



## Harris Financial Services

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From our family at Harris Financial Services to you and yours ... please have a happy and safe holiday season. We humbly thank you for the trust and confidence you have placed in us. Thank you for your continued support in 2011 and we renew our promise to serve you to the best of our collective ability in 2012 and beyond. God Bless and Merry Christmas!

### December 2011 - Harris Financial Services

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# Your Money Matters

“Big City Solutions - Small Town Service”



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## Qualified Charitable Distributions Qualify for RMDs

If you're an IRA owner who must take a required minimum distribution (RMD) in 2011, you can avoid some or all of the resulting income tax liability by donating a portion of it to charity. A qualified charitable distribution (QCD), also known as an IRA charitable rollover, can not only save you income taxes, it can help minimize your taxable estate and fulfill your philanthropic desires. Through December 31, you can make tax-free transfers of up to \$100,000 directly from your IRA to qualified charities. Here are the details.

### Background

The QCD provision was enacted in 2006, and was scheduled to end in 2009, but last-minute legislation extended it into 2010 and 2011.

Prior to 2006, if a donor withdrew funds from a traditional IRA in order to contribute to charity, the withdrawal had to be reported as ordinary income and was taxed at regular income tax rates. Once the contribution was made, the donor was generally entitled to an income tax deduction for the value of the charitable contribution, calculated and reported on Schedule A of Form 1040 (subject to certain limitations), which could potentially offset some or all of the taxable income generated by the withdrawal.

With a QCD, you can exclude from taxable income any IRA funds directly transferred to a charity as an outright contribution.

**Note:** There is currently legislation being considered in Congress that would make this provision permanent. It would also get rid of the \$100,000 cap, reduce the minimum age at which taxpayers are able to take advantage of certain giving vehicles (e.g., charitable remainder trusts) from 70½ to 59½, and make it easier for donors to give through supporting organizations, private foundations, and donor-advised funds.

### Who might consider this strategy?

You would benefit most from implementing this strategy if you:

- Do not need all of the income from your RMDs

- Make charitable gifts, but don't itemize deductions (generally, only taxpayers who itemize get federal income tax-saving benefits from charitable donations)
- Make large charitable gifts, but are unable to deduct all of them in a given year because of adjusted gross income limitations
- Want to avoid being taxed on your RMDs

### Certain limitations apply

Certain limitations apply to these nontaxable charitable distributions from an IRA:

- You must be at least 70½ years of age when the gift is transferred
- Total gifts cannot exceed \$100,000 per year, per IRA owner or beneficiary (married taxpayers with separate IRAs can give up to \$200,000 total per year, but no more than \$100,000 may be distributed from each spouse's IRA)
- Gifts must be made directly from your IRA to a public charity (i.e., they cannot be made to a private foundation, a supporting organization, or a donor-advised fund)
- The gifts must be outright (i.e., they cannot be used to establish a charitable gift annuity or fund a charitable remainder trust)

**Note:** Transfers must come from the IRAs directly to the charity. If you have retirement assets in a 401(k) or 403(b), for example, you must first roll those assets into an IRA, and then make the transfer from the IRA directly to the charity.

**Note:** You cannot do a QCD from a SEP-IRA or SIMPLE IRA.

### What are the income tax implications?

- Federal--You do not recognize the transfer as income, as long as it goes directly from the IRA to the charity. However, you are not eligible for an income tax charitable deduction.
- State--State laws vary, so check with your financial professional.

## How Much Do You Know about Social Security?



For more information, visit the Social Security website at [www.socialsecurity.gov](http://www.socialsecurity.gov) or call 800-772-1213.



Social Security is in the news more and more, as the first wave of baby boomers retire and economic pressures on the program increase. More than 90% of Americans are covered by Social Security,\* but how much do you know about this important program?

### How is Social Security funded?

Unlike many government programs, Social Security is funded primarily through the collection of payroll taxes. In 2010, 81.9% of funding came from this source, with the rest derived from interest earned on government bonds held by Social Security trust funds and income taxes paid on benefits.\* That's why Social Security is known as a "pay-as-you-go" system. However, someone working and paying Social Security taxes today is not funding his or her own benefits, but is funding the benefits of someone who is receiving them now or in the near future--one of the reasons why Social Security is facing a potential funding shortfall. According to the Social Security Administration (SSA), the number of retired workers will double in less than 30 years, but there will be fewer workers paying into the system. And with life expectancies increasing, benefits will be paid for a longer period.\*

### How are earnings reported to the SSA?

If you work for an employer, your employer will send a copy of your W-2 form annually to the SSA. If you're self-employed, the IRS will report your earnings to the SSA annually after your federal income tax return has been processed.

### What benefits are available?

Although Social Security is known as a retirement program, benefits are paid to people of all ages, including surviving family members and disabled individuals. In 2010, 5.7 million people were awarded Social Security benefits. Of those, 46% were retired workers, 36% were survivors or spouses/children of retired or disabled workers, and 18% were disabled workers.\*

### How do you qualify for benefits?

As you work and pay payroll taxes, you earn Social Security credits. Generally, you need to work 10 years to earn enough credits to qualify for retirement benefits--other benefits have different requirements. Contact the SSA if you have any questions about your benefit entitlement.

