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# 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.*

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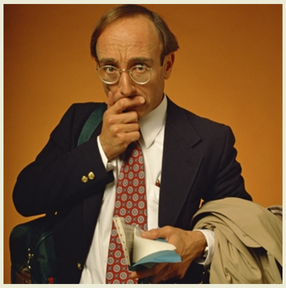
# Deciphering Health Savings Vehicles

*Beginning January 1, 2011, for HSA, MSA, FSA, and HRA programs, a drug or medicine is considered a qualified medical expense only if it is obtained with a prescription, or is insulin.*



*Effective January 1, 2013, contributions to a flexible spending account will be limited to $2,500 per year, increased annually by cost-of-living adjustments.*

Health savings accounts (HSAs), Archer medical savings accounts (MSAs), health reimbursement arrangements (HRAs), and flexible spending arrangements (FSAs) are all personal health accounts that may help you control your health-care costs. But trying to figure out what's what can be confusing. Here's a brief description of each type of account, including some of their major features and benefits.

## MSAs/HSAs

As of January 1, 2008, the MSA program expired and no new MSAs can be established, although if you already participate in an MSA, you can continue to receive contributions. HSAs have generally taken the place of MSAs because of their greater flexibility and options. In fact, in most instances you can roll over an existing MSA into an HSA. MSAs and HSAs are set up in a trust account with a financial entity. Contributions made through your employer are pretax dollars (or you can contribute to the account directly and deduct the contribution), no tax is due on funds in the account, or on any earnings until withdrawn, and if funds are used for qualified medical expenses, the withdrawals are not taxed. However, account withdrawals that aren't used for qualified medical expenses are subject to a tax penalty of 20%, in addition to regular income tax. Your account is portable, meaning if you change employers or leave the workforce, you can keep the account. To be eligible, you must be insured by a high deductible health plan (HDHP) that you maintain (if self-employed) or that's provided through your employer.

However, there are also differences between MSAs and HSAs. Generally, anyone with an HDHP can participate in an HSA. But to qualify for an MSA, you must have been either an employee of a company that employs 50 or fewer people, or be self-employed (or the spouse of such an employee or self-employed person). With an HSA, contributions can be made by you, your employer, or anyone else on your behalf within the same plan year. But MSA contributions can only be made by either your employer or yourself, but not both, in the same plan year. Contribution amounts also differ. In 2011, maximum HSA contributions are limited to $3,050 for single HDHP coverage and $6,150 for family HDHP coverage. MSA contributions can be up to 75% (65% if you participate in a self-only plan) of the annual deductible of your HDHP, but no more than your annual earnings from employment.

## FSAs

If you don't participate in an HDHP, you still can set money aside for uninsured medical expenses through an employer-established FSA. Unlike an HSA, you must be an employee of the employer providing the FSA in order to participate (self-employed persons are not eligible and certain limitations may apply if you are a highly compensated participant or key employee). Pretax contributions can be made by either you, your employer, or both of you (except employer contributions used to pay long-term care premiums must be included in income). You determine how much money you want deposited each year up to the plan's maximum dollar amount or percentage of compensation; funds in the account are not subject to tax; and distributions are tax free if used to pay for qualified, unreimbursed medical expenses you've incurred (no advance payments for anticipated expenses). Unlike HSAs, if you leave your employer, you can't keep the money in the account or take it with you to another employer (it's not portable). Also, what you don't spend on medical expenses by the end of the plan year is forfeited and not available the following year (i.e., you must use it or lose it).

## HRAs

Like FSAs, HRAs are only available to employees, not to self-employed individuals. And HRAs must be funded solely by an employer; you can't contribute directly to the account. The terms of the HRA are generally determined by the employer. For example, your employer's plan may or may not require you to have health insurance in order to participate. The plan sets the maximum amount of contributions, and determines whether a credit balance in the account can be rolled over from year to year, and if so, how much of the account can be rolled over. But contributions and reimbursements for qualified medical expenses are tax free. Reimbursements can be made to current and former employees, including spouses and dependents of employees and deceased employees. However, if the plan allows for any distribution to you or anyone else (e.g., spouse, dependent, estate at your death) for other than reimbursement for qualified medical expenses, then any distribution, whether for qualified medical expenses or not, is included in gross income.

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# 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.

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