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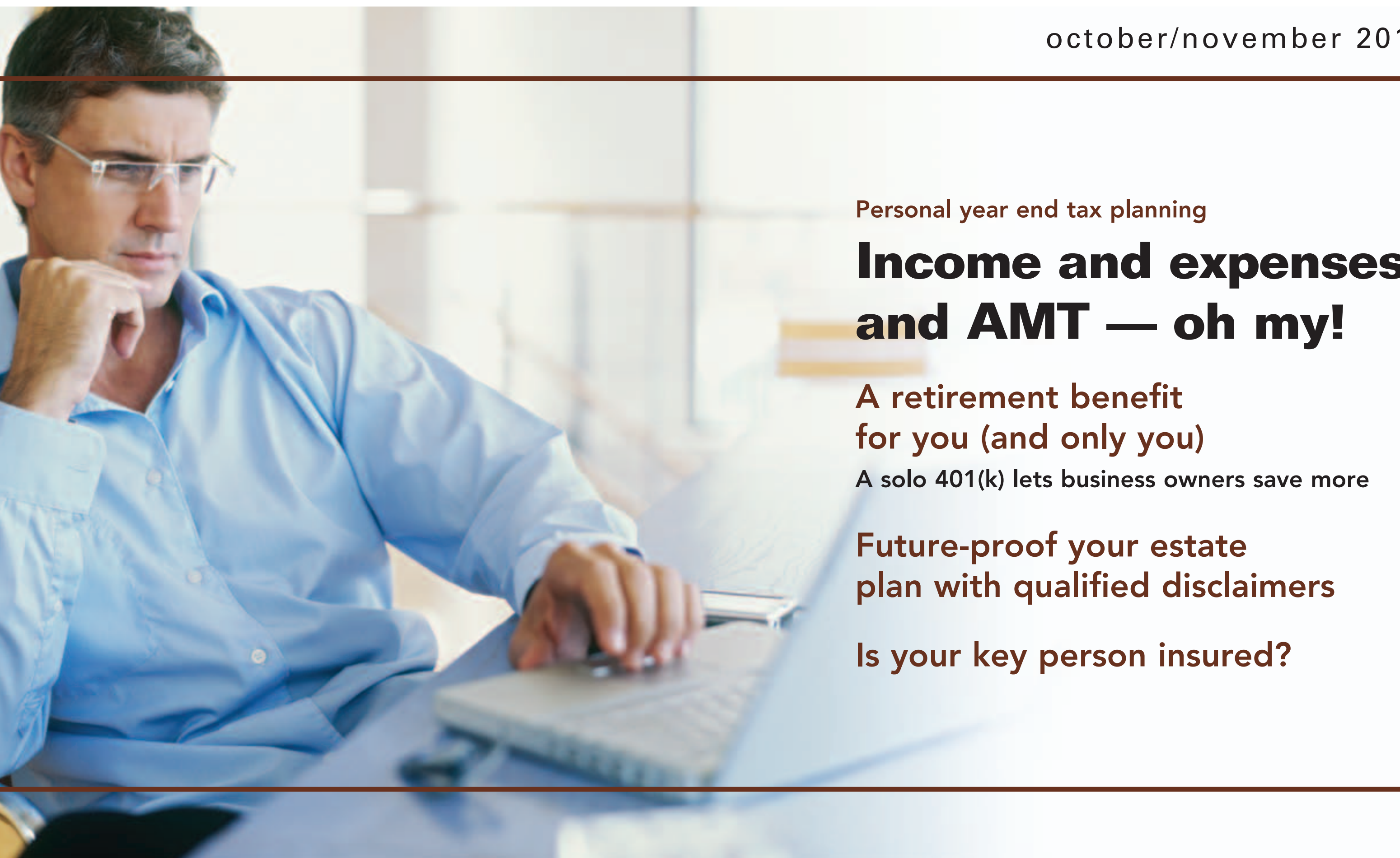

Personal year end tax planning

Income and expenses and AMT — oh my!

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Income and expenses and AMT – oh my!

