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Dear Tax Client:

It's that time of year again...time to look at how your tax returns could be affected by new tax laws. Fortunately, Congress seemed to be in bipartisan gridlock for most of the year as well as preparing for the upcoming elections, so we really don't have much in the way of new tax laws except for those that had been passed in previous years that are just now phasing in or even phasing out. While the tax laws for 2011 seem to mostly be a continuation from 2010, be aware that we are just about a year away from what could be some major adjustments in 2013, but even that is uncertain. Below are some of the highlights of the new tax legislation and key numbers as adjusted for inflation.

<u>HIRE Credit</u>: A credit can be claimed for the lesser of $1,000 or 6.2% of wages paid to a qualifying employee that is retained for at least 52 consecutive weeks. A qualifying employee is one that was hired between February 4, 2010 and December 31, 2010 and had previously been unemployed for 60 days prior to date of hire.

<u>Estate & Gift Tax</u>: The estate and gift tax is back for 2011 and 2012 at a marginal rate of 35% for estates and gifts that total more than the $5 million exemption. The annual non-includible gift limitation remains at $13,000 per person for 2011.

<u>Adoption Credit</u>: For 2011 and 2012, the adoption credit is increased to $13,360 and is refundable. However, this credit will start phasing out when Adjusted Gross Income (AGI) exceeds $185,710 for 2011 and $189,710 for 2012.

<u>Employer Health Insurance Credit</u>: Starting in 2010 and expiring at the end of 2013, a maximum 35% credit (25% for non-profits) can be taken by small employers who cover at least 50% of their employee health insurance premiums. The credit starts to phase out, however, as the average full-time number of employees exceeds 10 and completely phases out with an average of 25 or more employees. The credit also starts to phase out once average annual employee compensation exceeds $25,000 and completely phases out with an average employee compensation of $50,000 or more. The exact calculation is very complicated!

<u>Other Health Provisions</u>: Starting in 2010, children under the age of 27 can now be covered under their parents' health plan and the premiums deducted by the employer or by the self-employed. There is also a new 10% tax on indoor tanning services. Starting in 2011, over-the-counter medications (excluding insulin) will no longer be considered eligible expenses for health savings or flexible spending accounts.

IRA and Pensions: In 2011, the maximum deduction for IRA contributions is $5,000, or $6,000 for those 50 and older. The salary deferral for pensions is between $11,500 and $22,000, depending on age and plan type.

IRA to Roth Conversions: For 2011, taxpayers that converted traditional IRA funds to a Roth IRA and elected to pay the tax over two years will be paying the first installment of that deferred tax liability.

Pension Beneficiaries: Please review the beneficiaries listed for your pension and IRA accounts to make sure the money is distributed according to your wishes. It is especially important to review these after a death in the family, divorce or other event that could result in a change of your desired beneficiaries.

1099-B Stock Sale Reporting: Starting for 2011, brokerage firms will be required to report cost basis information for stock sales where the stock had originally been purchased on or after January 1, 2011. Mutual fund basis reporting will apply to purchases and reinvestments occurring on or after January 1, 2012, and basis reporting on options will start with purchases occurring on or after January 1, 2013.

1099-K Income Reporting: Beginning in 2011, Credit card companies will report to the IRS the income collected by a business from credit card sales. For tax years starting in 2012, businesses will be required to separately report cash sales and credit card sales on their tax returns so the IRS can match income to the 1099-K. Businesses should make an effort to record credit card sales separately in their accounting to match the issued 1099-K.

Hobby Losses: The IRS is stepping up audits in search of non-deductible hobby losses on individual and S-Corporation returns. To determine if there is a profit motive for a business, the IRS looks at the manner in which the activity is conducted, the expertise of the taxpayer, the time and effort expended by the taxpayer, the taxpayer's financial history and past successes, and whether an element of personal pleasure or recreation is present.

Auto Mileage Rates: For 2011, we have a split year for mileage rates, with the per-mile rate for business use at $0.51 for the first half of the year and $0.555 for the second half of the year. For medical and moving expenses, the per-mile rate is $0.19 for the first half of 2011 and $0.235 for the second half. The mileage rate for charity work remains at $0.14 for the entire year.

Depreciation: The Section 179 expense election on the federal level is $500,000 for 2011, but the California maximum expense election remains at $25,000. On federal returns for 2011, we have the return of the 100% bonus depreciation, which allows businesses to immediately deduct the cost of new qualifying personal property.

Education: For 2011 and 2012, we still have the American Opportunity Credit for the first 4 years of post-secondary education, which is a maximum credit of $2,500 per student, based on 100% of the first $2,000 of tuition, books, supplies and necessary equipment plus 25% of the next $2,000. As an alternative, the Lifetime Learning Credit remains in effect indefinitely and provides up to a 20% credit for up to $10,000 in qualified tuition and fees. Both, however, are subject to income limitations.

Kiddie Tax: For 2011, dependent children under age 19 or under the age of 24 if a full-time student with more than $1,900 in taxable investment income will pay tax on the excess at their parent's rates.

