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Client Bulletin

Smart Tax, Business & Planning Ideas from your Trusted Business Advisor[sm]

Back to the Brink

November 2012

Two years ago, many tax laws that were enacted in the early years of this century were about to expire. Income tax rates were scheduled to rise; estate taxes would have more bite; and various other tax provisions would end. In mid-December 2010, Congress acted to extend most of the expiring tax provisions for two years, through 2012.

Those two years are just about up as we enter the final months of 2012. The political climate in Washington may be even more contentious now than it was then, with presidential as well as congressional elections on the calendar. If Congress passes a tax law this year, enactment might not come until December... or such a law might not pass at all. Year-end tax planning is as difficult as it has ever been.

What will happen if we reach 2013 without any action on tax law? Here are some examples:

- Income tax rates will rise across the board. The top rate will increase from 35% to 39.6%.
- The top tax rate on long-term capital gains will go from 15% to 20%. Lower income taxpayers who now pay 0% on long-term gains will owe 10%. For assets held more than 5 years, the 20% rate is reduced to 18% (for assets with holding periods beginning after December 31, 2000), and the 10% rate is reduced to 8% (for all assets, regardless of when their holding period began).
- Similarly, the 15% and 0% tax rates on qualified dividends paid to investors will disappear. Instead, investors will owe ordinary income tax on dividends at rates up to 39.6%.

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2012 Tax Planning Roundup

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- The federal estate tax exclusion will fall from $5.12 million in 2012 to $1 million in 2013. Estate assets over that threshold will be taxed at graduated rates up to 55%, versus the flat 35% rate now in effect.
- The lifetime gift tax exclusion also will drop from $5.12 million this year to $1 million next year.
- Many tax provisions, including the child tax credit and higher education tax credits, will become less generous.

Congressional action, followed by President Obama's signature on the final bill, might prevent some or all of those tax changes from becoming reality. As explained in this issue of the *CPA Client Bulletin*, there are steps you can consider taking in late 2012 to lower your potential tax obligation now and in the future.

Meanwhile, some tax changes are scheduled to take effect in 2013 as a result of health care legislation passed in 2010 and recently left standing by the Supreme Court. Those changes might be overturned in the future, but for now it is prudent to assume they will be valid in 2013, so you should plan accordingly. ■

Planning Ahead for the 3.8% Surtax

As explained in the October 2012 CPA *Client Bulletin*, a 3.8% surtax on investment income takes effect in 2013 as a result of health care legislation. This tax applies to taxpayers filing joint returns or surviving spouses with modified adjusted gross income (MAGI) over $250,000, married individuals filing separate returns with MAGI over $125,000, and all other individuals with MAGI over $200,000. For most people, MAGI is the same as your adjusted gross income, reported on the bottom of page 1 of your federal income tax return.

This 3.8% surtax, designed to help fund Medicare, will be applied to the smaller of two numbers. One number is your net investment income, after expenses; the other number is the amount by which your MAGI is over the $125,000, $200,000, or $250,000 threshold.

Example 1: John Smith is single, with MAGI of $210,000 in 2013. His net investment income is $25,000 that year. John's MAGI is $10,000 over his $200,000 threshold, and that excess $10,000 is smaller than his $25,000 of net investment income. Thus, John owes the 3.8% surtax on $10,000, which equals an additional tax of $380.

Example 2: Bob and Betty Johnson are married with $600,000 of MAGI in 2013. Their net investment income that year is $320,000. The Johnsons' MAGI ($600,000) is $350,000 over their threshold ($250,000), so their $320,000 in investment income is the smaller number. The Johnsons owe the 3.8% surtax on $320,000, which equals an additional tax of $12,160.

Surtax surprises

Regardless of whether you have a large MAGI every year, you still might owe the surtax in specific situations. Such situations might include when you sell a house or start to take IRA distributions.

