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Dear Friends,
Enclosed please find our newsletter for this month. As always, should you have any questions, please feel free to contact our offices.

Sincerely,
Randhir S. Judge

June 2011

Mid-Year Tax Considerations

Though it may seem as if the ink has barely dried on your 2010 federal income tax return, the end of 2011 is now visible on the horizon. Here are some things to consider as you take stock of your current tax situation.

The 2% difference

If you're an employee, 6.2% of your wages (up to the taxable wage base--$106,800 in 2011) would normally be withheld for your portion of the Social Security retirement component of FICA employment tax. But legislation passed in December 2010 included a temporary one-year 2% reduction in this tax. That means for 2011, you're paying the tax at a rate of 4.2%. If you're self-employed, the 12.4% you would normally pay for the Social Security portion of your self-employment tax is reduced to 10.4%.

Have you earmarked the resulting extra dollars in your paycheck efficiently by, for example, paying down high-interest debt or saving for retirement? If you haven't, consider making up for it by contributing an extra 4% of your income to your 401(k) or an IRA for the remainder of the year. By applying the extra money toward a long-term goal, the potential benefit of the temporary tax reduction can extend beyond 2011.

Tax rates

The same federal income tax rates that applied in 2010 continue to apply in 2011 and 2012 (depending on your taxable income, you'll fall into either the 10%, 15%, 25%, 28%, 33%, or 35% rate bracket). And, as in 2010, long-term capital gains and qualifying dividends in 2011 and 2012 continue to be taxed at a maximum rate of 15%; if you're in the 10% or 15% marginal income tax brackets, a special 0% rate will generally apply. So, unlike this time last year, you don't have to contend with the uncertainty of not knowing what next year's tax rates will be.

That consistency, however, does not apply to the alternative minimum tax (AMT)--essentially a parallel federal income tax system, with its own rates and rules. While the December legislation extended regular income tax rates through 2012, it only extended AMT relief (in the form of increased AMT exemption amounts) through 2011. You can probably expect another AMT fix in legislation later this year, since without it there would be a dramatic increase in the number of individuals subject to AMT in 2012. But that leaves a fair degree of uncertainty today, however, as you consider your overall tax situation.

Also worth noting

Small business stock: Generally, individuals may exclude 50% of any capital gain from the sale or exchange of qualified small business stock provided they meet certain requirements, including a five-year holding period. For qualified small business stock issued and acquired after September 27, 2010, and before January 1, 2012, however, 100% of any capital gain may be excluded from income if the stock is held for at least five years and all other requirements are met.

IRA qualified charitable distributions: Absent additional legislation, 2011 will be the last year that you'll be able to make qualified charitable distributions (QCDs) of up to $100,000 from an IRA directly to a qualified charity if you're age 70½ or older. Such distributions may be excluded from income and count toward satisfying any required minimum distributions (RMDs) that you would otherwise have to receive from your IRA in 2011.

Depreciation and IRC Section 179 expensing: If you're a business owner or self-employed individual, you're allowed a first-year depreciation deduction of 100% of the cost of qualifying property acquired and placed in service during 2011 (the "bonus" first-year additional depreciation deduction will drop to 50% for property acquired and placed in service during 2012). For 2011, the maximum amount that can be expensed under IRC Section 179 is $500,000, but in 2012 the limit will drop to $125,000.

Life Insurance Policy Loans: Tax and Other Implications

What is a MEC?

A life insurance policy purchased after June 20, 1988, is a modified endowment contract if the accumulated premiums paid at any time during the first seven years exceed the sum of the net level premiums for a policy that would be paid up after seven years. A single premium policy is one example of a modified endowment contract. (Your life insurance company or life insurance agent can tell you if a policy is a modified endowment contract.)

As the owner of a life insurance policy, you can generally borrow the policy's cash surrender value and use the proceeds for any purpose. Before you take a policy loan, be sure you understand the implications of the loan on the policy itself as well as any tax implications, now and in the future.

Effect of policy loan on policy

You can generally borrow an amount up to the policy's cash surrender value (less an adjustment for interest) from the insurer. The insurer will charge you interest on the loan. Generally, interest is not actually paid, but is added to the amount of the loan. Interest charged on a policy loan is not generally deductible for income tax purposes. There could be other adjustments as well under the contract; for example, a participating policy may restrict the payment of dividends to you while a loan is outstanding.

You are not required to repay a life insurance policy loan. But you can generally repay a life insurance policy loan at any time while the insured is alive. If you do not repay the loan, the cash surrender value paid to you or the policy proceeds at death will be reduced by the amount of the loan (plus interest). Thus, a loan generally reduces life insurance protection.

If the amount borrowed plus interest ever equals or exceeds the cash surrender value, the policy can terminate if additional amounts are not paid into the life insurance policy. Life insurance protection could be lost.

If you have any incidents of ownership in a life insurance policy on your life, proceeds paid at death are includable in your gross estate for federal estate tax purposes. The right to obtain a policy loan is an incident of ownership. Generally, life insurance proceeds received at death by your beneficiary are received income tax free.

