



2010-2011 TAX PLANNING GUIDE

Year-round strategies to make the tax laws work for you



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In uncertain times, proactive tax planning can help you preserve your financial well-being

Ongoing changes in tax laws, an unpredictable economy and uncertainty about the future have made minimizing taxes more difficult than ever. Although the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, signed into law Dec. 17, has provided some relief, it's temporary. The act extends lower income, capital gains and estate tax rates only through 2012, and many other breaks only through 2011.

In this environment, you may need to create plans for multiple scenarios and be ready to move quickly as developments unfold. To this end, we are pleased to offer this overview of various tax-saving strategies you might employ. Of course, there are many others we don't have room to cover here. So please check with your tax advisor to see which are best for you.

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Consider applicable rates and limits to better time income and expenses

With the passage of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, the top regular income tax rate on ordinary income (salary, business income, interest and more) remains at 35% through 2012. The top AMT rate is only 28%, but it typically applies to a higher taxable income base. So it can result in unwelcome tax surprises if you plan only for regular income taxes. Also, income-based phaseouts and other limits can increase your marginal rate for regular-tax or AMT purposes.

That's why it's important to review your income, expenses and potential tax liability throughout the year, keeping in mind the many rates and limits that can affect income tax liability. Only then can you time income and expenses to your advantage.

AMT triggers

Before you take action to time income or expenses, determine whether you're already likely to be subject to the AMT — or whether the actions you're considering might trigger it. Many deductions used to calculate regular tax aren't allowed under the AMT and thus can trigger AMT liability. Some income items also might trigger or increase AMT liability. Common triggers include:

- ◆ Miscellaneous itemized deductions subject to the 2% of AGI floor, including investment advisory fees and employee business expenses,
- ◆ Long-term capital gains and dividend income, even though they're taxed at 15% for both regular tax and AMT purposes,
- ◆ Accelerated depreciation adjustments and related gain or loss differences when assets are sold, and
- ◆ Tax-exempt interest on certain private-activity municipal bonds. (For an exception, see the AMT alert on page 11.)
- ◆ State and local income tax deductions, especially if you live in a high-income-tax state,
- ◆ Real estate and personal property tax deductions,
- ◆ Interest on a home equity loan or line of credit not used to buy, build or improve your principal residence,

Finally, in certain situations incentive stock option (ISO) exercises can trigger significant AMT liability. (See "Incentive stock options" on page 6.)

Avoiding or reducing AMT

With proper planning, you may be able to avoid the AMT, or at least reduce its impact — and perhaps take advantage of its lower maximum rate. The first step is to work with your tax advisor to determine whether:

You could be subject to the AMT this year.

Consider accelerating income and short-term capital gain into the current year, which may allow you to benefit from the lower maximum AMT rate. Also consider deferring expenses you *can't* deduct for AMT purposes until next year — you may be able to preserve those deductions.

Additionally, if you defer expenses you *can* deduct for AMT purposes to next year, the deductions may become more valuable

What's new!

AMT relief extended through 2011

Who's affected: Many middle- and high-income taxpayers.

Key changes: Unlike the regular tax system, the AMT system isn't regularly adjusted for inflation. Instead, Congress must legislate any adjustments. Typically, it has done so in the form of a "patch" — an increase in the AMT exemption. Congress finally passed a patch for 2010 in December. (See Chart 6 on page 24.) Fortunately, the provision also included a patch for 2011. Without these patches, many more taxpayers would have faced the AMT for 2010 and 2011.

Planning tips: Planning for the AMT will continue to be a challenge until Congress passes longer-term relief. Talk to your tax advisor to determine the best strategy for your situation.

because of the higher maximum regular tax rate. Finally, carefully consider the tax consequences of exercising ISOs.

You could be subject to the AMT next year. Consider taking the opposite approach. For instance, defer income to next year, because you'll likely pay a relatively lower AMT rate. And prepay expenses that will be deductible this year but that won't help you next year because they're not deductible for AMT purposes. Also, before year end consider selling any private activity municipal bonds whose interest could be subject to the AMT.

The AMT credit

If you pay AMT in one year on deferral items, such as depreciation adjustments, passive activity adjustments or the tax preference on ISO exercises, you may be entitled to a credit in a subsequent year.

In effect, this takes into account timing differences that reverse in later years. But the credit might provide only partial relief or take years before it can be fully used. Fortunately, the credit's relatively new refundable feature can reduce the time it takes to recoup AMT paid.

What's new!

Itemized deduction and personal exemption AGI limits temporarily lifted

Who's affected: Many higher-income taxpayers.

Key changes: Under the Economic Growth and Tax Relief Reconciliation Act of 2001, the otherwise applicable AGI limits on itemized deductions and personal exemptions were eliminated for 2010. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 extended this elimination through 2012.

Planning tips: If you're normally subject to the itemized deduction limit, accelerating deductible expenses into the current year may be a smart move — as long as it won't trigger the AMT.

If you're normally subject to the personal exemption limit and in recent years have forgone the partial exemption available to you so that one or more of your children could take advantage of an education-related tax credit (see page 19), revisit this strategy to see if it will still provide the most tax savings overall for your family.

Timing income and expenses

Smart timing of income and expenses can reduce your tax liability, and poor timing can unnecessarily increase it.

If you don't expect to be subject to the AMT this year or next, consider deferring income to next year and accelerating deductible expenses into the current year. This will defer tax, which is usually beneficial. But if you expect to be in a higher tax bracket next year, the opposite approach may be beneficial.

Whatever the reason you'd like to time income and expenses, here are some income items whose timing you may be able to control:

- ♦ Bonuses,
- ♦ Consulting or other self-employment income,

- ♦ U.S. Treasury bill income,
- ♦ Real estate or other nonpublicly traded property sales, and
- ♦ Retirement plan distributions, if not required.

And here are some potentially controllable expenses:

- ♦ State and local income taxes,
- ♦ Real estate taxes,
- ♦ Mortgage interest,
- ♦ Margin interest, and
- ♦ Charitable contributions.

Warning: Prepaid expenses can be deducted only in the year to which they apply. For example, if you prepaid (by Dec. 31, 2010) real estate taxes that relate to the year 2010 but that are due in 2011, you can deduct the payment on your 2010 return. But if you prepaid in 2010 real estate taxes that relate to the year 2011, you can't deduct the payment on your 2010 return.

Bunching deductions

Expenses that may qualify as miscellaneous itemized deductions are deductible for regular tax purposes only to the extent they exceed, in aggregate, 2% of your AGI. Bunching these expenses into a single year may allow you to exceed this floor.



What's new!

Save on payroll tax in 2011

Who's affected: Employees and the self-employed.

Key changes: For 2011 only, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 reduces the employee portion of the Social Security tax on earned income from 6.2% to 4.2%. The self-employed pay both the employee and employer portions of Social Security tax, and the Tax Relief act also reduces their rate by two percentage points for 2011, from 12.4% to 10.4%. (This doesn't reduce a self-employed individual's deduction for the employer's share of these taxes, however.)

Planning tips: The maximum taxable wage base for Social Security taxes for 2011 is \$106,800 (the same as for 2010). So the maximum tax savings from this break is \$2,136. Unlike last year's Making Work Pay credit (which the payroll tax break essentially replaces), no other income-based limit applies. So even high-income taxpayers can enjoy the maximum benefit.

As the year progresses, record your potential deductions to date. If they're close to or already exceed the 2% floor — and you don't expect to be subject to the AMT this year — pay accrued expenses and incur and pay additional expenses by Dec. 31, such as:

- ◆ Deductible investment expenses, including advisory fees, custodial fees and publications,
- ◆ Professional fees, such as tax planning and preparation, accounting, and certain legal fees, and
- ◆ Unreimbursed employee business expenses, including travel, meals, entertainment and vehicle costs.

Similarly, medical expenses are generally deductible only to the extent that they exceed 7.5% of your AGI and aren't reimbursable by insurance or paid through a pretax Health Savings Account (HSA) or Flexible Spending Account (FSA). So consider bunching nonurgent medical procedures and other controllable expenses into one year. (See Case Study 1 on page 5.) If one spouse has high medical expenses and a relatively lower AGI, filing separately may allow that spouse to exceed the AGI floor and deduct some medical expenses that wouldn't be deductible if the couple filed jointly.

AMT ALERT! For AMT purposes, only medical expenses exceeding 10% of your AGI are deductible. Also, because the AMT exemption for separate returns is considerably lower than the exemption for joint returns, filing separately to exceed the 7.5% floor for regular tax purposes could trigger the AMT.

Sales tax

The break allowing you to take an itemized deduction for state and local sales taxes in lieu of state and local income taxes has been extended through 2011. It can be valuable to those residing in states with no or low income tax rates or who purchase major items, such as a car or boat.



Employment tax

In addition to income tax, you must pay Social Security and Medicare taxes on earned income, such as salary and bonuses. For 2010, the amount of income subject to the 12.4% Social Security tax (the 12.4% is split equally between employee and employer) is limited to \$106,800, but all earned income is subject to the 2.9% Medicare tax.

If you're self-employed, your employment tax liability doubles, because you also must pay the employer portion of these taxes. As a result, self-employment income can be taxed at an effective federal rate as high as 48% compared to about 43% for income from wages. Why isn't the difference greater? Because you receive a deduction for 50% of the self-employment tax you pay.

