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# Tax Planning Basics

## Consider applicable rates and limits to better time income and expenses

The top alternative minimum tax (AMT) rate is lower than the top regular income tax rate on ordinary income (salary, business income, interest and more). (See the Chart “2011 individual income tax rate schedules,” right.) But the AMT rate typically applies to a higher taxable income base.

So if you plan only for regular income taxes, it can result in unwelcome tax surprises. Also, income-based phase-outs 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 (see the Chart “Regular tax vs. AMT: What’s deductible?,” right) and thus can trigger AMT liability. Some income items also might trigger or increase AMT liability:

- Long-term capital gains and dividend income, even though they’re taxed at the same rate 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.

Finally, in certain situations incentive stock option (ISO) exercises can trigger significant AMT liability.

2011 individual income tax rate schedules					
Tax rate	Regular tax brackets				
	Single	Head of household	Married filing jointly or surviving spouse	Married filing separately	
10%	\$ 0 – \$ 8,500	\$ 0 – \$ 12,150	\$ 0 – \$ 17,000	\$ 0 – \$ 8,500	
15%	\$ 8,501 – \$ 34,500	\$ 12,151 – \$ 46,250	\$ 17,001 – \$ 69,000	\$ 8,501 – \$ 34,500	
25%	\$ 34,501 – \$ 83,600	\$ 46,251 – \$ 119,400	\$ 69,001 – \$ 139,350	\$ 34,501 – \$ 69,675	
28%	\$ 83,601 – \$ 174,400	\$ 119,401 – \$ 193,350	\$ 139,351 – \$ 212,300	\$ 69,676 – \$ 106,150	
33%	\$ 174,401 – \$ 379,150	\$ 193,351 – \$ 379,150	\$ 212,301 – \$ 379,150	\$ 106,151 – \$ 189,575	
35%	Over \$379,150	Over \$379,150	Over \$379,150	Over \$189,575	

Tax rate	AMT brackets			
	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
Amount	\$ 48,450	\$ 48,450	\$ 74,450	\$ 37,225
Phaseout <sup>1</sup>	\$ 112,500 – \$ 306,300	\$ 112,500 – \$ 306,300	\$ 150,000 – \$ 447,800	\$ 75,000 – \$ 223,900

<sup>1</sup> The alternative minimum tax (AMT) income ranges over which the exemption phases out and only a partial exemption is available. The exemption 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.

## Regular tax vs. AMT: What’s deductible?

Expense	Regular tax	AMT
State and local income or sales tax	✓	
Real estate tax	✓	
Mortgage interest	✓	✓
Interest on home equity debt not used to improve your principal residence	✓	
Investment interest	✓	✓
Investment expenses	✓	
Professional fees	✓	
Unreimbursed employee business expenses	✓	
Medical expenses	✓	✓
Charitable contributions	✓	✓

## Avoiding or reducing AMT

With proper planning, you may be able to avoid the AMT, or at least reduce its impact — or perhaps take advantage of its lower maximum rate. But, planning for the AMT will be a challenge until Congress passes long-term relief.

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. Currently such a patch is in effect for 2011, but not for 2012.

So it's critical 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 gains into this 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 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 refundable feature can reduce the time it takes to recoup AMT paid.

## 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 this 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.

Also keep in mind that the otherwise applicable adjusted gross income (AGI) limits reducing itemized deductions were eliminated for 2010, and this elimination has been extended through 2012. If you're normally subject to the limit, your deductions may provide you more tax savings this year — as long as they don't trigger the AMT.

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, you can prepay (by December 31) real estate taxes that relate to this year but that are due next year, and deduct the payment on this year's return. But you generally can't prepay real estate taxes that relate to next year and deduct the payment on this year's return.

## Miscellaneous itemized 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."

Carefully record your potential deductions throughout the year. If as the year progresses they get close to or start to exceed the 2% floor — and you don't expect to be subject to the AMT this year — consider paying accrued expenses and incurring and paying additional expenses by December 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.

### AMT ALERT!

Miscellaneous itemized deductions aren't deductible for AMT purposes and thus can trigger the AMT — or increase AMT liability. So don't bunch such expenses into a year you may be subject to the AMT.

## Health care breaks

Medical expenses are another deduction you may be able to bunch. If your medical expenses exceed 7.5% of your AGI, you can deduct the excess amount. Eligible expenses include:

- Health insurance premiums,
- Long-term care insurance premiums (limits apply),
- Medical and dental services, and
- Prescription drugs.

Consider bunching nonurgent medical procedures and other controllable expenses into one year to exceed the 7.5% floor. 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.

Also remember that expenses that are reimbursed (or reimbursable) by insurance or paid through one of the following accounts aren't deductible:

**HSA.** If you're covered by qualified high-deductible health insurance, a Health Savings Account allows 2011 contributions of pretax income (or deductible after-tax contributions) up to \$3,050 for self-only coverage and \$6,150 for family coverage. (The limits will be \$3,100 and \$6,250, respectively, for 2012.) Moreover, account holders age 55 and older can contribute an additional \$1,000.

HSAs bear interest or are invested and can grow tax-deferred similar to an IRA. Withdrawals for qualified medical expenses are tax-free, and you can carry over a balance from year to year.

**FSA.** You can redirect pretax income to an employer-sponsored Flexible Spending Account up to an employer-determined limit. The plan pays or reimburses you for medical expenses not covered by insurance. (If you have an HSA, your FSA is limited to funding certain "permitted" expenses.) What you don't use by the end of the plan year, you generally lose.

**Warning:** Beginning in 2011, you no longer can use HSA or FSA funds to pay for over-the-counter drugs unless they're prescribed.

## Sales tax deduction

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 taxpayers residing in states with no or low income tax rates or who purchase major items, such as a car or boat. If you're considering such a purchase, you may want to make it by December 31, 2011, in case the break isn't extended to 2012.

## Employment taxes

In addition to income tax, you must pay Social Security and Medicare taxes on earned income, such as salary and bonuses. For 2011 only, the employee portion of the Social Security tax on earned income has been reduced from 6.2% to 4.2%. 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 Social Security tax break essentially replaces), no other income-based limit applies. So even high-income taxpayers can enjoy the maximum benefit.

**Warning:** All earned income is subject to the 2.9% Medicare tax (split equally between the employee and the employer).

## Self-employment taxes

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.

However, for 2011 the self-employed's rate for the Social Security portion is also reduced by two percentage points, from 12.4% to 10.4%. This doesn't reduce a self-employed individual's deduction for the employer's share of these taxes — you can still deduct the full 6.2% employer portion of Social Security tax, along with one-half of the Medicare tax, for a full 7.65% deduction.

## Employment taxes for owner-employees

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 taxes — even if the income isn't actually distributed to you. But such income isn't subject to self-employment taxes if you're a limited partner or an LLC member whose ownership is equivalent to a limited partnership interest.

**S corporations.** Only income you receive as salary is subject to employment taxes. So to reduce these taxes, 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 would be paid to an outside individual performing the same services for your company.

**C corporations.** Only income you receive as salary is subject to employment taxes. 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, 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 (especially 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 as year end approaches you determine you've underpaid, consider having the tax shortfall withheld from your salary or year end bonus by December 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. •

# Investing

## 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, tax planning for investments is always complicated. So, although tax considerations shouldn’t be the primary driver of investment decisions, make sure you consider the potential tax consequences of your decisions 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, left, “What’s the maximum capital gains tax rate?”)





Holding on to an investment until you’ve owned it more than a year may help substantially cut tax on any gain. Fortunately, the 15% rate, which was set to expire after 2010, has been extended through 2012. But without Congressional action, in 2013 the capital gains rate will rise to 20%. So there may be actions you’ll want to take now to lock in lower rates while they’re still available.

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.