Example 3: Alice Brown is single and ordinarily has MAGI around $150,000, so she is not concerned about the surtax immediately. In the next few years, though, Alice starts to supplement her income with Social Security benefits. Alice takes required minimum distributions (RMDs) from her traditional IRA after she reaches age 70½. Then, in the same year, Alice sells a vacation home she has held for many years. So, in addition to her ordinary MAGI of $150,000, Alice now has $25,000 of taxable Social Security benefits, $30,000 of RMDs, and a $50,000 capital gain on the sale of her vacation home. That extra $105,000 pushes Alice's total MAGI to $255,000 that year, so she will owe the surtax. (If Alice had sold her principal residence, only the taxable portion of the gain would have been included in her MAGI.)

Note that Alice's Social Security benefits and her RMDs are not considered investment income. Even so, they count in her gross income and, thus, push her MAGI over the $200,000 threshold into surtax territory. In this example, Alice's MAGI would be $55,000 over that threshold. If her net investment income is $90,000, counting the $50,000 gain from the vacation home, her $55,000 of excess MAGI would be the smaller number, subject to the 3.8% surtax, meaning the surtax would cost Alice $2,090.

Planning pointers

If that's how the surtax will work every year starting in 2013, what can you do by year-end 2012 to reduce its impact in the future? Essentially, there are two ways to trim possible exposure to the 3.8% surtax. One is to reduce the net investment income you'll report in the coming years. The second tactic is to reduce future noninvestment income that would push up your MAGI and trigger the surtax.

On the investment side, see if you can shift taxable investment income to tax-exempt municipal bond

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interest that won't count in your MAGI. Use the last few weeks of 2012 to consult with your investment advisor about possibly adjusting your portfolio in this manner. Municipal bonds and muni funds will be especially attractive if you'll owe higher ordinary income tax as well as the 3.8% surtax on taxable investment income.

Taking capital losses by year-end can enable you to build up a bank of net capital losses that will offset future capital gains and enable you to avoid reporting highly taxed gains. You also might want to take capital gains in 2012, if that's in your plans, before the 3.8% surtax and possibly higher tax rates take effect. Our office can go over the tax implications of taking large capital gains by year-end, such as the sale of real estate or business interests.

On the noninvestment side, delaying Social Security benefits as long as practical may defer payment of the surtax and possibly shift income to a year when MAGI is lower. Converting a traditional IRA to a Roth IRA in 2012 can help you avoid the problem of RMDs' pushing your income over the threshold in the future, because Roth IRA owners never have to take RMDs, and qualified distributions from Roth IRAs are not taxable and not included in AGI. ■

Year-End Tax Planning for Investors

Tax loss harvesting is usually a savvy year-end strategy for investors. This year, taking losses may be especially worthwhile.

When you sell a security at a loss, that capital loss offsets capital gains you've taken during the year in other transactions. Thus, you avoid or reduce paying tax on those gains. If you wind up with more capital losses than capital gains, you can deduct those losses on your tax return, up to $3,000 per year.

If your net capital losses top $3,000, you can carry them forward. Consequently, excess net capital losses from 2012 can be used in 2013 and future years to offset future capital gains. The ability to avoid tax on future gains will become more valuable, if the maximum tax on long-term gains rises from 15% to 20%, as now scheduled. High-income investors, who might owe as much as 23.8% on such gains, including the 3.8% Medicare surtax, may want to make a concerted effort to accumulate capital losses for use in future years.

Example 1: Dan Jones reviews his securities trades for 2012 late in the year. So far, he has net capital gains of $16,000. Some of those gains are long-term and will be taxed at 15%, whereas others are short-term gains, which will be taxed at his ordinary income tax rate. Altogether, Dan would owe over $2,500 in tax on those trades, if he takes no further action.

Dan reviews all of the investments he holds in his taxable accounts and discovers some of those holdings now sell for less than his purchase price. By selling those assets, Dan takes $40,000 worth of capital losses by year-end.

