

“Last minute” year-end tax-saving moves for individuals

December, 2011

Although there are only three weeks left to go before the year ends, it's not too late to implement some planning moves that can improve a taxpayer's tax situation for 2011 and beyond.

Make HSA contributions. Under Code Sec. 223(b)(8)(A), a calendar year taxpayer who became an eligible individual under the health savings account (HSA) rules on December 1, 2011, is treated as having been an eligible individual for the entire year. Thus, he may make a full year's deductible-above-the-line contribution for 2011. That means a deduction of \$3,050 for individual coverage, and \$6,150 for family coverage (those age 55 or older get an additional \$1,000 catch-up amount).

Nail down losses on stock while substantially preserving your investment position. A taxpayer may have experienced paper losses on stock in a particular company or industry in which he wants to keep an investment. He may be able to realize his losses on the shares for tax purposes and still retain the same, or approximately the same, investment position. This can be accomplished by selling the shares and buying other shares in the same company or another company in the same industry to replace them. There are several ways this can be done. For example, an individual can sell the original holding, then buy back the same securities at least 31 days later.

Convert a regular IRA to a Roth IRA. Individuals who believe a Roth IRA is a better strategy than a traditional IRA, and want to remain in the market for the long term, should convert traditional-IRA money invested in beaten-down stocks (or mutual funds) into a Roth IRA if eligible to do so. Note, however, that such a conversion shouldn't be done without considering the individual's overall tax situation. Even at depressed market levels, a 2011 rollover or conversion still will increase a taxpayer's AGI, possibly propelling him or her into a higher tax bracket, and diluting (or eliminating) those tax breaks that have AGI-based phaseouts or “floors.”

Recharacterizing a traditional IRA to Roth IRA conversion. If an individual converted assets in a traditional IRA to a Roth IRA earlier in the year, the assets in the Roth IRA account may have declined in value. If things are left things as-is, the individual will wind up paying a higher tax than is necessary. However, there's a way to back out of the transaction, namely by recharacterizing the rollover or conversion. This involves transferring the converted amount (plus earnings, or minus losses) from the Roth IRA back to a traditional IRA via a trustee-to-trustee transfer. The individual can later reconvert to a Roth IRA.

Accelerate deductible contributions. Individuals should keep in mind that charitable contributions and medical expenses are deductible when charged to their credit card accounts (e.g., in 2011) rather than when they pay the card company (e.g., in 2012).

Solve an underpayment problem. An individual who expects to be underwithheld for 2011 should consider asking his employer—if it's not too late to do so—to increase income tax withholding before year-end. Generally, income tax withheld by an employer from an employee's wages or salary is treated as paid in equal amounts on each of the four installment due dates. Thus, if an employee asks his employer to withhold additional amounts for the rest of the year, the penalty can be retroactively eliminated. This is because the heavy year-end withholding will be treated as paid equally over the four installment due dates.

Outside-the-box solution. An individual can take an eligible rollover distribution from a qualified retirement plan before the end of 2011 if he is facing a penalty for underpayment of estimated tax and the increased withholding option is unavailable or won't sufficiently address the problem. Income tax will be withheld from the distribution at a 20% rate and will be applied toward the taxes owed for 2011. He can then timely roll over the gross amount of the distribution, as increased by the amount of withheld tax, to a traditional IRA. No part of the distribution will be includible in income for 2011, but the withheld tax will be applied pro rata over the full 2011 tax year to reduce previous underpayments of estimated tax.

Accelerate big ticket purchases into 2011 to get sales tax deduction. Unless Congress acts this year or next to extend it, the option for itemizers to deduct state and local sales taxes in lieu of state and local income taxes will expire at the end of 2011. As a result, individuals who will elect on their 2011 return to claim a state and local general sales tax deduction instead of a state and local income tax deduction, and are considering the purchase of a big-ticket item (e.g., a car or boat), should consider accelerating the purchase into this year to achieve a higher itemized deduction for sales taxes.

Pre-pay qualified higher education expenses for first quarter of 2012. Unless Congress extends it, the up-to-\$4,000 above-the-line deduction for qualified higher education expenses will not be available after 2011. Thus, individuals should consider prepaying eligible expenses if doing so will increase their deduction for qualified higher education expenses. Generally, the deduction is allowed for qualified education expenses paid in 2011 in connection with enrollment at an institution of higher education during 2011 or for an academic period beginning in 2011 or in the first 3 months of 2012.

Lock in the potential to earn tax-free gains. There is no tax on gain from the sale of qualified small business stock (QSBS) that is: (1) purchased after September 27, 2010 and before January 1, 2012, and (2) held for more than five years. In addition, such sales won't cause AMT preference problems. To qualify for these breaks, the stock must be issued by a regular (C) corporation with total gross assets of \$50 million or less, and a number of other technical requirements must be met.

Be sure to take required minimum distributions (RMDs). Taxpayers who have reached age 70- 1/2 should be sure to take their 2011 RMD from their IRAs or 401(k) plans (or other employer-sponsored retired plans). Failure to take a required withdrawal can result in a penalty of 50% of the amount of the RMD not withdrawn. Those who turned age 70- 1/2 in 2011, can delay the first required distribution to 2012. However, taxpayers who take the deferral route will have to take a double distribution in 2012—the amount required for 2011 plus the amount required for 2012.

Make year-end gifts. A person can give any other person up to \$13,000 for 2011 without incurring any gift tax. The annual exclusion amount increases to \$26,000 per donee if the donor's spouse consents to gift-splitting. Annual exclusion gifts take the amount of the gift and future appreciation in the value of the gift out of the donor's estate, and shift the income tax obligation on the property's earnings to the donee who may be in a lower tax bracket (if not subject to the kiddie tax).

A gift by check to a noncharitable donee is considered to be a completed gift for gift and estate tax purposes on the earlier of:

(1) the date on which the donor has so parted with dominion and control under local law as to leave in the donor no power to change its disposition, or

(2) the date on which the donee deposits the check (or cashes it against available funds of the donee) or presents the check for payment, if it is established that:

... the check was paid by the drawee bank when first presented to the drawee bank for payment;

... the donor was alive when the check was paid by the drawee bank;

... the donor intended to make a gift;

... delivery of the check by the donor was unconditional; and

... the check was deposited, cashed, or presented in the calendar year for which completed gift treatment is sought and within a reasonable time of issuance.

Thus, for example, a \$13,000 gift check given to and deposited by a grandson on Dec. 31, 2011, is treated as a completed gift for 2011 even though the check doesn't clear until 2012 (assuming the donor is still alive when the check is paid by the drawee bank).