Some payroll tax relief is available for 2011, however. (See "What's new!" at left.)

There are special considerations if you're a business owner who also works in the business, depending on its structure:

Partnerships and limited liability companies. Generally, all trade or business income that flows through to you for income tax purposes is subject to self-employment tax — even if the income isn't actually distributed to you.

S corporations. Only income you receive as salary is subject to employment tax. So to reduce your employment tax, you may want to keep your salary relatively low and increase your distributions of company income (which generally isn't taxed at the corporate level).

But to avoid potential back taxes and penalties, you must take a "reasonable" salary. What's considered "reasonable" is determined by the specific facts and circumstances, but it's generally what the company would pay an outsider to perform the same services.

C corporations. Only income you receive as salary is subject to employment tax. You may prefer to take more income as salary (which is deductible at the corporate level) because the overall tax paid by both the corporation and you may be less.

Warning: The IRS is cracking down on misclassification of corporate payments to shareholder-employees, and Congress also has been looking at this issue, so tread carefully.

Estimated payments and withholding

You can be subject to penalties if you don't pay enough tax during the year through estimated tax payments or withholding. To avoid such penalties, make sure your estimated payments or withholding equals at least 90% of your tax liability for this year or 110% of your tax last year (100% if your AGI last year was \$150,000 or less or, if married filing separately, \$75,000 or less).

Here are some more strategies that can help you avoid underpayment penalties:

Use the annualized income installment method. This method often benefits taxpayers who have large variability in income by month due to bonuses, investment gains and losses, or seasonal income, if it's skewed toward the end of the year. Annualizing computes the tax due based on income, gains, losses and deductions through each estimated tax period.

Estimate your tax liability and increase withholding. If you determine you've underpaid, consider having the tax shortfall withheld from your salary or year end bonus by Dec. 31. Because withholding is considered to have been paid ratably throughout the year, this is often a better strategy than making up the difference with an increased quarterly tax payment, which may still leave you exposed to penalties for earlier quarters. ♦

Case Study 1

Bunching deductions can save tax when income is low, medical expenses are high

2010 was a tough year for Mark and Joan. The married couple's business was struggling, so they projected their income would be lower than usual. And Joan suffered a skiing injury in January that caused their medical expenses to be much higher than normal.

Despite the fact that their health policy coverage was somewhat limited and they didn't have dental or vision insurance, the couple normally didn't have sufficient medical expenses to exceed the 7.5% of AGI floor. But as year end approached, it seemed like they'd exceed it in 2010 (and wouldn't be subject to the AMT and its 10% floor).

Fortunately, by October the couple felt their prospects were looking much brighter for 2011: The couple's business was starting to show signs of a turnaround, Joan's injury was healing well and the biggest medical expense they anticipated for 2011 was elective surgery Mark's doctor had recommended that would be mostly covered by insurance. The downside of this potential prosperity was that there was a good chance they wouldn't exceed the medical expense deduction AGI floor in 2011.

So, Mark and Joan decided to accelerate what medical expenses they could into 2010 to take advantage of the deduction:

Mark scheduled his surgery for late 2010 instead of early 2011.	\$5,000
Mark and Joan underwent eye exams and got new glasses and contact lenses in 2010, which they otherwise would have done in 2011.	1,000
They moved their normal January dentist appointments to December. Mark also had some follow-up dental work done.	2,000
<hr/>	
Total additional deduction	\$8,000
Federal tax rate	33%
Tax savings	\$2,640



Careful planning critical for stock options, restricted stock and NQDC

Many executives are compensated by more than just salary and bonuses: They also receive stock options, restricted stock or nonqualified deferred compensation (NQDC). Careful planning for these more complex forms of compensation is critical to avoid unnecessary tax liability.

Incentive stock options

Incentive stock options (ISOs) receive tax-favored treatment but must comply with many rules. ISOs allow you to buy company stock in the future (but before a set expiration date) at a fixed price equal to or greater than the stock's fair market value at the date of the grant.

Therefore, the ISOs don't provide a benefit until the stock appreciates in value. If it does, you can buy shares at a price below what they're then trading for, as long as you've satisfied the applicable ISO holding periods. Here are the key tax consequences:

- ♦ You owe no tax when the ISOs are granted.
- ♦ You owe no *regular* income tax when you exercise the ISOs.
- ♦ If you sell the stock *after* holding the shares at least one year from the date of exercise and two years from the date the ISOs were granted, you pay tax on the sale at your long-term capital gains rate.
- ♦ If you sell the stock *before* long-term capital gains treatment applies, a "disqualifying disposition" occurs and any gain is taxed as compensation at ordinary-income rates.

AMT ALERT! *In the year of exercise, a tax "preference" item is created on the difference between the stock's fair market value and the exercise price (the "bargain element") that can trigger the AMT.*

If you've received ISOs, plan carefully when to exercise them and whether to immediately sell shares received from an exercise or to hold them. Waiting until just before the expiration date to exercise ISOs (when the stock value may be the highest, assuming the stock is appreciating) and holding on to the stock long enough to garner long-term capital gains treatment often is beneficial. But there's also market risk to consider.

In several situations, acting earlier can be advantageous:

- ♦ Exercise early to start your holding period so you can sell and receive long-term capital gains treatment sooner.
- ♦ Exercise when the bargain element is small or when the market price is close to bottoming out to reduce or eliminate AMT liability.
- ♦ Exercise annually so you can buy only the number of shares that will achieve a breakeven point between the AMT

and regular tax and thereby incur no additional tax.

- ♦ Sell early in a disqualifying disposition and pay the higher ordinary-income rate to avoid the AMT on potentially disappearing appreciation.

On the negative side, exercising early accelerates the need for funds to buy the stock, exposes you to a loss if the shares' value drops below your exercise cost, and may create a tax cost if the preference item from the exercise generates an AMT liability. With the help of your tax advisor, evaluate the risks and crunch the numbers using various assumptions to determine the best strategy for your situation.

Nonqualified stock options

The tax treatment of nonqualified stock options (NQSOs) is different from that of ISOs: NQSOs create compensation income (taxed at ordinary-income rates) on the bargain element when exercised (regardless of whether the stock is held or sold immediately), but they don't create an AMT preference item.

You may need to make estimated tax payments or increase withholding to fully cover the tax on the exercise. Also consider state tax estimated payments.

Restricted stock

Restricted stock is stock that's granted subject to a substantial risk of forfeiture. Income recognition is normally deferred until the stock is no longer subject to that

risk or you sell it. You then pay taxes based on the stock's fair market value when the restriction lapses and at your ordinary-income rate.

But, under IRC Section 83(b), you can elect to instead recognize ordinary income when you receive the stock. This election, which you must make within 30 days after receiving the stock, can be beneficial if the income at the grant date is negligible or the stock is likely to appreciate significantly before income would otherwise be recognized. Why? Because the election allows you to convert future appreciation from ordinary income to long-term capital gains income and defer it until the stock is sold. (See Case Study 2 at right.)

There are some disadvantages of a Sec. 83(b) election: First, you must prepay tax in the current year. But if a company is in the earlier stages of development, this may be a small liability. Second, any taxes you pay because of the election can't be refunded if you eventually forfeit the stock or its value decreases. But you'll have a capital loss when you sell or forfeit the stock.

Work with your tax advisor to map out whether the Sec. 83(b) election is appropriate for you in each particular situation.

NQDC plans

NQDC plans pay executives in the future for services to be currently performed. They differ from qualified plans, such as 401(k)s (see page 20), in several ways. For example, NQDC plans can favor highly compensated employees, and any NQDC plan funding isn't protected from your employer's creditors.

One important NQDC tax issue is that employment taxes (see page 4) are generally due once services have been performed and there's no longer a substantial risk of forfeiture — even

Case Study 2

How the Sec. 83(b) election can save taxes on restricted stock

If you receive restricted stock, making an IRC Section 83(b) election can potentially save you significant taxes — if the stock's value is negligible or has great appreciation potential. Let's look at an example: Alex and Blake are executives at the same company, and in the same year each receives 50,000 shares of restricted stock with a fair market value of \$1 per share. Alex doesn't make a Sec. 83(b) election, but Blake does.

In an initial public offering (IPO) a year later, the stock is offered at \$5 per share. More than a year after the IPO, the market price reaches \$10 per share and Alex and Blake both sell all their shares. By making the Sec. 83(b) election, Blake has saved \$40,000 in federal income taxes!



	Alex (doesn't make the election)	Blake (does make the election)
Year the restricted stock is awarded	Recognizes no income related to the stock.	Recognizes \$50,000 (50,000 shares at \$1 per share) of compensation income, for a federal income tax bill of \$17,500.
Year of the IPO (which lifts the substantial risk of forfeiture)	Recognizes compensation income of \$250,000 (50,000 shares at the IPO price of \$5 per share), for a federal income tax bill of \$87,500.	Recognizes no income related to the stock.
Year of the stock sale	Recognizes a long-term capital gain of \$250,000 (50,000 shares at \$10 per share less basis of \$5 per share), for a federal income tax bill of \$37,500.	Recognizes a long-term capital gain of \$450,000 (50,000 shares at \$10 per share less basis of \$1 per share), for a federal income tax bill of \$67,500.
Total federal income tax paid	\$125,000	\$85,000

Note: The figures presume a 35% marginal income tax rate and a 15% long-term capital gains tax rate apply.

though compensation may not actually be paid or recognized for income tax purposes until *much* later. So your employer may withhold your portion of the payroll taxes from your salary or ask you to write a check for the liability. Or it may pay your portion, in which case you'll have additional taxable income.

