



July 5, 2011

To Our Clients and Friends:

Thanks to the extension through 2012 of the so-called Bush tax cuts, the current federal income tax environment remains favorable. Now is the time to take advantage because although we do not know what tax rates will be in 2013 and beyond, they almost certainly will be higher. While 2013 may seem far away, from a planning standpoint it is very close. This letter presents some tax planning ideas to consider this summer while we have plenty of time before year-end. Some of the ideas may apply to you, some to family members, and others to your business.

### **Leverage Standard Deduction by Bunching Deductible Expenditures**

If your 2011 itemized deductions are likely to be just under, or just over, the standard deduction amount, consider the strategy of bunching. This strategy groups together expenditures for itemized deduction items every other year, while claiming the standard deduction in the intervening years. The 2011 standard deduction for married joint filers is \$11,600; for single filers \$5,800; and for heads of household \$8,500.

For example, a joint filer whose only itemized deductions are about \$4,000 of annual property taxes and about \$8,000 of home mortgage interest will barely get any benefit from itemizing. If they wait to pay their 2011 property taxes until January 1 of next year, they could claim \$16,000 of itemized deductions on their 2012 return (\$4,000 of 2011 property taxes, plus another \$4,000 for the 2012 bill, plus the \$8,000 of mortgage interest). This year, they would only have the \$8,000 of interest, but could claim the standard deduction (probably around \$12,000). Following this strategy will cut their taxable income by a meaningful amount over the two-year period (cumulate deduction of \$28,000 vs. \$24,000, which at a 28% marginal rate is worth \$1,120). This can be an ongoing two-year strategy.

Examples of other deductible items that can be bunched together every other year to lower your federal income taxes include charitable donations and state income tax payments.

### **Consider Deferring Income**

It may also pay to defer some taxable income from this year into next year, especially if you expect to be in a lower tax bracket in 2012. For example, if you are in business for yourself and a cash-method taxpayer, you can postpone taxable income by waiting until late in the year to send out some client invoices. That way, you will not receive payment for them until early 2012. You can also postpone taxable income by accelerating some deductible business expenditures into this year. Both moves will defer taxable income from this year until next year. Deferring income may also be helpful if you are affected by unfavorable phase-out rules that reduce or eliminate various tax breaks (child tax credit, education tax credits, and so forth). By deferring income every other year, you may be able to take more advantage of these breaks every other year.

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**Note:** For higher-income taxpayers, it may not be advisable to repeat the income deferral drill in 2012 because pushing income from 2012 into 2013 could expose them to higher marginal tax rates in 2013. For 2013, the top two federal income tax rates will increase to 36% and 39.6% (up from the current 33% and 35%) unless Congress takes action.

**Note:** Economics should always reign supreme. You of course should not defer billing or collecting if it will endanger the ultimate collectability of your revenue.

### **Take Advantage of 0% Rate on Investment Income**

For 2011, the federal income tax rate on long-term capital gains and qualified dividends is 0% when they fall within the 10% or 15% regular federal income tax rate brackets. This will be the case to the extent your taxable income (including long-term capital gains and qualified dividends) does not exceed \$69,000 if you are married and file jointly (\$34,500 if you are single). While your income may be too high to benefit from the 0% rate, you may have children, grandchildren, or other loved ones who will be in one of the bottom two brackets. If so, consider giving them some appreciated stock or mutual fund shares that they can then sell and pay 0% tax on the resulting long-term gains. Gains will be long-term, as long as your ownership period plus the gift recipient's ownership period (before he or she sells) equals at least a year and a day.

Giving away stocks that pay dividends is another tax-smart idea. As long as the dividends fall within the gift recipient's 10% or 15% rate bracket, they will be federal-income-tax-free. The 0% rate is scheduled to be available through 2012, but things could change after that depending on how the 2012 elections turn out and other factors. So, consider doing what you need to do to take advantage of the 0% rate for this year and next year. In 2013, it could be history.

