

October 2011

Dear Clients and Friends:

YEAR-END TAX PLANNING

As 2011 draws to a close, you should make a final review of your 2011 tax situation to determine if you can take advantage of year-end tax planning. This letter and other useful accounting and tax information is also available on my website at www.solakco.com.

TAX HORIZON

As most of you should know by now the Bush tax cuts were extended for 2011 and 2012. The big question at this point is what will happen after December 31, 2012 and that will most likely depend on who wins the November 2012 elections. President Obama seems positioned on raising taxes in 2011 and 2012 and not extending the Bush tax cuts beyond 2012. With the Republicans in control of the House, it is unlikely that there will be any tax increase before January 1, 2013. If the Bush tax cuts are not extended beyond 2012 the tax rates for 2013 will revert to the tax rates in effect in 2001 (no 10% bracket and a 39.6% maximum bracket), higher tax rates on capital gains and dividends, lower AMT exemptions and reduction of the estate tax exemption from \$5,000,000 to \$1,000,000.

TAX RATES

For 2011, there are five tax brackets ranging from 10% to 35% for federal income tax purposes. The following table shows the tax brackets at the various levels of taxable income:

Bracket	Joint Returns	Single
10%	To \$ 17,000	To \$ 8,500
15%	To \$ 69,000	To \$ 34,500
25%	To \$139,350	To \$ 83,600
28%	To \$212,300	To \$174,400
33%	To \$379,150	To \$379,150
35%	Over \$379,150	Over \$379,150

Net long-term capital gains and qualifying dividends are subject to a maximum tax rate of 15% (**Zero if you are in the 15% or less tax bracket**).

ALTERNATIVE MINIMUM TAX

Federal income tax rules require a separate computation to be made to determine if the Alternative Minimum Tax (AMT) applies for a given year. The effect of the AMT is to eliminate the benefit of many tax deductions.

The AMT came into being many years ago because certain taxpayers with very high incomes did not have to pay any income taxes. The real problem with the AMT is that while incomes increased with inflation, the AMT exemption amounts (and rates) were not indexed to inflation and as an “unintended” result; taxpayers with very modest incomes are now being subject to the AMT.

With the AMT patch for 2011, it is likely that the AMT will have a similar effect as it did in 2010. To determine if you were subject to the AMT for 2010, you should review your tax return Form 6251 and Form 1040, page 2, line 45. If your tax return included an amount on line 45, you were subject to the AMT for 2010 and most likely will again be subject in 2011. If you were not subject to the AMT for 2010 but the spread reflected on your Form 6251 was small, you may be subject to the AMT for 2011.

The following tabulation shows which common itemized (Schedule A) deductions are deductible under the respective tax computation:

	<u>Regular Tax Computation</u>	<u>AMT Computation</u>
Interest		
Qualified Housing Interest	Yes	Yes
Home Equity Interest, other than Qualified Housing Interest on debt up to \$100,000 (any excess)	Yes No	No No
Investment Interest to the extent of Investment Income (any excess)	Yes No	Yes No
Personal Interest	No	No
Contributions	Yes	Yes
Taxes – All Types	Yes	No
Misc. Deductions – Subject to 2% floor	Yes	No

In addition to the above, several other items are used to compute regular and alternative minimum taxable incomes. Therefore, careful tax planning is necessary to make sure tax motivated transactions will provide the intended result.

PASSIVE ACTIVITY LOSSES

Generally, losses incurred from passive activities are deductible only to the extent of passive income. Losses not deductible in a given year will be labeled “suspended losses” and carried over to future years to offset future passive income.

Rental properties are classified as passive activities and therefore are subject to the passive loss rules on deductibility. An exception is provided to taxpayers who actively participate and own a 10% or more interest in real estate rental properties in that a maximum amount of \$25,000 of losses may be deducted without regard to the passive loss rules. The \$25,000 maximum amount is reduced by 50% of the amount of adjusted gross income (AGI) over \$100,000 and is completely phased out after the AGI exceeds \$150,000.

TIMING OF INCOME AND DEDUCTIONS

In 2011 itemized deductions will *not* be subject to any *reduction*.

TIMING OF INCOME – SALARIES, BONUSES AND FEES

The acceleration of income items may be appropriate if it appears deductions may exceed income or the AMT applies, thereby reducing or eliminating the tax benefit for deductions. The deceleration of income may be appropriate if your 2012 income will be substantially less than your 2011 income.

TIMING OF DEDUCTIONS

Deductions – General The payment of a deduction by December 31, 2011 will be considered valid if a check is mailed on or before December 31, 2011 with adequate postage and if you have sufficient funds in your account to cover the check.

Deductions – Interest Home mortgage interest is usually paid in the month following its accrual (your January mortgage payment usually pays December's interest). Therefore, payment of your January 2012 mortgage payment by December 31, 2011 allows the December interest to be deducted in 2011 rather than 2012. Mortgage companies are required to report to the IRS your mortgage interest paid during the year. To make sure your advanced January 2012 payment is reflected on your 2011 mortgage statement, payment should be made by December 20, 2011.

Personal interest, i.e., auto loans and credit cards is not tax deductible. You should therefore attempt to liquidate personal debts as soon as practicable.

