

November 10, 2011

Dear clients and business associates:

With tax laws constantly evolving, year-end tax planning can be a challenge. The 2012 tax year should be no different with a few changes already been set in place. Notably, Social Security will be undergoing some significant changes; benefits are to go up 3.6% and its wage base will be set at \$110,100 (a \$3,300 increase compared to prior year). In addition, the maximum 401(k) contribution will increase \$500 setting it at \$17,000; this is applicable for 403(b) and 457 plans as well. Further, if born before 1963, you may contribute as much as \$22,500. The 2012 tax year should prove to be interesting with numerous tax proposals from GOP candidates, such as flat tax rates, fewer tax brackets, a national sales tax, and the elimination of the federal estate tax. The following are 2009 filing statistics:

Tax Filing Statistics - Who Pays Income Taxes and How Much?

| Percentiles Ranked by AGI | AGI | Percentage of Federal Personal Income Tax Paid |
|---------------------------|-----------|--|
| Top 1% | \$343,927 | 36.73% |
| Top 5% | \$154,643 | 58.66% |
| Top 10% | \$112,124 | 70.47% |
| Top 25% | \$66,193 | 87.30% |
| Top 50% | \$32,396 | 97.75% |
| Bottom 50% | <\$32,396 | 2.25% |

Regardless of the current or future changes, nothing should not stop you from realizing tax savings. Although we realize that many things are beyond your control, we have provided a few things you can still do and take advantage of in 2011:

Avoid capital gains taxes this year

Review your investment accounts to be sure you shelter all of your capital gains by selling additional (loss) security positions if necessary. If you sell a loss security, then you cannot purchase the same security within 30 days (before or after), otherwise the tax loss will not be allowed under the 'wash sale' rules. Note that you can sell a mutual fund (Fidelity S&P 500) and purchase a similar mutual fund (Schwab S&P 500) or ETF from another company to avoid the wash sale rules. Pay special attention to your mutual fund long-term capital gain (LTCG) distributions by reviewing your brokerage statements. These distributions are made in the form of additional mutual fund shares and usually catch investors by surprise come tax time. You may not be able to predict your December mutual fund capital gains distributions, so consider taking excess capital losses to offset current capital gains and the potentially huge mutual fund LTCG distributions. Excess losses will carryover to future tax years so they will not be wasted.

Investment decisions to buy or sell should always be considered when tax trading.

Retirement Plan Contributions

Take a look at your last pay stub to check your YTD 401(k) or 403(b) contributions. You can contribute up to \$16,500 (\$22,000 if you are 50 or older). If you are able, see HR or the payroll department to maximize your contribution by December 31st for a tax write-off.

Charity

Donations are deductible in the year you make the gift so we recommend you make your last minute contributions by December 31st. Always obtain a receipt for non-cash gifts. Non-cash donations valued at \$5,000 or more require a qualified appraisal. Credit card donations are deductible in the year charged to your account.

The donation of appreciated securities held over 1 year allows you to deduct the fair market value of the stocks while avoiding the capital gains tax. Never donate (loss) securities. The donation of publicly traded securities does not require an appraisal.

Donor advised funds

Donor advised funds (DAF) are beneficial since: 1) you can contribute cash or stock by December 31st to obtain an immediate tax deduction even if you have not decided on a specific charity; and 2) it is usually easier to donate appreciated stock to a DAF than directly to a charity since many are not setup to accept stock donations. The DAF sells the stock and you "advise" where the money goes.

Prepay taxes (N/A if you are in AMT, see AMT section below)

Projecting and prepaying state income taxes allows you to accelerate this tax write-off by a year. If you have consulting income or substantial interest, dividends, capital gains, rental profits, or K-1 income, then you will likely owe additional state taxes beyond your paycheck withholding. In this instance, contact us if you would like assistance in calculating the amount of state income tax you should prepay. We also recommend you prepay your April 2012 real estate tax installment by December 31st to obtain a 2011 deduction on both your federal and California tax returns. State income and real estate taxes are not deductible if you are in AMT.

