by having more use of your own money. You might reverse such planning, though, if you expect your income to be significantly higher next year, pushing you into a higher tax bracket.

Estate tax

For 2011 and 2012, the federal estate tax exemption is set at $5 million. Similarly, the gift tax and generation skipping transfer tax exemptions are set at $5 million through next year. Those exemptions might be reduced in the future. Consequently, you may want to make large taxable gifts now, while the gift tax exemption is so substantial. Our office can review the tax consequences with you and make sure your estate plan conforms with current law. ■

Did You Know?

In the spring of 2011, the Standard & Poor's/Case-Shiller Home Price Indices had dropped nearly 33% from the peak levels of mid-2006. They were back to the price levels of the summer of 2003.

Source: Standard & Poor's

What's Inside

SPECIAL ISSUE: *2011 Tax Planning Roundup*

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From 2000 to 2011, IRAs increased from 22% of U.S. retirement savings to 27% of the total, passing government plans and defined contribution plans, such as 401(k)s.

Year-End Tax Planning for Investors

Stocks performed reasonably well for much of 2011 but fell precipitously after the downgrading of the United States' credit rating. As of this writing, the investment outlook for 2011 is quite uncertain. Despite that fact, there are things you can do with your portfolio by year-end to reduce the tax you'll owe for 2011.

Start by reviewing Schedule D of the federal income tax return you filed for 2010. See if you are carrying over any net capital losses from previous years. The next step is to tally your trading activity for 2011 so far. You can determine if you are in a net capital gain or loss position for the year to date.

Example 1: Jane Collins is carrying over $10,000 worth of net capital losses from prior years. So far this year, her securities trades have generated a net gain of $18,000. If Jane takes no further action, she can use her loss carryover to offset part of this year's gain and wind up with an $8,000 net capital gain. If those gains are all long term, meaning that Jane held the securities for more than a year before selling them, she will owe $1,200 in tax, at a 15% rate.

Learning to love losers

To reduce her tax bill, Jane can take capital losses before year end. If she takes $8,000 worth of losses, for example, Jane will have a $10,000 net gain for 2011: her previous $18,000 net gain minus $8,000 in year-end losses. With a $10,000 net gain for 2011 and a $10,000 loss carryover from her 2010 tax return, Jane will have neither net gains nor net losses. Therefore, she'll owe no tax on her trades for her 2011 tax return. If Jane takes $11,000 worth of losses by year end, she will have a $3,000 net capital loss to report for 2011. That amount is the largest capital loss you can deduct on your tax return each year.

If Jane is in a 25% federal income tax bracket and reports a $3,000 capital loss, she will save $750 in tax—25% of $3,000. On the other hand, if Jane takes no year-end losses she will owe $1,200 in tax, as explained in example 1. Altogether, Jane improves her tax position by $1,950 (going from a $1,200 tax obligation to a $750 tax savings) by taking $11,000 in capital losses by year end. Reducing her adjusted gross income (AGI) by going from a net capital gain to a net loss also might help her use other tax deductions and tax credits.

When you do your year-end tax planning for capital gains and losses, remember to include capital gains distributions from mutual funds. If you hold the funds in a taxable account, you'll owe tax on those distributions, even if you reinvest the distributions in the same fund. Your fund's website should post 2011 distribution information by November or December. If you have 1,000 shares of ABC Fund, for instance, and the fund announces a $1 per share capital gains distribution, you'll know that you'll be reporting $1,000 of taxable gains.

Reinvestment rules

If you sell securities to generate capital losses, you'll receive cash. You may want to maintain the shape of your portfolio; however, you can't immediately purchase the same security you've just sold. Such a transaction, called a "wash sale," disallows your capital loss.

There are three ways to keep your portfolio on track yet avoid a wash sale:

1. **Double up.** To use this tactic, you must begin the process before the end of November. You buy an additional amount of the securities you wish to sell, wait more than 30 days, then sell the original holding for a capital loss.