Taxation of policy loan

You can borrow against your life insurance policy, and the loan proceeds are generally not taxable to you (unless the policy is a modified endowment contract (MEC), see sidebar).

A loan from a MEC is treated as a distribution from the MEC. A distribution from a MEC is subject to the income-out-first rule. As amounts are distributed, they are treated as consisting of taxable income to the extent that they do not exceed the excess of the cash surrender value of the policy over the investment in the contract (generally, premiums paid less tax-free distributions). The taxable income will also be subject to a 10% penalty tax unless the distribution is made after age 59½, on account of disability, or as part of a series of substantially equal periodic payments.

Example(s): *You have a MEC with a cash surrender value of $100,000. You have paid premiums of $50,000. You take a policy loan for $60,000. The first $50,000 ($100,000 cash surrender value - $50,000 investment in the contract) of the loan is taxable income to you.*

Lapse or surrender of policy

An outstanding loan is generally treated as an amount received if a policy lapses or is surrendered and may result in taxable income. A policy can lapse if premiums are not paid and the policy terminates when any policy benefits are exhausted as a result. Also, as noted above, if the amount borrowed plus interest ever equals or exceeds the cash surrender value, the policy can terminate if additional amounts are not paid into the life insurance policy. You can cash in a policy by surrendering the policy to the insurer in return for the policy's cash surrender value (as reduced by the amount of the loan plus interest).

If you surrender your policy to the life insurance company or the policy lapses, any gain realized is taxable at ordinary income tax rates. The gain is the excess of the amount you receive over the net premium cost. The net premium cost is the total premiums you paid less any tax-free distributions received. An outstanding loan is generally treated as an amount received if a policy is surrendered or lapsed and may result in taxable income.

Example(s): *You have a life insurance policy with a cash surrender value of $200,000. You have paid premiums of $75,000. You also have an outstanding policy loan of $175,000. There have been no distributions from the policy. You surrender the policy to the insurer for $25,000 cash. You have taxable ordinary income of $125,000 ($25,000 cash + $175,000 loan - $75,000 premiums). If you have not prepared for it, it may come as quite a shock.*

Example(s): *You have a life insurance policy with a cash surrender value of $200,000. You have paid premiums of $75,000. You also have an outstanding policy loan of $200,000. There have been no distributions from the policy. The policy lapses. You have taxable ordinary income of $125,000 ($200,000 loan - $75,000 premiums). Once again, if you have not prepared for it, it may come as quite a shock.*

These Deferred Annuity Mistakes Can Be Taxing

The situations described here relate to deferred annuities. Different tax rules may apply to annuities in the payment stage (annuitization).

The tax treatment of nonqualified deferred annuities (annuities that are not part of a tax-qualified plan such as an IRA or 401(k)) appears to be fairly clear-cut:

- A distribution that represents a return of your investment in the contract is not taxed
- Earnings aren't taxed until they're withdrawn
- Earnings are taxed as ordinary income and not capital gains, and
- A distribution of earnings taken before age 59½ is subject to a 10% tax penalty unless an exception applies

Simple, right? Yes--except for those particular circumstances that trigger unexpected tax consequences.

Ownership by a "non-natural entity"

"Non-natural entity" is tax speak meaning the annuity owner is not a human being, but is an entity (e.g., trust, partnership, corporation). This creates a situation where the annuity is not treated as a tax-deferred annuity, so any earnings will be taxed to the annuity owner/entity as ordinary income during the current year--even if the earnings haven't been distributed.

There are some exceptions to this rule. It doesn't apply to immediate annuities or those considered qualified funding assets (e.g., annuities held for periodic payments due to personal injury settlements). Also, the annuity may not lose its tax-deferred status if the non-natural entity/owner is acting as the agent for a natural person. For example, ownership of the annuity by the estate of a deceased annuity owner, or the trustee of an IRA or qualified plan, will not, in and of itself, remove its tax-deferred status.

Certain revocable (grantor) trusts may also be the annuity owner without negating the annuity's tax-deferred status, as long as all of the trust beneficiaries are natural persons. However, if an irrevocable (non-grantor) trust, such as a credit shelter trust, is the annuity owner, distributions of earnings from the annuity may be subject to an additional 10% tax penalty. That's because exceptions to this penalty that are available to a person/annuity owner don't apply to a non-natural entity. For example, a non-natural entity can't claim to be over age 59½, nor can it be disabled from work.

Gifting an annuity contract

If you make a gift of an annuity you own, special income tax rules apply. If you owned the annuity for some time before making the gift, you are subject to a tax on the difference between the value of the annuity (its cash surrender value) and the amount you have invested in the contract (your premiums). You would have to claim the income in the tax year you make the gift. This rule applies to gifts of annuities to charities and charitable remainder trusts as well. A gift of an annuity contract between spouses generally does not trigger this tax, however.

A trust as your annuity beneficiary

Revocable living trusts are a common estate planning tool. Often, an annuity owner/trustor will name the trust as beneficiary of an annuity. However, if you're survived by a spouse, naming the trust as the annuity beneficiary may remove some settlement options your spouse would otherwise have.