### What’s the maximum capital gains tax rate?

Maximum tax rate for assets held	2011–2012	2013
12 months or less ( <i>short term</i> )	35%	39.6%
More than 12 months ( <i>long term</i> )	15%	20%

Some key exceptions	2011–2012	2013
 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% <sup>1</sup>	14% <sup>1</sup>
 Long-term gain that would be taxed at 15% or less based on the taxpayer’s ordinary-income rate	0%	10%

<sup>1</sup> Effective rate based on 50% exclusion from a 28% rate.

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 consider selling them to offset your gains.

## AMT ALERT!

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

## 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, before selling the security, you can purchase additional shares of that security equal to the number you want to sell at a loss, 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. Thus, you achieve a tax loss with virtually no change in economic position.

## 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 to future years 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. They'll be even more powerful if rates go up in 2013.

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.

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

## The 0% rate

Through 2012, 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.

**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'" in the Family and Education section") Also, consider any gift tax consequences.

## 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 — and increase your basis accordingly — 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.

## 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 as long as they've held the stock for at least five years. But, depending on the acquisition date, the exclusion may be greater. (See chart, right: "What's new! 100% gain exclusion for certain small business stock purchased by December 31.")

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 on page 7, "What's the maximum capital gains tax rate?") Thus, if the 28% rate and the 50% exclusion apply, the effective rate on the QSB gain will be 14% ( $28\% \times 50\%$ ).

## What's new!

100% gain exclusion for certain small business stock purchased by Dec. 31

**Who's affected:** Investors considering small business stock.

**Key changes:** Generally, taxpayers selling qualified small business (QSB) stock are allowed to exclude up to 50% of their gain if they've held the stock for more than five years. Because the 50% exclusion is computed based on an old tax rate of 28%, the 14% rate is only slightly less than the rate for other long-term gains. But under 2010 tax legislation, the exclusion is 100% for stock acquired after Sept. 27, 2010, and before Jan. 1, 2012. (If the stock was acquired after Feb. 17, 2009, and before Sept. 28, 2010, the exclusion is 75%.) The five-year holding requirement still applies.

**Planning tips:** You may want to purchase QSB stock by year end so you can potentially take advantage of the 100% gain exclusion. But keep in mind that the tax benefits are subject to additional requirements. Consult your tax and financial advisors to be sure investing in QSB stock is right for you.

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" in the Real Estate section") 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), possible changes in IRS regulations may reduce the number of hours you must be involved. Check with your tax advisor for more 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, so that you don't meet the 500 hours test, 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 from a tax perspective than other income investments, such as CDs and bonds. And you now have through 2012 to take advantage of the 15% rate.

But there are exceptions.

First, 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.

Second, 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.

## AMT ALERT!

Tax-exempt interest from private activity municipal bonds can trigger or increase AMT liability. However, the American Recovery and Reinvestment Act of 2009 excluded from the AMT 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.

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.

## 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 gain 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 offers many benefits — including tax savings

Although the real estate market has its ups and downs, real estate can be a valuable investment — whether it's your home or vacation home or a rental or investment property. (For information on some temporary breaks for owners of leasehold, restaurant or retail properties, see “What's new! Depreciation-related breaks extended and expanded” on the next page.) 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 make the most of available tax breaks:

**Property tax deduction.** If you're looking to accelerate or defer deductions, property tax is one expense you may be able to time. You can choose to pay your bill for this year that's due early next year by December 31, and deduct it this year. Or you can wait until the due date and deduct it next year.

**Mortgage interest deduction.** You generally can deduct (for both regular tax and AMT purposes) 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.

**Home-office deduction.** Many rules apply.

**Debt forgiveness exclusion.** Homeowners who receive debt forgiveness in a foreclosure or a mortgage workout for a principal residence generally don't have to pay federal income taxes on that forgiveness.

**Energy-related breaks.** A wide variety of breaks designed to encourage energy efficiency and conservation are available. Consult your tax advisor for details.

#### AMT ALERT!

Property tax isn't deductible for AMT purposes. If you're subject to the AMT this year, a prepayment will hurt you rather than help you because you'll lose the benefit of the deduction.

#### 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 won't be 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. Exactly what you can deduct depends on whether the home is classified as rental property for tax purposes (based on the amount of personal vs. rental use):

**Nonrental property.** 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.

**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.

## 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 through an installment sale or a Section 1031 exchange.

Or you may be able to deduct a loss, but only to the extent attributable to a decline in value *after* the conversion.

### What's new!

#### Depreciation-related breaks extended and expanded

**Who's affected:** Owners of leasehold, restaurant or retail properties.

**Key changes:** Three depreciation-related breaks have been significantly enhanced:

- **Bonus depreciation.** Qualified leasehold-improvement property — if *new* — is eligible for bonus depreciation, and the 2010 Tax Relief act increases this additional first-year depreciation allowance to 100% for property acquired and placed in service after Sept. 8, 2010, and before Jan. 1, 2012. For property acquired and placed in service in 2012, bonus depreciation is scheduled to return to 50%. And it will expire after 2012 if Congress doesn't take action.
- **Section 179 expensing.** For 2011 (but not for 2012), the Small Business Jobs Act of 2010 allows you to expense under Sec. 179 (rather than depreciate over a number of years) up to \$250,000 of qualified leasehold-improvement, restaurant and retail-improvement property. The break begins to phase out dollar for dollar when total asset acquisitions for the tax year exceed \$2 million. But unlike bonus depreciation, Sec. 179 expensing can be applied to *used* property.
- **Accelerated depreciation.** The 2010 Tax Relief act extends through 2011 the accelerated depreciation (a shortened recovery period of 15, rather than 39, years) available for qualified leasehold-improvement, restaurant and retail-improvement property. This might be beneficial for property ineligible for bonus depreciation and in excess of the Sec. 179 expensing limits.

**Planning tips:** If you're anticipating investments in qualified property in the next year or two, you may want to time them so you can benefit from the enhanced breaks available for 2011.

## 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; 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.

## 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 about future capital gains rates — if rates go up, tax deferral could be costly. (See chart on page 7, "What's the maximum capital gains tax rate?"). 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 from 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. •

# Business and Executive Compensation

## Are you doing all you can to save tax?

No business wants to pay more tax than it has to, yet many do just that. Some don't take advantage of all the breaks available to them; others fail to plan, paying tax that could be deferred or falling into tax traps. If you *own* the business, it's likely your biggest investment, so thinking about long-term considerations, such as your exit strategy, is critical as well. And if you're an executive, you likely have to think about not only the company's taxes, but also tax considerations related to compensation you receive beyond salary and bonuses, such as stock options.

## Projecting income

Projecting your business's income for this year and next will allow you to time income and deductions to your advantage. It's generally better to defer tax. So if you expect to be in the same or a lower tax bracket next year, consider:

**Deferring income to next year.** If your business uses the cash method of accounting, you can defer billing for your products or services. Or, if you use the accrual method, you can delay shipping products or delivering services.

**Accelerating deductions into the current year.** If you're a cash-basis taxpayer, you may want to make an estimated state tax payment before December 31, so you can deduct it this year rather than next. But consider the alternative minimum tax (AMT) consequences first. Both cash- and accrual-basis taxpayers can charge expenses on a credit card and deduct them in the year charged, regardless of when paid.

**Warning:** Think twice about these strategies if you're experiencing a low-income year. Their negative impact on your cash flow may not be worth the potential tax benefit. And, if it's likely you'll be in a higher tax bracket next year, the opposite strategies (accelerating income and deferring deductions) may save you more tax.

## Depreciation

For assets with a useful life of more than one year, you generally must depreciate the cost over a period of years. In most cases the Modified Accelerated Cost Recovery System (MACRS) will be preferable to the straightline method because you'll get a larger deduction in the early years of an asset's life.

But if you make more than 40% of the year's asset purchases in the last quarter, you could be subject to the typically less favorable midquarter convention. Careful planning during the year can help you maximize depreciation deductions in the year of purchase.

Other depreciation-related breaks and strategies also are available:

**Bonus depreciation.** The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 encourages businesses to invest by significantly enhancing bonus depreciation. (See "What's new! 100% bonus depreciation provides strong incentive to invest in your business this year" on the next page)

**Section 179 expensing election.** Business owners can use this election to deduct (rather than depreciate over a number of years) the cost of purchasing such assets as equipment, furniture and off-the-shelf computer software. For 2011, the expensing limit is \$500,000.