   Example 2: Ken Larsen bought 200 shares of XYZ Bank Corp. a few years ago at $80 a share. XYZ now trades at $50 a share. On November 23, 2011, Ken buys another 200 shares of XYZ. On December 27, 2011, which is more than 30 days later, Ken instructs his broker to sell the original 200 shares at $50 apiece. He takes a capital loss of $30 a share, or $6,000 on the 200 shares.

   With this tactic, Ken avoids a wash sale. He also maintains his position in XYZ Bank Corp., which Ken believes is undervalued at $50 a share. As you can see, Ken has invested another $10,000 in XYZ, so he stands to gain more if the stock price moves up or lose more if it keeps falling while he is holding the additional 200 shares. If this approach appeals to you, double up before the end of November so you can wait more than 30 days and still claim a capital loss for 2011 with a year-end sale.
2. **Hold your cash.** You also can avoid a wash sale by holding onto the sales proceeds for more than 30 days before reinvesting. If Ken sells his original lot of XYZ Bank Corp. for a $6,000 capital loss on November 23, he can park the money he receives in a bank or brokerage liquid account for more than 30 days. Then Ken can repurchase 200 shares of XYZ without losing his capital loss. In this scenario, Ken takes the risk that the trading price of XYZ will move sharply higher while he sits on the sidelines.

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3. **Buy something similar but not identical.** If Ken does not want to be out of the market for more than a month, he can take the $10,000 he receives for selling 200 shares of XYZ on November 23 and immediately buy another bank stock or a fund that holds many bank stocks. Such investments may rise or fall with the industry outlook, just as XYZ would, but they won't jeopardize a capital loss. After more than 30 days, Ken can repurchase XYZ if he wishes. In the interim, Ken takes the risk that the replacement holding might not perform as well as XYZ. ■

Year-End Family Tax Planning

When you turn your attention to year-end tax planning, you probably focus on your own situation as a single taxpayer or as a married individual who will file a joint tax return. Broadening your horizons, though, may pay off. If you have relatives in a low tax bracket, some strategies can permit you to take advantage of their low tax rates. The outcome might be lower taxes and more money for you and your loved ones to spend or invest.

Coping with the kiddie tax

You may believe that shifting income from parent to student is a tax-efficient way to build an education fund. You might, for instance, give taxable bonds to your children so they can receive interest in a low tax bracket. Similarly, you might give appreciated assets to youngsters, who can sell them and owe little or no tax on the gains.

Such tactics can be useful, but they are limited by the so-called "kiddie tax." This tax code provision caps the amounts of unearned income that can be taxed at a youngster's rate. Excess amounts are taxed at the parents' rate, so there may be no family tax benefit.

Kid stuff

Recent legislation has changed the kiddie tax rules. In 2011

- everyone under age 18 is considered a "kiddie."
- the same is true for full-time students under age 24, if their earned income is less than half of their support. Here, *support* is the total spent on a student's behalf during the year.
- 18-year-olds are still considered kiddies even if they are not full-time students, as long as their earned income is less than half of their support.

In 2011, individuals subject to those rules owe no tax on unearned income up to $950. The next $950 of unearned income will be taxed at the child's rate, which will be no more than 10%. Over $1,900, all unearned income will be taxed at the parents' rate. The kiddie tax limits change periodically to keep up with inflation, so the $1,900 limit might move up to $2,000, $2,100, and so forth in the future.

Weighing the trade-offs

Even with the kiddie tax limits in place, some families might find tax benefits in income shifting.

Example 1: John and Karen Jackson hold $35,000 in a taxable bond fund yielding 5%. When their daughter Sarah is born, they transfer their shares in that fund to the newborn. If Sarah receives $1,750 (5% of $35,000) this year, she will owe no tax on the first $950 and

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Trusted Advice

Estate and Gift Tax

- The federal and estate gift tax exemptions are each set at $5 million for 2011 and 2012.
- This year, the federal gift tax exclusion is $13,000. Excess gifts have gift tax consequences.
- Suppose that Marge Jones, a widow, gives $300,000 to her daughter in 2011. The first $13,000 is covered by the annual exclusion.
- The remaining $287,000 reduces Marge's estate tax exemption.
- Assume that Marge dies in 2012 and has made no other gifts over the annual exclusion amount.
- In this scenario, Marge's estate would have an estate tax exemption of $4,713,000: $5,000,000 minus $287,000.