Keep in mind that the rules for NQDC plans have been tightened and clarified. The penalties for noncompliance can be severe: You could be taxed on plan benefits at the time of vesting, and a 20% penalty and potential interest charges also could apply. So check with your employer to make sure it's addressing any compliance issues. ♦



Tax planning for investments can get complicated

Tax treatment of investments can vary dramatically based on several factors — including type of investment, type of income it produces, how long it's been held, whether any special limitations or breaks apply and potentially changing tax rates and rules. Consequently, planning for investments is always complicated. So before you make any investment decisions, consider the potential tax consequences under multiple scenarios.

Capital gains tax and timing

While time, not timing, is generally the key to long-term investment success, timing can have a dramatic impact on the tax consequences of investment activities. The 15% long-term capital gains rate is 20 percentage points lower than the highest ordinary-income rate of 35%. It generally applies to investments held for more than 12 months. (Higher long-term gains rates apply to certain types of assets — see Chart 1 on page 11.)

Holding on to an investment until you've owned it more than a year may help substantially cut tax on any gain. Fortunately, you now can take advantage of the 15% rate through 2012. (See "What's new!" below.)

To determine capital gains tax liability, realized capital gains are netted against realized capital losses. First, short-term gains are netted with short-term losses and long-term gains with long-term losses. Then if, for example, you have a

net short-term gain but a net long-term loss, you can use the long-term loss to offset the short-term gain. This can save more taxes because you're reducing or eliminating gain that would have been taxed at your higher ordinary-income rate.

AMT ALERT! Substantial net long-term capital gains can trigger the AMT.

Remember that appreciating investments that don't generate current income aren't taxed until sold, deferring tax and perhaps allowing you to time the sale to your tax advantage — such as in a year when you have capital losses to absorb the capital gain.

If you've cashed in some big gains during the year and want to reduce your tax liability, before year end look for unrealized losses in your portfolio and sell them to offset your gains.

The 0% rate

The long-term capital gains rate is 0% for gain that would be taxed at 10% or 15% based on the taxpayer's ordinary-income rate. If you have adult children in one of these tax brackets, consider transferring appreciated or dividend-producing assets to them so they can enjoy the 0% rate, which also applies to qualified dividends. The 0% rate also has been extended through 2012. (See "What's new!" at left.)

Warning: If the child is under age 24, first make sure he or she won't be subject to the kiddie tax. (See "The 'kiddie tax'" on page 18.) Also, consider any gift tax consequences. (See page 23.)

What's new!

Low capital gains and qualified-dividend rates temporarily extended

Who's affected: Investors holding appreciated or dividend-producing assets.

Key changes: The 15% long-term capital gains rate had been scheduled to return to 20% in 2011. Fortunately, under the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Congress extended the 15% rate through 2012. The 15% rate also has applied to qualified dividends, and these dividends had been scheduled to return to being taxed at your marginal ordinary-income rate in 2011. But the Tax Relief act also extended the 15% qualified dividend rate through 2012.

Planning tips: For the time being, taxes on your investments may be less of a concern. But in your investment planning, you'll want to keep in mind that the extension of the lower rates is for only two years. There may be actions you'll want to take to lock in lower rates while they're still available.



Loss carryovers

If net losses exceed net gains, you can deduct only \$3,000 (\$1,500 for married taxpayers filing separately) of the net losses per year against ordinary income. You can carry forward excess losses indefinitely.

By determining whether, year to date, you have excess losses, you can time sales of other investments before year end to achieve your tax planning goals. For example, loss carryovers can be a powerful tax-saving tool in future years if you have a large investment portfolio, real estate holdings or a closely held business that might generate substantial future capital gains.

If, on the other hand, it looks like it could take a long time to fully absorb a large loss carryover, you might want to realize gains before year end to absorb excess losses — as long as this will also help you accomplish your investment goals. Remember that capital gains distributions from mutual funds can also absorb capital losses.

If you don't have enough gains to absorb more losses and you want to minimize loss carryovers, from a tax perspective it might not make sense to sell any more

investments at a loss. Plus, if you hold on to an investment, it may recover its lost value.

But if you're ready to divest yourself of a poorly performing stock because you think it will continue to lose value — or because your investment objective or risk tolerance has changed — don't hesitate solely for tax reasons. The *nontax* reasons for the sale may outweigh the possible downside of it taking many years to absorb the loss. And tax considerations shouldn't be the primary driver of investment decisions.

The wash sale rule

If you're trying to achieve a tax loss with minimal change in your portfolio's asset allocation, keep in mind the wash sale rule. It prevents you from taking a loss on a security if you buy a substantially identical security (or option to buy such a security) within 30 days before or after you sell the security that created the loss. You can recognize the loss only when you sell the replacement security.

Fortunately, there are ways to avoid the wash sale rule. For example, you may immediately buy securities of a different company in the same industry or shares in a mutual fund that holds securities much

like the ones you sold. Or, you can wait 31 days to repurchase the same security. Alternatively, you can double your purchase and then wait 31 days to sell the original portion.

You also can do a bond swap, where you sell a bond, take a loss and then immediately buy another bond of similar quality and duration from a different issuer. Generally, the wash sale rule doesn't apply because the bonds aren't considered substantially identical.

Paying attention to details

If you don't pay attention to the details, the tax consequences of a sale may be different from what you expect. For example, the trade date, not the settlement date, of publicly traded securities determines the year in which you recognize the gain or loss.

And if you want to sell high-tax-basis shares to reduce gain or increase a loss and offset other gains, but you bought the same security at different times and prices, be sure to specifically identify which block of shares is being sold.

Mutual funds

Investing in mutual funds is an easy way to diversify your portfolio. But beware of the tax pitfalls. First, mutual funds with high turnover rates can create income taxed at ordinary-income rates. Choosing funds that provide primarily long-term gains can save you more tax dollars because of the lower long-term rates.

Second, earnings on mutual funds are typically reinvested, and unless you (or your investment advisor) keep track of these additions to your basis, you may report more gain than required when you sell the fund.

Third, buying equity mutual fund shares later in the year can be costly tax-wise. Such funds often declare a large capital

gains distribution at year end. If you own the shares on the distribution's record date, you'll be taxed on the full distribution amount even if it includes significant gains realized by the fund *before* you owned the shares. And you'll pay tax on those gains in the current year — even if you reinvest the distribution. (See Case Study 3 below.)

Small business stock

By purchasing stock in certain small businesses, you can diversify your portfolio. You also may enjoy preferential tax treatment:

Conversion of capital loss to ordinary loss. If you sell qualifying Section 1244 small business stock at a loss, you can treat up to \$50,000 (\$100,000, if married filing jointly) as an ordinary, rather than a capital, loss — regardless of your holding period. This means you can use it to offset ordinary income, reducing your tax by as much as 35% on this portion of the loss. Sec. 1244 applies only if total capital invested isn't more than \$1 million.

Tax-free gain rollovers. If within 60 days of selling qualified small business (QSB) stock you buy other QSB stock with the proceeds, you can defer the tax on your gain until you dispose of the new stock. The rolled-over gain reduces your basis in the new stock. For determining long-term

capital gains treatment, the new stock's holding period includes the holding period of the stock you sold. To be a QSB, a business must be engaged in an active trade or business and must not have assets that exceed \$50 million.

Exclusion of gain. Generally, taxpayers selling QSB stock are allowed to exclude up to 50% of their gain if they've held the stock for at least five years. But the exclusion is 100% if the stock is acquired after Sept. 27, 2010, and before Jan. 1, 2012, and it's 75% if the stock was acquired after Feb. 17, 2009, and before Sept. 28, 2010.

The taxable portion of any QSB gain will be subject to the lesser of your ordinary-income rate or 28%, rather than the normal long-term gains rate. (See Chart 1 on page 11.) Thus, if the 28% rate and the 75% exclusion apply, the effective rate on the QSB gain will be 7% (28% x 25%).

Keep in mind that all three of these tax benefits are subject to specific requirements and limits. Consult your tax or financial advisor to be sure an investment in small business stock is right for you.

Passive losses

If you've invested in a trade or business in which you don't materially participate,

remember that passive activity losses generally are deductible only against income from other passive activities. You can carry forward disallowed losses to the following year, subject to the same limits.

To avoid passive activity treatment, typically you must participate in a trade or business more than 500 hours during the year or demonstrate that your involvement constitutes substantially all of the participation in the activity. (Special rules apply to real estate; see "Real estate activity losses" on page 12.) If you don't pass this test, consider:

Increasing your involvement. If you can exceed 500 hours, the activity no longer will be subject to passive loss limits. If the business is structured as a limited liability company (LLC), expected changes in IRS regulations may reduce the number of hours you must be involved. Check with your tax advisor for the latest information.

Disposing of the activity. You're then allowed to deduct all the losses — including any loss on disposition (subject to basis and capital loss limitations). But the rules are complex, so consult your tax advisor.

Looking at other activities. Limit your participation in another activity that's generating income to less than 500 hours or invest in another income-producing trade or business that will be passive to you. Under both strategies, you'll then have passive income that can absorb your passive losses.