The break begins to phase out dollar for dollar when total asset acquisitions for the tax year exceed \$2 million. You can claim the election only to offset net income, not to reduce it below zero.

Before the 2010 Tax Relief act, the Section 179 expensing limit was scheduled to drop to \$25,000 in 2012, with a phaseout threshold of \$200,000. The act increases the 2012 limits to \$125,000 and \$500,000, respectively, and both amounts will be indexed for inflation.

Sec. 179 may be less important while 100% bonus depreciation is available. Depending on the type of asset, 100% bonus depreciation may provide the same tax savings — without any net income requirement or limit on asset purchases. But only Sec. 179 expensing can be applied to *used* assets, and you'll also want to consider state tax consequences.

**Cost segregation study.** If you've recently purchased or built a building or are remodeling existing space, consider a cost segregation study. It identifies property components and related costs that can be depreciated much faster and dramatically increase your current deductions. Typical assets that qualify include decorative fixtures, security equipment, parking lots, landscaping and architectural fees allocated to qualifying property.

The benefit of a cost segregation study may be limited in certain circumstances — for example, if the business is subject to the AMT or located in a state that doesn't follow federal depreciation rules.

## Manufacturers' deduction

The manufacturers' deduction, also called the Section 199 or domestic production activities deduction, has been fully phased in and is now 9% of the lesser of qualified production activities income or taxable income. The deduction is also limited by W-2 wages paid by the taxpayer that are allocable to domestic production gross receipts.

The deduction is available to traditional manufacturers and to businesses engaged in activities such as construction, engineering, architecture, computer software production and agricultural processing. The deduction isn't allowed in determining net earnings from self-employment and generally can't reduce net income below zero. But it can be used against the AMT.

## Vehicle-related tax breaks

Business-related vehicle expenses can be deducted using the mileage-rate method (51 cents per business mile driven January 1 through June 30, 2011, and 55.5 cents per mile driven July 1 through December 31, 2011) or the actual-cost method (total out-of-pocket expenses for fuel, insurance and repairs, plus depreciation).

### What's new!

100% bonus depreciation provides strong incentive to invest in your business this year

**Who's affected:** Businesses that have made or are considering asset purchases.

**Key changes:** The 2010 Tax Relief act significantly enhances bonus depreciation by temporarily increasing this additional first-year depreciation allowance to 100% and providing a 50% allowance for 2012. (See the chart below.) Qualified assets include *new* tangible property with a recovery period of 20 years or less (such as office furniture, equipment and company-owned vehicles), off-the-shelf computer software, water utility property and qualified leasehold-improvement property.

The act also extends the provision allowing corporations to accelerate certain credits in lieu of claiming bonus depreciation for qualified assets acquired and placed in service through Dec. 31, 2012 (Dec. 31, 2013, for certain long-lived and transportation property).

**Planning tips:** Bonus depreciation will benefit more taxpayers than Section 179 expensing, because it isn't subject to any asset purchase limits. However, unlike Sec. 179 expensing, bonus depreciation isn't available for *used* property. If you're anticipating major purchases of assets in the next year or two that would qualify, you may want to time them so you can benefit from 100% bonus depreciation.

Qualified assets acquired and placed in service	Bonus depreciation
Jan. 1, 2008, through Sept. 8, 2010	50%
Sept. 9, 2010, through Dec. 31, 2011	100%
Jan. 1, 2012, through Dec. 31, 2012	50%
After Dec. 31, 2012	none

*Note: Later deadlines apply to certain long-lived and transportation property.*

Purchases of *new or used* vehicles may be eligible for Sec. 179 expensing, and purchases of new vehicles may be eligible for bonus depreciation. However, many rules and limits apply. For example, under Sec. 179 expensing, you can deduct up to \$25,000 of the purchase price of an SUV that weighs more than 6,000 pounds but no more than 14,000 pounds. The normal Sec. 179 expensing limits generally apply to vehicles weighing more than 14,000 pounds.

Vehicles weighing 6,000 pounds or less don't satisfy the SUV definition and thus are subject to the passenger automobile limits. For autos placed in service in 2011, the depreciation limit is \$3,060. The limit is increased by \$8,000 for autos eligible for bonus depreciation. The amount that may be deducted under the combination of MACRS depreciation, Sec. 179 and bonus depreciation rules for the first year is limited under the luxury auto rules.

In addition, if a vehicle is used for business and personal purposes, the associated expenses, including depreciation, must be allocated between deductible business use and nondeductible personal use. The depreciation limit is reduced if the business use is less than 100%. If business use is 50% or less, you can't use Sec. 179 expensing, bonus depreciation or the accelerated regular MACRS; you must use the straightline method.

## Employee benefits

Including a variety of benefits in your compensation package can help you not only attract and retain the best employees, but also manage your tax liability:

**Qualified deferred compensation plans.** These include pension, profit-sharing, SEP and 401(k) plans, as well as SIMPLEs. You can enjoy a tax deduction for your contributions to employees' accounts, and the plans offer tax-deferred savings benefits for employees. Small employers (generally those with 100 or fewer employees) that create a retirement plan may be eligible for a \$500 credit per year for three years. The credit is limited to 50% of qualified startup costs.

**HSAs and FSAs.** If you provide employees with qualified high-deductible health insurance, you can also offer them Health Savings Accounts. Regardless of the type of health insurance you provide, you also can offer Flexible Spending Accounts.

**Fringe benefits.** Some fringe benefits, such as group term-life insurance (up to \$50,000), health insurance, parking and mass transit / van pooling (up to \$230 per month), and employee discounts, aren't included in employee income. Yet the employer still receives a deduction and typically avoids payroll tax as well.

Certain small businesses providing health care coverage to their employees may be eligible for a new tax *credit* that became available in 2010. Remember, tax credits are more powerful than deductions because they provide dollar-for-dollar savings.

**NQDC.** Nonqualified deferred compensation plans generally aren't subject to nondiscrimination rules, so they can be used to provide substantial benefits to executives and other key employees. But the employer generally doesn't get a deduction for NQDC plan contributions until the employee recognizes the income.

## NOLs

A net operating loss occurs when operating expenses and other deductions for the year exceed revenues. Generally, an NOL may be carried back two years to generate a refund. Any loss not absorbed is carried forward up to 20 years.

Carrying back an NOL may provide a needed influx of cash. But carrying the entire loss forward can be more beneficial in some situations.

## Tax credits

Tax credits reduce your business's tax liability dollar-for-dollar, making them particularly valuable. Numerous types of credits are available to businesses. Here are a few that have been extended or created by recent legislation:

**Research credit.** The 2010 Tax Relief act extended the research credit (also commonly referred to as the "research and development" or "research and experimentation" credit) through 2011, and there's been much discussion about making it permanent. The credit generally is equal to a portion of qualified research expenses. It's complicated to calculate, but savings can be substantial, so consult your tax advisor.

**Work Opportunity credit.** The 2010 Tax Relief act also extended the Work Opportunity credit through December 31, 2011. It benefits businesses hiring employees from certain disadvantaged groups, such as ex-felons, food stamp recipients and disabled veterans. (Note that the act did *not* extend the provision expanding the eligible groups to include unemployed veterans and disconnected youth.) The credit equals 40% of the first \$6,000 of wages paid to qualifying employees (\$12,000 for wages paid to qualified veterans). For information on the subsequent extension and expansion of the Work Opportunity credit for hiring qualified veterans, see the "VOW to Hire Heroes Act of 2011" Tax Act Summary, included as a supplement at the end of the Guide.

**Health care coverage credit for small businesses.** For tax years 2010 to 2013, the maximum credit is 35% of group health coverage premiums paid by the employer. To get the credit, you must contribute at least 50% of the total premium or of a benchmark premium. The full credit is available for employers with 10 or fewer full-time equivalent employees (FTEs) and average annual wages of less than \$25,000 per employee. Partial credits are available on a sliding scale to businesses with fewer than 25 FTEs and average annual wages of less than \$50,000.