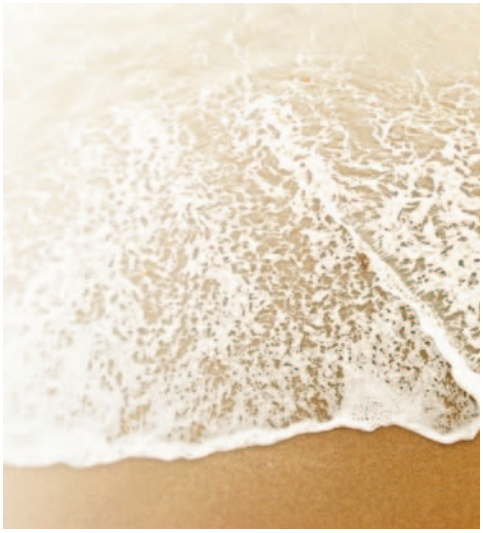
Those $40,000 of losses change Dan's 2012 capital gain position from $16,000 in net capital gains to $24,000 in net capital losses. Dan can deduct $3,000 on his 2012 tax return. Assuming that Dan is in a 28% tax bracket, this deduction saves him $840 in tax: 28% times $3,000. Without taking year-end losses, Dan would have owed over $2,500 in tax on his 2012 trades, as previously mentioned. Thus, the immediate tax saving is more than $3,300.

If Dan has $24,000 in net capital losses by year-end 2012 and takes a $3,000 tax deduction, he will carry forward the unused $21,000 in net capital losses. In 2013 and future years, he will be able to take capital gains, and instead of perhaps paying 20% or 23.8% on long-term gains and as much as 43.4% on short-term gains (the scheduled 39.6% top rate and the 3.8% surtax), Dan can use the $21,000 of capital losses that were carried forward to offset $21,000 of capital gains and avoid paying tax.

High-income seniors should realize that capital gains reported in 2012 might be even more taxing because the income could result in higher fees for Medicare Part B in 2014.

Watch out for wash sales

Although tax loss harvesting is tax-efficient, you shouldn't let these moves disrupt your investment strategy. Use the sales proceeds to reinvest, if you don't need the cash



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right away, and aim to wind up with a portfolio that's in line with your goals as well as your risk tolerance.

There's a catch, though. You shouldn't reinvest immediately in the securities you sell as a loss. If you do, you won't be able to claim the loss on your 2012 tax return. The so-called "wash sale" rules prevent this tactic.

Fortunately, there are several ways to avoid the wash sale rules and maintain a similar portfolio. For example, you can take a loss, wait for at least 30 days, and then repurchase the same asset you sold for a loss. The delay allows you to claim your capital loss.

Another approach is to sell an investment for a loss and then immediately buy something that's similar but not identical. You might sell one bank stock fund at a loss and reinvest in another bank stock fund right away. With this method, you'll have a capital loss, and you'll also be in a position to profit if bank stocks move up after your sale.

Gauging gains

If taking capital losses by year-end makes sense in 2012, what about taking gains this year? Is it better to cash in long-term capital gains now, and pay 15% in tax, rather than take gains in the future when you might owe 20% or 23.8% in tax?

That depends. If you are planning to sell any appreciated assets soon, acting this year can pay off. The 15% tax rate on long-term gains applies to securities, real estate, shares in a private business, etc.

However, if you have no immediate plans to sell an asset, accelerating the sale also accelerates the tax bill. As of this writing, there is no certainty that capital gains tax rates will increase in 2013, and the 3.8% surtax will apply only to high-income taxpayers. If there is no pressing reason to sell an asset, you might want to wait until late December, when the election results are in and the prospect of tax legislation in 2012 is clearer to decide whether to take gains this year.

Zeroing in

That said, there are some situations in which you should consider a year-end sale at a gain. In 2012, at least, lower income taxpayers owe 0% tax on long-term capital gains and qualified investment dividends. The 0% rate applies to single taxpayers and married individuals filing separate returns with taxable income up to $35,350 in 2012, and to married couples filing joint returns with taxable income up to $70,700.

If you plan to sell appreciated securities, consider giving the securities to your parents, if they are retired and have a relatively low income.

