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Wealth Management & Tax

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Dear Client:

Year-end tax planning could be especially productive this year because timely action could nail down a host of tax breaks that won't be around next year unless Congress acts to extend them, which, at the present time, looks doubtful. These include, for individuals: the option to deduct state and local sales and use taxes instead of state and local income taxes; the above-the-line deduction for qualified higher education expenses; and tax-free distributions by those age 70-— or older from IRAs for charitable purposes. For businesses, tax breaks that are available through the end of this year but won't be around next year unless Congress acts include: 50% bonus first-year depreciation for most new machinery, equipment and software; an extraordinarily high $500,000 expensing limitation; the research tax credit; and the 15-year write-off for qualified leasehold improvements, qualified restaurant buildings and improvements and qualified retail improvements.

High-income-earners have other factors to keep in mind when mapping out year-end plans. For the first time, they have to take into account the 3.8% tax surtax on unearned income and the additional 0.9% Medicare (hospital insurance, or HI) tax that applies to individuals receiving wages with respect to employment in excess of $200,000 ($250,000 for married couples filing jointly and $125,000 for married couples filing separately).

The surtax is 3.8% of the lesser of: (1) net investment income (NII), or (2) the excess of modified adjusted gross income (MAGI) over an unindexed threshold amount ($250,000 for joint filers or surviving spouses, $125,000 for a married individual filing a separate return, and $200,000 in any other case). As year-end nears, a taxpayer's approach to minimizing or eliminating the 3.8% surtax will depend on his estimated MAGI and NII for the year. Some taxpayers should consider ways to minimize (e.g., through deferral) additional NII for the balance of the year, others should try to see if they can reduce MAGI other than unearned income, and others should consider ways to minimize both NII and other types of MAGI.

The additional Medicare tax may require year-end actions. Employers must withhold the additional Medicare tax from wages in excess of $200,000 regardless of filing status or other income. Self-employed persons must take it into account in figuring estimate tax. There could be situations where an employee may need to have more withheld toward year end to cover the tax. For example, consider an individual who earns $200,000 from one employer during the first half of the year and a like amount from another employer during the balance of the year. He would owe the additional Medicare tax, but there would be no withholding by either employer for the additional Medicare tax since wages from each employer don't exceed $200,000. Also, in determining whether they may need to make adjustments to avoid a penalty for underpayment of estimated tax, individuals also should be mindful that the additional Medicare tax may be overwithheld. This could occur, for example, where only one of two married spouses works and reaches the threshold for the employer to withhold, but the couple's income won't be high enough to actually cause the tax to be owed.

We have compiled a checklist of additional actions based on current tax rules that may help you save tax dollars if you act before year-end. Not all actions will apply in your particular situation, but you will likely benefit from many of them. We can narrow down the specific actions that you can take once we meet with you to tailor a particular plan. In the meantime, please review the following list and contact us at your earliest convenience so that we can advise you on which tax-saving moves to make:

Year-End Tax Planning Moves for Individuals

- Increase the amount you set aside for next year in your employer's health flexible spending account (FSA) if you set aside too little for this year.
- If you become eligible to make health savings account (HSA) contributions in December of this year, you can make a full year's worth of deductible HSA contributions for 2013.
- Realize losses on stock while substantially preserving your investment position. There are several ways this can be done. For example, you can sell the original holding, then buy back the same securities at least 31 days later. It may be advisable for us to meet to discuss year-end trades you should consider making.
- Postpone income until 2014 and accelerate deductions into 2013 to lower your 2013 tax bill. This strategy may enable you to claim larger deductions, credits, and other tax breaks for 2013 that are phased out over varying levels of adjusted gross income (AGI). These include child tax credits, higher education tax credits, the above-the-line deduction for higher-education expenses, and deductions for student loan interest. Postponing income also is desirable for those taxpayers who anticipate being in a lower tax bracket next year due to changed financial circumstances. Note, however, that in some cases, it may pay to actually accelerate income into 2013. For example, this may be the case where a person's marginal tax rate is much lower this year than it will be next year or where lower income in 2014 will result in a higher tax credit for an individual who plans to purchase health insurance on a health exchange and is eligible for a premium assistance credit.
- If you believe a Roth IRA is better than a traditional IRA, and want to remain in the market for the long term, consider converting traditional-IRA money invested in beaten-down stocks (or mutual funds) into a Roth IRA if eligible to do so. Keep in mind, however, that such a conversion will increase your adjusted gross income for 2013.
- If you converted assets in a traditional IRA to a Roth IRA earlier in the year, the assets in the Roth IRA account may have declined in value, and if you leave things as-is, you will wind up paying a higher tax than is necessary. You can back out of the transaction by recharacterizing the rollover or conversion, that is, by transferring the converted amount (plus earnings, or minus losses) from the Roth IRA back to a traditional IRA via a trustee-to-trustee transfer. You can later reconvert to a Roth IRA.