**Retention credit.** If you hired workers in 2010, you may be eligible for a retention credit. It generally applies to workers who qualified for payroll tax forgiveness under the Hiring Incentives to Restore Employment (HIRE) Act of 2010 and are retained for 52 consecutive weeks. The tax savings per qualified retained worker are equal to the lesser of 6.2% of wages paid to the worker during the 52-week retention period or \$1,000.

**Energy-related credits.** The 2010 Tax Relief act extends certain energy-related incentives. While most typically apply to either home builders or manufacturers of energy-efficient appliances, there are some that are more generally applicable. For example, if you buy or lease hybrid or lean-burn-technology vehicles, you may be able to claim tax credits, but these credits phase out once a certain number of a particular vehicle has been sold.

**Other credits.** The 2010 Tax Relief act also extended the empowerment zone tax credit, as well as certain disaster relief credits for the Gulf Opportunity Zone.

## Business structure

Income taxation and owner liability are the main factors that differentiate one business structure from another. Many businesses choose entities that combine flow-through taxation with limited liability, namely limited liability companies (LLCs) and S corporations. See “Tax differences based on business structure”, right, to compare the tax treatment for pass-through entities vs. C corporations. Also see “2011 individual income tax rate schedules” (page 2) and “2011 corporate income tax rate schedule,” below. Sometimes it makes sense to change business structures, but there may be unwelcome tax consequences, so be sure to consult your tax advisor.

### Tax differences based on business structure

Pass-through entity or sole proprietorship	C corporation
One level of taxation: The business's income flows through to the owner(s).	Two levels of taxation: The business is taxed on income, and then shareholders are taxed on any dividends they receive.
Losses flow through to the owner(s).	Losses remain at the corporate level.
Top individual tax rate is 35%.	Top corporate tax rate is generally 35%. Dividends are generally taxed at 15%.

Some tax differences between structures may provide planning opportunities, such as those related to salary vs. distributions.

## 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:

### 2011 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.



**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.

A key issue with any buy-sell agreement is providing the buyer(s) 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, and valuation discounts may further reduce the taxable value. On top of that, for 2011, the lifetime gift tax exemption is \$5 million, compared to \$1 million for 2010. You also can leverage your \$13,000 annual gift tax exclusions.

**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.

**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 December 31, 2012.)

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

## Incentive stock options

If you're an executive with a larger company, you may receive incentive stock options (ISOs). 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, 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* 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. A future AMT credit, however, may mitigate this AMT hit.

If you've received ISOs, plan carefully when to exercise them and whether to immediately sell shares received from an exercise or 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. See the Chart "ISOs vs. nonqualified stock options" on the next page for a direct comparison.

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 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.

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

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

ISOs vs. nonqualified stock options	
Tax treatment at exercise	Tax treatment at stock sale
<p><b>ISOs:</b> No regular tax, but an AMT preference item is created on the bargain element (difference between FMV on exercise date and exercise price)</p> <p><i>Example</i><sup>1</sup>: <math>\\$30,000 - \\$10,000 = \\$20,000</math>  <math>\\$20,000 \times 28\% = \\$5,600^2</math> tax</p>	<p><b>ISOs:</b> Difference between sale price and exercise price taxed at long-term capital gains rate (generally 15%)<sup>3</sup></p> <p><i>Example</i><sup>1</sup>: <math>\\$50,000 - \\$10,000 = \\$40,000</math>  <math>\\$40,000 \times 15\% = \\$6,000</math> tax</p>
<p><b>ISO disqualifying disposition</b><sup>4</sup>: NA</p> <p><i>Example</i><sup>1</sup>: NA</p>	<p><b>ISO disqualifying disposition</b><sup>4</sup>: Difference between sale price and exercise price taxed at ordinary-income rate</p> <p><i>Example</i><sup>1</sup>: <math>\\$50,000 - \\$10,000 = \\$40,000</math>  <math>\\$40,000 \times 35\% = \\$14,000</math> tax</p>
<p><b>Nonqualified stock options:</b> Bargain element taxed at ordinary-income rate</p> <p><i>Example</i><sup>1</sup>: <math>\\$30,000 - \\$10,000 = \\$20,000</math>  <math>\\$20,000 \times 35\% = \\$7,000</math> tax</p>	<p><b>Nonqualified stock options:</b> Difference between sale price and FMV on exercise date taxed at applicable capital gains rate</p> <p><i>Example</i><sup>1</sup>: <math>\\$50,000 - \\$30,000 = \\$20,000</math>  <math>\\$20,000 \times 15\%^3 = \\$3,000</math> tax</p>

<sup>1</sup> Assumes exercise price is \$10,000, FMV on exercise is \$30,000 and FMV at stock sale is \$50,000, and that tax is applied at the top 2011 rate.  
<sup>2</sup> Only if you're subject to the AMT for the year of exercise. A tax credit may be available in a future year.  
<sup>3</sup> Assumes necessary holding period has been met for long-term capital gains treatment.  
<sup>4</sup> Stock is sold before it can qualify for long-term capital gains treatment.

One important NQDC tax issue is that employment taxes are generally due once services have been performed and there's no longer a substantial risk of forfeiture — even 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 are tighter than they once were, and 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. •

# Family and Education

## Make tax planning a family affair

Many tax breaks are available to families. Whether it's a tax credit or tax-advantaged savings opportunity, or it's for child care or education expenses, there's something for just about everybody. And by making tax planning a family affair, you not only can save taxes, but also teach children from an early age the value of earning and saving money.

### Tax credits

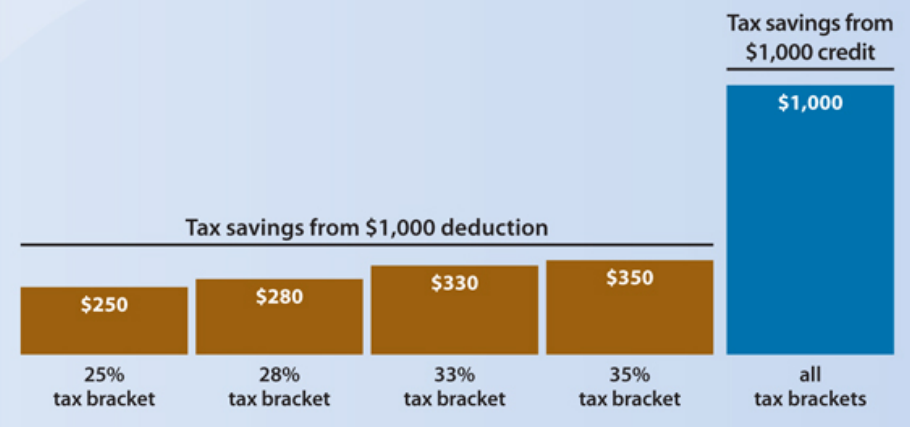
Tax credits reduce your tax bill dollar-for-dollar. (See the chart, right, "Tax deductions vs. credits: What's the difference?") So make sure you're taking every credit you're entitled to:

- For each child under age 17 at the end of the year, you may be able to claim a \$1,000 credit. But the credit phases out for higher-income taxpayers; check with your tax advisor for details.
- For children under age 13 (or other qualifying dependents), you may be eligible for a credit for a portion of your dependent care expenses. Eligible expenses are limited to \$3,000 for one dependent, \$6,000 for two or more. The maximum credit is generally 20% of eligible expenses, which is \$600 for one dependent and \$1,200 for more than one dependent.
- If you adopt, you may be able to take a credit or use an employer adoption assistance program income exclusion; both are limited to \$13,360 for 2011. An income-based phaseout also applies.

#### Tax deductions vs. credits: What's the difference?

Both deductions and credits can be powerful tax-saving tools, but they work differently. A *tax deduction* reduces the amount of income that's taxed and thus becomes more valuable the higher the tax bracket. A *tax credit* reduces the actual tax you owe dollar-for-dollar, providing much more tax savings than a deduction of an equal amount. But many deductions and credits are subject to income-based limits that reduce or eliminate the tax savings for higher-income taxpayers.