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$80 on the next $800, at a 10% rate. This can go on every year, permitting Sarah to build up an education fund at a very low tax rate.

Example 2: Brett and Caroline Morgan hold large amounts of stock in the company for which Caroline has worked for many years. This stock has appreciated sharply, so they would owe capital gains tax on a sale.

At the end of each year, Brett and Caroline transfer shares to their three young children, who can sell the shares and report the long-term capital gain. The Morgans monitor the transfer and sale of shares so that their children do not report gains over the kiddie tax limit each year. This strategy allows the Morgans to cash in appreciated stock while the family pays little or no capital gains tax.

Do these maneuvers make sense? Any tax savings can help families bear expenses such as the increasing costs of college.

There are drawbacks, however. Some asset transfers may have to be reported on a gift tax return. Holding assets in a student's name might reduce eligibility for need-based financial aid. Perhaps most important, assets transferred to a youngster eventually will be controlled by that youngster, who may spend the money on things other than higher education. Our office can help you quantify the tax savings available through income shifting so you can decide whether these tactics are worthwhile.

Income tax and estate planning with your parents

Although the kiddie tax limits the impact of shifting income to children, shifting income to retired parents who are in a low tax bracket may be much more effective. Moreover, such income shifts can be profitably paired with participation in a parent's estate

plan. The kiddie tax does not apply to retired parents. Your parents may have relatively low income and substantial tax deductions, perhaps from unreimbursed medical expenses. In such a situation, you may be able to take advantage of their low tax bracket.

Senior strategies

Some examples can illustrate income-shifting to low-bracket parents.

Example 1: Roger and Kate Donovan are in the top 35% federal income tax bracket. Kate's parents are in their late 70s and have taxable income (after all deductions) of around $40,000 a year. Kate's father has $200,000 in a traditional IRA, all in pretax money. Because Kate's parents live comfortably on their current income, her father has been taking only the required minimum distribution from his IRA.

In 2011, married couples who file joint tax returns can have up to $69,000 of taxable income and remain in the 15% federal income tax bracket. Therefore, Kate's father can convert an additional $29,000 of his traditional IRA to a Roth IRA in late 2011 and owe only 15% on the taxable income generated by the conversion. Kate's father executes this conversion and names Kate, his only child, as the Roth IRA beneficiary.

The Roth IRA conversion will add $4,350 to the federal income tax bill owed by Kate's parents. To ease that burden, Roger and Kate might increase the year-end holiday presents they give to her parents. In 2011, each individual generally can give up to $13,000 each, to any number of people, without incurring gift tax.

Pretax money in a traditional IRA eventually will be subject to income tax, paid either by the account owner or by the beneficiary after the owner's death. In this example, Kate might take some withdrawals, in a high tax bracket, after her father dies and she inherits his IRA.

By facilitating a Roth IRA conversion, this family is able to take money from the traditional IRA at a low 15% tax rate. Similar partial conversions can be executed each year until all the money has been moved from the traditional IRA to a Roth IRA at a low tax cost.

Roth IRA owners never have to take required distributions. Moreover, all distributions from a Roth IRA are tax free after five years and after age 59½. (The age requirement does not apply to Roth

IRA beneficiaries.) The five-year calculation begins at the start of the year, so a December 2011 Roth IRA conversion starts the five-year clock at January 1, 2011; after January 1, 2016, just over four years from now, all distributions from that Roth IRA will be tax free because Kate's father is older than 59½.

If Kate's father has a pressing need for money before the five-year mark, he can withdraw the converted amount without owing income tax because he will already have paid income tax on the Roth IRA conversion. Otherwise, the money can keep growing inside the Roth IRA until it passes to Kate, who can take tax-free withdrawals.

Give and get

Other families may benefit by transferring assets from middle-aged children to elderly parents, with the understanding that those assets eventually will pass back to the children.