Income investments

While qualified dividends generally are taxed at the reduced rate of 15%, interest income is taxed at ordinary-income rates up to a maximum of 35%. So, dividend-paying stocks may be more attractive tax-wise than other income investments, such as CDs and bonds. And you now have

Case Study 3

Mutual fund distributions can cost you taxes

When capital gains distributions from a mutual fund are reinvested in the fund, the distribution itself doesn't change your value in the fund. It simply increases the number of shares you own, yet now at a lower per-share value. Unfortunately, the distribution can cost you taxes.

For example, let's say you purchased 2,000 shares of an equity mutual fund on Dec. 1, 2010, at \$100 per share, for a total investment of \$200,000. The next week, the fund made a capital gains distribution of \$15 per share. You'd end up with capital gains income of \$30,000, reportable on your 2010 return. It doesn't matter whether the actual value of the shares had increased or even decreased since you purchased them.

through 2012 to take advantage of the 15% rate. (See “What’s new!” on page 8.)

But there are exceptions.

Some dividends are subject to ordinary-income rates. These may include certain dividends from:

- ♦ Real estate investment trusts (REITs),
- ♦ Regulated investment companies (RICs),
- ♦ Money market mutual funds, and
- ♦ Certain foreign investments.

The tax treatment of bond income varies. For example:





- ♦ Interest on U.S. government bonds is taxable on federal returns but generally exempt on state and local returns.
- ♦ Interest on state and local government bonds is excludible on federal returns. If the bonds were issued in your home state, interest also may be excludible on your state return.
- ♦ Corporate bond interest is fully taxable for federal and state purposes.
- ♦ Bonds (except U.S. savings bonds) with original issue discount (OID) build up “interest” as they rise toward maturity. You’re generally considered to earn a portion of that interest annually — even though the bonds don’t pay this interest annually — and you must pay tax on it.

Keep in mind that, although state and municipal bonds usually pay a lower interest rate, their rate of return may be higher than the after-tax rate of return for a taxable investment, depending on your tax rate.

AMT ALERT! Tax-exempt interest from private activity municipal bonds can trigger AMT liability. However, any income from tax-exempt bonds issued in 2009 and 2010, along with 2009 and 2010 re-fundings of bonds issued after Dec. 31, 2003, and before Jan. 1, 2009, is excluded from the AMT.

Chart 1

What’s the maximum capital gains tax rate?

	2010–2012	2013 ¹
Maximum tax rate for assets held		
12 months or less (<i>short term</i>)	35%	39.6%
More than 12 months (<i>long term</i>)	15%	20%
Some key exceptions		
 Long-term gain on collectibles, such as artwork and antiques	28%	28%
 Long-term gain attributable to certain recapture of prior depreciation on real property	25%	25%
 Gain on qualified small business stock held more than 5 years	14% ²	14% ²
 Long-term gain that would be taxed at 15% or less based on the taxpayer’s ordinary-income rate	0%	10%

Source: U.S. Internal Revenue Code

¹ If Congress doesn’t take action.
² Effective rate based on 50% exclusion rules.

Investment interest expense

Investment interest — interest on debt used to buy assets held for investment, such as margin debt used to buy securities — is deductible. But special rules apply.

Your investment interest deduction is limited to your net investment income, which generally includes taxable interest, nonqualified dividends and net short-term capital gains (but not long-term capital gains), reduced by other investment expenses. Any disallowed interest is carried forward, and you can deduct it in a later year if you have excess net investment income.

You may elect to treat net long-term capital gains or qualified dividends as

investment income in order to deduct more of your investment interest. But if you do, that portion of the long-term capital gain or dividend is taxed at ordinary-income rates.

Payments a short seller makes to the stock lender in lieu of dividends may be deductible as an investment interest expense. But interest on debt used to buy securities that pay tax-exempt income, such as municipal bonds, isn’t deductible.

Also keep in mind that passive interest expense — interest on debt incurred to fund passive activity expenditures — becomes part of your overall passive activity income or loss, subject to limitations. ♦



Property ownership still offers many benefits — including tax savings

Although the real estate market is a lot less rosy than it was a few years ago, real estate can still be a valuable investment — whether it's your home or vacation home or a rental or investment property. Property ownership also can offer significant tax savings, as long as you take advantage of all the breaks available to you. But watch out for the limitations as well.

Home-related tax breaks

Whether you own one home or several, it's important to maximize available credits and deductions:

Homebuyers credit. If you purchased a home before May 1, 2010 (Oct. 1 if a binding contract was in place before May 1), you may be eligible for a credit of up to \$8,000 as a "first-time" homebuyer or \$6,500 as a "long-time" homeowner. But income-based phaseouts apply. Check with your tax advisor to see if you're eligible.

Property tax deduction. If you're looking to accelerate or defer deductions, property tax is one expense you may be able to time. (See "Timing income and expenses" on page 3.)

AMT ALERT! *Property tax isn't deductible for AMT purposes. If you're subject to the AMT this year, a prepayment will be for naught because you'll lose the deduction.*

Mortgage interest deduction. You generally can deduct interest on up to a combined total of \$1 million of mortgage debt incurred to purchase, build or improve your principal residence and a second residence. Points

paid related to your *principal* residence also may be deductible.

Home equity debt interest deduction. Interest on home equity debt used to improve your principal residence — and interest on home equity debt used for any purpose (debt limit of \$100,000) — may be deductible. So consider using a home equity loan or line of credit to pay off credit cards or auto loans, for which interest isn't deductible.

AMT ALERT! *If home equity debt isn't used for home improvements, the interest isn't deductible for AMT purposes and could trigger the AMT.*

Home rental rules

If you rent out all or a portion of your principal residence or second home for less than 15 days, you don't have to report the income. But expenses associated with the rental aren't deductible.

If you rent out your principal residence or second home for 15 days or more, you'll have to report the income. But you also may be entitled to deduct some or all of your rental expenses — such as utilities, repairs, insurance and depreciation.

If the home *isn't* classified as a rental property for tax purposes (based on the amount of personal vs. rental use), you can deduct rental expenses only to the extent of your rental income. Any excess can be carried forward to offset rental income in future years. You also can take an itemized deduction for the personal portion of both mortgage interest and property taxes.

If the home *is* classified as a rental property, you can deduct rental expenses, including losses, subject to the passive activity rules. You can't deduct any interest that's attributable to your personal use of the home, but you can take the personal portion of property tax as an itemized deduction. In some situations, it may be beneficial to reduce personal use of a residence so it will be classified as a rental property.

Real estate activity losses

Losses from investment real estate or rental property are passive by definition — unless you're a real estate professional. Then you can deduct real estate activity losses in full. To qualify as a real estate professional, you must annually perform:

- ◆ More than 50% of your personal services in real property trades or businesses in which you materially participate, and
- ◆ More than 750 hours of service in these businesses during the year.

Each year stands on its own, and there are other nuances to be aware of. If you're concerned you'll fail either test and be stuck with passive losses, consider increasing

your hours so you'll meet the test. (For more on passive loss rules, see "Passive losses" on page 10.)

Home sales

When you sell your principal residence, you can exclude up to \$250,000 (\$500,000 for joint filers) of gain if you meet certain tests. To support an accurate tax basis, maintain thorough records, including information on your original cost and subsequent improvements, reduced by casualty losses and any depreciation that you may have claimed based on business use.

Warning: Gain on the sale of a principal residence generally isn't excluded from income if the gain is allocable to a period of nonqualified use. Generally, this is any period after 2008 during which the property isn't used as your principal residence. There's an exception if the home is first used as a principal residence and then converted to nonqualified use.

Losses on a principal residence aren't deductible. But if part of your home is rented or used exclusively for your business, the loss attributable to that portion will be deductible, subject to various limitations.

Because a second home is ineligible for the gain exclusion, consider converting it to rental use before selling. It will be considered a business asset, and you may be able to defer tax on any gains by doing a Section 1031 exchange. (See "Sec. 1031 exchange" at right.) Or you may be able to deduct a loss, but only to the extent attributable to a decline in value *after* the conversion.

Tax-deferral strategies for investment property

It's possible to divest yourself of appreciated investment real estate or rental property but defer the tax liability. Such strategies may, however, be risky from a tax perspective until there's more certainty

Case Study 4

Are you eligible for the home office deduction?

If you have a home office, you may be entitled to a deduction — but be aware that this requires more than just "regular" use of the office. Let's look at an example. Kim and Lisa are both executives who typically work at home three days a week. Only one of them, however, qualifies for the home office deduction:

- ♦ Kim works at home to cut down on her weekly commute so she can spend more time with her children. Kim's husband also uses the office regularly for activities related to his charity work, and her children often do their homework there.
- ♦ Lisa works at home because her company, in an effort to save money on office space, is requiring employees who don't need to be in the office regularly to work remotely. When she's not in the office she usually is traveling for business purposes. Neither her husband nor her children use the office.

Who gets the deduction? Lisa. Kim is ineligible because her home office use is for her own convenience, not her employer's. In addition, the office isn't used *exclusively* for business purposes.

Because Lisa's home office use is for her employer's benefit and it's the only use, she can deduct a portion of her mortgage interest, real estate taxes and certain household utilities. Further, she can take a deduction for the depreciation allocable to the portion of her home used for the office. She can also deduct direct expenses, such as business-only phone and fax lines and office supplies.

