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Los Angeles | Daily Journal

FRIDAY, DECEMBER 23, 2011

What To Do About Year-End Tax Uncertainty

By Robert W. Wood

Much of taxes is about timing, and one of the precepts of tax planning is to defer paying tax today if you can legitimately pay it tomorrow. Traditional tax planning says you should accelerate tax deductions and defer income. But conventional tax advice also puts a premium on crunching numbers to see how you'll benefit most.

For example, taxpayers can pay their state income taxes by Dec. 31 so they can deduct them on their 2011 federal return. Alternatively, they can pay them in April 2012 and deduct them on their 2012 federal return. On the income side of the equation, taxpayers may try to delay receiving income so it is taxed in the next year. Most lawyers don't want to know too much about taxes, but lawyers can engage in this kind of planning. Within limits, they can plan their income to get paid in 2011 or 2012. The tax doctrines of constructive receipt and economic benefit make this tricky. However, lawyers can choose to be slow to send out invoices.

Moreover, if clients and defendants cooperate, there's nothing illegal about arranging to receive a contingent fee in 2012 even if settlement documents are signed in 2011. Still, similar fact patterns can yield surprisingly different tax results, so professional tax advice is needed. That's especially true this year, when the normal year-end gyrations are more nuanced than ever by an array of uncertainties.

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There are dozens of expiring tax provisions impacting year-end and a complete list is available here: www.jct.gov/publications.html?func=startdown &id=3722. The volume of changes from 2011 to 2012 is so significant that it would pay to discuss your own situation with a tax adviser. Here are some key issues to consider.

Although a basic tenet of tax planning is to accelerate deductions and defer income, you may want to reconsider that conventional wisdom this year. In part, consider some of the specific issues noted below and your own situation. Also take into account more general fears about changes in the tax laws. With the upcoming presidential election, the pressure is enormous to raise taxes and to keep tinkering with the system. Depending on what you see in your crystal ball, it is possible that tax rates (on ordinary income, capital gains or both) will go up in 2012. That may encourage taking income now to lock in the current tax rates.

One of the most publicized tax breaks expiring Dec. 31 is the payroll tax cut that saved employers and employees money in 2011. Congress just extended it, but only through February of 2012, and excluded from the cut anyone who makes more than $110,100 annually. There will be more Congressional wrangling about this provision and whether (and how) to extend it through 2012. In the meantime, it argues for taking (and paying) payroll in 2011, not 2012.

One of the most dreaded taxes is the alternative minimum tax (AMT). It used to catch only very high income taxpayers with excessive specialized deductions. But over the years since its enactment, it has swallowed up millions more taxpayers and applies to most deductions. The AMT was enacted in 1969 to impose a minimum tax on fat cats who claimed huge and unusual tax deductions - things like drilling expenses from oil deals.

But gradually the AMT grew to cover almost everything. Whether you know it or not, your accountant is probably calculating AMT for you too. You compute the regular tax and the AMT rate. If the AMT is higher, you must pay it. Given the ingredients that go into the AMT, you cannot eyeball it. It is the reason many clients cannot deduct their attorney fees - they still face the AMT rate of 28 percent.

In 1997, about 1 percent of all taxpayers were subject to the AMT. In 2008, about 2.8 percent of all taxpayers were subject to the AMT. In 2012, estimates suggest 20 percent of taxpayers will face AMT.

At the end of 2010, Congress "patched" the AMT with healthy exemptions that rolled back many onerous effects for 2010 and 2011 only. For 2012, expect to pay AMT, especially if you have large deductions for California income and property taxes. Run the numbers, but you may want to pay in 2011 and claim deductions this year rather than waiting until 2012.

Another expiring perk is a huge auto industry incentive for buying luxury SUVs. If you're self-employed or own a small business and are in the market for a new vehicle, consider buying before Dec. 31. If you qualify, you can write off the full cost of purchasing a new luxury SUV provided that it is used 100 percent for business and that its gross vehicle weight is more than 6,000 pounds. Qualifying 2011 models include the Porsche Cayenne Turbo (MSRP: $106,000), the BMW X6 M (MSRP: $89,200) and the Ford Lincoln Navigator (MSRP: $62,635).

Most financial advisers suggest maximizing retirement contributions for 2011 and even considering pre-funding retirement contributions for 2012. The fear is that permitted retirement plan deductions may be cut back. Speak to your tax or financial adviser.

This is an especially good year to donate. And that's especially true if you donate appreciated securities. You can deduct the full fair market value of the stock (and offset up to 30 percent of your income with a charitable contribution deduction) and you will not have to pay tax on your gain.

Another idea is to check your investment gains and losses before year-end and retool. Of course, you needn't consider the tax effects of gains and losses in retirement accounts. Outside that context, "loss harvesting" can be smart. If you sell your losing positions you can use the losses to offset taxable capital gains you've realized this year. Beyond offsetting gains and losses, only $3,000 a year in net capital losses can offset ordinary income.

Fortunately, the so-called Bush tax cuts are set to remain in effect until Dec. 31, 2012. That may suggest that this year-end won't be confusing, and it may have lulled some people into inaction. Even with the Bush tax cuts, however, your tax picture in 2012 is clouded.

No one has a crystal ball, but see your financial planner or tax adviser to evaluate your situation. Stay flexible and allow time at year-end for basic comparisons. If you've ever lost out on a big tax deduction because of AMT that you could (with a little planning) have claimed in a prior or subsequent year, you won't want to unnecessarily feel that sting again.

This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.