

YEAR-END TAX PLANNING FOR 2011

Year-end tax planning often focuses on reducing taxes by accelerating deductions or timing income recognition within IRS and state requirements. This article reviews some of the more pertinent year-end 2011 tax-saving opportunities you can consider.

Your Janney Financial Advisor can work with you and your other advisors to implement strategies to help you preserve assets by minimizing taxes in 2011. Not all strategies will apply in any one client's situation, and it is important to consult with a tax advisor before implementing them.

Capital Gains and Losses

Assets owned and then sold may generate a capital gain or loss. By planning when to realize losses or gains, you can time sales of other investments before year-end to help achieve your tax planning goals.

As a general rule, if you have realized capital gains or losses over a given year, you can offset one with the other. For example, if you have net capital gains, you can consider which securities have losses that could be harvested to save on capital gains tax. Alternatively, if you have net capital losses, you can use some or all of those net capital losses to offset income.

Long-term and Short-term Capital Gain Strategies

Assets that have been held longer than one year are considered long-term and are taxed at a maximum 15% rate for ordinary income tax and the Alternative Minimum Tax until year-end 2012.¹ Assets held for less than a year are short-term and are taxed at ordinary income tax rates. The distinction is an important one.

¹ Exceptions are the 28% gain on collectibles and certain small business stock holdings, and unrecaptured section 1250 gains. Note that long-term capital gains are preference items for calculation of Tentative Minimum Tax.

In calculating tax on asset sales, a taxpayer must first net the short-term gains and losses; then net the long-term gains and losses independently. Then the short-term and long-term gains and losses are netted against one another. If a net capital loss is generated, it may be used to offset up to \$3,000 of ordinary income (\$1,500 if the taxpayer is filing as Married Filing Separately).

Any unused portion may be carried forward indefinitely until the death of the taxpayer, when the carryforward expires. Capital losses realized on the sale of securities may also be used to offset capital gains on other classes of assets, such as real estate, and vice versa, on Schedule D. It is important to determine whether you are already carrying losses over into 2011 from previous years.

Because of the cost of capital, the sooner a capital loss is used, the better. In general, capital losses are more tax-effective if they can be used to offset income taxed at higher tax rates (short-term capital gains and ordinary income). Long-term losses used against short-term gains are tax-efficient. Short-term losses used against long-term capital gains are tax-inefficient.

For that reason, a taxpayer normally should try to avoid having long-term capital losses offset long-term capital gains, as the losses will be more valuable if used to offset short-term gains or ordinary income. To do this requires ensuring that the long-term capital losses are not taken in the same year as the long-term capital gains.

Considerations for Those in Lower Tax Brackets (or With Children in Lower Tax Brackets)

For investors with lower taxable income (e.g. those who, for 2011, were in the 10% and 15% federal tax brackets, with taxable income less than \$34,500 for a single individual and \$69,000 for a married couple), the tax rate on capital gains would be 0%. For these investors, harvesting of capital losses would be wasted, since they will not be taxed on their gains. For these investors, it may make sense to harvest gains instead of losses—and sell appreciated securities without having to pay capital gains tax on the sale.



It is also worth noting that, even if you are not in these lower tax brackets, you may be able to take advantage of this tax rule. If you have adult children in one of these tax brackets (beyond the reach of the Kiddie tax rules), consider using your \$13,000 annual gift tax exclusion to transfer appreciated or dividend-producing assets to them so they can enjoy the 0% rate, which also applies to qualified dividends.

It is helpful to remember that you can “give away a gain” and have the recipient taxed on the appreciation on the subsequent sale of the asset, but you cannot “give away a loss” in a symmetrical fashion.

Focusing on Both Investment and Tax Goals

Both investment objectives and tax strategy should be weighed when selling investments—or continuing to hold them in your portfolio. The decision to wait to defer a gain until the next year needs to be balanced against the risk to the value of the property, whether its value may decline before it can be sold. Similarly, a taxpayer should not risk increasing loss on property that he or she expects will continue to decline in value by deferring sale of that property until the next year.

Your Janney Financial Advisor can help you and your tax advisor to evaluate tax minimization and investment goals relative to your portfolio in 2011 and future years.

Minimizing Taxes on Appreciated Mutual Funds

An investor who owns appreciated mutual funds, which may also be good candidates for sale, may wish to consider selling those funds prior to the December capital gains payment made by fund managers to shareholders.

Other advanced planning techniques that can be used to defer payment of capital gains tax also exist.

Loss Carryovers

Loss carryovers can be a powerful tax-saving tool in future years if you have a large investment portfolio, real estate holdings or a closely held business that might generate substantial future capital gains. They will be even more valuable if tax rates go up in 2013 (and the carryover benefit is retained in tax law).

If, on the other hand, it looks like it could take a long time to absorb a large loss carryover, you might want to realize gains before year-end to absorb excess losses as long as this is consistent with your investment goals. Remember that capital gains distributions from mutual funds can also absorb capital losses.