Lisa must claim these expenses as a miscellaneous itemized deduction, which means she'll enjoy a tax benefit only if her home office expenses plus her other miscellaneous itemized expenses exceed 2% of her AGI. If Lisa instead were self-employed, she could use the deduction to offset her self-employment income and the AGI floor wouldn't apply.

Of course, there are numerous exceptions and caveats. If this break might apply to you, discuss it with your tax advisor in more detail.



about future capital gains rates — if rates go up, tax deferral could be costly. (See "What's new!" on page 8.) So tread carefully if you're considering a deferral strategy such as the following:

Installment sale. An installment sale allows you to defer gains by spreading them over several years as you receive the proceeds.

Warning: Ordinary gain, including certain

depreciation recapture, is recognized in the year of sale, even if no cash is received.

Sec. 1031 exchange. Also known as a "like-kind" exchange, this technique allows you to exchange one real estate investment property for another and defer paying tax on any gain until you sell the replacement property. **Warning:** Restrictions and significant risks apply. ♦

Special planning required to ensure personal financial security



For most business owners, their business is one of their bigger investments — or even their biggest. If you're among them, special planning is required to ensure your personal financial security. After all, with your business making up a large portion of your portfolio, it may lack both diversity and liquidity.

Retirement saving

If most of your money is tied up in your business, retirement can be a challenge. So if you haven't already set up a tax-advantaged retirement plan, consider setting one up this year. Keep in mind that, if you have employees, they generally must be allowed to participate in the plan, provided they work enough hours. Here are a few options that may allow you to make large contributions:

Profit-sharing plan. This is a defined contribution plan that allows discretionary employer contributions and flexibility in plan design. You can make deductible 2010 contributions (see Chart 2 on page 15 for limits) as late as the due date of your 2010 income tax return, including extensions — provided your plan existed on Dec. 31, 2010.

SEP. A Simplified Employee Pension (SEP) is a defined contribution plan that provides benefits similar to those of a profit-sharing plan. But you can establish the SEP in 2011 and still make deductible 2010 contributions (see Chart 2 on page 15 for limits) as late as the due date of your 2010 income tax return, including extensions. Another benefit is that a SEP is easier to administer than a profit-sharing plan.

Defined benefit plan. This plan sets a future pension benefit and then actuarially calculates the contributions needed to attain that benefit. The maximum annual benefit for both 2010 and 2011 is generally \$195,000 or 100% of average earned income for the highest three consecutive years, if less. Because it's actuarially driven, the contribution needed to attain the projected future annual benefit may exceed the maximum contributions allowed by other plans, depending on your age and the desired benefit.

You can make deductible 2010 contributions until the due date of your return, provided your plan existed on Dec. 31, 2010.

Warning: Employer contributions generally are required and must be paid quarterly if there was a shortfall in funding for the prior year.

Exit planning

An exit strategy is a plan for passing on responsibility for running the company, transferring ownership and extracting your money from the business. This requires planning well in advance of the transition. Here are the most common exit options:

Buy-sell agreements. When a business has more than one owner, a buy-sell agreement can be a powerful tool. The agreement controls what happens to the business when a specified event occurs, such as an owner's retirement, disability or death. Among other benefits, a well-drafted agreement:

- ♦ Provides a ready market for the departing owner's shares,
- ♦ Sets a price for the shares, and
- ♦ Allows business continuity by preventing disagreements caused by new, unwanted owners.



Chart 2

Profit-sharing plan vs. SEP: How much can you contribute?

Profit-sharing plan	SEP
2010 and 2011 maximum contribution: \$49,000 or \$54,500.	2010 and 2011 maximum contribution: \$49,000.
Eligibility: You can't contribute more than 100% of your compensation. To qualify for the higher limit, your plan must include a 401(k) arrangement and you must be eligible to make catch-up contributions (that is, be age 50 or older). Additional rules may further limit your contribution.	Eligibility: You can't contribute more than 25% of your eligible compensation. Additional rules may further limit your contribution.

A key issue with any buy-sell agreement is providing the buyer with a means of funding the purchase. Life or disability insurance often helps fulfill this need and can give rise to several tax and nontax issues and opportunities.

One of the biggest advantages of life insurance as a funding method is that proceeds generally are excluded from the beneficiary's taxable income. There are exceptions, however, so be sure to consult your tax advisor.

Succession within the family. You can pass your business on to family members or close relatives by giving interests, selling interests or doing some of each. Be sure to consider your income needs, how family members will feel about your choice, and the gift and estate tax consequences.

Now may be a particularly good time to transfer ownership interests. If your business has lost value, you can transfer a greater number of shares without giving away more value for gift tax purposes. You also can leverage your annual gift tax exclusion (see page 23) by gifting ownership interests, which may be eligible for valuation discounts.

Nonfamily succession. If family members aren't interested in or capable of taking

over your business, one option is a management buyout. This may provide for a smooth transition because there may be little learning curve for the new owners. Plus you avoid the time and expense of finding an outside buyer.

If you want rank and file employees to become owners as well, an employee stock ownership plan (ESOP) may be the ticket. An ESOP is a qualified retirement plan created primarily to purchase your company's stock. Whether you're planning for liquidity, looking for a tax-favored loan or supplementing an employee benefit program, an ESOP can offer you many advantages.

Selling to an outsider. This can also be an excellent option. If you can find the right buyer, you may even be able to sell the business at a premium.

Sale or acquisition

Whether you're selling your business as part of your exit strategy or acquiring another company to help grow it, the tax consequences can have a major impact on the transaction's success or failure. Here are a few key tax considerations:

Asset vs. stock sale. With a corporation, sellers typically prefer a stock sale for the capital gains treatment and to avoid double

taxation. Buyers generally want an asset sale to maximize future depreciation write-offs.

Taxable sale vs. tax-deferred transfer. A transfer of ownership of a corporation can be tax-deferred if made solely in exchange for stock or securities of the recipient corporation in a qualifying reorganization. But the transaction must comply with strict rules. Although it's generally better to postpone tax, there are some advantages to a taxable sale:

- ♦ The seller doesn't have to worry about the quality of buyer stock or other business risks that might come with a tax-deferred transfer.
- ♦ The buyer benefits by receiving a stepped-up basis in its acquisition's assets and not having to deal with the seller as a continuing equity owner, as it would in a tax-deferred transfer.
- ♦ The parties don't have to meet the technical requirements of a tax-deferred transfer.

Installment sale. If a taxable sale is chosen, the transaction may be structured as an installment sale, due to the buyer's lack of sufficient cash or the seller's desire to spread the gain over a number of years. Installment sales are also useful when the buyer pays a contingent amount based on the business's performance. But an installment sale can backfire. For example:

- ♦ Depreciation recapture must be reported as gain in the year of sale, no matter how much cash the seller receives.
- ♦ If tax rates increase in the future, the overall tax could wind up being more on an installment sale than on a cash sale. (Remember, the favorable 15% rate on long-term capital gains is scheduled to end after Dec. 31, 2012.)

Of course, tax consequences are only one of many important considerations when planning a merger or acquisition. ♦

Provide support *and* save taxes with this powerful tool

Donations to qualified charities are generally fully deductible. To ensure your gifts do as much as possible for both your favorite charities *and* your tax bill, discuss with your tax advisor which assets to give and the best ways to give them.

Cash donations

Outright gifts of cash (which include donations made via check, credit card and payroll deduction) are the easiest. The key is to substantiate them. To be deductible, cash donations must be:

- ♦ Supported by a canceled check, credit card receipt or written communication from the charity if they're under \$250, or
- ♦ Substantiated by the charity if they're \$250 or more.

Deductions for cash gifts to public charities can't exceed 50% of your AGI. The AGI limit is 30% for cash donations to nonoperating private foundations. Contributions in excess of the applicable AGI limit can be carried forward for up to five years.

AMT ALERT! Charitable contribution deductions are allowed for AMT purposes, but your tax savings may be less if you're subject to the AMT.

Stock donations

Publicly traded stock and other securities you've held more than one year are long-term capital gains property, which can make one of the best charitable gifts. Why? Because you can deduct the current fair

market value and avoid the capital gains tax you'd pay if you sold the property.

Donations of long-term capital gains property are subject to tighter deduction limits — 30% for gifts to public charities, 20% for gifts to nonoperating private foundations. In certain circumstances it may be better to deduct your tax basis (generally the amount paid for the stock) rather than the fair market value, because it allows you to take advantage of the higher AGI limits that apply to donations of cash and ordinary-income property (such as stock held one year or less).

Don't donate stock that's worth *less* than your basis. Instead, sell the stock so you can deduct the loss and then donate the cash proceeds to charity.

IRA donations

Through 2011, if you're age 70½ or older, you can make a direct contribution from your IRA to a qualified charitable organization without owing any income tax on the distribution. The contribution can be used to satisfy the required minimum distribution requirement. (See page 21.)

The maximum allowable distribution for charitable contribution purposes is \$100,000 per tax year.

Making gifts over time

If you don't know which charities you want to benefit but you'd like to start making large contributions now, consider a private foundation. It offers you significant control over how your donations will be used.

But you must comply with complex rules, which can make foundations expensive to run. Also, the AGI limits for deductibility of contributions to nonoperating foundations are lower. (See the discussions of cash donations and stock donations, at left.)

If you'd like to influence how your donations are spent but avoid a foundation's tight rules and high expenses, consider a donor-advised fund. Many larger public charities offer them. **Warning:** To deduct your donor-advised fund contribution, you must obtain a written acknowledgment from the sponsoring organization that it has exclusive legal control over the assets contributed.

