The Colony Group, LLC
Two Atlantic Avenue
Boston, Massachusetts 02110
800-758-8200 617-723-8200
fax: 617-723-6338
www.thecolonygroup.com

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Re: Year-End Tax Considerations

Dear Client:

As the end of 2011 approaches, it appears that partisan politics will prevent any meaningful tax legislation from being passed this year. President Obama's ***American Jobs Act of 2011***, which includes numerous tax provisions, has stalled. As part of the move to extend the federal debt ceiling, Congress established a "Super Committee" to recommend a plan for deficit reduction by a minimum of $1.2 trillion over the next 10 years, but it, too, failed to make any progress. As a result, automatic cuts likely will be made to the federal budget, concentrated mostly in defense and entitlement-program spending. The President continues to push for a tax increase for higher income individuals, while Republicans advocate for increased spending cuts. What remains is a great deal of uncertainty surrounding the tax code for 2012 and beyond, adding additional complexity to year-end tax planning.

Even if there is no major tax legislation in the immediate future, Congress must grapple with a number of difficult tax issues next year.

- On December 31, 2011, the AMT exemption amount is scheduled to revert from the current $48,450 ($74,450 if married filing jointly (MFJ)) to the year 2000 exemption level of $33,750 ($45,000 MFJ). Allowing this reduction would expose more than 31 million additional taxpayers to the AMT.
- On December 31, 2012, the Bush-era income tax cuts are scheduled to expire. If they are allowed to expire, the top tax rate would revert back to 39.6%, qualified dividends would be taxed as ordinary income, and the long-term capital gains tax rate would increase to 20%.
- On December 31, 2012, the favorable estate and gift tax exemptions that recently were enacted are set to expire. As a result, the estate and gift exemption amounts would decrease from $5 million to $1 million, and the top estate and gift tax rates would increase from 35% to 55%.
- Beginning in January of 2013, a new 3.8% Medicare surtax is scheduled to be assessed on unearned income under the recent health care legislation.

Regardless of any Congressional action later this year or early next year, there are certain tax savings that can be realized by taking advantage of current tax initiatives for individual filers that are in effect for 2011 but scheduled to expire next year. Provisions that should be considered include:

- The option to deduct state and local sales and use taxes instead of state and local income taxes;

- The credit for certain non-business energy property;
- The above-the-line deduction for qualified higher education expenses;
- Tax-free distributions by those individuals age 70½ or older from IRAs for charitable purposes; and
- A deduction for certain expenses for elementary and secondary school teachers.

We have compiled a checklist of actions based on current tax rules that may assist you with tax-saving opportunities before year-end. Not all actions will apply to your particular situation, but you likely can benefit from some. If you have any questions about your specific individual tax circumstances, please contact your Colony Group counselor.

Year-End Tax Planning for Individuals

- Consider deferring income into 2012 and accelerating deductions into 2011 to lower your 2011 tax bill. This strategy may enable you to claim larger deductions, credits, and other tax benefits for 2011 that are phased out over varying levels of adjusted gross income (AGI). These include child tax credits, higher education tax credits, the above-the-line deduction for higher-education expenses, and deductions for student loan interest. Postponing income is also desirable for those taxpayers who anticipate being in a lower tax bracket next year due to changed financial circumstances. Note, however, that in some cases, it actually may be beneficial to accelerate income into 2011. For example, this may be the case where a taxpayer's marginal tax bracket will be lower this year than next year.
- Fund retirement plans in full. At the very least, contribute enough to obtain the maximum possible employer match, if available.
- Make an IRA or Roth IRA contribution if circumstances warrant such a contribution.
- Consider converting a Traditional IRA to a Roth IRA. Keep in mind that you will be taxed on the value over your basis in the Traditional IRA, but if your IRA has lost value recently due to market volatility, it may be an ideal time to take advantage of the ability to convert.
- If you have self-employment income, consider opening and/or funding a self-employed retirement plan.
- Spend down your flexible spending account (FSA) and consider how much you should defer for 2012. Please remember, however, that you can no longer set aside amounts toward tax-free reimbursements for over-the-counter drugs, such as aspirin and antacids.
- If you become eligible to make health savings account (HSA) contributions in December of this year, you can make a full year's worth of deductible HSA contributions for 2011.
- Consider recognizing capital losses (to offset gains) in your investment accounts.
- Before investing in a mutual fund, determine when the year-end distribution will be made and plan your investment to avoid a tax on this distribution.
- Consider short-term use of a credit card to prepay expenses that can generate deductions for this year such as charitable contributions.

- If you expect to owe state and local income taxes when you file your 2011 return, consider asking your employer to increase withholding of state and local taxes (or make estimated payments of state and local taxes) before year-end to accelerate that deduction into 2011. Caution: You should not accelerate state and local tax payments if you are subject to the alternative minimum tax (AMT).
- Consider using securities to make charitable gifts. You either can donate appreciated shares directly to the charity to avoid taxable gain or sell depreciated shares to create a tax loss and donate the cash proceeds.
- Review the effect of any year-end tax planning on the AMT for 2011, keeping in mind that many tax breaks allowed for purposes of calculating regular taxes are disallowed for AMT purposes. These include the deduction for state property taxes on your residence, the deduction of state income taxes (or state sales tax if you elect this deduction option), miscellaneous itemized deductions, and personal exemption deductions. Other deductions, such as medical expenses, are calculated in a more restrictive manner for AMT purposes than for regular tax purposes. As a result, some deductions should not be accelerated if you are a taxpayer in the AMT.
- If you will elect to claim a state and local general sales tax deduction instead of a state and local income tax deduction, consider accelerating large purchases into 2011. Unless Congress acts, this election will not be available after 2011.
- If you own a home, make energy-saving improvements to your residence such as installing extra insulation, energy-saving windows, or energy-efficient heaters or air conditioners. You may qualify for a tax credit of up to $500 if the assets are installed in your home before 2012 and you have not previously claimed this energy credit.
- Unless extended, the up-to-$4,000 above-the-line deduction for qualified higher education expenses will not be available after 2011. Consider prepaying eligible education expenses if doing so will increase your deduction. 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.
- If you are age 70½ or older, own an IRA, and intend to make one or more charitable gifts, consider arranging for the gift to be made directly by the IRA trustee to the charity. Such transfers avoid the income tax on the IRA distribution.
- Take required minimum distributions (RMDs) from your IRA or 401(k) plan (or other employer-sponsored retired plan) if you have reached age 70½. Failure to take a required withdrawal can result in a penalty of 50% of the amount of the RMD not withdrawn.
- Make gifts sheltered by the annual gift tax exclusion before year-end, and reduce potential future gift and estate taxes. You can gift up to $13,000 in 2011 to an unlimited number of individuals, but you cannot carry over unused exclusions from one year to the next. Husbands and wives can make split gifts, thereby combining their exemptions for a total of $26,000 per donee. The transfers also may save family income taxes where income-earning property is given to family members in lower income tax brackets and not subject to the kiddie tax.

These are just some of the year-end steps that can be taken to save taxes. As always, we are pleased to speak with you individually about the strategies that make the most sense for your specific circumstances. Many of you have engaged The Colony Group for tax planning and return preparation, and, as part of those services, your financial counselor will be sure to consider the above strategies for you.

We appreciate the opportunity to be of service to you.

Very truly yours,

Jeffrey T. Craig, CFP®, Enrolled Agent
Director of Tax Services

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