As Dec. 31 approaches, it's time to think about year end tax planning. A fundamental strategy is to time income and deductible expenses to your benefit. Deferring income and accelerating expenses usually is the best option because it defers taxes to the next year. But deferral isn't always advantageous, such as if you end up in a higher tax bracket in 2012.

Further complicating matters is the alternative minimum tax (AMT). In fact, before you can decide how to best time income and expenses, you need to consider whether you're likely to be subject to the AMT this year or next.

What's the AMT's impact?

The AMT is a separate tax system that was originally designed to ensure wealthy taxpayers with "excessive" deductions would still pay some income tax. The AMT rates are lower than regular tax rates — the top AMT rate is 28% compared to the top regular tax rate of 35% — but the AMT applies to a larger income base.

For example, subject to the AMT are some income-related items that normally aren't taxed, such as certain stock option exercises and interest from certain private activity municipal bonds. In addition, the AMT doesn't allow several deductions, including some common ones such as for property tax and state and local income tax (or sales tax).

After these income adjustments are made, an AMT exemption is subtracted (if it isn't phased out because your income is too high), and the AMT rate is applied to the difference. If your AMT liability is higher than your regular tax liability, you must pay the higher amount.

In recent years, more taxpayers have been at AMT risk, in part because there's less of a difference between the top regular tax rate and the top AMT rate than there once was. Also, unlike the regular tax brackets, the AMT brackets aren't adjusted for inflation every year.

Congress has provided some relief in the form of a "patch" — which increases the AMT exemption as well as the top of its phaseout

ranges. As of this writing, however, a patch is in effect only through 2011. So if Congress doesn't extend it, there's a greater chance you could be subject to the AMT in 2012.

Projections and timing

Your tax advisor can help you project whether you're likely to be subject to the AMT this year or next, considering multiple scenarios to take into account uncertainty about 2012 AMT relief.

Also important to project is whether you'll be subject to the same or a different marginal *regular* income tax rate next year. Fortunately, this will be a little easier to predict, because rates are scheduled to remain the same for 2012. You'll need to assess only whether any changes in your financial situation could push you into a different tax bracket.

More taxpayers are at AMT risk, in part because there's now less of a difference between the top regular tax rate and the top AMT rate.

If you *don't* expect to be subject to the AMT in 2011 *or* 2012, consider the following:

- If you expect to be in the *same or a lower* regular tax bracket in 2012, defer income to 2012 and accelerate deductible expenses into 2011.
- If you expect to be in a *higher* regular tax bracket in 2012, take the opposite approach, accelerating income and deferring expenses.

If you *don't* expect to be subject to the AMT in 2011 *but* may be subject to it in 2012, these actions, where possible, may be beneficial:

- Accelerate expenses into 2011 that you won't be able to deduct for AMT purposes next year.
- Sell in 2011 private activity municipal bonds whose interest otherwise could be subject to the AMT next year.

If you *do* expect to be subject to the AMT in 2011, take the following steps where possible:

- Defer expenses to 2012 that you *can't* deduct for AMT purposes — otherwise you may lose the benefit of the deduction.
- Avoid incentive stock option exercises.

Also keep in mind that deductions are more valuable when you pay tax at a higher rate. So even if expenses can be deducted for AMT purposes, you can benefit by timing them for a year you won't be subject to the AMT.

Don't wait

Determining how to time income and expenses to your tax advantage is complicated. And we've discussed only a few of the considerations here. But proper timing can save you substantial taxes — and you must take action before year end to benefit. So don't wait to contact your tax advisor to discuss timing and other year end tax planning strategies. ◈

A retirement benefit for you (and only you)

A solo 401(k) lets business owners save more

If you're in business for yourself, it's important to invest in your retirement just as you invest in your business. A solo or individual 401(k) plan, sometimes known as the uni-k or one-participant k, allows you to sock away more than some other retirement plans do.

Rules and regulations

Solo 401(k) plans are available to both incorporated and unincorporated businesses, including sole proprietorships, partnerships and LLCs. As the name suggests, the plan is designed for businesses without employees other than the owner (and perhaps his or her spouse). If you have other employees — subject to exceptions for certain part-time and union employees — they must be included in the plan.