- It may be advantageous to try to arrange with your employer to defer a bonus that may be coming your way until 2014.
- Consider using a credit card to prepay expenses that can generate deductions for this year.
- If you expect to owe state and local income taxes when you file your return next year, consider asking your employer to increase withholding of state and local taxes (or pay estimated tax payments of state and local taxes) before year-end to pull the deduction of those taxes into 2013 if doing so won't create an alternative minimum tax (AMT) problem.
- Take an eligible rollover distribution from a qualified retirement plan before the end of 2013 if you are facing a penalty for underpayment of estimated tax and the increased withholding option is unavailable or won't sufficiently address the problem. Income tax will be withheld from the distribution and will be applied toward the taxes owed for 2013. You can then timely roll over the gross amount of the distribution, as increased by the amount of withheld tax, to a traditional IRA. No part of the distribution will be includible in income for 2013, but the withheld tax will be applied pro rata over the full 2013 tax year to reduce previous underpayments of estimated tax.
- Estimate the effect of any year-end planning moves on the alternative minimum tax (AMT) for 2013, keeping in mind that many tax breaks allowed for purposes of calculating regular taxes are disallowed for AMT purposes. These include the deduction for state property taxes on your residence, state income taxes (or state sales tax if you elect this deduction option), miscellaneous itemized deductions, and personal exemption deductions. Other deductions, such as for medical expenses, are calculated in a more restrictive way for AMT purposes than for regular tax purposes in the case of a taxpayer who is over age 65 or whose spouse is over age 65 as of the close of the tax year. As a result, in some cases, deductions should not be accelerated.
- Accelerate big ticket purchases into 2013 in order to assure a deduction for sales taxes on the purchases if you will elect to claim a state and local general sales tax deduction instead of a state and local income tax deduction. Unless Congress acts, this election won't be available after 2013.
- You may be able to save taxes this year and next by applying a bunching strategy to miscellaneous itemized deductions, medical expenses and other itemized deductions.
- If you are a homeowner, make energy saving improvements to the residence, such as putting in extra insulation or installing energy saving windows, or an energy efficient heater or air conditioner. You may qualify for a tax credit if the assets are installed in your home before 2014.
- Unless Congress extends it, the up-to-$4,000 above-the-line deduction for qualified higher education expenses will not be available after 2013. Thus, consider prepaying eligible expenses if doing so will increase your deduction for qualified higher education expenses. Generally, the deduction is allowed for qualified education expenses paid in 2013 in connection with enrollment at an institution of higher education during 2013 or for an academic period beginning in 2013 or in the first 3 months of 2014.

- You may want to pay contested taxes to be able to deduct them this year while continuing to contest them next year.
- You may want to settle an insurance or damage claim in order to maximize your casualty loss deduction this year.
- Purchase qualified small business stock (QSBS) before the end of this year. There is no tax on gain from the sale of such stock if it is (1) purchased after September 27, 2010 and before January 1, 2014, and (2) held for more than five years. In addition, such sales won't cause AMT preference problems. To qualify for these breaks, the stock must be issued by a regular (C) corporation with total gross assets of $50 million or less, and a number of other technical requirements must be met. Our office can fill you in on the details.
- If you are age 70-1/2 or older, own IRAs and are thinking of making a charitable gift, consider arranging for the gift to be made directly by the IRA trustee. Such a transfer, if made before year-end, can achieve important tax savings.
- Take required minimum distributions (RMDs) from your IRA or 401(k) plan (or other employer-sponsored retired plan) if you have reached age 70-1/2. Failure to take a required withdrawal can result in a penalty of 50% of the amount of the RMD not withdrawn. If you turned age 70-1/2 in 2013, you can delay the first required distribution to 2013, but if you do, you will have to take a double distribution in 2014 the amount required for 2013 plus the amount required for 2014. Think twice before delaying 2013 distributions to 2014 bunching income into 2014 might push you into a higher tax bracket or have a detrimental impact on various income tax deductions that are reduced at higher income levels. However, it could be beneficial to take both distributions in 2014 if you will be in a substantially lower bracket that year, for example, because you plan to retire late this year.
- Make gifts sheltered by the annual gift tax exclusion before the end of the year and thereby save gift and estate taxes. You can give $14,000 in 2013 to each of an unlimited number of individuals but you can't carry over unused exclusions from one year to the next. The transfers also may save family income taxes where income-earning property is given to family members in lower income tax brackets who are not subject to the kiddie tax.

Year-End Tax-Planning Moves for Businesses & Business Owners

- Businesses should consider making expenditures that qualify for the business property expensing option. For tax years beginning in 2013, the expensing limit is $500,000 and the investment ceiling limit is $2,000,000. And a limited amount of expensing may be claimed for qualified real property. However, unless Congress changes the rules, for tax years beginning in 2014, the dollar limit will drop to $25,000, the beginning-of-phaseout amount will drop to $200,000, and expensing won't be available for qualified real property. The generous dollar ceilings that apply this year mean that many small and medium sized businesses that make timely purchases will be able to currently deduct most if not all their outlays for machinery and equipment. What's more, the expensing deduction is not prorated for the time that the asset is in service during the year. This opens up significant year-end planning opportunities.

- Businesses also should consider making expenditures that qualify for 50% bonus first year depreciation if bought and placed in service this year. This bonus writeoff generally won't be available next year unless Congress acts to extend it. Thus, enterprises planning to purchase new depreciable property this year or the next should try to accelerate their buying plans, if doing so makes sound business sense.
- Nail down a work opportunity tax credit (WOTC) by hiring qualifying workers (such as certain veterans) before the end of 2013. Under current law, the WOTC won't be available for workers hired after this year.
- Make qualified research expenses before the end of 2013 to claim a research credit, which won't be available for post-2013 expenditures unless Congress extends the credit.
- If you are self-employed and haven't done so yet, set up a self-employed retirement plan.
- Depending on your particular situation, you may also want to consider deferring a debt-cancellation event until 2014, and disposing of a passive activity to allow you to deduct suspended losses.
- If you own an interest in a partnership or S corporation you may need to increase your basis in the entity so you can deduct a loss from it for this year.

These are just some of the year-end steps that can be taken to save taxes. Again, by contacting us, we can tailor a particular plan that will work best for you.

Best regards,

Stephen W. DeFilippis, EA