Example 2: Brian and Jean Russell are in the top 35% federal income tax bracket. They have been helping to support Brian's widowed mother, who has scant income beyond Social Security checks. Instead of making periodic cash gifts to Brian's mother, Brian and Jean transfer $100,000 worth of dividend paying stock to her by year-end 2011 and another $100,000 in 2012. The Russells bought that stock many years ago for $50,000. In 2011, each individual has a $5 million gift tax exemption, so Brian and Jean can make this gift without paying gift tax. By spreading their gifts over two calendar years, the Russells get more use of the annual gift tax exclusion, set at $13,000 in 2011. (Gifts over $13,000 a year reduce the giver's estate tax exemption, now set at $5 million.)

Assume the transferred stock pays a 4% dividend. If so, Brian's mother will receive $8,000 per year in extra income: 4% of $200,000. Assuming the dividends are "qualified," which is the case for most investment income dividends, low-bracket taxpayers owe 0% tax. As long as Brian's mother keeps her taxable income at $34,500 or less this year, she will owe no tax on the dividends. Brian and Jean would have owed 15% tax on the dividends if they had kept the shares.

In this example, Brian's mother revises her will so that Brian will inherit the shares she now owns. Suppose Brian's mother dies when those shares are worth $215,000. If Brian's mother has lived for more than one year after the gift, Brian will have a $215,000 basis (cost for tax purposes) in the inherited shares. He can sell them for $215,000 and owe no tax. Therefore, no one will ever owe capital gains tax on the shares' appreciation from $50,000. However, if Brian's mother dies before a year has passed since the gift, he will not get a step up in basis. ■

Year-End Estate Tax Planning

As mentioned previously in this issue, decedents have a $5 million exemption from the federal estate tax for deaths in 2011 and 2012. Many states also impose tax on estates or estate beneficiaries. Depending on the state, people with a net worth of $1 million or more may leave their heirs with tax to pay. In addition, future legislation might reduce the federal estate tax exemption. As a result, you may want to take some actions by year-end 2011 that can reduce your heirs' exposure to future estate tax.

Embracing the exclusion

Do you have more wealth than the amount you're likely to need for yourself and perhaps for a surviving spouse? If that's the case, use your annual gift tax exclusion for 2011 before year end. Once the calendar flips to January, you can use your gift tax exclusion for 2012, but you can't go back and use any leftover exclusion from 2011.

In 2011, the exclusion amount is $13,000 per recipient, and no limit exists on the number of recipients for which you can use the exclusion. Thus, married couples effectively have annual exclusions up to $26,000 per recipient to an unlimited number of recipients this year.

Gifts in excess of $13,000 this year will be sheltered from gift tax by a $5 million lifetime gift tax exemption, per giver. Gifts in excess of the annual exclusion and the lifetime exemption are taxed at 35% in 2011 and 2012, the same rate that applies to estate assets over $5 million.

Great GRATs

Grantor retained annuity trusts (GRATs) may help reduce your taxable estate, if you anticipate having a large estate—and a potentially large estate tax obligation. If you act in 2011, you can take advantage of low interest rates, some relatively low asset values, and current tax law. The Obama administration has proposed tightening the rules on GRATs. Moreover, some Congressional leaders have expressed a desire to rein in the tax advantages of GRATs.

You can take advantage of the current GRAT rules by creating a GRAT before any legislation takes effect. With a GRAT, you create a trust (so you're the grantor) and contribute assets to it. You set the

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term of the trust and the annuity you'll retain; that's the payout you'll receive during the life of the GRAT. After the trust term, the assets will pass to the trust beneficiaries you've named, perhaps your children.

Example 1: Sheila Simmons transfers stock worth $500,000 to a GRAT. She sets a trust term of four years and agrees to receive an annuity of $135,000 a year from the trust. Suppose that the current IRS interest rate table sets the present value of receiving $540,000 over the next four years at $500,000. If so, Sheila has not made a gift and owes no gift tax. This transaction gives Sheila a return on her money of around 3% a year.