You can wait to establish your plan until as late as Dec. 31 of the year in which you'd like to receive the tax deduction. If your business year differs from the calendar year, you'll need to set it up by the end of your fiscal year.

What's more, with an unincorporated business you can contribute to your solo 401(k) right up until your tax filing date. For incorporated businesses, the rules are a little different: Although the "employer" portion of your contribution can be deferred until the filing date, the "employee" salary-deferral portion must be contributed by the end of the calendar year.

Contribution calculations

An advantage of the solo 401(k) is that its contribution limits are higher than those of many other qualified retirement plans. One reason is that you can contribute both as an employee, through salary deferral, and as the employer, through a percentage of either your compensation or what the IRS calls "earned income." The calculation varies depending on whether your business is structured as a corporation or as a sole proprietorship, as the examples below show.

For 2011, the contribution limit for solo 401(k)s is $49,000 — plus another $5,500 in catch-up contributions if you're age 50 or older, for a total of $54,500. (These limits double if the spouse is in the plan.)

Within these limits, the maximum salary deferral is $16,500, up to 100% of your pay. In addition, as the employer, and assuming you're incorporated, you can contribute up to 25% of your compensation, as it's defined in your 401(k) plan. Again, the total for both portions of the plan can't exceed $49,000 (or $54,500 if you're eligible to add catch-up contributions to your salary deferral).

For example, let's say that you're age 48, your business is incorporated and you earn $125,000 in salary, or what the IRS calls "W-2 wages." You can sock away $16,500 from

The Solo Roth 401(k) plan

If you're in business for yourself and want to save on an *after*-tax basis, you can use the solo 401(k) plan's cousin, the solo *Roth* 401(k) plan. As with a Roth IRA, you contribute to a solo Roth 401(k) on an after-tax basis. This means that, when you retire and withdraw funds, you won't have to worry about paying taxes on the withdrawals (assuming you're age 59½ or older and the account has been open at least five years).

One caveat: Even with a solo Roth 401(k), the employer portion of your contribution must be made pretax and go into a separate, traditional account. You'll then pay taxes on those funds when you withdraw them. You also have the option of splitting your salary-deferral contributions between a traditional solo 401(k) and a Roth solo 401(k).

your salary, plus another 25% of $125,000, or $31,250. In total, you're able to save $47,750.

If you're in business for yourself but not incorporated, the total contribution limit of $49,000 still applies. As the employee in your firm, you can contribute up to 100% of your earned income — that is, the net earnings from self-employment — to a maximum of $16,500 ($22,000 if you're age 50 or older).

An advantage of the solo 401(k) is that its contribution limits are higher than those of many other qualified retirement plans.

You also can contribute as the employer in your firm, although Uncle Sam makes this part of the calculation a little more involved. Your financial advisor can offer more information on calculating your maximum contribution.

These contribution limits allow you to save more than you can with a Savings Incentive Match Plan for Employees (SIMPLE), which tops out at $11,500 (plus another $2,500 in catch-up contributions) for 2011, along with up to 3% of your compensation. In some cases, this contribution may be limited to the first $245,000 of compensation.

With a Simplified Employee Pension (SEP) plan, your contribution limit for 2011 is limited to the lesser of $49,000 or 25% of salary. So, with the example above, your contribution limit under a SEP plan would be $31,250 (25% of $125,000).

If you decide to withdraw the money before you turn age 59½, you can do so, but you'll have to pay a 10% penalty unless you meet one of the hardship exceptions, such as a sudden disability. On top of the penalty, you'll pay income taxes on the money you withdraw.

Paperwork and costs

A solo 401(k) is most appropriate if you're confident you can take advantage of the higher contribution limits. Setting up and maintaining a solo 401(k) plan requires more paperwork than other types of plans, and that means more costs. Most providers, such as mutual fund companies, charge both a set-up fee and ongoing maintenance fees, although some will waive the fees if your account balance tops a certain amount. (You can roll over or transfer balances from other qualified plans, such as an IRA or SEP plan, into a solo 401(k) to increase the balance.)

Before signing with a provider, check the range of funds offered. Some providers limit the type of funds in which you can invest.