Deductions – State Taxes If you are paying your State income tax under the installment method or you expect a State tax balance due for the year, consideration should be given to the prepayment of the Voucher #4 or tax due by December 31, 2011 to accelerate the federal tax benefit for prepayment. *AMT Caution.*

Deductions – Property Taxes Consideration should also be given to a prepayment of an otherwise due in early 2012 real property taxes if payment by December 31, 2011 will produce a tax benefit. *AMT Caution.*

Deductions – Miscellaneous Miscellaneous deductions including unreimbursed employee expenses, accounting fees, tax return preparation fees, investment advisory fees, and others are subject to a floor of 2% of the adjusted gross income. Only the amount of such expenses that exceed the floor will be deductible. From a tax planning standpoint, you should consider "bunching up" such expenses to the extent possible in the year you will exceed the 2% threshold. *AMT Caution.*

CAPITAL ASSET TRANSACTIONS

The holding period for long-term capital assets is “more than twelve months”. If you have realized capital losses in 2011 or have a capital loss carryover from 2010, you should consider realizing capital gains to offset the capital losses. In addition, if you have “paper losses” in your stock portfolio, you may wish to realize such losses by selling the security. A net capital loss for the year can be used to offset other income up to \$3,000 per year with the balance being carried over to future years. The trade date rather than settlement date controls the tax reporting of a stock transaction. Therefore, if you desire to realize stock transactions in 2011, make sure the trade date is on or before December 31, 2011.

PERSONAL RESIDENCE

Federal and State tax laws afford special tax benefits to personal residence ownership, i.e., tax-free gains *up to \$500,000* and deduction for qualified housing interest. Interest on certain refinancing may not be deductible. Loan fees should be paid by a separate payment versus adding the amount to the loan. The determination of what interest is or is not qualified housing interest generally refers to the original purchase price plus the cost of improvements. You should be maintaining adequate records (updated at least annually) to substantiate your total cost basis of the residence including improvements.

A change in the tax law was made in 2008 regarding the use of the tax-free gain exclusion for sales of a principal residence after December 31, 2008 if the house was used for any other purpose than a principal residence, i.e. rental property, second residence or vacation rental. The tax law change, in general, now requires a pro-ration of the gain for periods of “nonqualified use” after 2008 that would not qualify for the tax-free gain exclusion.

ESTIMATED TAX PENALTIES AND WITHHOLDINGS

If your 2011 withholdings and estimated tax payments are less than 90% of your 2011 tax liabilities, you could be subject to the nondeductible penalty for underpayment of estimated tax. You may be able to avoid this penalty by having paid in an amount equal to the prior year’s (2010) total tax liability, or in some cases 110% of your prior year’s (2010) total tax liability. You should review your 2011 withholdings and estimated tax payments to see if you meet one of the exceptions noted above. You can authorize your employer to increase your December 2011 income tax withholdings to reduce or eliminate your exposure to the penalty.

INDIVIDUAL RETIREMENT ACCOUNT (IRA)

A \$5,000 IRA contribution can be made by individuals that are not covered by an employer sponsored retirement plan. If you are 50 or over, by December 31, 2011 you can make an additional “catch-up” contribution of \$1,000. Contributions to an IRA for 2011 must be made by April 15, 2012.

ROTH IRA CONVERSIONS

You should note that most IRA and Qualified plan retirement accounts are eligible for rollover conversion to a Roth IRA. A Roth IRA conversion is subject to tax at the time of conversion. However, *qualified distributions* from a Roth IRA are tax free. Roth IRA conversions are complex and should only be done after careful analysis.

SELF-EMPLOYED RETIREMENT PLANS

If you are self-employed, you may establish a Self-employed 401(k) Retirement Plan (Keogh) or a Simplified Employee Plan (SEP) for 2011. To be eligible for a 401(k) Keogh for 2011, the plan must be established by **December 31, 2011**. A SEP can be established by the due date of your return. The maximum contribution to a 401(k) Keogh or a SEP for 2011 is \$49,000. If you are 50 or over, by December 31, 2011 you can make an additional “catch-up” contribution of \$5,500 for 2011. Contributions to Keoghs and SEPs for 2011 need not be made until the due date of your tax returns, usually April 15, 2012. However, if you file a valid extension application to October 15, 2012, your 2011 contribution may be deferred to the extended due date.

ANNUAL GIFT TAX EXCLUSIONS

Certain gifts are subject to gift taxes. If you are contemplating making a gift, you should note that you may give, in general, \$13,000 in cash or value to each donee in a calendar year without being subject to gift taxes. January 1, 2012 starts a new calendar year for gift tax purposes; therefore, you may give \$13,000 in December 2011 and \$13,000 in January 2012 without incurring a gift tax liability.

REVIEW OF TAX REPORTING INFORMATION

Banks, savings and loans and others are required to report to the IRS certain amounts paid during the year on Forms 1099. You should periodically review all your account information and received Forms 1099 to determine if the paying agency has your correct reporting (social security) number. Incorrect reporting numbers or income can and usually does result in communications from the tax authorities that could easily be avoided.

EMPLOYEE WITHHOLDING CERTIFICATE (FORM W-4)

Employees should submit updated withholding allowance information to their employer each year. As part of my tax preparation service, I provide my clients with appropriate withholding allowance information.

In conclusion, November and December are the months to make a final review of your 2011 tax status. I am available to advise you on these or any other tax planning opportunities should you so desire.

Very truly yours,

Charles E. Solak

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