Let's take a look at how the tax savings can differ, assuming that no income-based limits apply:



### Dependent care FSA

You can redirect up to \$5,000 of pretax income to an employer-sponsored child and dependent care Flexible Spending Account. The plan then pays or reimburses you for child and dependent care expenses. You can't claim a tax credit for expenses reimbursed through an FSA.

## Employing your children

If you own a business, consider hiring your children. As the business owner, you can deduct their pay, and other tax benefits may apply. They can earn as much as the standard deduction for singles (\$5,800 for 2011) and pay zero federal income tax. They can earn an additional \$5,000 without paying current tax if they contribute it to a traditional IRA.

**Warning:** They must perform actual work and be paid in line with what you'd pay nonfamily employees for the same work.

## Roth IRAs for teens

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

The 2011 contribution limit is 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 (\$5,800 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 probably 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.

## 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 under age 19, 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 2011) is taxed at their parents' marginal rate rather than their own, likely lower, rate. Keep this in mind before transferring assets to them.

## 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 is 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 precollege 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 may be subject to tax and a 10% penalty.

## 529 plan pluses and minuses

529 college savings plans can be used to pay a student's qualified expenses at most postsecondary educational institutions. (Be aware that the provision that expanded the definition of "qualified expenses" to also include computers, computer technology and Internet service expired after 2010.)

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-based 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 of prepaid tuition plans 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 savings plan or prepaid tuition program.

## 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 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.

## Education credits

When your child enters college, you may be able to claim the American Opportunity credit (an expanded version of what was previously known as the Hope credit). It 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, but an income-based phaseout applies. The credit has been extended through 2012.

If you're paying postsecondary education expenses beyond the first four years, check whether you're eligible for the Lifetime Learning credit (up to \$2,000 per tax return). An income-based phaseout also applies.

Both a credit and tax-free 529 plan or ESA distribution can be taken as long as expenses paid with the distribution aren't used to claim the credit.

If you don't qualify for one of the credits because your income is too high, your child might. 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 income anyway, so this decision may have been an easy one. But through 2012, that income limit has been lifted. So you'll need to work with your tax advisor to see whether the exemption or the credit will provide more tax savings overall for your family.

## Education-related deductions

If you don't qualify for one of the credits, you might be eligible to *deduct* up to \$4,000 of qualified higher education tuition and fees. This break has been extended through 2011. The deduction is limited to \$2,000 for taxpayers with incomes exceeding certain limits and is unavailable to taxpayers with higher incomes.

If you're paying off student loans, you may be able to deduct up to \$2,500 of interest (per tax return). An income-based phaseout applies. •

# Charitable Giving

## Provide support and save taxes with this powerful tool

Donations to qualified charities are generally fully deductible. So not only can they provide much-needed support to causes you care about, but they also can be a powerful tax-saving tool. 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 adjusted gross income (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.

### 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, although limited, 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.

### Other types of donations

Gifts of cash are simple and gifts of stock can be tax-smart, but many taxpayers make other types of donations, such as vehicles, collectibles, services and even use of property. For an overview of the deductibility of various types of donations, see the Chart "What's your donation deduction?" on the next page.

#### AMT ALERT!

Charitable contribution deductions are allowed for AMT purposes, but your tax savings may be less if you're subject to the AMT. For example, if you're in the 35% tax bracket for regular tax purposes, but the 28% tax bracket for AMT purposes, your deduction may be worth only 28% instead of 35%.

## 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 or a donor-advised fund.

## 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.

### What's your donation deduction?



**Cash.** This also includes gifts made by check, credit card or payroll deduction. You may deduct 100%.



**Long-term capital gains property.** This might be stocks or bonds held more than one year. You may deduct the current fair market value.



**Ordinary-income property.** Examples include stocks and bonds held one year or less, inventory, and property subject to depreciation recapture. You generally may deduct only the lesser of fair market value or your tax basis.



**Tangible personal property.** Your deduction depends on the situation:

- If the property *isn't* related to the charity's tax-exempt function (such as an antique donated for a charity auction), your deduction is limited to your basis.
- If the property *is* related to the charity's tax-exempt function (such as an antique donated to a museum for its collection), you can deduct the fair market value.



**Use of property.** Examples include use of a vacation home and a loan of artwork. Generally, you receive no deduction because it isn't considered a completed gift. There may, however, be ways to structure the gift to enable you to get a deduction.



**Services.** You may deduct only your out-of-pocket expenses, not the fair market value of your services. You can deduct 14 cents per charitable mile driven.



**Vehicle.** Unless it's being used by the charity, you generally can deduct only the amount the charity receives when it sells the vehicle.



**IRA funds.** If you're age 70½ or older, you can distribute up to \$100,000 from your IRA (Roth or traditional) directly to charity. No charitable deduction is allowed for any amount that would otherwise have been taxable, but you save the tax you would otherwise have owed. A donation from your traditional IRA can be used to help satisfy your required minimum distribution.

*Note: Your 2011 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.*

- 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 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.

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

# Retirement

## Ensuring your retirement dreams materialize

Whatever your age, you must plan carefully to ensure your retirement dreams materialize. This means leveraging tax-advantaged savings opportunities. Starting contributions early can make a big difference; older taxpayers may need to save more to make up for lost time. It also means avoiding early withdrawals and being tax-smart with required minimum distributions.

## 401(k)s and other employer plans

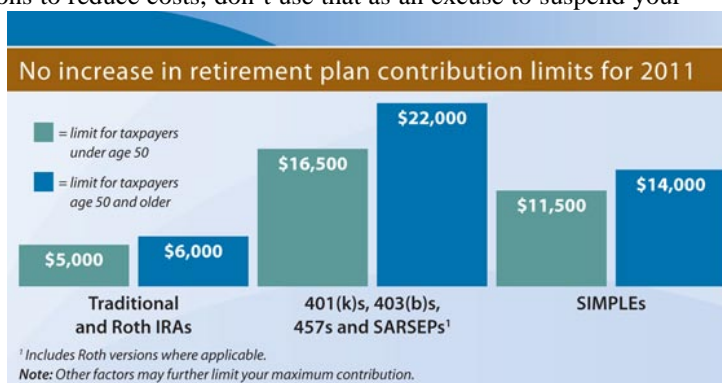
Contributing to an employer-sponsored defined-contribution plan, such as a 401(k), 403(b), 457, SARSEP or SIMPLE, is usually the best first step in retirement planning:

- 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.

See “No increase in retirement plan contribution limits for 2011” graph below for the 2011 limit for employee contributions to 401(k), 403(b), 457 and SARSEP plans. If you’re age 50 or older, you may be able to make an additional “catch-up” contribution. If your employer offers a match, contribute at least the amount necessary to get the maximum employer match and avoid missing out on that “free” money.

If your employer has suspended matching contributions to reduce costs, 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 income for the year will increase compared to what it would be if you had contributed to the plan.

If your employer provides a SIMPLE, it’s required to make contributions (though not necessarily annually). But the employee contribution limits are lower than for other employer-sponsored plans.



## Traditional IRA

If your employer doesn’t offer a retirement plan, consider a traditional IRA. You can likely deduct your contributions, though your deduction may be limited based on your adjusted gross income (AGI) if your spouse participates in an employer-sponsored plan. You can make contributions for 2011 as late as April 16, 2012.

## Roth accounts

A potential downside of tax-deferred saving is that you’ll have to pay taxes when you make withdrawals at retirement. Two retirement plan options allow tax-free distributions; the tradeoff is that contributions to these plans don’t reduce your current-year taxable income:

1. **Roth IRAs.** In addition to tax-free distributions, an important benefit is that, unlike other retirement plans, Roth IRAs don’t require you to take distributions during your lifetime. This can provide estate planning advantages: You can let the entire balance grow tax-free over your lifetime for the benefit of your heirs.