In this example, Sheila transfers stock that has lost value in recent years. She thinks the shares will appreciate by more than 3% a year over the next four years. If that happens, assets will be left in the trust when the GRAT terminates. Sheila's beneficiaries might receive shares worth $50,000, $100,000, or more when the trust terminates, free of any gift tax.

If you create a GRAT, you'll use the "Section 7520 interest rate" published monthly by the IRS, to put a value on the annuity you retain. The lower the interest rate, the greater the chance that the appreciation of the trust assets will result in a transfer of wealth to the trust beneficiaries with little or no gift tax.

Home runs

Qualified personal residence trusts (QPRTs) are similar to GRATs in some ways. You create a QPRT, transfer assets into it, set a trust term, and name trust beneficiaries who eventually will receive the assets from the trust. With a QPRT, however, the asset you transfer must be a house, and instead of receiving a flow of assets from the trust, as you do with a GRAT, you receive the right to use the house during the trust term. The house can be a principal residence or a vacation home.

The transfer of the house to the QPRT is treated, for gift tax purposes, as a gift of the remainder interest in the house that the trust beneficiaries will receive at the end of the trust term. The value of the remainder interest is the value of the house at the time of transfer less the value of the right to use the house during the trust term. The value of the right to use the home is determined according to the length of the trust, the grantor's life expectancy, and the Section 7520 interest rate as determined by the IRS for the month of the transfer.

At the end of the trust term, you are allowed to live in or use the house if you wish. However, you must pay a fair market rent to the new owners—the QPRT beneficiaries. Such payments will move even more assets to your loved ones, free of gift tax.

Example 2: Phil Matthews, age 50, transfers a $1 million vacation home to a QPRT, setting the trust term at 25 years. Using interest rates in effect at that time, the value of Phil's retained interest is about $700,000. Thus, Phil has made a gift of $300,000, which will be amply covered by his $5 million lifetime gift tax exemption.

Phil can continue to use the vacation home for the next 25 years. Assuming appreciation of less than 3% a year, the home will be worth around $2 million when the QPRT expires. At that point, the $2 million home will pass to the trust beneficiaries with no gift or estate tax due. QPRTs might make sense now that real estate values are depressed, if you assume the property will gain value in the future.

With a QPRT, you can enlarge the gift tax break by creating a trust with a long term. However, you must outlive the trust term to get the estate tax exemption. If you die during the QPRT term, the house will go back into your estate. Our office can illustrate how various QPRT terms will result in smaller or greater gift tax obligations. ■

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Citation and Resource Guide

A Year of Uncertainty?

- For a technical explanation of the law passed at the end of 2010, go to the website of the Joint Committee on Taxation at **www.jct.gov/publications.html?func=startdown&id=3716.**

Year-End Tax Planning for Investors

- The IRS explains the wash sale rules in Publication 550, Investment Income and Expenses, at **www.irs.gov/pub/irs-pdf/p550.pdf,** p. 58.

Year-End Family Tax Planning

- Go to **www.irs.gov/publications/p929/ar02.html#en_US_2010_publink1000203825,** "Tax for Certain Children Who Have Investment Income of More Than $1,900," for the IRS's explanation of the kiddie tax rules.
- The IRS answers frequently asked questions about the gift tax at **www.irs.gov/businesses/small/article/0,,id=108139,00.html.**

Year-End Estate Tax Planning

- An "Introduction to Estate and Gift Taxes" can be found at **www.irs.gov/pub/irs-pdf/p950.pdf.**

Did you know National Estate Planning Awareness Week is October 17-23, 2011? The AICPA PFP Division and the National Association of Estate Planners & Councils have teamed up once again to help increase awareness of the need for estate planning. Estate planning is one of the most overlooked areas of personal financial planning. Rep. Mike Thompson (D-CA) and 49 other members of the House of Representatives co-sponsored and helped pass H. Res. 1499 on September 27, 2008, creating a Congressional Proclamation for National Estate Planning Awareness Week in order to bring attention to the estimated 120,000,000 Americans who do not have up-to-date estate plans to protect themselves and their families in the event of sickness, accidents, or untimely death. This costs the affluent and middle classes wasted dollars and hours of emotional hardship each year that can be minimized with proper advanced planning and action. Stay tuned to aicpa.org and AICPA News Updates with more information on how to get involved in helping your community to understand the importance of estate planning.

