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2011 Year-End Tax Planning Basics

AMT triggers

You're more likely to be subject to the AMT if you claim a large number of personal exemptions, deductible medical expenses, state and local taxes, and miscellaneous itemized deductions. Other common triggers include home equity loan interest when proceeds aren't used to buy, build, or improve your home, and the exercise of incentive stock options.

Year-end tax planning is as much about the 2012 tax year as it is about the 2011 tax year. That's because there's a real opportunity for tax savings when you can predict that you'll be paying taxes at a lower rate in one year than in the other. Of course, to effectively plan, you have to have a good understanding of not only your own financial situation, but the tax rules that apply for both years. Luckily, legislation passed in December of 2010 extended several expiring tax provisions through 2012, allowing you to consider potential year-end moves with a relative degree of certainty.

Timing income and deductions

Consider opportunities to defer income to 2012. For example, you may be able to defer a year-end bonus, or delay the collection of business debts, rents, and payments for services. Doing so may allow you to put off paying tax on the income until next year. If there's a chance that you'll be in a lower tax bracket next year, deferring income could mean paying less tax on the income as well.

Similarly, consider ways to accelerate deductions into 2011. If you itemize deductions, you might accelerate some deductible expenses like medical expenses, qualifying interest, or state and local taxes by making payments before year end. Or, you might consider making next year's charitable contribution this year instead.

If you think you'll be paying tax at a higher rate next year, consider taking the opposite tack--think about ways to accelerate income into 2011, and possibly postponing deductions until 2012.

Tax rates

The same six federal income tax rates that applied in 2010 continue to apply in both 2011 and 2012. So, depending upon your income, you'll fall into either the 10%, 15%, 25%, 28%, 33%, or 35% rate bracket. And, as in 2010, long-term capital gains and qualifying dividends continue to be taxed at a maximum rate of 15% in both 2011 and 2012; if you're in the 10% or 15% tax rate brackets, a special 0% tax rate will generally apply. So, the good news is that, unlike last year at this time, you're able to evaluate potential year-end moves with the benefit of knowing what next year's income tax rates will be. The bad news is that, while the legislation passed in December of 2010 extended current income tax rates through 2012, it only extended existing alternative minimum tax (AMT) rules through 2011.

Alternative minimum tax (AMT)

If you're subject to the AMT--essentially a separate federal income tax system with its own rates and rules--traditional year-end maneuvers, like deferring income and accelerating deductions, can actually hurt you. That's because AMT effectively disallows a number of itemized deductions, making it a significant consideration when it comes to year-end planning. For example, if you're subject to the AMT in 2011, prepaying 2012 state and local taxes won't help your 2011 tax situation, but could hurt your 2012 bottom line.

Since 2001, a series of temporary AMT "fixes" have increased AMT exemption amounts, forestalling a dramatic increase in the number of individuals ensnared by the tax. The last such fix expires at the end of 2011, however. While you can probably expect another AMT fix for 2012, as it stands now, AMT exemption amounts are set to drop significantly next year, leaving a fair degree of uncertainty as you consider your overall tax situation.

AMT Exemption Amounts	2011	2012
Married filing jointly	$74,450	$45,000
Single or head of household	$48,450	$33,750
Married filing separately	$37,225	$22,500

IRA and retirement plan contributions

Traditional IRAs (assuming that you qualify to make deductible contributions) and employer-sponsored

Qualified charitable IRA distributions

Barring additional legislation, 2011 will be the last year to take advantage of a popular provision allowing individuals age 70½ or older to make qualified charitable distributions of up to $100,000 from an IRA directly to a qualified charity. These charitable distributions can be excluded from your income, and count toward satisfying any RMDs that you would otherwise have to take from your IRA for 2011.

retirement plans such as 401(k) plans allow you to contribute funds pretax, reducing your 2011 taxable income. Contributions you make to a Roth IRA (assuming that you meet the income requirements) or a Roth 401(k) plan aren't deductible, so there's no tax benefit for 2011. However, qualified Roth distributions are completely free from federal income tax--making these retirement savings vehicles very appealing.

For 2011, the maximum amount that you can contribute to a 401(k) plan is $16,500, and you can contribute up to $5,000 to an IRA. If you're age 50 or older, you can contribute up to $22,000 to a 401(k) and up to $6,000 to an IRA. The window to make 2011 contributions to your employer plan closes at the end of the year, but you can generally make 2011 contributions to your IRA up to April 17, 2012.

Distributions from IRAs and retirement plans

Once you reach age 70½, you're generally required to start taking required minimum distributions (RMDs) from any traditional IRAs or employer-sponsored retirement plans you own (special rules apply if you continue working past age 70½ and are still participating in your employer's retirement plan). It's important to understand the distribution requirements and to make withdrawals by the date required--the end of the year for most individuals. The penalty is steep for failing to do so: 50% of the amount that should have been distributed.

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Other expiring provisions

Without additional legislation, 2011 will also be the last year to take advantage of the following tax breaks:

- *"Bonus" depreciation and IRC Section 179 expense limits:* If you're a small business owner or self-employed individual, you're allowed a first-year depreciation deduction of 100% of the cost of qualifying property acquired and placed in service during 2011; this "bonus" first-year additional depreciation deduction will drop to 50% for property acquired and placed in service during 2012. For 2011, the maximum amount that can be expensed under IRC Section 179 is $500,000, but in 2012 the limit will drop to $139,000.
- *Small business stock:* Generally, you can exclude 50% of any capital gain from the sale or exchange of qualified small business stock provided you meet certain requirements, including a five-year holding period. For qualified small business stock issued and acquired in 2011, however, you'll be able to exclude 100% of any capital gain from income if the qualified stock is held for at least five years and all other requirements are met.
- *State and local sales tax:* 2011 will be the last year individuals who itemize their deductions will be able to elect to deduct state and local general sales tax in lieu of state and local income tax.
- *Education deductions:* Both the above-the-line deduction (maximum $4,000 deduction) for qualified higher education expenses, and the above-the-line deduction for up to $250 of out-of-pocket classroom expenses paid by education professionals will not be available beginning in 2012.
- *Energy-efficient home improvements:* 2011 may be your last opportunity to claim a credit for energy-efficient improvements you make to your home. The credit can equal up to 10% of the cost of qualifying property, which can include a qualifying roof, windows, skylights, exterior doors and insulation materials. Specific credit amounts may also be available for the purchase of specified energy-efficient property including a qualified furnace or hot water boiler. There's a lifetime credit cap of $500 ($200 for windows), however. So, if you've claimed the credit in the past--in one or more years since 2005--you're only entitled to the difference between the current cap, and the amount you've claimed in the past. That includes any credit you claimed in 2009 and 2010, when the aggregate limit on the credit was $1,500.

Talk to a professional

When it comes to year-end tax planning, there's always a lot to think about. A financial professional can help you evaluate your situation, keep you apprised of any last-minute legislative changes, and determine if any year-end moves make sense for you.

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