Charitable remainder trusts

To benefit a charity while helping ensure your own financial future, consider a charitable remainder trust (CRT):

- ♦ For a given term, the CRT pays an amount to you annually (some of which may be taxable).
- ♦ At the term's end, the CRT's remaining assets pass to one or more charities.
- ♦ When you fund the CRT, you receive an income tax deduction for the present value of the amount that will go to charity.
- ♦ The property is removed from your estate.

A CRT also can help diversify your portfolio if you own non-income-producing assets that would generate a large capital gain if sold. Because a CRT is tax-exempt, it can sell the property without paying tax on the gain at the time of the sale. The CRT can then invest the proceeds in a variety of stocks and bonds.

You can name someone other than yourself as income beneficiary or fund the CRT at your death, but the tax consequences will be different.

Charitable lead trusts

To benefit charity while transferring assets to loved ones at a reduced tax cost, consider a charitable lead trust (CLT):

- ◆ For a given term, the CLT pays an amount to one or more charities.
- ◆ At the term's end, the CLT's remaining assets pass to one or more loved ones you name as remainder beneficiaries.
- ◆ When you fund the CLT, you make a taxable gift equal to the present value of the amount that will go to the remainder beneficiaries.
- ◆ The property is removed from your estate.

For gift tax purposes, the remainder interest is determined assuming that the trust assets will grow at the Internal Revenue Code's Section 7520 rate. The lower the Sec. 7520 rate, the smaller the remainder interest and the lower the possible gift tax. If the trust's earnings outperform the Sec. 7520 rate, the excess earnings will be transferred to the remainder beneficiaries tax free. Because the Sec. 7520 rate currently is low, now may be a good time to take the chance that your actual return will outperform it. (For more on the gift tax, go to page 23.)

You can name yourself as the remainder beneficiary or fund the CLT at your death, but the tax consequence will be different. ◆

Chart 3
What's your donation deduction?

Donation	Examples	Deduction
Cash	Gifts made by check, credit card, payroll deduction	100%
Long-term capital gains property	Stock or bonds held more than one year or land held more than one year to be used by the charity in its exempt function	Fair market value
Ordinary-income property	Stock or bonds held one year or less, inventory, or property subject to depreciation recapture, such as business personal property	Lesser of fair market value or your tax basis
Tangible personal property used in relation to the charity's tax-exempt function	Artwork donated to an art museum or furniture donated for use in the charity's office	Fair market value
Tangible personal property <i>not</i> used in relation to the charity's tax-exempt function	Artwork donated to a charity auction or sports memorabilia donated to a food pantry	Your basis
Use of property	Use of a vacation home; loan of artwork	Generally no deduction, though there may be ways to structure the gift to qualify for one
Services	Professional services such as legal, accounting, medical; administrative services such as envelope-stuffing or making phone calls	Out-of-pocket expenses only; 14 cents per charitable mile driven
Vehicle <i>sold</i> by the charity	Charity sells the vehicle within a specified time period	Amount the charity receives from the sale
Vehicle <i>used</i> by the charity	Vehicle used in connection with the charity's exempt purpose — for example, to deliver meals to the elderly	Fair market value

Note: Your charitable donation deductions may be reduced if they exceed certain limits based on your AGI, the type of donation and the type of charity receiving the donation. If you receive some benefit from the charity in connection with your donation, such as services or products, your deduction must be reduced by the value of the benefit you receive. Various substantiation requirements also apply. Consult your tax advisor for additional details.





Make tax planning a family affair

It's the hope of parents everywhere that their children grow up to be financially secure. The keys to achieving that goal are trifold: 1) teaching children from an early age the value of earning and saving money, 2) ensuring they have the financial resources needed to obtain the best quality education possible, and 3) making tax planning a family affair.

The "kiddie tax"

The income shifting that once — when the "kiddie tax" applied only to those under age 14 — provided families with significant tax savings now offers much more limited benefits. Today, the kiddie tax applies to children age 18 and younger, as well as to full-time students under age 24 (unless the students provide more than half of their own support from earned income).

For children subject to the kiddie tax, any unearned income beyond \$1,900 (for 2010 and 2011) is taxed at their parents' marginal rate rather than their own, likely lower, rate. Keep this in mind before transferring investments to them.

Roth IRAs for teens

Roth IRAs can be perfect for teenagers because they likely have many years to let their accounts grow tax free.

Both the 2010 and 2011 contribution limits are the lesser of \$5,000 or 100% of earned income, reduced by any traditional IRA contributions. Contributions aren't deductible, but if the child earns no more than the standard deduction for singles (\$5,700 for 2010 and \$5,800 for 2011) and

has no unearned income, he or she will pay zero federal income tax anyway. If a child earns more than the standard deduction, the income likely will be taxed at only 10% or 15%. So the tax-free treatment of future qualified distributions will likely be well worth the loss of any current deduction.

If your children or grandchildren don't want to invest their hard-earned money, consider giving them the amount they're eligible to contribute — but keep the gift tax in mind. (See page 23.) If they don't have earned income and you own a business, consider hiring them. You can deduct their pay, and other tax benefits may apply. **Warning:** They must perform actual work and be paid in line with what you'd pay nonfamily employees.

Saving for education

Coverdell Education Savings Accounts (ESAs) and 529 savings plans offer parents (or anyone else, such as grandparents) a tax-smart way to fund education expenses:

- ♦ Contributions aren't deductible for federal purposes, but plan assets grow tax-deferred.
- ♦ Distributions used to pay for qualified expenses — such as tuition, mandatory

fees, books, equipment, supplies and, generally, room and board — are income-tax free for federal purposes and may be tax free for state purposes.

- ♦ You remain in control of the account — even after the child is of legal age.
- ♦ You can make rollovers to another qualifying family member.

Which plan is better depends on your situation and goals. You may even want to set up both an ESA and a 529 plan for the same student.

ESA pluses and minuses

Perhaps the biggest ESA advantage is that you have direct control over how and where your contributions are invested. Another significant advantage has been that tax-free distributions aren't limited to college expenses; they also can fund elementary and secondary school costs.

However, if Congress doesn't act to extend this treatment, distributions used for pre-college expenses will be taxable starting in 2013. Additionally, the annual ESA contribution limit per beneficiary is only \$2,000 through 2012, and it's scheduled to go down to \$500 beginning in 2013. Contributions are further limited based on income.

Generally, contributions can be made only for the benefit of a child under age 18. Amounts left in an ESA when the beneficiary turns 30 generally must be distributed within 30 days, and any earnings will be subject to tax.

529 plan pluses and minuses

529 college savings plans can be used to pay a student's qualified expenses at most postsecondary educational institutions. For 2010, qualified expenses also include computers, computer technology and Internet service. As of this writing, this expanded definition expired after 2010; check with your tax advisor to see if it's been extended.

For many taxpayers, 529 plans are better than ESAs because they typically offer much higher contribution limits (determined by the sponsoring state). Plus, there are no income limits for contributing — and there's generally no beneficiary age limit for contributions or distributions.

The biggest downside may be that you don't have direct control over investment decisions; you're limited to the options the plan offers. Additionally, for funds already in the plan, you can make changes to your investment options only once during the year or when you change beneficiaries.

But each time you make a *new* contribution, you can select a different option for that contribution, regardless of how many times you contribute throughout the year. And you can make a tax-free rollover to a different 529 plan for the same child every 12 months.

529 plans also are available in the form of a prepaid tuition program. If your contract is for four years of tuition, tuition is guaranteed regardless of its cost at the time the beneficiary actually attends the school. The main downside is that there's uncertainty in how benefits will be applied if the beneficiary attends a different school.

Your state may offer tax benefits to residents who invest in its own 529 plan.

Jumpstarting a 529 plan

To avoid gift taxes on 529 plan contributions, you must either limit them to \$13,000 annual exclusion gifts or use up part of your

Case Study 5

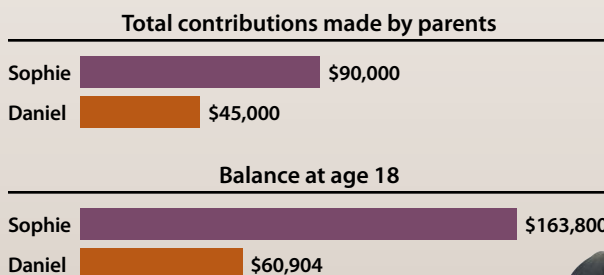
Tax-free savings for education add up

529 savings plans don't offer a federal deduction for contributions, and the plans come with a lot of restrictions. Are their tax-deferred growth and tax-free distributions really worth it? They can be — especially if you start early:

When Sophie is born, her parents fund a 529 savings plan with a \$5,000 contribution, and they put in another \$5,000 on her birthday each year through age 17.

Daniel is born on the same day as Sophie, but his parents wait until his ninth birthday to start putting money into a 529 plan. They then make the same annual \$5,000 contributions through age 17 as Sophie's parents do.

When Sophie and Daniel turn 18, Sophie's plan has nearly \$103,000 more than Daniel's — even though her parents contributed only \$45,000 more. And the \$73,800 of growth in Sophie's plan will be completely tax free, as long as all distributions are used to pay for qualified education expenses. Daniel's plan provides a much smaller tax benefit — only \$15,904 of tax-free growth.