If, for example, you name your child as the beneficiary, he or she will be required to start taking distributions upon inheriting the Roth IRA. But the 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 for many years to come.

Roth IRAs are subject to the same low annual contribution limit as traditional IRAs, and your Roth IRA limit is reduced by any traditional IRA contributions you make for the year. It may be further limited based on your AGI.

If you have a traditional IRA, consider whether you might benefit from converting it to a Roth IRA. A conversion can allow you to turn tax-deferred future growth into tax-free growth and take advantage of a Roth IRA's estate planning benefits.

There's no longer an income-based limit on who can convert. But, unlike when the limit was first lifted in 2010, the converted amount is now taxable in the year of the conversion.

Whether a conversion makes 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.

2. **Roth 401(k)s, Roth 403(b)s and Roth 457s.** If your 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.

Profit-sharing plan vs. SEP: How much can you contribute?	
Profit-sharing plan	SEP
2011 maximum contribution: \$49,000 or \$54,500.	2011 maximum contribution: \$49,000.
<b>Eligibility:</b> 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.	<b>Eligibility:</b> You can't contribute more than 25% of your eligible compensation. Additional rules may further limit your contribution.

Under recent legislation, you may be able to make a rollover from your traditional account to a Roth account under the same plan. But there will be tax consequences similar to those of a Roth IRA conversion.

## Plans for business owners and the self-employed

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 contributions for this year as late as the due date of your income tax return, including extensions — provided your plan exists on December 31. See "Profit-sharing plan vs. SEP: How much can you contribute?", above.

**SEP.** A Simplified Employee Pension is a defined contribution plan that provides benefits similar to those of a profit-sharing plan. But you can establish a SEP next year and still make deductible contributions for this year as late as the due date of your 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 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 contributions until the due date of your return, provided your plan exists on December 31.

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

## Early withdrawals

If you're facing financial challenges this year, it may be tempting to make withdrawals from your retirement plans. But generally this should be a last resort. With a few exceptions, retirement plan distributions made before age 59½ are 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%. Even if you're in a lower bracket, you can lose a substantial amount to taxes and penalties. Additionally, you'll lose the potential tax-deferred future growth on the amount you've withdrawn.

If you have a Roth account, you can withdraw up to your contribution amount free of tax and penalty. But you'll still be losing the potential *tax-free* future growth on the withdrawn amount.

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.

Another option to consider, if your employer-sponsored plan allows it, is to take a loan from the plan. You'll have to pay it back with interest, but you won't be subject to current taxes or penalties.

## 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.

## 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. You can avoid the RMD rule for a Roth 401(k), Roth 403(b) or Roth 457 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: 1) cause your Social Security payments to become taxable, 2) increase Medicare prescription drug charges, or 3) affect other deductions or credits with income-based limits.

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


## Minimizing estate taxes is a perpetual challenge

Yes, death and taxes are inevitable. But that doesn't mean they have to go together. By taking advantage of all the exemptions, deductions and estate planning strategies available, you can leave the legacy you desire to your loved ones, not Uncle Sam.

### Estate tax

The 2010 Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 retroactively brought back the estate tax for 2010 (along with the unlimited step-up in basis), but, through 2012, provided an exemption increase and a rate reduction compared to 2009. See the Chart "Transfer tax exemptions and highest rates" below.

Transfer tax exemptions and highest rates					
	2009	2010	2011	2012	2013
Gift tax exemption	\$ 1 million	\$ 1 million	\$ 5 million	\$5.12 million	\$ 1 million
Estate tax exemption <sup>1</sup>	\$3.5 million	\$ 5 million <sup>2</sup>	\$ 5 million	\$5.12 million	\$ 1 million
GST tax exemption	\$3.5 million	\$ 5 million	\$ 5 million	\$5.12 million	\$ 1 million <sup>3</sup>
Highest estate and gift tax rates and GST rate	45%	35% <sup>2</sup> (0% GST tax)	35%	35%	55% <sup>4</sup>



<sup>1</sup> Less any gift tax exemption already used during life. For 2011 and 2012, these amounts are "portable" between spouses.  
<sup>2</sup> Estates can elect to follow the pre-2010 Tax Relief act regime (estate tax repeal + limited step-up in basis).  
<sup>3</sup> Indexed for inflation.  
<sup>4</sup> The benefits of the graduated gift and estate tax rates and exemptions are phased out for gifts/estates over \$10 million.

The act also temporarily provides exemption "portability" between spouses.

If you have a loved one who died in 2010 and you haven't already consulted a tax advisor, be sure to do so. The option is available to follow the pre-2010 Tax Relief act estate tax repeal / limited step-up in basis regime instead of the new regime, but which is better depends on a variety of factors.

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 won't have to worry about any limits on the step-up in basis.

### What's new!

More flexibility — temporarily — for married couples

**Who's affected:** Married couples and their loved ones.

**Key changes:** Under the 2010 Tax Relief act, 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.

**Planning tips:** Although similar results can be achieved by making asset transfers between spouses during life and/or setting up certain trusts at death, making this election will be much simpler and provide flexibility if proper planning hasn't been done before the first spouse's death.

Still, this election is currently available for only two years unless Congress extends it. Also, exemption portability doesn't protect future growth on assets from estate tax as effectively as applying the exemption to a credit shelter trust does. So married couples should still consider making asset transfers and setting up trusts to ensure that they take full advantage of both spouses' exemptions. Also be aware that the provision doesn't apply to the generation-skipping transfer tax exemption.



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 assets are going to a surviving spouse vs. other heirs will need to be considered.

## GST tax

The generation-skipping transfer tax generally applies to transfers (both during life and at death) made to people two generations or more below you, such as your grandchildren.

The GST tax also had been repealed for 2010, and the 2010 Tax Relief act brought it back with the same exemption amounts as for the estate tax through 2012. However, the act set the GST tax rate for 2010 at 0%.

This is likely 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 such 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 35% to match the top estate tax rate in 2011 and 2012.

## Gift tax

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, and it follows the estate tax exemptions and top rates for 2011 and 2012. Any gift tax exemption used during life reduces the estate tax exemption available at death.

If you can afford to do so without compromising your own financial security, consider using part or all of your gift tax exemption this year and next, in case the high exemption isn't extended beyond 2012.

But keep in mind that 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. So first consider maximizing your annual exclusion gifts.

## Tax-smart giving

Giving away assets now will help you reduce the size of your taxable estate.

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:

- To minimize *estate tax*, gift property with the greatest future appreciation potential.
- To minimize *your beneficiary's income tax*, gift property that hasn't already appreciated significantly since you've owned it.
- To minimize *your own income tax*, don't gift property that's declined in value. Instead, sell the property so you can take the tax loss and then gift the sale proceeds.

**Plan gifts to grandchildren carefully.** Annual exclusion gifts are generally exempt from the GST tax, so they also help you preserve your GST tax exemption for other transfers. 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.

So, for example, if you make an annual exclusion gift to your grandson when the GST tax is in effect and you want to give him an additional \$30,000 in the same year to help him make a down payment on his first home, you'll have to use \$30,000 of your GST tax exemption plus \$30,000 of your gift tax exemption to avoid any tax on the transfer.

**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.

**Gift FLP interests.** Another way to benefit from valuation discounts is to set up a family limited partnership. You fund the FLP and then gift limited partnership interests.

**Warning:** The IRS is scrutinizing FLPs, so be sure to set up and operate yours properly.

**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

Trusts can provide significant tax savings while preserving some control over what happens to the transferred assets. Here are some trusts you may want to consider and the estate tax benefits they provide when estate tax is a concern:

**Marital trust.** This trust is created to benefit the surviving spouse and is often funded with just enough assets to ensure that no estate tax will be due upon the first spouse's death. The remainder of the estate, which would equal the estate tax exemption amount, is used to fund a credit shelter trust.

**Credit shelter trust.** Also referred to as a bypass trust, this is funded at the first spouse's death to take advantage of his or her full estate tax exemption. The trust primarily benefits the children, but the surviving spouse can receive income, and perhaps a portion of principal, during his or her lifetime.