Save for your future

If you're a sole proprietor or self employed, a retirement plan may not be top of mind. However, a solo 401(k) plan is too valuable an opportunity to ignore. Talk to your financial advisor to see if setting up a solo 401(k) is right for you. ◈

Future-proof your estate plan with qualified disclaimers

As Jeff works to make final decisions regarding his estate plan, a thought occurs to him: What happens when my personal circumstances change? Or if federal or state tax laws change? Jeff's estate planning advisor explains that, while it's nearly impossible to prepare for every contingency, Jeff can build flexibility into his plan by taking into account the potential for his heirs to take advantage of qualified disclaimers.

Benefits of a flexible plan

How does disclaimer-based estate planning allow for more flexibility? Let's look at Jeff's situation again for an example. Jeff might leave all of his assets outright to his wife, Susan, but name a nonmarital trust or his children as contingent beneficiaries so Susan can use disclaimers to redirect a portion of those assets if her estate is likely to be subject to estate taxes.

Or, let's say Jeff's will leaves a significant inheritance to his daughter, Melissa. By the time he dies, however, Melissa has built a substantial estate of her own. If she accepts the inheritance, it will ultimately be taxed as part of her estate.

Before making a disclaimer, check to ensure it won't trigger generation-skipping transfer taxes.

With proper planning, Melissa can disclaim the inheritance and allow it to pass directly to her children (or to a trust for their benefit), avoiding double taxation. Before making a disclaimer, however, she should check to ensure it won't trigger generation-skipping transfer taxes.

What does "qualified" mean?

A disclaimer can be a powerful tool, but it requires careful planning. To avoid negative gift or estate tax consequences, a disclaimer must be "qualified." That means the disclaimer must be in writing and delivered to your estate's representative within nine months after the transfer is made (or, if later, within nine months after the beneficiary turns 21).

In addition, the person making the disclaimer (the "disclaimant") can't have accepted the property or any of its benefits, and the disclaimer must cause the property to pass — without any direction from the disclaimant — to your spouse or to someone other than the disclaimant.

For a disclaimer to work, your plan needs to set the stage by spelling out what happens

to property in the event it's disclaimed. To ensure that the property passes without any direction from the disclaimant, the terms of your will or living trust must name a contingent beneficiary.

Educate your loved ones

As beneficial as qualified disclaimers can be, it's important to keep in mind that they depend on a beneficiary voluntarily relinquishing the right to an inheritance. And your spouse or children may be reluctant to do so, even if their resources are more than sufficient to support their lifestyles. Or they might accept inherited assets without understanding the benefits of a disclaimer or recognizing that accepting the property disqualifies any future disclaimer.

You can minimize these risks by communicating with your loved ones, explaining how disclaimers can benefit the family as a whole, and educating them about the requirements for qualified disclaimers.

A powerful, flexible tool

It's almost a given that your personal circumstances — or tax law — will change after you complete your estate plan. Taking steps to enhance flexibility, such as by preparing for the potential use of qualified disclaimers, can help your estate plan weather whatever changes are on the horizon. ◈

Is your key person insured?

Quick! Name the most valuable person employed by your business.

The person you named likely is the founding owner, a senior executive, or a key research or technical professional. Regardless of position, the death of this key person would negatively impact your company. For example, it could affect your business's credit standing and ability to secure financing, result in a loss of supplier and customer confidence and, as a worst-case scenario, force the sale of the company.

To protect your business against these potential outcomes, consider buying a key person life insurance policy. The business pays for, owns and is the designated beneficiary of the policy. The premiums aren't tax deductible, but the death benefits generally will be exempt from income tax.

Many factors are considered in the cost of the policy, such as the key person's age, health and medical history. In addition, the type of policy your company buys affects the cost. A term policy of 10 to 20 years with level premiums generally is less expensive than a permanent policy. However, the latter policy type builds up cash value that can be accessed if the company needs it.

Regardless of the type of policy, should the unthinkable happen, your company could use the proceeds to compensate for lost revenue the key person otherwise would have brought in. In addition, the proceeds could be used to fulfill contractual obligations with employees, vendors and customers.

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