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Tax law changes call for careful planning in 2012.

If there ever was a year when it made sense to plan your tax strategy carefully, 2012 is that year. After filing your annual income tax return, don't assume that you have 11 months of tax-free thoughts. It's important to be proactive in planning your personal tax strategy for 2012 so that you can take advantage of all opportunities.

This year, because several major changes are set to take place at year end, it is especially important to take the time to understand what has changed in 2012, what is expected to change in 2013, and how these new tax laws may affect you. Once you have a good idea of what to expect, learn what you can do to take best advantage of lower tax rates and credits before they expire, and how to manage new tax laws next year. Tax planning should always be a year-round activity, but this is particularly true this year.

As always, discuss your tax situation with an expert, and stay tuned for any new developments between now and December 31 that could affect your tax strategies for this year and next.

The AMT could affect 30 million taxpayers

The 2012 tax year brings a number of changes. One of the most significant changes involves a vast expansion in the reach of the Alternative Minimum Tax (AMT).

The AMT was introduced in 1969 to prevent excessive tax sheltering by high-income taxpayers. If your income exceeds the AMT exemption, you must calculate both regular income tax and the AMT and pay the larger amount. Although the original target of the AMT was a small group of high-income taxpayers who paid no, or little, tax because the AMT exemption hasn't been indexed to the rate of inflation, in recent years this tax has spread to include many upper-middle income taxpayers.

For years, Congress has limited the impact of the AMT by passing legislation ("patches") that provides temporary relief for millions of Americans who might otherwise have had to pay much more income tax than they had anticipated. The last patch was passed in 2010 and covered 2010 and 2011. According to TurboTax, the patch spared up to 21 million taxpayers from having to pay AMT in 2010.¹

This year, the AMT exemption has been substantially reduced—from \$74,450 in 2011 to \$45,000 in 2012 for married taxpayers who file jointly and from \$48,450 to \$33,750 for single filers. If your adjusted gross income (AGI) is above these exemption thresholds, you'll need to do a separate calculation to see if your income taxes based on the AMT are higher.

The AMT calculation removes a number of tax deductions, including Schedule A itemized deductions for state income taxes and property tax, and limits others—notably medical and dental expenses and home mortgage interest deductions. It also removes other tax benefits, including personal exemptions. Depending on your personal situation, the impact could be far-reaching.

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It is still possible that Congress could pass another AMT patch for this year, but that is hard to plan for. If Congress does nothing and the lower AMT exemptions stand as announced, an estimated 30 million tax returns could be subject to the AMT, up from 4 million last year, according to the Committee for a Responsible Federal Budget, a bipartisan nonprofit group.²

Because the AMT is quite complex and could result in your having to pay thousands of dollars in additional income tax, speak with your tax advisor to learn more. Also read the sidebar, “AMT Action Steps,” for actions to consider taking now and later this year.

Other changes in 2012

- The option to claim an itemized tax deduction for state or local sales taxes paid in lieu of state income taxes on Schedule A expired in 2011.
- The foreign earned income deduction increases \$2,200 to \$95,100 for 2012.
- The lifetime learning credit begins to phase out at \$104,000 (joint filers) and \$52,000 (singles and heads of household), up from \$102,000 and \$51,000.
- The earned income tax credit rises to \$5,891 from \$5,751.
- Additionally, various exemptions and deductions have increased (see below), based on automatic triggers when the rate of inflation exceeds a certain level.

Table 1: Inflation adjustments for 2012

	2011	2012
Personal and dependent exemptions	\$3,700	\$3,800
Standard deduction – single filer	\$5,800	\$5,950
Standard deduction – married joint filers	\$11,600	\$11,900
Retirement account annual contribution limit (for 401(k), 403(b), most 457 plans, and the federal government’s Thrift Savings Plan)	\$16,500	\$17,000
Adjusted gross income (AGI) phase-out for making Roth IRA contributions: single filers	\$107,000 - \$122,000	\$110,000 - \$125,000
AGI phase-out for making Roth IRA contributions: married filing jointly	\$169,000 - \$179,000	\$173,000 - \$183,000
AGI phase-out for making deductible IRA contributions: single filers	\$56,000 - \$66,000	\$58,000 - \$68,000
AGI phase-out for making deductible IRA contributions: married filing jointly, if covered by an employer-based retirement plan	\$90,000 - \$110,000	\$92,000 - \$112,000
Modified AGI phase-out for making deductible IRA contributions: married filing jointly, if you aren’t covered by an employer-based retirement plan, but your spouse is	\$169,000 - \$179,000	\$173,000 - \$183,000

Higher taxes likely coming in 2013

Beyond the pending widespread expansion of the AMT this year, almost all the major changes in store relate to tax increases and the expiration of Bush-era credits and tax breaks at the end of 2012. The following changes will take place in January 2013 unless Congress acts to delay or change any of this.