Example 2: Several years ago, Ed Martin invested $20,000 in a mutual fund that holds gold mining stocks. Ed's shares are now worth $35,000, and Ed believes that gold prices will retreat before moving up again.

Instead of selling the shares himself, Ed gives them to his parents, who have taxable income of $50,000 in 2012. The senior Martins sell the shares in late 2012, taking the $15,000 long-term capital gain, which boosts their taxable income for the year to $65,000. That's still under $70,700, so the senior Martins will owe 0% tax on the trade.

Similar results may be possible by transferring assets to children or grandchildren. However, the so-called "kiddie tax" may limit the advantages of giving investments to minors or giving investments to full time students 23 or younger. You can avoid those limits by giving assets to lower income young adults who are finished with school or to students 24 and older.

In any case, gifts over $13,000 in 2012 probably will have gift tax consequences. Our office can explain those consequences to you, so you can decide if transferring assets to use the 0% tax rate this year is worthwhile. ■

Year-End Tax Planning for IRAs

Generally, year-end Roth IRA conversions are a smart move. That's because all Roth IRA distributions will be tax free after 5 years and after age 59½. For all Roth IRA conversions, the 5 year mark starts on January 1. Therefore, a year-end conversion may cut the wait to just over 4 years.

Example: Kim Parker, age 56, has $100,000 in a traditional IRA, which she converts to a Roth IRA in December 2012. For Kim, the 5 year clock starts on January 1, 2012. Therefore, Kim will be able to take any amount from her Roth IRA, tax free, on or after January 1, 2017—4 years and one month later.

This year, Kim may have extra reasons to convert her traditional IRA. On such conversions, individuals owe tax on all the pretax money moving into the Roth IRA. Assuming that Kim has only pretax money in her IRA, she would report $100,000 of extra taxable income in 2012, as a result of the conversion.

Therefore, Kim might want to convert to a Roth IRA in 2012, when income tax rates are relatively low. Converting in the future could cause Kim to pay tax at higher rates and perhaps pay the 3.8% Medicare surtax as well.

On the other hand, Kim might decide not to convert her traditional

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IRA to a Roth IRA. In that case, after age 70½, she will have to take required minimum distributions (RMDs) and pay tax at future rates, which could be much higher than those now in effect. Roth IRA owners never have to take RMDs, so Kim can avoid those by converting her traditional IRA to a Roth IRA this year. ■

Year-End Estate Tax Planning

The federal gift tax is one way to keep people from escaping the estate tax. However, it's understood that most people will want to make gifts during their lifetime, so the tax code makes some allowances.

Annual exclusion

Every year, you can give away a certain amount of assets per recipient with no tax consequences. This year's exclusion is $13,000, so you can give up to $13,000 to Dick, $13,000 to Jane, $13,000 to your old kindergarten teacher, and so on. You won't owe gift tax, and you won't deplete your estate tax exemption.

The annual exclusion is a use-it-or-lose-it provision. If you don't make gifts to use your 2012 exclusions by December 31, you can't carry the unused amounts into 2013. Therefore, if you have concerns about future estate tax, federal or state, you should consider using your exclusions this year.

Among married couples, both spouses can use their $13,000 annual exclusion. That applies even if property is owned jointly.

Example 1: George and Grace Henderson have a joint checking account. In 2012, the Hendersons are entitled to use that account to give up to $26,000 to each of their children and grandchildren.

Lifetime exclusion

If you give more than $13,000 to any recipient during 2012, you will have to report the excess gifts on IRS Form 709, the gift tax return.

Example 2: Julia King gives $20,000 to each of her five grandchildren in 2012. In 2013, by the deadline for her income tax return, Julia also must report $100,000 of gifts on Form 709.

Of that $100,000, $65,000 will be covered by five $13,000 annual exclusions. Therefore, Julia reports only $35,000 of taxable gifts, in this example.