**Warning No. 1:** If you give securities to someone who is under age 24, the Kiddie Tax rules could potentially cause some of the resulting capital gains and dividends to be taxed at the parent's higher rates instead of at the gift recipient's lower rates. That would defeat the purpose. Please contact us if you have questions about the Kiddie Tax.

**Warning No. 2:** Be aware that if you give away assets worth over \$13,000 during 2011 to an individual gift recipient, it will generally eat into your \$5 million unified federal gift and estate tax exemption. However, you and your spouse can together give away up to \$26,000 without any adverse effects on your respective exemptions.

### **Time Investment Gains and Losses and Consider Being Bold about It**

As you evaluate investments held in your taxable brokerage firm accounts, consider the impact of selling appreciated securities this year. The maximum federal income tax rate on long-term capital gains realized from 2011 sales of securities held over a year is only 15%. Therefore, it often makes sense to hold appreciated securities for at least a year and a day before selling.

Biting the bullet and selling some loser securities (currently worth less than you paid for them) before year-end can also be a good idea. The resulting capital losses will offset capital gains from other sales this year, including short-term gains from securities owned for one year or less, which would otherwise be taxed at higher ordinary income rates.

You may have significant short-term gains if you bought into the stock market before this year's uptick.

The bottom line is that you do not have to worry about paying a higher tax rate on short-term gains if you have enough capital losses to shelter those short-term gains.

If capital losses for this year exceed capital gains, you will have a net capital loss for 2011. You can use that net capital loss to shelter up to \$3,000 of this year's high-taxed ordinary income from salaries, bonuses, self-employment, and so forth (\$1,500 if you are married and file separately). Any excess net capital loss is carried forward to next year.

**Important Point:** Selling enough loser securities to create a bigger net capital loss that exceeds what you can use this year might make sense. You can carry forward the excess net capital loss to 2012 and beyond and use it to shelter both short-term gains and long-term gains recognized in those years. That will give you extra investing flexibility in 2012 and beyond because you will not have to hold appreciated securities for over a year to get better tax results. Remember: the maximum federal income tax rate on long-term capital gains is scheduled to increase to 20% for 2013 and beyond (up from the current 15%). Also, the top two federal rates on ordinary income (including net short-term capital gains) are scheduled to increase for 2013 and beyond to 36% and 39.6% (up from the current 33% and 35%).

### **For the Charitably Inclined: Sell Loser Shares and Give Away Cash; Give Away Winner Shares**

Imagine you want to make some gifts to favorite relatives (who may be hurting financially) and/or favorite charities. You can make gifts in conjunction with an overall revamping of your holdings of stocks and equity mutual fund shares held in taxable brokerage firm accounts. Here is how to get the best tax results from your generosity.

**Gifts to Relatives.** *Do not* give away loser shares (currently worth less than what you paid for them). Instead sell the shares, and take advantage of the resulting capital loss. Then, give the cash sales proceeds to the relative. *Do* give away winner shares to relatives. Most likely, they will pay lower tax rates than you would pay if you sold the same shares. In fact, relatives who are in the 10% or 15% federal income tax brackets will generally pay a 0% federal tax rate on long-term gains from shares that were held for over a year before being sold. (For purposes of meeting the more-than-one-year rule for gifted shares, you get to count your ownership period plus the recipient relative's ownership period, however brief.) Even if the shares are held for one year or less before being sold, your relative will probably pay a lower tax rate than you would (typically only 10% or 15%). However, beware of one thing before employing this give-away-winner-shares strategy: Gains recognized by a relative who is under age 24 may be taxed at his or her parent's higher rates under the so-called Kiddie Tax rules (mentioned previously).

**Gifts to Charities.** The strategies for gifts to relatives work equally well for gifts to IRS-approved charities. So, sell loser shares and claim the resulting tax-saving capital loss on your return. Then, give the cash sales proceeds to the charity and claim the resulting charitable write-off (assuming you itemize).

This strategy results in a double tax benefit (tax-saving capital loss plus tax-saving charitable contribution deduction). With winner shares, give them away to charity instead of giving cash. Here is why... For publicly traded shares that you have owned over a year, your charitable deduction equals the full current market value at the time of the gift.