Another way to use excess capital losses is to begin a program of writing covered calls—when this is appropriate. The premiums received from the covered calls are treated as short-term capital gains when the call expires and may be effectively tax-free if you have a loss carryover large enough to absorb the gains.

Paying Attention to Details

If you fail to pay attention to the details, the tax consequences of a sale may be different from what you expect. For example, the trade date, not the settlement date, of publicly-traded securities determines the year in which you recognize the gain or loss.

If you bought the same security at different times and prices, and you want to sell high-tax-basis shares to reduce gains or increase a loss and offset other gains, you will need to specifically identify which block of shares is being sold.

The Wash Sale Rule

If you are trying to achieve a tax loss with minimal change in your portfolio’s asset allocation, keep in mind the wash sale rule. It prevents you from taking a loss on a security if you buy a substantially identical security (or option to buy such a security) within 30 days before or after you sell the security that created the loss. In that case, you can recognize the loss only when you sell the replacement security.

Fortunately, there are ways to avoid the wash sale rule. For example, you may immediately buy securities of a different company in the same industry or shares in a mutual fund that holds securities much like the ones you sold. Or, you can wait 31 days to repurchase the same security. Alternatively, before selling the security, you can purchase additional shares of that security equal to the number you want to sell at a loss, and then wait 31 days to sell the original portion.

You also can do a bond swap, where you sell a bond, take a loss, and then immediately buy another bond of similar quality and duration from a different issuer. Generally, the wash sale rule doesn’t apply as the bonds aren’t considered substantially identical. You can then achieve a tax loss with no change in economic position.

Special Cases

Generally, gold, held as coins or bullion, is treated as a “collectible,” for which the long-term capital gain rate is 28%. All short-term capital gains are treated as ordinary income. An investor in a lower tax bracket would be better off triggering short-term, rather than long-term, capital gain on gold coins or bullion. The “wash sale rule” does not apply to “collectible” losses.

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Benefiting from Deductions Expiring in 2011

The following tax deductions, credits and opportunities extend only through 2011—and can be applied this year, as appropriate:

- The election to take an itemized deduction for state and local general sales taxes in lieu of the itemized deduction permitted for state and local income taxes
- The above-the-line deduction for qualified higher education (tuition) expenses
- The \$250 above-the-line deduction for certain expenses of teachers
- Deductibility of premiums paid on mortgage insurance on a qualified residence
- The tax credit for energy-saving home improvements
- Increased contribution limits and a carryforward period for contributions of partial and complete interests in appreciated real property for conservation
- For those age 70½ or older, making tax-free distributions to charity from an IRA of up to \$100,000 per taxpayer, per tax year

If these opportunities are useful to you, they can be considered or applied in the 2011 tax year.

Income Timing Considerations

Planning for taxes on your income often involves seeking opportunities to generate income in ways that are tax-deferred, tax-free or taxed at favored rates—and managing timing of income recognition. If it is expected that an investor's marginal tax rates will be lower in the future, timing of income flows may be used to push income recognition into the future. Likewise, if income tax rates are expected to be higher in future years, recognition of income in the present year (2011) would be recommended. Note that such changes in rates could come from a number of sources, including possible regulatory changes and changes in personal circumstance. Care needs to be taken, as deferring of income or acceleration of expenses may lead to Alternative Minimum Tax (AMT) problems. Your tax advisor can help you in this area.

Investing in a Rising Tax Environment

Under current law, ordinary income tax rates will increase to their pre-2001 levels in tax years beginning on or after January 1, 2013. Some taxpayers may want to consider accelerating certain types of ordinary income (bond interest, annuity income, traditional IRA income, compensation income) into 2011 and 2012 if they expect to be in the same tax bracket or higher in future tax years. This is especially true for top bracket taxpayers who may pay the 3.8% Medicare surtax on their “net investment income” in 2013.

Example: Accelerating Bond Interest—Mike has \$100,000 of accrued bond interest that will be paid in January, 2013. He is in the 35% tax bracket for 2012 and 39.6% + 3.8% for 2013. If he sells his bonds at par in 2012 and recognizes the accrued interest income, he will pay \$35,000 in taxes vs. \$43,400 if he waits and collects the interest in 2013. This step would save \$8,400 in taxes.

Example: Sale/Repurchase of Bonds—Michelle purchased \$1 million of corporate bonds in 2008 at par value with a maturity date of December 31, 2013. On December 31, 2012, she sold them for \$1,050,000. On January 3, 2013, she repurchases the same bonds for \$1,050,000. Under tax law, this \$50,000 premium can be used to offset her interest income over the remaining life of the bond (one year). By selling the bonds in 2012 and repurchasing them in 2013, she realizes a net income tax savings of \$14,200 (\$21,700 in income tax savings on the bond premium, less \$7,500 in capital gains tax on the sale of the bonds = \$14,200).