### Do most people apply for early retirement benefits?

Yes. According to a report by the Government Accounting Office (GAO), 43% of people take

early retirement benefits at age 62, while almost 73% of people apply for benefits before they reach full retirement age.\*\*

### How much more will you receive if you delay applying for benefits?

For each year past your full retirement age you delay receiving benefits, your Social Security benefit will increase by a certain percentage (8% for anyone who was born in 1943 or later). For example, if your full retirement age is 66 and you delay receiving benefits until age 70, your annual benefit will be 32% higher.

### Can you receive benefits based on an ex-spouse's record?

You may qualify for divorced spousal benefits if you were married for at least 10 years, you haven't remarried, you are age 62 or older, and you don't qualify for a higher benefit based on your own work record.

### Do workers with lower earnings receive more from Social Security?

A worker who has lower earnings will receive a lower monthly benefit than someone with higher earnings because benefits are based on average lifetime earnings (the highest 35 years of earnings are used in the calculation). However, the Social Security benefit formula is designed to ensure that workers with lower earnings receive a greater percentage of their preretirement earnings. For example, a worker with relatively low earnings may receive a benefit that is approximately 55% of his or her preretirement earnings, while a worker with relatively high earnings may receive a benefit that is approximately 25% of his or her earnings.\*\*\*

### Do you have to stop working to receive Social Security retirement benefits?

No. As long as you've reached early retirement age and meet eligibility requirements, you can apply for Social Security benefits even if you decide to continue working. However, if you're younger than full retirement age and earn more than a certain amount, your benefits will be temporarily reduced (once you reach full retirement age, your benefits will be increased to account for the money that was withheld).

*\*Source: Fast Facts & Figures About Social Security, 2011*

*\*\*Source: GAO-11-400, Retirement Income, June 2011, based on data compiled by the SSA Office of the Chief Actuary*

*\*\*\*Source: SSA Publication No. 05-10045, 2011*



## Gift Tax Strategies



**Now may be a great time to make gifts that take advantage of the current large gift tax applicable exclusion amount, low gift tax rates, depressed property values, and low interest rates.**

The current large gift tax applicable exclusion amount, low gift tax rates, depressed property values, and low interest rates create a favorable environment for making certain gifts.

### Federal gift tax basics

**Annual exclusion.** Each year, you can give a certain amount (\$13,000 in 2011 and 2012) to as many individuals as you like gift tax free.

**Qualified transfers exclusion.** You can give an unlimited amount on behalf of any individuals for tuition or medical expenses gift tax free. You must pay the amount directly to the educational or medical care provider.

**Applicable exclusion amount.** Gifts can also be sheltered by the applicable exclusion amount, which can protect gifts of up to \$5,120,000 (in 2012; \$5,000,000 in 2011). The dollar limit applies to all taxable gifts you make during life and to your estate at your death for federal estate tax purposes.

### Basic planning

The first gifts you consider should generally be annual exclusion and qualified transfer gifts. You can make annual exclusion gifts to anyone for any purpose. The annual exclusion is lost in any year in which you do not use it. You can make unlimited gifts using the exclusion for qualified transfers, but gifts are limited to educational and medical purposes.

You and your spouse can split gifts that either of you make. Doing so allows you and your spouse to effectively use each other's annual exclusions and applicable exclusion amounts. For example, if you have 2 children, you and your spouse could make annual exclusion gifts totaling \$52,000 to your children (2 spouses x 2 children x \$13,000). If you make gifts of \$52,000 for 10 years, you will have transferred \$520,000 to your children gift tax free.

Next, consider gifts that are sheltered by the applicable exclusion amount. But remember that use of the applicable exclusion amount during life reduces the amount available for estate tax purposes at your death.

If you are likely to have a very large taxable estate at your death that could not be sheltered by the applicable exclusion amount, it might even make sense to make gifts that cause you to pay gift tax. For example, let's assume any additional transfer you make would be subject to the current top gift or estate tax rate of 35% and you make a taxable gift of \$1 million to your child on which you pay \$350,000 of gift tax. If instead you retained the \$1,350,000 until death, \$472,500 of estate tax would be due (\$1,350,000 x 35%) and only \$877,500 of the

\$1,350,000 would remain for your child. By making the taxable gift and paying gift taxes that reduced your taxable estate, you reduced taxes by \$122,500 while increasing the amount transferred to your child by the same \$122,500.

### Gift considerations

If you have property whose value is depressed, now may be a good time to make a gift of it. The gift tax value of a gift is its fair market value, and a lower value means a smaller gift for gift tax purposes. However, you generally should not make gifts of property that would produce an income tax loss if sold (basis in excess of sales price). The person receiving the property would have a carryover basis and would not be able to claim the loss. In these cases, instead consider selling the property, claiming the loss, and making a gift of the sales proceeds.

