

# the Bridge

DECEMBER 2011

## Year-End Tax Planning

BY BRIAN R. MILES



As the clock winds down on 2011, now is a good time for taxpayers to take a look at their financial situation and determine if they can be better positioned with respect to their 2011 tax bill. With that in mind, here are some potential year-end tax strategies that may make a difference in what's owed for the 2011 tax year now drawing to a close.

### INCOME AND DEDUCTION SHIFTING

Traditional income tax planning calls for postponing income to the next year and accelerating deductions into the current year. This approach defers taxes, which is generally beneficial if you will be subject to the same (or a lower) tax bracket in the next year. Because the 2010 Tax Relief Act locked in lower income tax rates through 2012, taxpayers have the opportunity to take advantage of this strategy in 2011.

Potentially deferrable income items include year-end bonuses and self-employment income. Taxable income may also be reduced in the current year by maxing out contributions to a retirement account such as an IRA or 401(k), or to a Health Savings Account.

Deductible expenditures can be accelerated by making an early payment on a mortgage installment and by pre-paying state and local income and real estate taxes. Even though these expenses may not be due until 2012, making the payments before December 31st could produce higher 2011 itemized deductions. Depending on your situation, uninsured medical costs and miscellaneous itemized deductions may also be candidates for prepayment to accelerate deductions. Although out-of-pocket medical costs are — *continued*

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HAPPY HOLIDAYS!



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only deductible to the extent they exceed 7.5% of AGI and miscellaneous itemized deductions count only to the extent they exceed 2% of AGI, bunching these expenses into one calendar year could result in additional tax-saving write-offs.

Unfortunately income and deduction shifting strategies are not without peril. That's because the alternative minimum tax (AMT) significantly limits some deductions and completely disallows others, such as write-offs for state and local income and property taxes. As a result, it's a good idea to consult a tax professional to explore whether you are subject to the AMT and, if so, which deductions will qualify for AMT purposes.

### GAINS AND LOSSES

Timing the recognition of capital gains and losses at year-end may help minimize capital gains tax and maximize deductible capital losses. Realizing losses on investments before the end of the year can help lower your 2011 tax bill because such losses can be used to offset any capital gains from earlier in the year. Moreover, up to \$3,000 of excess capital losses can be deducted from ordinary income and any remaining capital losses may be carried over to future years. At Bridges, we review year-to-date realized gains and losses for all client portfolios during the fourth quarter in order to capture opportunities to minimize capital gains taxes in the current year.

### CHARITABLE CONTRIBUTIONS

With the holidays approaching, it's a perfect time to make a gift to charity. Taxpayers with appreciated stock held for more than one year may want to consider donating the shares instead of cash. An itemized charitable contribution deduction is available for the full market value of the shares on the date of the donation and capital gains taxes will be avoided. On the other hand, taxpayers holding shares of stock with an unrealized loss should sell the shares, donate the proceeds and book the capital loss. That way the full amount of the donation will be deductible and the tax-saving capital loss will be retained.


Also, taxpayers age 70 1/2 and older have the unique opportunity in 2011 to make a qualified charitable distribution (QCD) directly from their IRA. Normally, charitable contributions from an IRA are treated as distributions and included in ordinary income. A charitable deduction is then available to those taxpayers who itemize. However, in 2011 up to \$100,000 in IRA assets may be distributed directly to charity. No charitable deduction is allowed but the QCD will satisfy the required minimum distribution rules and won't be included in taxable income, thereby avoiding tax on the distributed funds. This tax break is scheduled to end for distributions made in tax years beginning after December 31, 2011.

### GIFT AND ESTATE TAX

Although estate planning strategies may not necessarily affect your income tax bill, it's generally a good idea to review estate planning goals as the year-end approaches. The current gift-tax and estate-tax is set at a maximum 35% rate with a \$5 million exemption amount (\$5.12 million in 2012). However, without action by Congress, the estate-tax exemption will revert to \$1 million and the tax rate will jump to 55% in 2013. In light of this possibility, lifetime gift-giving may provide an attractive planning opportunity.


For instance, the annual gift-tax exclusion allows each individual taxpayer to gift up to \$13,000 per recipient, per year (\$26,000 per recipient, per year for gifts from married couples) tax-free without using any of the lifetime gift tax and estate tax exemption. Also, consider that the current \$5 million lifetime gift tax exemption may present a unique opportunity to transfer substantial wealth, including assets that are expected to appreciate significantly in value, tax-free.

### CONCLUSION

Bottom line – make it a priority to review your financial situation with your tax, legal and financial advisers. If you act now, you still have time to make a difference in your 2011 tax bill. 

## Simple Steps for Late Savers

As the old adage states – the sooner you start putting aside money for retirement, the more you will have once that highly anticipated day arrives. Unfortunately, saving for college tuition, purchasing a new home and paying for unforeseen medical expenses and life's other necessities and surprises cause many investors to postpone saving for their own retirement. Although starting the retirement planning process late in life can be challenging, it is certainly not impossible to reach your savings goals. Here are some basic steps to consider.

An initial step to getting on track is to put together a budget. Simply outline all of your expenses and subtract the total from your net income. The result will help you identify areas in which you may be spending too much and give you a clear and realistic indication of how much you can potentially save. 