New in 2013

- Personal income tax rates to rise to a maximum federal rate of 39.6% from a 35% top rate
- Loss of Bush-era reduced tax rates on long-term capital gains (set to rise to 20% from 15% and to 10% from 0%) and qualified dividends (from 15% to the individual’s ordinary income tax rate—as high as 39.6%)
- Introduction of a 3.8% Medicare surtax on unearned income for high-income filers (modified AGI of more than \$250,000 if married, filing jointly; modified AGI of more than \$200,000 for single filers)
- Section 179 deduction for business depreciation to be significantly reduced in 2013
- American Opportunity Tax Credit for certain college expenses expires in 2012
- Two percentage points payroll tax reduction to expire in 2012

AMT Case Study³

Take the case of Mary and Richard Green. In 2011, their adjusted gross income was \$60,000. Because it was below the AMT exemption, the AMT didn’t apply to them. In 2012, however, their adjusted gross income rises to \$65,000 and is above the new, lower exemption of \$45,000 for married joint filers. Therefore, they must calculate their income taxes by completing Form 6251 for Alternative Minimum Tax in addition to calculating regular income tax using Form 1040.

After following the detailed instructions, or having their accountant do so, the Greens determine that they owe \$1,500 in AMT in addition to their regular income tax.

- Education IRA limit reduced to \$500 in 2013 from \$2,000
- Highest estate tax rate rises to 55% from 35%; estate tax exemption drops to \$1 million from \$5 million

Tax changes at a glance

New in 2012

The big change in 2012 is a substantial drop in the AMT exemption, which could cause many millions of additional taxpayers to suddenly owe much more in income taxes.

New in 2013

The tax rates on ordinary income, long-term capital gains, and qualified dividends are set to rise next year. These changes and others listed below may affect almost all taxpayers. You might consider strategies that involve shifting income to this year if possible, or pushing deductions back to next year.

Congress could delay or reverse any of the pending tax changes listed in this chart at any time between now and year-end 2012 or even during 2013. We recommend you check with your tax professional regarding all tax-related issues.

Item	2011	2012	2013
Alternative Minimum Tax exemption	\$48,450 Single filers \$74,450 Married filing jointly	\$33,750 Single \$45,000 Married	To be determined
Tax rate ranges—ordinary income	10% - 35%	10% - 35%	15% - 39.6%
Long-term capital gains tax rate (top rate)	15%	15%	20%
Qualified dividends tax rate (top rate)	15%	15%	39.6%
Payroll tax reduction of two percentage points	Yes	Final year	Expired
Surtax of 3.8% on investment income	No surtax	No surtax	Surtax applies to single taxpayers with modified AGI of more than \$200,000; more than \$250,000 for joint filers
Increase in Medicare hospital insurance tax wage base for self-employed	N/A	N/A	0.9% increase in employee portion of high income wage base of single filers with wages of more than \$200,000; more than \$250,000 for joint filers
Phase-out of personal exemptions and itemized deductions for high income earners	N/A	Final year of suspended phase-out of personal exemptions and itemized deductions	Reinstatement of phase-out of personal exemptions and itemized deductions
Marriage penalty equalization	Expanded deduction for married joint filers	Expanded deduction for married joint filers	Expanded deduction expires
Child credit	\$1,000 per child under age 17	\$1,000 per child under age 17	\$500 per child under age 17
Child care deduction	\$3,000 limit	\$3,000 limit	\$2,400 limit
Estate tax top rate	35%	35%	55%
Estate tax exemption	\$5 million	\$5.12 million	\$1 million

AMT action steps

With so much uncertainty, what can or should you do? Here are a few items to consider:

- **Meet with your tax advisor** to determine whether you are liable for AMT or are likely to be.
- **Consider the tax implications** as well as other benefits or costs associated with any financial move that could trigger the AMT, such as exercising stock options or claiming certain itemized deductions. For instance, consider exercising stock options over several years and delaying or prepaying state and local tax bills.
- **Conduct a “what-if” scenario** with the AMT threshold at its current “unpatched” level for 2012 and with a patch that would maintain the 2011 AMT exemption levels. You can do this with tax software or by hand on Form 6251.
- **Consider waiting until there is greater certainty** regarding the AMT for 2012 before making any major financial moves that might trigger it.