Plus, when you give winner shares away, you walk away from the related capital gains tax. So, this idea is another double tax-saver (you avoid capital gains tax on the winner shares, and you get a tax-saving charitable contribution write-off). Because the charitable organization is tax-exempt, it can sell your donated shares without owing anything to the IRS.

### **Convert Traditional IRA into Roth IRA**

Here is the best scenario for this idea: Your traditional IRA is (or was) loaded with equities and took a major beating during the 2008 stock market meltdown. So, your account is still worth less than it once was. Correspondingly, the tax hit from converting your traditional IRA into a Roth IRA right now would also be less than it would have been at the market peak. Why? Because a Roth conversion is treated as a taxable liquidation of your traditional IRA followed by a nondeductible contribution to the new Roth IRA. While even the reduced tax hit from converting is unwelcome, it may be a small price to pay for future tax savings. After the conversion, all the income and gains that accumulate in your Roth IRA, and all withdrawals, will be totally free of any federal income taxes—assuming you meet the tax-free withdrawal rules. In contrast, future withdrawals from a traditional IRA could be hit with tax rates that are higher than today's rates.

Of course the specifics of any one conversion are not nearly so simple. You have to be satisfied that paying the up-front conversion tax bill makes sense in your circumstances. In particular, converting a big account all at once could push you into higher 2011 tax brackets, which would not be good. You must also make assumptions about future tax rates, how long you will leave the account untouched, the rate of return earned on your Roth IRA investments, and so forth. If the Roth conversion idea intrigues you, please contact us so we can discuss whether a full analysis of the relevant variables would be worthwhile for you.

### **Make Charitable Donations from Your IRA**

IRA owners and beneficiaries who have reached age 70½ are permitted to make cash donations totaling up to \$100,000 to IRS-approved public charities directly out of their IRAs. These so-called *Qualified Charitable Distributions*, or QCDs, are federal-income-tax-free to you, but you get no itemized charitable write-off on your Form 1040. That is just fine, because the tax-free treatment of QCDs equates to an immediate 100% federal income tax deduction without having to worry about restrictions that can delay itemized charitable write-offs. QCDs have other tax advantages too. If you are interested in taking advantage of the QCD strategy for 2011, you will need to arrange with your IRA trustee for money to be paid out to one or more qualifying charities before year-end.

**Note:** The QCD provision will expire at the end of this year unless Congress extends it.

## **Watch out for Alternative Minimum Tax**

While many recent tax-law changes have been helpful in reducing your regular federal income tax bill, they do not do much to reduce the odds that you will owe the dreaded Alternative Minimum Tax (AMT). Therefore, it is critical to evaluate all tax planning strategies in light of the AMT rules before actually making any moves. Because the AMT rules are complicated and run parallel to the regular tax rules, software projections are almost always needed to account for all the variables.

## **Claim the Health Insurance Tax Credit for Small Employers**

Qualifying small employers can claim a tax credit that can potentially cover up to 35% of the cost of providing health insurance coverage to employees. A qualifying small employer is one that: (1) has no more than 25 full-time-equivalent (FTE) workers, (2) pays an average FTE wage of less than \$50,000 and (3) has a qualifying healthcare arrangement in place. The allowable credit is quickly reduced under a complicated phase-out rule when the employer has more than 10 FTE employees or an average FTE wage in excess of \$25,000. In many cases, the cost of recordkeeping and compliance outweigh the benefit. However, please contact us if you have questions about this break.

## **Take Advantage of Generous But Temporary Business Tax Breaks**

Several favorable business tax provisions have a limited shelf life that may dictate taking action between now and year-end. They include the following.

**Bigger Section 179 Deduction.** Your business may be able to take advantage of the temporarily increased Section 179 deduction. Under the Section 179 deduction privilege, an eligible business can often claim first-year depreciation write-offs for the entire cost of new and used equipment and software additions. For tax years beginning in 2011, the maximum Section 179 deduction is \$500,000 (same as for tax years beginning in 2010). For tax years beginning in 2012, however, the maximum deduction is scheduled to drop back to \$125,000.