Medical and miscellaneous itemized deductions (see AMT section below)

Try to bunch "threshold" expenses such as medical expenses or miscellaneous itemized deductions. These expenses are deductible only to the extent they exceed a certain percentage of adjusted gross income. These expenses are more valuable in lower income years.

Income shifting (for business owners)

If you are able to control your income, then deferring revenue to January will result in delaying the associated taxes as well. Consider billing your clients in late December or January to avoid receiving the payment until 2012. If you are able to prepay January expenses this year, then you should pay them now and get a deduction in 2011. If you use a "bank" credit card (Visa, MC, AMEX, Discover) then the expense is deductible this year even though you pay your credit card bill in 2012.

But do not prepay expenses if you think you will be in a higher tax bracket next year!

If you think your income will be substantially higher next year (maybe you were unemployed for a portion of this year, or you are anticipating a large bonus next year), then you might consider doing the opposite of the planning suggested above. That is, you may want to accelerate income into this year and defer expenses to next year to shift income to a lower tax bracket.

Qualified Small Business Stock

Qualified small business stock (stock with an active company with assets of less than \$50 million) acquired by December 31, 2011 and held more than 5 years can be sold tax-free (other than state income taxes).

Incentive Stock Options

An exercise and hold strategy will most likely result in you paying AMT. Unless we have already prepared a tax projection for you, you should call us if you exercised and held ISOs this year or are contemplating such a strategy. If you ex-and-held ISOs earlier this year, then you may be able to reduce your tax bill by selling the stock by December 31st if it has lost value since the exercise. The wash-sale rules apply to the sale of ISOs if they have lost value since exercise.

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Tax Credits for solar and fuel-cell equipment (for purchases through December 31, 2016)

The 30% tax credit for the purchase of residential solar water heating and geothermal heat pump equipment (\$2,000 max), solar electric equipment (no limit) and fuel cell property (\$500 per 0.5 kilowatt) has been extended through Dec. 31, 2016. The cost of installation is included in the credit calculation. The manufacturer will certify, in the materials that come with their products, whether equipment and materials create or save enough energy to qualify for a tax credit.

Health Savings Accounts

Health Savings Accounts resemble IRAs for medical costs since:

1. The HSA is a financial account,
2. Contributions to the account are tax deductible, and
3. The account grows tax free

The funds in the account are used to pay your qualified medical expenses and you are not taxed on HSA distributions to pay these costs. HSA health plans are more tax-efficient than regular insurance plans due to the ability to deduct the contributions to the account. Without an HSA, payments for medical expenses are usually not deductible due to AGI limitations. You will need to comparison shop to see if it makes sense to switch from your current insurance plan to an HSA plan since HSA premiums tend to be higher due to the tax benefits.

* The insurance premium for an HSA insurance plan is deductible but subject to the AGI limits. However, it may be deductible if you are self-employed.

*** Alternative Minimum Tax (AMT) - be careful when tax planning**

The following are typical AMT adjustments:

1. State income taxes are not deductible
2. Real estate taxes are not deductible
3. Sales taxes are not deductible
4. Miscellaneous itemized deductions that are not deductible
5. The exercise of ISOs is taxable

If you are in AMT, then we recommend that you do not prepay state and real estate taxes. The AMT significantly complicates tax planning and the proper timing for certain tax deductions. We will be able to determine if you are in AMT by preparing a tax projection.

Gift Planning

Each person is entitled to give \$13,000/year to an unlimited number of persons without incurring a gift tax. You can contribute \$65,000 (\$130,000 with your spouse) to a §529 college savings plan in a single year and avoid gift taxes if a gift tax return is filed with the proper tax elections. The direct payment (to the provider) of education or medical expenses for another are considered tax-free gifts without limitation. Contact us for details.