**QDOT.** A qualified domestic trust can allow you and your non-U.S.-citizen spouse to take advantage of the unlimited marital deduction.

**QTIP trust.** A qualified terminable interest property trust passes trust income to your spouse for life, with the remainder of the trust assets passing as you've designated. The trust gives you (not your surviving spouse) control over the final disposition of your property and is often used to protect the interests of children from a previous marriage.

**ILIT.** An irrevocable life insurance trust owns one or more policies on your life, and it manages and distributes policy proceeds according to your wishes. An ILIT keeps insurance proceeds, which could otherwise be subject to estate tax, out of your estate (and possibly your spouse's). You aren't allowed to retain any powers over the policy, such as the right to change the beneficiary. The trust can be designed so that it can make a loan to your estate for liquidity needs, such as paying estate tax.

**Crummey trust.** This trust allows you to enjoy both the control of a trust that will transfer assets at a later date and the tax savings of an outright gift. ILITs are often structured as Crummey trusts so annual exclusion gifts can fund the ILIT's payment of insurance premiums.

**GRAT and GRUT.** Grantor-retained annuity trusts and grantor-retained unitrusts allow you to give assets to your children today — removing them from your taxable estate at a reduced value for gift tax purposes (provided you survive the trust’s term) — while you receive payments from the trust for a specified term. At the end of the term, the principal may pass to the beneficiaries or remain in the trust. In a GRAT, the income you receive is an annuity based on the assets’ value on the date the trust is formed. In a GRUT, the payments are a set percentage of the assets’ value as redetermined each year.

**QPRT.** A qualified personal residence trust is similar to a GRAT except that, instead of holding assets, the trust holds your home — and, instead of receiving annuity payments, you enjoy the right to live in your home for a set number of years. At the end of the term, your beneficiaries own the home. You may continue to live there if the trustees or owners agree and you pay fair market rent.

**Dynasty trust.** The dynasty trust allows assets to skip several generations of taxation. You can fund the trust either during your lifetime by making gifts or at death in the form of bequests. The trust remains in existence from generation to generation. Because the beneficiaries have restrictions on their access to the trust funds, the trust is excluded from their estates. If any of the beneficiaries have a real need for funds, the trust can make distributions to them. If you live in a state that hasn’t abolished the rule against perpetuities, special planning is required. A dynasty trust can help you take full advantage of the currently high GST tax exemption if you can afford to fund the trust before 2013.

## Life insurance

Life insurance can replace income, offer a way to equalize assets among children active and inactive in a family business, provide cash to pay estate tax or be a vehicle for passing leveraged funds free of estate tax.

Life insurance proceeds generally aren’t subject to income tax. But, if you own the policy, the proceeds will be included in your estate:

- Ownership is determined by several factors, including who has the right to name the beneficiaries of the proceeds. Generally, to reap maximum tax benefits you must sacrifice some control and flexibility as well as some ease and cost of administration.
- Determining who should own insurance on your life is a complex task because there are many possible owners, including you or your spouse, your children, your business and an ILIT.
- To choose the best owner, consider why you want the insurance, such as to replace income, to provide liquidity or to transfer wealth to your heirs. You must also determine the importance to you of tax implications, control, flexibility and ease and cost of administration. •

## Tax Law Change Updates

### **Congress extends and expands tax credit for hiring veterans**

On November 16, Congress passed the VOW to Hire Heroes Act. A key provision of the act extends the Work Opportunity credit through 2012 for companies that hire qualified veterans. (The credit is still scheduled to expire at the end of 2011 for other targeted groups.) The act also expands the credit by:

- Doubling the maximum credit — to \$9,600— for disabled veterans who've been unemployed for six months or more in the preceding year,
- Adding a credit of up to \$5,600 for hiring *nondisabled* veterans who've been unemployed for six months or more in the preceding year, and
- Adding a credit of up to \$2,400 for hiring *nondisabled* veterans who've been unemployed for four weeks or more, but less than six months, in the preceding year.

To be eligible for the credit, you must take certain actions before and shortly after you hire a qualified veteran. Your tax advisor can help you determine exactly what you need to do.

### **HIRE Act provides valuable tax incentives to businesses**

The Hiring Incentives to Restore Employment (HIRE) act, signed into law March 18, provides tax incentives for hiring and retaining workers and purchasing equipment and many other business assets.

#### **Payroll tax forgiveness**

This essentially exempts qualified employers (generally employers other than government entities) from having to pay the 6.2% Social Security portion of Federal Insurance Contribution Act (FICA) taxes on certain new hires through the end of the year. To qualify, a worker must be hired after Feb. 3, 2010, and before January 1, 2011, and must have been unemployed (defined as not having worked more than 40 hours) for the 60-day period ending on his or her start date.

#### **Retention credit**

This credit applies to workers who qualify for payroll tax forgiveness if they are retained for 52 consecutive weeks. The tax savings per qualified retained worker are equal to the lesser of 6.2% of the wages paid to the worker during the 52-week retention period or \$1,000.

#### **Sec. 179 expensing**

The HIRE act extends the increase in the Section 179 limit for initial year expensing to \$250,000 (from \$134,000). The Sec. 179 expensing election allows a current deduction for newly acquired assets that otherwise would have to be depreciated over a number of years. The HIRE act also extends the increase in the threshold at which the expensing election begins to phase out to \$800,000 (up from \$530,000). The higher limits apply for calendar year 2010 or a business's fiscal year that begins in 2010. A business can claim the expensing election only to offset its net income, not to reduce net income below zero.

## Other provisions

The HIRE act includes additional provisions that may be of interest to you, such as:

- A new election to convert tax credit bonds to Build America Bonds,
- Extension of highway and transit programs through 2010,
- Strengthening of foreign account tax compliance, and
- Deferral of implementation of “worldwide allocation of interest” to 2020.

Various changes to estimated tax payment requirements for certain large corporations also were included in the act, but they don’t go into effect until 2014 or later.

## Many rules apply

These breaks might provide your business with valuable tax savings, but many rules apply to them. So please contact us for the details before acting.

## The Patient Protection act includes many tax provisions

Representing a sweeping overhaul of the U.S. health care system, the Patient Protection and Affordable Care Act was signed into law on March 23, and its companion reconciliation act will be signed into law early next week. Here’s a brief summary of the main tax provisions affecting individuals and businesses.

### Individual tax provisions

Important tax provisions affecting individuals include:

**Penalties for the uninsured.** Beginning in 2014, most individuals who aren’t eligible for Medicaid, Medicare or other government-provided coverage will have to purchase minimum essential health coverage. Those who fail to do so will be hit with a penalty (with exceptions for the poor and certain others).

**Premium assistance for those with lower incomes.** Beginning in 2014, people with income between 133% and 400% of the federal poverty level (FPL) are eligible for tax credits or cost-sharing subsidies on a sliding scale to help pay insurance premiums.

**Higher taxes on the affluent.** To help offset the act’s cost, affluent taxpayers will face higher taxes. Beginning in 2013, taxpayers with more than \$200,000 in earned income (\$250,000 for families) will pay an additional 0.9% Medicare tax on the excess. In addition, those with an adjusted gross income (AGI) over \$200,000 (\$250,000 for joint filers) will pay a new, 3.8% Medicare tax on unearned income, such as interest, dividends, rents, royalties and certain capital gains. The tax doesn’t apply to retirement plan distributions.

Also starting in 2013, the act raises the threshold for deducting unreimbursed medical expenses from 7.5% to 10% of AGI and limits contributions to flexible spending accounts for medical expenses.

### Business tax provisions

Key tax provisions affecting businesses include:

**Penalties for failure to provide coverage.** The Patient Protection act doesn’t require employers to provide insurance coverage, but starting in 2014 it imposes tax penalties on certain employers that don’t provide it. Employers with 50 or more full-time-equivalent workers (FTEs) that don’t offer coverage and have at least one full-

time employee who receives a premium tax credit are subject to an annual fee of \$2,000 per FTE (not including the first 30 FTEs).