**Note:** Watch out if your business is already expected to have a tax loss for the year (or close) before considering any Section 179 deduction, as you cannot claim a Section 179 write-off that would create or increase an overall business tax loss.

**Section 179 Deduction for Real Estate.** Real property improvement costs are generally ineligible for the Section 179 deduction privilege. However, an exception applies to tax years beginning in 2011 (and 2010). Under the exception, your business can immediately deduct up to \$250,000 of qualified improvement costs for the following types of real property under the Section 179 deduction privilege:

- Interiors of leased nonresidential buildings.
- Restaurant buildings.
- Interiors of retail buildings.

The \$250,000 Section 179 allowance for real estate improvements is part of the overall \$500,000 allowance. This temporary real estate break will not be available for tax years beginning after 2011 unless Congress extends it.

**Note:** Once again, watch out if your business is already expected to have a tax loss for the year (or close) before considering any Section 179 deduction. You cannot claim a Section 179 write-off that would create or increase an overall business tax loss.

**100% First-year Bonus Depreciation.** Above and beyond the bumped-up Section 179 deduction, your business can also claim first-year bonus depreciation equal to 100% of the cost of most new (not used) equipment and software placed in service by December 31 of this year. For a new passenger auto or light truck that is used for business and is subject to the luxury auto depreciation limitations, the 100% bonus depreciation break increases the maximum first-year depreciation deduction by \$8,000 for vehicles placed in service this year. The 100% bonus depreciation break will expire at year-end unless Congress extends it.

**Note:** 100% bonus depreciation deductions can create or increase a net operating loss (NOL) for your business's 2011 tax year. You can then carry back a 2011 NOL to 2009 and 2010 and collect a refund of taxes paid in those years. Please contact us for details on the interaction between asset additions and NOLs.

**S Corporation Built-in Gains Tax Break.** When a C corporation converts to S corporation status, the corporate-level built-in gains tax generally applies when built-in gain assets (including receivables and inventories) are turned into cash or sold within the recognition period. The recognition period is normally the 10-year period that begins on the conversion date. For tax years beginning in 2011, however, there is an exemption from the built-in gains tax if the fifth year of the recognition period had gone by before the start of the 2011 tax year. Therefore, making asset sales that would trigger built-in gains this year (instead of in future years) is something to consider if those gains would be exempt from the built-in gains tax.

**100% Gain Exclusion for Qualified Small Business Stock.** Legislation enacted in 2010 created a temporary 100% gain exclusion (within limits) for sales of Qualified Small Business Corporation (QSBC) stock that is issued in calendar-year 2011. QSBC shares must be held for more than five years to be eligible for the 100% gain exclusion break, so we are talking about sales that will occur well down the road here (in 2016 and beyond). Nevertheless, there is a short fuse on the 100% gain exclusion deal.

## **Don't Overlook Estate Planning**

For 2011 and 2012, the unified federal gift and estate tax exemption is a relatively generous \$5 million. However, the exemption will drop back to only \$1 million in 2013 unless Congress takes action. In addition, the maximum federal estate tax rate for 2011 and 2012 is 35%. For 2013 and beyond, it is scheduled to rise from the current 35% to a painfully high 55%.

Therefore, planning to avoid or minimize the federal estate tax should still be part of your overall financial game plan. Even if you already have a good plan, it may need to be updated to reflect the current \$5 million exemption, carryover provisions, etc.

## **Conclusion**

This letter is intended to give you just a few planning ideas to ponder for the rest of this tax year. Please do not hesitate to contact us if you want more details or would like to schedule a tax planning strategy session.

Very truly yours,

GORDON & ASSOCIATES, P.A., CPAs

A handwritten signature in blue ink, appearing to read "H. Gordon" with a stylized flourish.

Horace C. Gordon, IV, CPA/PFS, CFP®

HCG/lrc