Note: This example is for illustrative purposes only and isn't a guarantee of future results. The figures presume a 6% rate of return.



lifetime gift tax exemption. Fortunately, a special break for 529 plans allows you to front-load five years' worth of annual exclusion gifts and make a \$65,000 contribution (or \$130,000 if you split the gift with your spouse). And that's *per beneficiary*.

If you're a grandparent, this can be a powerful estate planning strategy. (See page 22 for more on gift and estate planning.)

American Opportunity credit

When your child enters college, you may not qualify for the American Opportunity credit because your income is too high, but your child might. The credit covers 100% of the first \$2,000 of tuition and related expenses and 25% of the next \$2,000 of expenses. The maximum credit is \$2,500

per year for the first four years of postsecondary education. And both a credit and a tax-free ESA or 529 plan distribution can be taken as long as expenses paid with the distribution aren't used to claim the credit.

If your dependent child claims the credit, however, you must forgo your dependency exemption for the child (and the child can't take the exemption). Before 2010, your dependency exemption might have been partially phased out based on your AGI anyway, so this decision may have been an easy one. But for 2010 through 2012, that AGI limit has been lifted. (See "What's new!" on page 3.) So you'll need to work with your tax advisor to see whether the exemption or the credit will provide the most tax savings overall for your family. ♦

Retirement plans offer opportunities and pitfalls

For higher-income taxpayers, the contribution limits on most retirement plans may make them seem like more trouble than they're worth. After all, the plans are subject to a variety of rules, and investment choices can be limited. Yet those in the top tax brackets also have the most tax savings to gain from such plans. The key is to make the most of the opportunities the plans offer and avoid their pitfalls.

Retirement plan contributions

Contributing the maximum you're allowed (see Chart 4 on page 21) to an employer-sponsored defined-contribution plan, such as a 401(k), 403(b), 457, SARSEP or SIMPLE, is likely a smart move:

- ◆ Contributions are typically pretax, so they reduce your taxable income.
- ◆ Plan assets can grow tax-deferred — meaning you pay no income tax until you take distributions.
- ◆ Your employer may match some or all of your contributions — also on a pretax basis.

Unfortunately, many employers (if their plans allow) have suspended matching contributions to reduce costs. If yours is among them, don't use that as an excuse to suspend your own contributions. Doing so will only exacerbate the negative impact on your retirement nest egg — plus your taxable 2011 income will increase compared to what it would be if you had contributed to the plan.

If you participate in a 401(k) or 403(b) plan and the plan allows it, you may designate

some or all of your contributions as Roth contributions. (Employer matches aren't eligible.)

There are no AGI limits on designating Roth 401(k) or 403(b) contributions, so

these plans may be especially beneficial for higher-income earners who are ineligible to contribute to Roth IRAs. (See "What's new!" below for information on another way you may be able to take advantage of Roth benefits.)

If you're a business owner or self-employed, you may be able to set up a plan that allows you to make much larger contributions. (See page 14 for details.)

Early withdrawals

With a few exceptions, retirement plan distributions made before age 59½ are

What's new!

AGI limits lifted on Roth IRA conversions

Who's affected: Taxpayers with AGIs exceeding \$100,000.

Key changes: Before 2010, you couldn't convert a traditional IRA to a Roth IRA if your AGI for the year of conversion was more than \$100,000. This limit was eliminated beginning in 2010, allowing more high-income taxpayers the opportunity to benefit from the tax-free growth a Roth IRA offers. (Many high-income taxpayers haven't been eligible to contribute to Roth IRAs because of other AGI-based limits, and those limits are still in effect.)

The converted amount is taxable in the year of the rollover. But for conversions made in 2010, the income can be deferred in equal installments to 2011 and 2012.

Converting a traditional IRA to a Roth IRA can allow you to turn *tax-deferred* future growth into *tax-free* growth. It also can provide estate planning benefits: No Roth IRA distributions are required during your life, so you can let the entire balance continue to grow tax free over your lifetime. If you name your child as beneficiary, he or she will be subject to the required minimum distribution (RMD) rules upon inheriting the Roth IRA. But distributions will be tax free and spread out over his or her lifetime, and funds remaining in the account can continue to grow tax free. (See page 22 for more on estate planning.)

Planning tips: Whether a conversion will make sense for you depends on a variety of factors, such as your age, whether you can afford to pay the tax on the conversion, your tax bracket now and expected tax bracket in retirement, and whether you'll need the IRA funds in retirement. Your tax advisor can help you determine the best course of action.

subject to a 10% penalty, in addition to income tax. This means that, if you're in the top federal tax bracket of 35%, you can lose close to half of your withdrawal to federal taxes and penalties. If you're subject to state income taxes and/or penalties, the total of your taxes and penalties may easily exceed 50%. Additionally, you'll lose the potential tax-deferred future growth on the amount you've withdrawn.

So if you're in need of cash, you're likely better off tapping taxable investment accounts than dipping into your retirement plan. Long-term gains from sales of investments in taxable accounts will be taxed at the lower long-term capital gains rate, currently 15%, and losses on such sales can be used to offset other gains or carried forward to offset gains in future years. (See page 8 for more information on the tax treatment of investments.)

Leaving a job

When you change jobs or retire, you'll want to avoid taking a lump-sum distribution from your employer's retirement plan because it generally will be taxable, plus potentially subject to the 10% early-withdrawal penalty. Here are options that will help you avoid current income tax and penalties:

Stay put. You may be able to leave your money in your old plan. But if you're changing employers or already have an IRA, this may not be the best option, because keeping track of multiple plans can make managing your retirement assets more difficult. Also assess the plan's investment options.

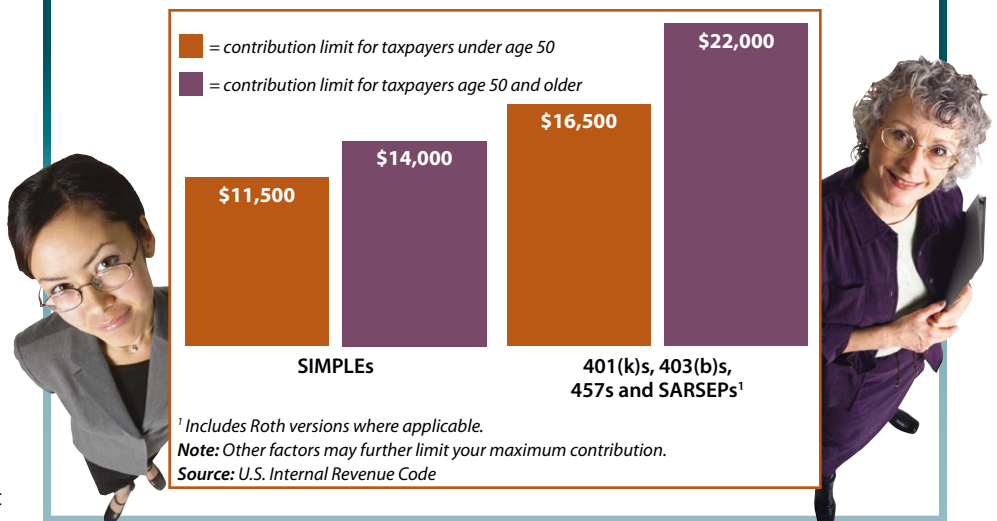
Roll over to your new employer's plan.

This may be a good solution if you're changing jobs, and it will leave you with only one retirement plan to keep track of. But first compare the new plan's investment options to the old plan's options.

Roll over to an IRA. This may be the best alternative because IRAs offer nearly unlimited investment choices.

Chart 4

No increase in retirement plan limits for 2010 or 2011



If you choose a rollover, request a direct rollover from your old plan to your new plan or IRA. Otherwise, you'll need to make an indirect rollover within 60 days to avoid tax and potential penalties. **Warning:** The check you receive from your old plan may be net of 20% federal income tax withholding. If you don't roll over the gross amount (which will require you to make up for the

withheld amount with other funds), you'll likely be subject to income tax, and potentially the 10% penalty, on the difference.

Required minimum distributions

Normally once you reach age 70½ you must take annual required minimum distributions (RMDs) from your IRAs (except Roth IRAs) and defined contribution plans. If you don't comply, you can owe a penalty equal to 50% of the amount you should have withdrawn but didn't. (Note that the 2009 suspension of RMD rules hasn't been extended to 2010 or 2011.) You can avoid the RMD rule for a Roth 401(k) or Roth 403(b) by rolling the funds into a Roth IRA.

So, should you take distributions between ages 59½ and 70½, or more than the RMD after age 70½? Distributions in any year your tax bracket is low may be beneficial. But also consider the lost tax-deferred growth and, if applicable, whether the distribution could cause your Social Security payments to become taxable.

If you've inherited a retirement plan, consult your tax advisor regarding the distribution rules that apply to you. ♦





ESTATE PLANNING

Estate tax law uncertainty continues to make planning a challenge

A one-year repeal of the estate and generation-skipping transfer (GST) taxes went into effect Jan. 1, 2010, with a return of these taxes scheduled for 2011 — at higher levels than in 2009. For months, Congress was expected to make estate tax law changes, and changes were finally signed into law in December. But they're only temporary, so significant uncertainty remains, continuing to make planning a challenge.