Generally, a surviving spouse named as beneficiary of a deferred annuity has four options available: (1) take the full death benefit in a lump sum (the earnings will be treated as taxable income at the time the benefit is paid); (2) take the annuity proceeds over a period of five years; (3) elect to receive the annuity payments over a period of time not to exceed his or her lifetime (with the last two options, each payment is part nontaxable return of investment and part taxable earnings); or (4) the surviving spouse may also have the unique option of becoming the new owner of the inherited annuity, in which case the annuity can continue in deferral (the spouse doesn't have to take any payments).

However, by naming the trust as beneficiary instead of your spouse, you'd be eliminating the last two options for your spouse--even if your spouse is the beneficiary of the trust. With the trust as beneficiary, the annuity proceeds would have to be paid in a lump sum or over five years following your death. If your annuity has significant earnings, those earnings would be taxed upon distribution, even if your spouse neither needs nor wants the proceeds.

Using an annuity as collateral for a loan

Using your deferred annuity as collateral for a loan may result in the unwanted realization of taxable income to you. For instance, say the basis (premiums paid) in your annuity is $100,000 and it's now worth $150,000. If you use this annuity as collateral for a loan, the collateral assignment is treated like a distribution and all of the gain (i.e., $50,000) will be taxable to you as ordinary income.

The income tax rules for deferred annuities can be tricky, so before making any ownership or beneficiary designation changes, consult your financial or tax professional.

Ask the Experts

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Can the IRS waive the 60-day IRA rollover deadline?

If you take a distribution from your IRA intending to make a 60-day rollover, but for some reason the funds don't get to the new IRA trustee in time, the tax impact can be devastating. In general, the rollover is invalid, the distribution becomes a taxable event, and you're treated as having made a regular, instead of a rollover, contribution to the new IRA. But all may not be lost. The 60-day requirement can be automatically waived in some cases, and the IRS has the discretion to waive the rule in others. The 60-day requirement is automatically waived if *all* of the following apply:

- The financial institution receives the funds on your behalf before the end of the 60-day rollover period
- You followed all the procedures set by the financial institution for depositing funds into an IRA within the 60-day period (including giving instructions to deposit the funds into an IRA)
- The funds are not deposited into an IRA within the 60-day rollover period solely because of an error on the part of the financial institution
- The funds are deposited within 1 year from the beginning of the 60-day rollover period
- It would have been a valid rollover if the financial institution had deposited the funds as instructed

If you don't qualify for an automatic waiver, you can apply to the IRS for a discretionary waiver. The IRS may waive the 60-day requirement where failure to do so would be against equity or good conscience, such as in the event of a casualty, disaster, or other event beyond your reasonable control. The IRS will consider all relevant facts and circumstances, including:

- Whether errors were made by the financial institution (in addition to those described under automatic waiver, above)
- Whether you were unable to complete the rollover on a timely basis due to death, disability, hospitalization, incarceration, restrictions imposed by a foreign country, or postal error
- Whether you used the amount distributed
- How much time has passed since the date of distribution

What is the IRA one-rollover-per-year rule?

The one-rollover-per-year rule is a little known provision that says you can only make one rollover from a particular IRA to any other IRA in any 12-month period. A violation of the rule can have serious adverse tax consequences. Luckily, it's a problem that's very easy to avoid.

Here's how the IRS states the rule: "If you make a tax-free rollover of any part of a distribution from an IRA, you cannot, within a 1-year period, make a tax-free rollover of any later distribution from that same IRA. You also cannot make a tax-free rollover of any amount distributed, within the same 1-year period, from the IRA into which you made the tax-free rollover. The 1-year period begins on the date you receive the IRA distribution, not on the date you roll it over to an IRA."

This is best understood with an example. Assume you have three IRAs, A, B, and C. On January 1, 2011, you receive a distribution from IRA A and, within 60 days, you roll that distribution over to IRA B. The one-rollover-per-year rule says that any other distribution from IRA A that you receive before January 1, 2012, can't be rolled over. Similarly, any distribution from IRA B that you receive before January 1, 2012, can't be rolled over. You can, however, receive a distribution from IRA C and roll it over to any other IRA without restriction.

What happens if you violate the rule? The disallowed rollover is taxed as a distribution to you; if you're not age 59½, the additional 10% early distribution penalty may apply; you're treated as having made a regular, rather than rollover, contribution to the receiving IRA, so a 6% excess contribution penalty may apply; and you may be subject to additional penalties if you fail to report the "rollover" as a distribution on your income tax return.

So how do you avoid the problem? It's easy. Use direct transfers instead of 60-day rollovers. The rule doesn't apply when IRA funds are transferred directly from one trustee to another trustee (you never receive the funds). The rule also doesn't apply to conversions of traditional IRAs to Roth IRAs. So you can make as many trustee-to-trustee transfers, or Roth IRA conversions, as you like in any year--the one-rollover-per-year rule will not apply.