Practice Development Tip

States May Have Steep Estate Taxes

National Estate Planning Awareness Week is an excellent time to suggest financial and estate planning meetings to clients. Your clients may be aware that the federal estate tax exemption is now $5 million per decedent. Those clients who have less than $5 million of assets ($10 million for married couples) might believe that they need not worry about estate tax. To the contrary, if your clients include residents of states with their own estate tax, meetings may be an excellent opportunity to remind clients that estate tax planning is still necessary. Such a reminder, and the advice you provide, can save these clients substantial amounts of money.

Suppose, for example, that your client list includes Jack and Beth Wilson, who live in New York and have a combined $4 million net worth. The Wilsons are retired and anticipate no further asset accumulation, so they are not concerned about estate tax. You might inform such a couple that, yes, they probably won't owe federal estate tax, at least under current law. However, with New York's $1 million state estate tax exemption, the Wilsons are now $3 million over the threshold. The state estate tax bill could be hundreds of thousands of dollars. Once you have their attention in this manner, you could enter into discussions about tax planning. Should the first spouse to die leave $1 million to their children? To a trust? Such tactics would eliminate state as well as federal estate tax at the first death but could leave the survivor with a $3 million estate, $2

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million over New York's limit. Should more or less be left to the children or to a trust at the first death? Should these clients give away some assets now, to reduce state estate tax when they die?

Many clients live in states with relatively low estate tax exemptions. By going over the numbers with them, you can demonstrate your expertise in this area and prove your ability to trim the tax on assets passing to younger generations.

Practice Development and Management Resources

from the AICPA

For more information or to order, log on to *www.cpa2biz.com* or call 888.777.7077.

Advanced Estate Planning: Practical Strategies for Your Clients

This CPE self study course is designed to help you

- Comprehend various types of trusts and life insurance that may be used in an effective estate plan
- Utilize credits and deductions available to reduce estate and gift taxes
- Minimize estate and gift transfer taxes by advising your clients on planning techniques and opportunities

[CPE Course no. 736982—AICPA Member $159.00, Nonmember $198.75]

Estate Planning After the Tax Relief and Job Creation Act of 2010: Tools, Tips, and Tactics

Make sure you and your clients understand why everyone still needs to plan for their estate—not just the ultra-wealthy. This CD provides a detailed analysis of the law—and a wealth of practical information and tools that you can immediately put to use to help your clients. Covers

- Changes that should be made to most wills and powers of attorney
- How the new estate, gift, and GST exemptions of $5 million will affect existing and future estate planning
- Why these rules are a unique planning opportunity

[CD-ROM no. 091056HS—AICPA Member $45.00, Nonmember $56.25]

The Adviser's Guide to S Corporations: Tax Compliance and Planning Strategies

Here are the strategies to help you minimize your small business clients' tax bills using the latest S Corp tax rules. This guide employs dozens of examples and practice tips to illustrate complex S Corp rules and concepts, including S Corp elections, revocations, and terminations.

[Text no. 091095—AICPA Member $75.00, Nonmember $98.75]

Managing Your Tax Season

Bestseller reveals how to make every tax season better than the last. Tips and techniques include how to use pre-year-end planning to develop tax and financial planning opportunities, sample checklists and letters, and much more.

[Text no. 090560—AICPA Member $75.00, Nonmember $93.75]

Management of an Accounting Practice Handbook

Created by top CPA practitioners and recently updated, the MAP Handbook provides a vast collection of practice management guidance and tools. In three well-organized loose-leaf binders, you get quick access to answer questions on a wide variety of topics, such as employee compensation and benefits, staffing, disaster recovery, firm organization, and streamlining your practice with technology.

[Text no. 090407—AICPA Member $138.00, Nonmember $172.50. Also available online so you can download the forms, checklists ad letters you need: no. MAPXX12—AICPA Member $150.00, Nonmember $250.00]

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