Future appreciation on gifted property is removed from your gross estate for federal estate tax purposes. However, while property included in your estate generally receives a basis stepped up (or stepped down) to fair market value when you die, lifetime gifts do not. Therefore, you may wish to balance the gift tax advantage of a gift with carryover basis and income tax on gain if the property is sold against the income tax advantage of a stepped-up basis and estate tax (if any) if you retain the property until your death.

In the current low interest rate environment, you may wish to consider a grantor retained annuity trust (GRAT). In a GRAT, you transfer property to a trust, but retain a right to annuity payments for a term of years. After the trust term ends, the remaining trust property passes to your beneficiaries, such as family members. The value of the gift of a remainder interest is discounted for gift tax purposes to reflect that it will be received in the future. Also, if you survive the trust term, the trust property is not included in your gross estate for estate tax purposes. Any appreciation in the trust property that is greater than the IRS interest rate used to value the gift escapes gift and estate taxation. The lower the IRS interest rate, the more effective this technique generally is.

In the current low interest rate environment, you may also wish to consider a low-interest loan to family members. You are generally required to provide for adequate interest on the loan, or interest will be deemed for gift tax purposes. However, with the current low interest rates, you can provide loans at a very low rate and family members can effectively keep any earnings in excess of the interest they are required to pay you.



## Ask the Experts

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### Are hobby expenses deductible?

So, you have a hobby that you enjoy. Lately, you have been viewing the hobby as a possible source of income. Of course, you will have to report that income on your income tax return. But can you deduct your hobby expenses?

If your activity qualifies as a business, you are able to deduct qualified business expenses, even if they exceed income from your business. However, there is a hobby loss rule designed to limit the deduction of losses when an activity is not carried on to make a profit. (The rule does not apply to C corporations.)

Whether you carry on an activity to make a profit is determined by all relevant facts and circumstances. However, your activity will be presumed carried on for profit if it produces a profit in at least three of the last five years (two out of seven for certain activities involving horses). The IRS can rebut this presumption.

When you first start out, it may be difficult to show a profit. You can elect to have the three out of five years (or two out of seven years) presumption made after you have the five (or seven) years of experience allowed by the test. You do this by filing Form 5213 (generally,

within three years of the due date--determined without extensions--for filing your income tax return for the first year of the activity). Filing the form delays the IRS determination of whether your activity was carried on for a profit. It also extends the period of limitations for possible denial of hobby loss deductions until two years after the end of the five- (or seven-) year period.

If your activity is not carried on for profit, deductions from the activity are limited:

1. You can take any deductions that would be allowable for personal purposes, such as real estate taxes or home mortgage interest.
2. Deductions that do not result in an adjustment to basis can be taken, limited to the excess of income from the activity over deductions in (1).
3. Deductions that result in an adjustment to basis (for example, depreciation) can be taken, limited to the excess of income from the activity over deductions in (1) and (2).

Deductions claimed under (2) or (3) are miscellaneous deductions, which are allowable only to the extent all such deductions exceed 2% of your adjusted gross income.



### Are business start-up costs deductible?

Generally, costs that you incur prior to the time that you actually begin operating a business are treated as capital expenditures, which are part of your basis in the business. However, certain start-up expenditures may be deducted, either in the first year of business or over time (amortized).

Such start-up costs must be incurred before the business begins operation and be ones that otherwise would be deductible as a normal business expense. Certain syndication costs of marketing or selling interests in a new business cannot be deducted, and must be capitalized.

You may elect to deduct your business start-up costs. If you make the election, you may deduct up to \$5,000 of start-up costs in the taxable year in which you actively start the business. The \$5,000 amount is reduced (but not below zero) to the extent that start-up costs for the business exceed \$50,000. Thus, no first-year deduction is available if start-up costs exceed \$55,000. The remainder of the start-up costs are amortized over a period of 180 months. If you do not elect to deduct your start-up costs, you must capitalize them.

You deduct amortized start-up costs in equal amounts over a period of 180 months. You take the total start-up costs, reduced by the amount you deduct in the year you start the business, and divide that amount by the 180 months in the amortization period. This figure is the amount deductible each month. If the business is terminated before the end of the 180-month amortization period, you may be able to deduct as a business loss any remaining start-up costs that have not been previously deducted.

**Example:** You incur \$52,000 of costs starting up your business before it begins operation and elect to deduct start-up costs. In the year your business actively starts, you can deduct \$3,000 of start-up costs [\$5,000 - (\$52,000 - \$50,000)]. You can also deduct the remaining \$49,000 ratably over 180 months, or \$272.22 a month for 180 months; your deduction for a year with 12 months of amortization would be \$3,266.67.

**Tip:** You are deemed to have elected to deduct eligible start-up expenses unless you affirmatively elect to capitalize the expenses on a timely filed federal income tax return.