Ultimately, a budget will force you to take a close look at your current financial situation and serve as a road map to reaching your goals.

Second, although there are essential expenses that cannot be eliminated like food and electricity, most people can identify some areas, such as entertainment, that are not vital to one's existence and can be cut back. The more areas that you can trim the more money you can earmark for retirement.

Third, take advantage of catch-up contributions. Catch-up contribution limits allow individuals age 50 and above to increase their allowable contributions for retirement. For example, participants age 50 and older can make an extra contribution of \$5,500 to their 401(k) in 2011, equating to a maximum contribution of \$22,000. Catch-up contributions to an IRA are limited to \$1,000 in 2011, leading to a maximum contribution of \$6,000.

## Searching for Income and Total Return

BY DOUGLAS R. PLAHN

Investors continue to face significant headwinds in the pursuit of income returns. A pronouncement by the Federal Reserve that the current monetary policy of maintaining the target range for the federal funds rate at 0 to 1/4 percent may be warranted through at least mid-2013 has led to the lowest interest rate environment in the post-World War II era, with the yield for 10-year U.S. Treasury securities declining through the 2.00% threshold. The Standard & Poor's 500 Stock Index dividend yield actually surpassed the 10-year U.S. Treasury yield during September, something that investors have experienced very few times over the last 30 years.



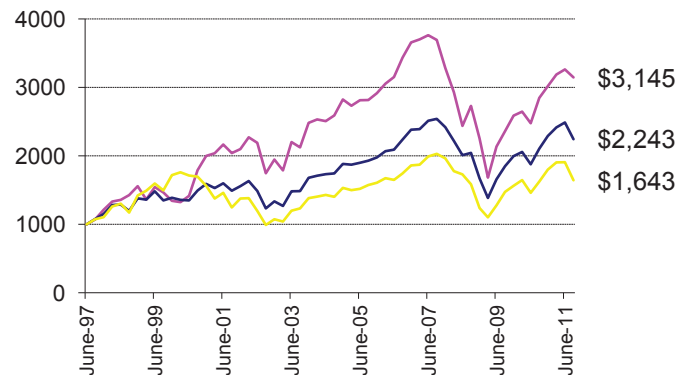
Bond investors are operating in an environment where nominal returns are at historically low levels and a major risk, on a real return basis to the bond investor, is that current monetary policy decisions may result in significant inflation pressures in the future. Inflation is detrimental to bond investors in the long run, as the purchasing power of the cash flow and the principal value have actually declined.

For investors with a defined investment strategy of pursuing income and total returns, with a commensurate risk tolerance, dividend-paying stocks can be a rewarding place to invest. Dividend income can add meaningfully to a portfolio's total return, which comprises income and price return (capital appreciation). Since 1950, there have been 21 instances (approximately one-third of the years) where the income return exceeded the price return for the Standard & Poor's 500 Stock Index. The income component of the return can be especially important for investors who may be drawing supplemental funds from the portfolio.

We look for companies that have the earnings power that will allow for dividend increases over time.

The following graph demonstrates the effect of dividends on total return. Over the 1997-2011 timeframe, the dividend-earning stocks – represented by Morningstar's Dividend Composite Index – had compound annual returns of 5.8%, while the Standard & Poor's 500 Index had compound annual returns of 3.5%. Additionally, the 100 highest-yielding stocks of the Morningstar U.S. Market Index – calculated by Morningstar's Dividend Leaders Index – had compound annual returns of 8.4% versus the 3.5% for the Standard & Poor's 500 Index over the period studied.

### Dividend Income and Total Return



### Compound Annual Return


- Morningstar's Dividend Leaders Index - 8.4%
- Morningstar's Dividend Composite Index - 5.8%
- Standard & Poor's 500 Index - 3.5%

This is for illustrative purposes only and not indicative of any investment. Past performance is no guarantee of future results. Returns and principal invested in stocks are not guaranteed. Dividends are not guaranteed and are paid solely at a company's discretion.

Source: Bloomberg Finance L.P.

Standard & Poor's 500 Index - considered to be representative of the stock market in general; Morningstar Dividend Composite Index and Morningstar Dividend Leaders Index - stocks in both indexes have a consistent record of dividend payment, have the ability to sustain their dividend payments and are weighted in proportion to the total pool of dividends available to investors. The Morningstar Dividend Composite Index captures the performance of all stocks in the U.S. Market Index. The Morningstar Dividend Leaders Index captures the performance of the 100 highest-yielding stocks in the U.S. Market Index.

Although the 100 highest-yielding stocks have demonstrated an ability to outperform the Standard & Poor's 500 Index, we must keep in mind that dividends are paid at a company's discretion. Exceptionally high dividend yields can sometimes be an indicator of company-specific issues that could lead to potential dividend cuts in the future. A good example of this would be the newspaper industry stocks, which have experienced dividend cuts as profitability has declined primarily due to loss of income and market share as consumers continue to shift to the Internet as their primary information source.

A key characteristic that we focus on is the consistency of a company's dividend-paying history. We look for companies that have the earnings power that will allow for dividend increases over time. Dividend increases provide inflation protection for the portfolio as the stream of income increases over the timeframe for holding the investment. 





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