Capital Gains and Dividends: For 2011 and 2012, there is a 0% rate (yes, zero) for capital gains and qualified dividends included in taxable income that would otherwise fall in the 15% tax bracket, and a 15% rate for capital gains and dividends in taxable income normally subject to the 25% or higher marginal rates. However, AMT could increase the overall effective rates.

Residential Energy Credits: For 2011, homeowners may qualify for a credit up to a maximum of $500 on the purchase of qualifying energy-efficient improvements to their primary residences, such as adding insulation, energy-efficient exterior windows and doors, and energy-efficient heating and air conditioning systems. This credit does not apply to homes in the process of being built or to the installation costs of the improvement, and all equipment or materials installed must be new. A separate 30% credit that is not subject to a cap and that can be used for second or newly constructed homes applies to the purchase of solar hot water heaters or electrical equipment, geothermal heat pumps, or wind turbines.

Alternative Fuel Credit: A credit for purchasing hybrid vehicles is still in effect for 2011, though the amount depends on the make, model and date purchased. Credits on hybrid vehicles produced by some manufacturers, like Toyota, have already expired since the credit is limited to the sale of the first 60,000 units per manufacturer.

Plug-in Electric Drive Vehicle Credit: For 2011, a new credit for buying qualified plug-in hybrid electric vehicles will start at $2,500 and cap at $15,000, based on the vehicle's battery capacity and gross weight. Only the first 200,000 of these vehicles sold by each manufacturer will receive the full credit before it starts to phase out. Qualifying vehicles must be newly purchased and derive its propulsion from a rechargeable battery with a 4 kilowatt-hour capacity, or 2.5 kilowatt-hour capacity for 2 or 3-wheeled vehicles. Golf carts do not qualify, however.

Charitable Contributions: For charitable contributions, last year's rules remain in effect: used clothing or household items must be in "good" condition to have charitable value, all items worth $5,000 or more require an appraisal, deductions for cash donations require a written receipt or a canceled check, but all cash donations of $250 or more require a written receipt.

Foreign Bank and Financial Accounts: This law has been around awhile, but lately the IRS seems more determined to get full compliance. Anyone with a financial interest or signature authority over one or more accounts in a foreign country with an aggregate of more than $10,000 in value at any time during the calendar year must file Form TDF 90-22.1 by the following June 30th, and any person or entity with more than $50,000 in value ($100,000 if married filing joint) must also file Form 8938 with their individual, corporate, partnership or fiduciary tax returns.

Foreign Property Trusts and Corporations: The IRS is stepping up compliance in this area as well, requiring anyone owning an interest in or making a transfer of property to a foreign trust or corporation, including those commonly used to establish ownership of foreign property, such as a Fideicomiso, to file Forms 3520, 3520-A, 5471 and/or 926 each year. The penalties for failure to file any of these foreign reporting forms are substantial, starting at $10,000 or 10% of total value, depending on the form. Our firm will not be filing Forms 3520, 3520-A, 5471 or 926 as they are not supported by our tax software and do not fall within our area of expertise.

<u>Expiring Provisions</u>: There are a number of tax provisions expiring at the end of 2011 that may or may not be renewed. The expired provisions include the $250 teacher deduction, the sales tax deduction, the college tuition deduction, the allowable IRA contributions to charities, the higher AMT exemptions, the 15-year leasehold improvement depreciation, the expanded Section 179 and Bonus depreciation amounts, the R&D credit and many others.

<u>California Updates</u>: With the expiration of California's two-year tax increase plan, for 2011 we have an increase in the dependent credit to $315 each and a reduction of one-quarter percent in personal income tax rates. Thank goodness for bipartisan gridlock at the state level!

<u>CA Head-of-Household Credit</u>: California now has a credit for qualifying taxpayers who are seniors filing as head-of-household or parents filing as single but who have joint custody of one or more children.

<u>California Estimates</u>: Tax estimates paid to CA will be uneven for 2012, following the 30%, 40%, 0% and 30% pattern we've had for the last couple years. However, if any estimate or extension payment is greater than $20,000, or if an individual or corporation reports a total tax on their CA return greater than $80,000, then they are required to remit the funds electronically from that point forward. There is a 1% penalty on the amount paid if it is not electronically transmitted when required.

<u>California Jobs Credit</u>: California still offers a credit for employers with 20 or fewer employees of up to $3,000 for each additional full-time employee hired, such that there is an increase in total employees over the prior year.

<u>California Use Tax</u>: California requires in a situation where goods are purchased out of state, via mail order or internet, and no CA sales tax is collected but the goods are used or consumed in CA, that the responsible party must pay the equivalent sales tax as a use tax. This use tax can be paid on an individual return, and California now offers a “safe harbor” table based on income level if a taxpayer has difficulty finding a year's worth of receipts for out-of-state purchases, as long as no single item is purchased for $1,000 or more.

<u>California Worker Misclassification</u>: Starting in 2012, California will be able to collect substantial penalties as well as civil penalties and initiate enforcement action by the Contractors' State License Board against an employer and even their advisers for the willful misclassification of workers as independent contractors instead of employees. Our firm recommends that employers seek legal counsel experienced in employment issues to determine the appropriate classification of workers.

Keep in mind that your own tax situation can be different from anyone else’s. We would be happy to consult with you on how these changes might affect you specifically.

Best wishes for a Happy New Year!

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