Don't Forget the Alternative Minimum Tax (AMT)

The effect of any year-end tax strategies should be evaluated as to their impact on a taxpayer's regular income tax as well as the Alternative Minimum Tax (AMT). Many tax breaks allowed in calculating regular tax are not permitted when calculating AMT. To determine AMT, a taxpayer may not claim deductions for residential property taxes, state income tax (or sales tax if that option has been elected), miscellaneous itemized deductions, and personal exemptions. The deduction for medical expenses is more restrictive for AMT than for regular tax purposes. So, in some instances, tax deductions should not be accelerated, depending on the particulars of a taxpayer's situation with respect to AMT.

A large, long-term capital gain, even though taxed at the same rate for regular tax and AMT purposes, can push you into AMT, as it has the effect of absorbing your AMT exemption.

With proper planning, you may be able to avoid the AMT, reduce its impact—or perhaps take advantage of its lower maximum rate. Yet planning for the AMT will be a challenge until Congress passes long-term relief.

It is critical to work with your tax advisor to determine if:

You could be subject to the AMT this year. If so, you can consider accelerating income and short-term capital gains into this year, which may allow you to benefit from the lower maximum AMT rate. You can also consider deferring expenses you can't deduct for AMT purposes until next year—since you may be able to preserve those deductions. If you defer expenses that you can deduct for AMT purposes to next year, the deductions may become more valuable because

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of the higher maximum regular tax rate. Finally, carefully consider the tax consequences of exercising Incentive Stock Options (ISOs).

You could be subject to the AMT next year. Consider taking the opposite approach. For instance, defer income to next year, because you'll likely pay a relatively lower AMT rate. And prepay expenses that will be deductible this year but that won't help you next year, because they are not deductible for AMT purposes. Also, before year-end, consider selling any private activity municipal bonds whose interest could be subject to the AMT.

Charitable Gifts

There are many options for charitable giving in 2011, from direct contributions of cash and property to donor-advised funds, foundations, and charitable trusts. Consider gifting securities that you have held for at least one year. This will help to ensure that you receive the full value deduction for the donation and that you will not have to pay capital gains tax on the securities' appreciation.

Charitable remainder trusts (CRTs), which have always offered benefits to individuals, could become very attractive again—if, in 2013, the capital gains tax rate increases to 20% and the 3.8% Medicare surtax applies. Since appreciated assets that are transferred to a CRT are not taxed, the full value of these assets is available to provide income to the donor, generating much more income than if the donor had sold the asset, paid the capital gains tax, and reinvested the proceeds. With the current historically low 7520 rates, charitable lead trusts can be used now by charitably-inclined individuals to shift significant wealth while using only an insignificant amount of their estate/gift tax exemption.

Gifts to Family

You can give \$13,000 annually to anyone (\$26,000 for a couple). It often makes sense to gift investments that you expect to appreciate in the future.

Roth IRAs

Conversions of traditional IRAs to Roth IRAs are still permitted in 2011. Roth IRAs can provide for future tax-free withdrawals and the ability to keep the money invested longer, compared to a traditional IRA. You can no longer split the taxes due from the conversion over two years as you could in 2010. Roth IRAs may be an opportunity to consider if you are concerned that tax rates may increase after 2012.

Business Owners

Businesses owners can consider tax savings through: (1) the 100% bonus first year depreciation, (2) a \$500,000 cap on "Section 179" expensing, (3) deducting up to \$250,000 for qualified real property, or (4) a tax credit for qualifying research expenses.

The rise in capital gains tax rates in 2013 may affect the exit strategies of owners looking toward a liquidation event for retirement funding. They may wish to begin developing a strategy soon, as sometimes, a significant length of time is required to conclude a sale. Also, any owners of C corporations with accumulated earnings and profits (and available cash) may want to make larger dividends in 2011 and 2012 to avoid the higher tax rates applicable to dividends scheduled to apply in 2013.

Business Investors: Individuals who are considering purchasing stock in a qualified small business will want to conclude this transaction before year-end 2011 to ensure that they qualify for the exclusion of 100% of the gain on sale if the stock is ultimately held for over five years.

Planning for Future Changes

Under current law, on January 1, 2013, the top income tax rate will rise from 36% to 39.6%, qualified dividends will become subject to ordinary income tax rates, the long-term capital gains tax will rise from 15% to 20%, and the 3.8% Medicare surtax will apply (unless the health care reform act is struck down or repealed). It is also possible that Congress will legislate tax changes later this year or in 2012. It is important to consider these future changes when implementing tax strategies in 2011.

SUMMARY

Your Janney Financial Advisor can work with you and your other advisors to discuss, and then implement, strategies that can help you to minimize 2011 taxes. Please consult with your tax advisor before implementing any of these strategies.

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