Potentially Tax-Free Roth IRA Conversions

If your income is down due to a business loss or unemployment, yet you still have significant deductions such as mortgage interest, real estate taxes, charitable contributions and dependent exemptions, then this presents an opportunity to convert your taxable IRA accounts to tax-free Roth-IRA accounts with potentially little to zero tax cost. Contact us to assist you in calculating the amount you should convert.

Other reasons to convert a Traditional/SEP IRA to a Roth IRA

Now may be a good time to convert your traditional IRA to a Roth-IRA since your portfolio may have taken a beating. The conversion isn't subject to the 10% premature distribution tax. All taxpayers may participate regardless of AGI beginning in 2012.

RMDs

If you are over 70 1/2, you must take required minimum distributions from your IRA or 401(k) plan otherwise you will be subject to significant tax penalties.

Retirement Planning for Kids

If your child or grandchild had a summer job this summer, consider making a contribution to a Roth-IRA for him/her. The contribution is limited to the lower of their earned income or \$5,000. This counts against your annual tax-free gift limit of \$13,000 (\$26,000 for couples). A 16 year old with \$5,000 in a Roth IRA that earns 7% each year will have \$193,000 of tax free money at age 70 (for a single \$5,000 contribution), \$319,000 at 8%.

Earning their Allowance

Hiring your children can save substantial taxes since your children are in a lower tax bracket, and there are no social security taxes when sole proprietors or husband-wife partnerships hire their under-age-18 kids. This may be especially useful if your children are in college.

529 Plans

Designed to encourage saving for future college costs, these saving plans offer tax-free growth for qualified education expenses. Earnings in 529 plans are not subject to federal tax, and in most cases state tax. Withdrawals that are used to pay for qualified college costs are also tax-free.

Education Tax Credits

Various education tax credits are phased out if your AGI is too high. Consider shifting income to children enrolled in college so that they can shelter their federal income taxes with Education Credits.

Not all Long-term gains get 15% tax treatment

ETFs that invest in metals do not qualify for the federal 15% cap on long-term capital gains; these gains are taxed at 28% if long-term. On the bright side, IRAs are generally not allowed to invest in metals, but they are allowed to invest in 'metal' ETFs to give you a bit more diversification if desired.

Flexible Spending Plans

Flexible spending accounts are a beneficial way to continue to stretch your tax dollars. Contributions made to these plans are free from both federal and Social Security taxes and these funds can be used for out of pocket medical expenses. Currently there is no limit to the amount you can contribute to a flexible spending account. However, starting in 2013, there will be a \$2,500 limit per employee. If you need an expensive medical procedure done, such as braces or eye surgery, consider having it done before 2013 so you can pay for these procedures with these pre-tax funds. See your human resource department or payroll manager to determine if your employee offers this tax benefit.

1099s

Beginning in 2011, landlords will be required to issue 1099s to service providers paid \$600 during the calendar year. Be sure to obtain the name, address, and social security numbers of service providers before you pay them (otherwise, good luck getting that info). You will not have to issue 1099s to corporate service providers other than lawyers.

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Federal Tax Deposit Coupons

The IRS will eliminate use of federal tax deposit coupons after 2010 (these are usually used for payroll tax deposits); thus, firms will have to wire deposits of all taxes to the IRS. Go to www.eftps.gov or call 800-555-4477 to enroll for electronic deposits. Small firms can continue to use tax deposit coupons if quarterly employment taxes do not exceed \$2500.

Identity Theft Scams

Do not respond to emails purportedly from the IRS requesting your social security number, credit card data, bank account data, PINS, donations for wildfire victims, or other personal information as it is likely a scam. Feel free to call us if you receive correspondence from the IRS or CA Franchise Tax Board and you are not sure what to do.

We are here to help you

These are strategies we think apply to most of our clients, but we know every client and situation is unique. If you think your particular situation warrants a closer look, please call or e-mail us and we will prepare a year-end tax projection. The taxes saved with proper planning can be substantial. For additional tax articles and tools, visit our website at www.cariondotycpa.com.