Will Julia owe gift tax? Probably not. In 2012, each taxpayer is permitted to make up to $5.12 million of such taxable gifts before paying any gift tax. That $5.12 million lifetime exclusion from the gift tax may not be available in the future—it's scheduled to drop to $1 million next January. Therefore, wealthy individuals and couples might want to make large gifts in late 2012, removing large amounts of assets from their taxable estates without having to pay gift tax. ■

Trusted Advice

Canny Contributions

- Gift tax rules don't apply to charitable donations.
- For year-end donations, consider giving appreciated securities instead of cash. As long as you have held the securities more than one year, you can take a deduction for the market value of the securities.
- With this tactic, you get a full deduction for the relinquished asset's value and avoid payment of capital gains tax.
- If this strategy appeals to you, contact the charity to which you intend to donate. The charity's representatives most likely can guide you through the procedure for donating securities.

Year-End Tax Planning for Business Owners

When it comes to year-end tax planning, business owners face the same uncertainties that confront all taxpayers. Will tax rates rise? Will the estate tax exemption be reduced? Moreover, the same certainty also exists: high-income taxpayers will owe a 3.8% surtax on investment income, as explained on the previous pages of this issue.

Therefore, if you are planning on selling your company in the near future, you should consider closing the deal by December 31 this year, if possible. That would keep your income from the sale in 2012, when long-term capital gains are capped at 15%, and the 3.8% surtax won't apply.

Review retirement plans

The end of the year is also an excellent time to review your company's retirement plan. Some

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business owners find that they cannot make maximum contributions to their own company's 401(k) plans. That's because such plans usually are subject to tests that prevent highly compensated employees (such as the company's owners) from contributing much more, in aggregate, than other employees contribute. Business owners who wish to contribute the maximum $22,500 this year, for participants 50 or older, may be limited to a much smaller contribution.

Accelerate equipment purchases

Section 179 of the tax code allows purchasers to "expense" certain amounts of business equipment, meaning that you can take a full deduction in the first year the equipment is used in the business. Typically, you must write off the cost of business equipment over several years, via depreciation. Therefore, the Section 179 election provides faster deduction and improves the cash flow of profitable companies.

In 2012, companies can deduct up to $139,000 of equipment purchases. However, a phaseout takes effect, dollar for dollar, once 2012 purchases top $560,000.

Example 1: ABC Corp. buys $130,000 of new and used equipment in 2012. It can take a $130,000 deduction, under Section 179.

Example 2: DEF Corp. buys $630,000 of new equipment in 2012. Therefore, DEF is into the phaseout range by $70,000 ($630,000 minus $560,000). The $139,000 maximum is reduced by that $70,000, so DEF can take a $69,000 tax deduction this year. Of its $630,000 in 2012 purchases, $561,000 ($630,000 minus the $69,000 deduction) must be depreciated.

Another tax code provision, the so-called "bonus depreciation," allows companies to deduct 50% of most new equipment purchases placed in service in 2012. In Example 2, DEF can take a further first year bonus depreciation deduction of $280,500 (50% of $561,000) and use multi-year depreciation on the remaining $280,500.

Business owners should keep in mind that a company cannot claim a Section 179 deduction that would create or increase a reported business loss; however, any amount that cannot be deducted due to the limitation can be carried forward. On the other hand, 50% bonus depreciation deductions can create or increase a net operating loss (NOL) for the current year. Your company can carry back a 2012 NOL to 2011 and collect a refund of taxes already paid, if that was the case.

A matter of time

Under current law, the Section 179 allowance will drop to $25,000 in 2013, and bonus depreciation will be sharply limited. Therefore, companies should try to accelerate planned equipment purchases into 2012. To qualify as a 2012 purchase, the equipment must be placed in service (used in your business) before year end. Payment can be made in 2013, if that's what you've arranged.

Conversely, equipment for which you've paid in 2012 won't qualify for this year's tax treatment if it's first used in 2013. ■

TAX CALENDAR

NOVEMBER 2012

November 13

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the third quarter of 2012. This due date applies only if you deposited the tax for the quarter in full and on time.

November 15

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in October if the monthly rule applies.

DECEMBER 2012

December 17

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in November if the monthly rule applies.

Corporations. Deposit the fourth installment of estimated income tax for 2011.

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