Capital gains tax strategies in 2012 and 2013

In a more typical tax year, one key rule regarding capital gains and losses would be to consider taking capital losses to offset gains, thereby reducing your tax obligations, subject to “wash sale rules” that penalize individuals for buying and selling the same stock in 30 days or less.

In 2012, however, something as basic as harvesting capital losses to offset capital gains and reduce capital gains tax is worth reevaluating. A different approach might make more sense in order to take advantage of changing tax rates. For example, if capital gains taxes rise, it would be preferable to pay capital gains tax in 2012 at 15%. On the other hand, if you have a capital loss that you could claim in December 2012 at a tax rate of 15%, you may want to consider waiting until January 2013, when the same capital loss would generate a higher deduction, at 20%.

However, before committing to any actions with tax implications, it might be prudent to wait until later in 2012 to see whether Congress extends the current lower tax rates. As always, discuss strategies with your tax advisor. Also, as compelling as any tax strategies might be, they should be considered along with other financial variables (for example, commissions), and should factor into—rather than drive—investment decisions.

Tax action checklist

To do by year-end 2012

- ✓ Review the tax landscape for 2013; consult with a tax professional to determine your best tax moves for this year and next.
- ✓ Consider appropriate year-end tax strategies. Specifics may depend on whether Congress passes an AMT patch and whether planned increases in tax rates on long-term capital gains and qualified dividends go into effect.
- ✓ Once there is greater clarity over what tax changes will occur in 2013 and how they may affect you, consider accelerating income or deferring deductions based on your most beneficial tax strategies. Discuss with your tax advisor.
- ✓ Consider converting a traditional IRA to a Roth IRA, which would result in owing taxes on the taxable amount you convert at this year’s potentially lower tax rates.
- ✓ Consider selling real estate or a business that has appreciated significantly in value this year, before higher tax rates are due to take effect.

To do at any time

- ✓ Conduct a thorough review of your personal finances and the potential impact of anticipated tax changes in 2013, such as higher long-term capital gains and qualified dividend tax rates beginning next year.
- ✓ Consider investing any available money in tax-deferred and tax-free vehicles, such as a Roth IRA, a traditional IRA, a 401(k), or a tax-favored college account, such as a 529 college plan.
- ✓ If you are unsure whether you are better off claiming standard or itemized deductions, consider alternating them each year. Bunch deductible expenditures by accelerating or deferring certain expenses. This maximizes your deductions in the year that you itemize them; the previous year and following year, you take a standard deduction.⁴

How Merrill Edge® can help

Merrill Edge® can provide some basic tax information. Log in to merrilledge.com and visit the Tax Center to:

- Read articles about tax strategies for your investments
- Obtain your annual tax reporting statement
- Access IRS tax forms and calculators, including the AMT Assistant and a tax withholding calculator.

If you’re working with the Merrill Edge Advisory Center™, a Merrill Edge Financial Solutions Advisor™ can work with you and your tax professional to help you align your tax planning with your financial, investment and retirement goals.

For more information

Tax planning can be a challenge in any year. But with so much uncertainty concerning next year’s tax framework, this is a critical time to plan carefully and with expert help. Consult with a qualified tax professional.

Other resources include:

- irs.gov
- taxtopics.net/
- 1040.com/
- section179.org/

¹ <http://turbotax.intuit.com/tax-tools/tax-tips/IRS-Tax-Return/Alternative-Minimum-Tax--Common-Questions/INF12072.html>

² <http://www.chicagotribune.com/news/opinion/editorials/ct-edit-precipice-20120401,0,2407722.story>

³ The case study presented is hypothetical and does not reflect specific strategies we may have developed for actual clients. This is for illustrative purposes only and intended to demonstrate the capabilities of Merrill Edge and/or Bank of America. It is not intended to serve as investment advice since the availability and effectiveness of any strategy is dependent upon your individual facts and circumstances. Results will vary, and no suggestion is made about how any specific solution or strategy performed in reality.

⁴ <http://www.smartmoney.com/taxes/income/year-end-tax-planning-strategies-for-individuals>

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