**Tax credits for small businesses.** Starting this year, small businesses are entitled to tax credits for purchasing group health coverage. For tax years 2010 to 2013, the maximum credit is 35%, provided the employer contributes at least 50% of the total premium or 50% of a benchmark premium. Starting in 2014, a maximum credit of 50% is available for two years for employers that purchase coverage through a state exchange and contribute at least 50% of the total premium. Smaller credits are available for tax-exempt businesses.

**Excise tax on “Cadillac” plans.** Starting in 2018, high-cost group plans will be subject to a 40% nonrefundable excise tax. The tax applies to annual premiums in excess of \$10,200 for individual coverage and \$27,500 for family coverage (excluding stand-alone dental and vision plans). The thresholds are higher (\$11,850 and \$30,950, respectively) for retirees and employees in certain high-risk professions. These amounts will be indexed for inflation.

## An all-encompassing act

The tax provisions of the Patient Protection act will have an impact on most taxpayers, as well as on how employers deal with health care insurance for their employees. Please contact us if you have questions about how the provisions may affect you or your business.

## Small Business Jobs Act benefits more than just small businesses

The Small Business Jobs Act of 2010 (SBJA) has just been passed by Congress, and it benefits more than just small businesses. It also provides tax-saving opportunities for larger businesses and individuals — including small-business investors, the self-employed and employees saving for retirement.

## Changes affecting businesses

**Section 179 expensing.** SBJA helps small-business owners invest in their own businesses by increasing the Internal Revenue Code Sec. 179 expensing election limit. For tax years beginning in 2010 and 2011, the limit will now be \$500,000, with a dollar-for-dollar phaseout starting when purchases for the year exceed \$2 million.

SBJA also temporarily expands the definition of eligible property to include qualified leasehold-improvement, restaurant and retail-improvement property. The maximum amount of such property that can be expensed is \$250,000.

**Bonus depreciation.** Another depreciation-related provision extends the special allowance for certain property, generally if acquired in calendar year 2010. Businesses can recover the costs of qualifying depreciable property more quickly by immediately deducting 50% of the cost. Bonus depreciation isn't subject to any asset purchase limits, so businesses ineligible for Sec. 179 expensing can take advantage of it.

Property that qualifies for bonus depreciation includes tangible property with a recovery period of 20 years or less, computer software purchased by the business, water utility property, and qualified leasehold improvement property.

**Other key changes.** Here are some additional changes businesses should be aware of:

- New five-year carryback of the general business credit,
- Increase in the start-up expenditures deduction,
- Shortening of the S corporation built-in gains period, and

- Removal of cell phones from the definition of "listed property" that's subject to tighter substantiation requirements and special depreciation rules.

## Changes affecting individuals

**Exclusion on small business stock gains.** To make investing in certain small businesses more attractive, SBJA temporarily increases the qualified small business (QSB) stock gain exclusion. The exclusion will be 100% for stock acquired after SBJA's enactment date (that is, the date the president signs it into law) and before January 1, 2011, that's held for at least five years. Additionally, the act eliminates the alternative minimum tax (AMT) preference item on such gain, making it tax free for AMT purposes as well.

**Self-employment tax.** If you're self-employed, SBJA permits you to deduct for 2010 self-employment tax purposes any costs incurred in 2010 for health insurance for you and your spouse, dependents and children age 26 or under.

**Roth 457(b) plans.** If you're a government employee who participates in a 457(b) plan, be aware that SBJA may allow your employer to start providing you the option to designate some or all of your contributions as Roth contributions. The contributions won't reduce your taxable income, but you won't have to pay any tax on qualified distributions.

**401(k), 403(b) or 457(b) rollovers to Roth accounts.** Under SBJA, your 401(k), 403(b) or 457(b) plan may allow (but isn't *required* to allow) you to roll any portion of your pretax account balance into a Roth account. The amount of the rollover would be includible in your taxable gross income — except to the extent it's the return of any after-tax contributions. If the rollover is made in 2010, you can elect to pay the tax over a two-year period in 2011 and 2012.

## How you can benefit

Whether or not you're a small-business owner, you may be able to reap significant tax savings by taking advantage of the opportunities SBJA offers. We'd be pleased to help you determine exactly how you can benefit.

## Tax Relief act extends breaks for individuals and businesses

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, signed into law December 17, extends and expands a wide variety of valuable tax breaks and includes tax provisions affecting individuals and businesses. Here's a brief summary of the most important provisions.

### Individual tax provisions

General:

- New two-percentage-point payroll tax cut for 2011
- Extension of the lower ordinary income tax rates for all tax brackets through 2012
- Extension of marriage penalty relief through 2012
- Extension of the elimination of itemized deduction and personal exemption phaseouts through 2012
- Extension of the deduction for state and local sales taxes in lieu of state and local income taxes through 2011
- Extension of the increased alternative minimum tax (AMT) exemptions through 2011
- Extension of the ability to offset AMT liability with certain nonrefundable personal credits through 2011

Investing:

- Extension of the lower long-term capital gains rates through 2012
- Extension of the lower qualified dividend tax rates through 2012
- Extension of the 100% gain exclusion on certain qualified small business stock to stock acquired through 2011

Children and education:

- Extension of the \$1,000 child credit and other enhancements of the credit through 2012
- Extension of the higher adoption credit and income exclusion for employer-provided adoption assistance through 2012
- Extension of the higher dependent care credit through 2012
- Extension of the American Opportunity education credit through 2012
- Extension of the above-the-line tuition and fees deduction through 2011
- Extension of the income exclusion for employer-provided education assistance through 2012
- Extension of the enhancements to the student loan interest deduction through 2012
- Extension of the \$2,000 Coverdell Education Savings Account contribution limit and other enhancements through 2012

Charitable giving:

- Extension of the ability to exclude from income direct contributions from IRAs to qualified charities (up to \$100,000 annually) through 2011
- Extension of the ability to take a larger deduction for donations of long-term capital gains real property for conservation purposes through 2011

Estate planning:

- Reinstatement of the estate tax for 2010 with a top rate of 35% and a \$5 million exemption (compared to 45% and \$3.5 million for 2009)
- Option for estates of taxpayers who died in 2010 to elect to follow the pre-Tax Relief act regime — no estate tax but limits on step-up in basis for transferred assets
- Reinstatement of the generation-skipping transfer (GST) tax for 2010 at a 0% rate with a \$5 million exemption (compared to 45% and \$3.5 million for 2009)
- Decrease in the top estate and gift tax rates and the GST tax rate to 35% for 2011 and 2012
- Increase in the estate, GST and gift tax exemptions to \$5 million for 2011, indexed for inflation in 2012
- Ability of the estate of a taxpayer who dies in 2011 or 2012 to elect to allow the surviving spouse to use the deceased's unused estate tax exemption

## Business tax provisions

Investment incentives:

- Increase in bonus depreciation to 100%, generally for assets placed in service after September 8, 2010, and before January 1, 2012
- Extension of 50% bonus depreciation, generally for assets placed in service January 1, 2012, through December 31, 2012
- Increase in the Sec. 179 expensing limit to \$125,000 (indexed for inflation) for 2012
- Increase in the Sec. 179 expensing phaseout threshold to \$500,000 (indexed for inflation) for 2012
- Extension of accelerated depreciation for qualified leasehold-improvement, restaurant and retail-improvement property through 2011

Tax credits:

- Extension of the research credit through 2011
- Extension of the Work Opportunity credit through 2011

Charitable giving:

- Extension of the enhanced deduction for food inventory donations through 2011
- Extension of the enhanced deduction for donations of book inventory to public schools through 2011
- Extension of the enhanced deduction for computer inventory donations for educational purposes through 2011

## Just the tip of the iceberg

As you can see, the Tax Relief act includes numerous provisions, and we've only touched on some of them here. Many breaks are subject to a variety of rules and limitations, so it's important to discuss them with your tax advisor to determine exactly how they'll affect you. We'd be pleased to help.