Estate tax law changes

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 retroactively brings back the estate tax for 2010, but with an exemption increase and a rate reduction compared to 2009. It extends these levels to 2011 and 2012. Then, in 2013, the exemption and top rate will return to levels prescribed by pre-2001 tax law — the levels that would have gone into effect in 2011 without the 2010 Tax Relief act. (See Chart 5, below.)

While what for 2010 is essentially a repeal of the estate tax repeal may sound

unattractive, it actually may prove beneficial to many families with loved ones who died in 2010. Why? Because the estate tax repeal was accompanied by a limit on the step-up in basis. (See “What’s new!” on page 23.)

GST tax changes

The Tax Relief act brings the GST tax back for 2010 as well, with the same exemption amounts as the estate tax through 2012. However, the act sets the GST tax rate for 2010 at 0%.

This is probably because, unlike the estate tax — where the elimination of the step-up

in basis limitation could be provided to essentially offset liability from the return of the estate tax — there was no offset that could make up for tax liability due to the return of the GST tax in 2010. Such a retroactive tax would likely have brought lawsuits.

That’s not an issue after 2010, so the GST tax rate goes back up to match the top estate tax rate in 2011 and 2012. (See Chart 5, below.)

More flexibility for married couples

The 2010 Tax Relief act includes a provision that will (temporarily) provide significant estate planning flexibility to married couples. If one spouse dies in 2011 or 2012 and part (or all) of his or her estate tax exemption is unused at his or her death, the estate can elect to permit the surviving spouse to use the deceased spouse’s remaining estate tax exemption.

Similar results can be achieved by making asset transfers between spouses during life and/or setting up certain trusts at death.

Chart 5
Transfer tax exemptions and rates for 2009–2013

	2009	2010	2011	2012	2013
Gift tax exemption	\$ 1 million	\$ 1 million	\$ 5 million	\$ 5 million ²	\$ 1 million
Estate tax exemption¹	\$3.5 million	\$ 5 million ³	\$ 5 million	\$ 5 million ²	\$ 1 million
GST tax exemption	\$3.5 million	\$ 5 million	\$ 5 million	\$ 5 million ²	\$ 1 million ²
Highest estate and gift tax rates and GST rate	45%	35% ³ (0% GST tax)	35%	35%	55% ⁴

¹ Less any gift tax exemption already used during life. For 2011 and 2012, these amounts are “portable” between spouses.
² Indexed for inflation.
³ Estates can elect to follow the pre-Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 regime (estate tax repeal + limited step-up in basis).
⁴ The benefits of the graduated gift and estate tax rates and exemptions are phased out for gifts/estates over \$10 million.
Source: U.S. Internal Revenue Code



What's new!

Step-up in basis changes could increase income taxes for heirs

Who's affected: Those inheriting assets from someone who died in 2010.

Key changes: A tax law change that was paired with the 2010 estate tax repeal could substantially increase *income* taxes for heirs. Normally, the income tax basis of most inherited property is "stepped-up" to its date-of-death fair market value. This means that recipients of such property can sell it immediately without triggering capital gains taxes.

Under the estate tax repeal, the *automatic* step-up in basis is eliminated. Instead, estates generally can allocate only up to \$1.3 million to increase the basis of certain assets plus up to \$3 million to increase the basis of assets left to a surviving spouse.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 allows the estate of anyone who died in 2010 to either follow the new rules under the act or elect to follow the pre-act estate-tax-repeal regime.

Planning tips: If the estate of someone who died in 2010 doesn't exceed the new \$5 million exemption (less any gift tax exemption used during life), then following the new rules will likely be more beneficial: No estate tax will be due anyway, and the deceased's heirs don't have to worry about any limits on the step-up in basis.

If the estate exceeds the deceased's available estate tax exemption, the decision becomes more complicated. Factors such as the extent of the possible estate tax liability, the extent to which assets have appreciated beyond the deceased's basis and the extent to which the assets are going to a surviving spouse vs. other heirs will need to be considered.

(Under the marital deduction, your estate generally can deduct the value of all assets that pass from you to your spouse at your death, provided he or she is a U.S. citizen.) But making this election will be simpler and provide flexibility if proper planning hasn't been done before the first spouse's death.

Still, this election is available for only two years unless Congress extends it. So married couples can't depend on it being available to ensure that they take full advantage of both spouses' exemptions. Also, the provision doesn't allow the deceased spouse's remaining GST tax exemption to be used by the surviving spouse.

Gifting

One way to reduce your taxable estate is to start giving away assets now. Gifts to your spouse are tax free under the marital deduction (a limit applies to noncitizens), but most other gifts are potentially taxable.

The gift tax was never repealed for 2010, and the 2010 Tax Relief act provides no change to the gift tax regime for 2010.

But, the gift tax will follow the estate tax exemptions and top rates for 2011 and 2012. (See Chart 5 on page 22.) Any gift tax exemption used during life reduces the estate tax exemption available at death.

You can exclude certain gifts of up to \$13,000 per recipient each year (\$26,000 per recipient if your spouse elects to split the gift with you, or you're giving community property) without using up any of your gift tax exemption. Consider maximizing your annual exclusion gifts and perhaps also using part or all of your gift tax exemption. Here are some additional strategies for tax-smart giving:

Choose gifts wisely. Take into account both estate and income tax consequences and the economic aspects of any gifts you'd like to make. For example, to minimize estate tax, gift property with the greatest future appreciation potential.

Plan gifts to grandchildren carefully. Annual exclusion gifts are generally exempt from the GST tax. For gifts that don't qualify for the exclusion to be

completely tax free, you generally must apply both your GST tax exemption and your gift tax exemption.

Gift interests in your business. If you own a business, you can leverage your gift tax exclusions and exemption by gifting ownership interests, which may be eligible for valuation discounts. So, for example, if the discounts total 30%, you can gift an ownership interest equal to as much as \$18,571 tax free because the discounted value doesn't exceed the \$13,000 annual exclusion. **Warning:** The IRS may challenge the value; a professional appraisal is strongly recommended.

Pay tuition and medical expenses. You may pay these expenses for a loved one without the payment being treated as a taxable gift, as long as the payment is made directly to the provider.

Trusts and insurance

Trusts can provide significant tax savings while preserving some control over what happens to the transferred assets. Here are three trusts you may want to consider:

- ♦ A qualified terminable interest property (QTIP) trust is good for benefiting first a surviving spouse and then children from a prior marriage.
- ♦ A qualified personal residence trust (QPRT) allows you to give your home to your children today at a reduced tax cost (provided you survive the trust's term) while you retain the right to live in it for the trust's term.
- ♦ A grantor-retained annuity trust (GRAT) works similarly to a QPRT but allows you to transfer other assets; you receive payments from the trust for a certain period.

Life insurance can be used to achieve a variety of estate planning goals. Proceeds are generally income-tax free to the beneficiary. And with proper planning, you can ensure proceeds aren't included in your taxable estate. ♦

TAX RATES

Chart 6
2010 individual income tax rate schedules

Regular tax brackets				
Tax rate	Single	Head of household	Married filing jointly or surviving spouse	Married filing separately
10%	\$ 0 – \$ 8,375	\$ 0 – \$ 11,950	\$ 0 – \$ 16,750	\$ 0 – \$ 8,375
15%	\$ 8,375 – \$ 34,000	\$ 11,950 – \$ 45,550	\$ 16,750 – \$ 68,000	\$ 8,375 – \$ 34,000
25%	\$ 34,000 – \$ 82,400	\$ 45,550 – \$ 117,650	\$ 68,000 – \$ 137,300	\$ 34,000 – \$ 68,650
28%	\$ 82,400 – \$ 171,850	\$ 117,650 – \$ 190,550	\$ 137,300 – \$ 209,250	\$ 68,650 – \$ 104,625
33%	\$ 171,850 – \$ 373,650	\$ 190,550 – \$ 373,650	\$ 209,250 – \$ 373,650	\$ 104,625 – \$ 186,825
35%	Over \$ 373,650	Over \$ 373,650	Over \$ 373,650	Over \$ 186,825

AMT brackets				
Tax rate	Single	Head of household	Married filing jointly or surviving spouse	Married filing separately
26%	\$ 0 – \$ 175,000	\$ 0 – \$ 175,000	\$ 0 – \$ 175,000	\$ 0 – \$ 87,500
28%	Over \$ 175,000	Over \$ 175,000	Over \$ 175,000	Over \$ 87,500

AMT exemption				
	Single	Head of household	Married filing jointly or surviving spouse	Married filing separately
Exemption ¹	\$ 47,450	\$ 47,450	\$ 72,450	\$ 36,225

¹ The alternative minimum tax (AMT) exemption phases out over certain income ranges and is completely phased out if AMT income exceeds the top of the applicable range.
Note: Consult your tax advisor for AMT rates and exemptions for children subject to the kiddie tax.
Source: U.S. Internal Revenue Code

Chart 7
2010 corporate income tax rate schedule

Tax rate	Tax bracket
15%	\$ 0 – \$ 50,000
25%	\$ 50,001 – \$ 75,000
34%	\$ 75,001 – \$ 100,000
39%	\$ 100,001 – \$ 335,000
34%	\$ 335,001 – \$10,000,000
35%	\$10,000,001 – \$15,000,000
38%	\$15,000,001 – \$18,333,333
35%	Over \$18,333,333

Note: Personal service corporations are taxed at a flat 35% rate.
Source: U.S. Internal Revenue Code



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