

Year-End Tax Planning Letter

2012



**GELMAN, ROSENBERG
& FREEDMAN**

CERTIFIED PUBLIC ACCOUNTANTS



Introduction

We have a challenging year before us on the tax planning front, with expiring provisions leading to uncertain future rates and pending elections leaving us with little in the way of legislative expectations.

Historically, we use the last few months of the year to help our clients implement tax planning techniques to manage their tax liability for the current year with the relative certainty that comes from having the majority of the year behind us. This year, the only certainty appears to be everyone's uncertainty.

Ambiguity in the tax realm can have a paralyzing effect on planning, but a wait-and-see approach can lead to lost opportunities or last-minute scrambles to seize the remains of an opportunity.

Although the tax future remains unclear, planning opportunities remain.



We have gifting provisions that are largely considered once-in-a-lifetime opportunities and rates that may be the lowest we will see in a while. They provide an opening to make meaningful tax planning decisions before 2012 comes to a close.

Our focus is on tax planning techniques that can be initiated during the remainder of 2012. But, depending on your facts and circumstances, these are just the beginning of the opportunities that might be available to you. If you think any of these strategies apply to you or would like to discuss overall tax planning for 2012 and beyond, please let us know.



Changes on the Horizon

Despite the quiet year for tax legislation, significant changes are before us for 2013. Two years ago, when faced with a comparable series of expiring provisions, the can was legislatively kicked down the road. Conclusive action was deferred in favor of short-term extension solutions.

Here we stand, nearly two years later with a similar collection of rate reductions, deductions, credits and incentives set to expire as the calendar flips from one year to the next. In addition, two new taxes stemming from healthcare reform legislation become effective in January.

Absent any late-year legislation, the significant changes on the horizon in 2013 are as follows:

- ▲ Two new taxes established under the Patient Protection and Affordable Care Act will go into effect on Jan. 1:
 - ✱ A 0.9 percent tax on wages and self-employment income
 - ✱ A 3.8 percent contribution tax on investment income
- ▲ Individual tax rates will universally climb, with the highest rate rising from 35 percent to 39.6 percent before accounting for the new taxes stemming from the act. Including the 3.8 percent UIMC tax, the top rate on investment income will rise to



43.4 percent. The current 10 percent rate bracket expires, reverting back to 15 percent as the lowest tax rate.

- ▲ Federal estate and gift tax rates will increase from 35 percent to 55 percent, and the exclusion amount will drop from \$5.12 million to \$1 million.
- ▲ A series of tax rules designed to reduce what is commonly referred to as the marriage penalty will sunset at the end of this year, raising taxes for many dual income couples.
- ▲ Preferential tax rates on capital gains and dividends, currently 15 percent for most of our clients, will expire at the end of the year, with the tax rate on long-term capital gains returning to 20 percent and qualified dividends losing preferential treatment altogether, returning to the ordinary income rates of up to 39.6 percent (43.4 percent if the UIMC tax is applicable).
- ▲ Limitations on itemized deductions and personal exemptions will return in 2013 for higher-income taxpayers.
- ▲ It is anticipated that millions of additional taxpayers will become subject to the alternative minimum tax (AMT) with the expiration of the “AMT patch.”
- ▲ The child tax credit will be reduced by half for 2013.
- ▲ The American Opportunity Tax Credit expires at the end of the year.



Individual Tax Planning Strategies

Planning for the new healthcare taxes

Effective Jan. 1, 2013, a 0.9 percent hospital insurance (HI) tax applies to wages and self-employment income, while a 3.8 percent Medicare contribution (UIMC) tax applies to investment income. Neither tax becomes applicable until income exceeds the established threshold noted in the table on the next page.

The HI tax may be managed through withholding for employees, but in certain circumstances, such as for dual income households or in years of employer transitions, withholding may not fully cover the wages subject to the HI tax.

For the purposes of the UIMC tax, net investment income has been defined to include dividends, rents, interest, passive activity income, capital gains, annuities and royalties.

Specifically excluded from the definition are self-employment income, income from an active trade or business, gain on the sale of an active interest in a partnership or S corporation, IRA or qualified plan distributions, and income from charitable remainder trusts.





For individuals, the amount subject to the UIMC tax is the lesser of:

- ▲ Your net investment income; or
- ▲ The excess of your modified adjusted gross income, which is generally your adjusted gross income with certain foreign earned income adjustments, over the applicable threshold amount.

For both taxes, the applicable thresholds are as follows:

Applicable Threshold Amounts	
Married individuals filing jointly	\$250,000
Married filing separately	\$125,000
Unmarried individuals	\$200,000

Keep in mind that the UIMC tax applies if you have net investment income and your modified adjusted gross income is above the threshold. The impact of the tax may be minimized through shrewd management of your net investment income, proximity to the thresholds or both.

Following are several strategies that you might consider before the end of 2012 to minimize UIMC tax:

- ▲ **Shift to investments that produce tax-exempt or tax-deferred income.** Consider non-dividend-paying growth stocks, tax-deferred annuities and/or state and local government bonds.
- ▲ **Mind your passive activities.** Classifying income as passive is generally advantageous for those with sufficient passive losses to offset the passive income. But with passive income being considered investment income for purposes of the UIMC tax, it may be prudent for those with passive income in excess of passive losses to evaluate their activities for rate management techniques.

▲ **Take a new look at family tax planning.** If you think you may be subject to the UIMC tax, consider the use of family limited partnerships and other income-shifting techniques to transfer investment income to your children or grandchildren. Although investment income transferred to children may be taxed at the parents' rate under the "kiddie tax" rules, the children will be subject to the UIMC tax only if their income exceeds the thresholds.

Income tax withholding

Individual tax rates are set to rise effective Jan. 1, 2013. In addition to the higher graduated rates, the current 2 percent payroll tax holiday is set to expire at the end of this year, and the 0.9 percent HI tax on wages will begin in 2013 for those with earnings in excess of the applicable threshold.

To avoid surprises at tax filing time for 2012 or as new rates come into effect for 2013, consider reviewing your income tax withholdings. An exception in the underpayment rules provides for withholdings to be treated as if they were made ratably throughout the year. This exception allows taxpayers to adjust their withholding in the final months to catch up on underpayments and limit or avoid underpayment penalties.

In addition, as the year winds down and we find more certainty in our rates for 2013, evaluating and adjusting withholdings early in 2013 may prevent an interest-free loan to the government in the form of over-withholding.



Year-end tax planning strategies

Bearing in mind the new Medicare taxes and the scheduled changes in tax rates in the table below, traditional year-end tax planning techniques may need to be reversed to take advantage of the known lower rates of 2012.



Provision	2012	2013
Ordinary income rates	10.0%	15.0%
	15.0%	15.0%
	25.0%	28.0%
	28.0%	31.0%
	33.0%	36.0%
	35.0%	39.6%
Long-term capital gains	15.0%	20.0%
Qualified dividends	15.0%	39.6%
UIMC tax		3.8%
HI tax		0.9%

Shifting taxable income between years – When you’re expecting stable rates in the future, the traditional year-end strategies are largely focused on deferring income and accelerating deductions. But with the rates set to rise for most taxpayers, the better tax answer may come from an opposite approach. Income accelerated into 2012 could potentially result in a significantly lower rate than the same income recognized during 2013.

Because rates remain relatively uncertain, now may not be the time to accelerate income. But having a plan in place should the rates hold will allow taxpayers to act deliberately as the rates become more certain.

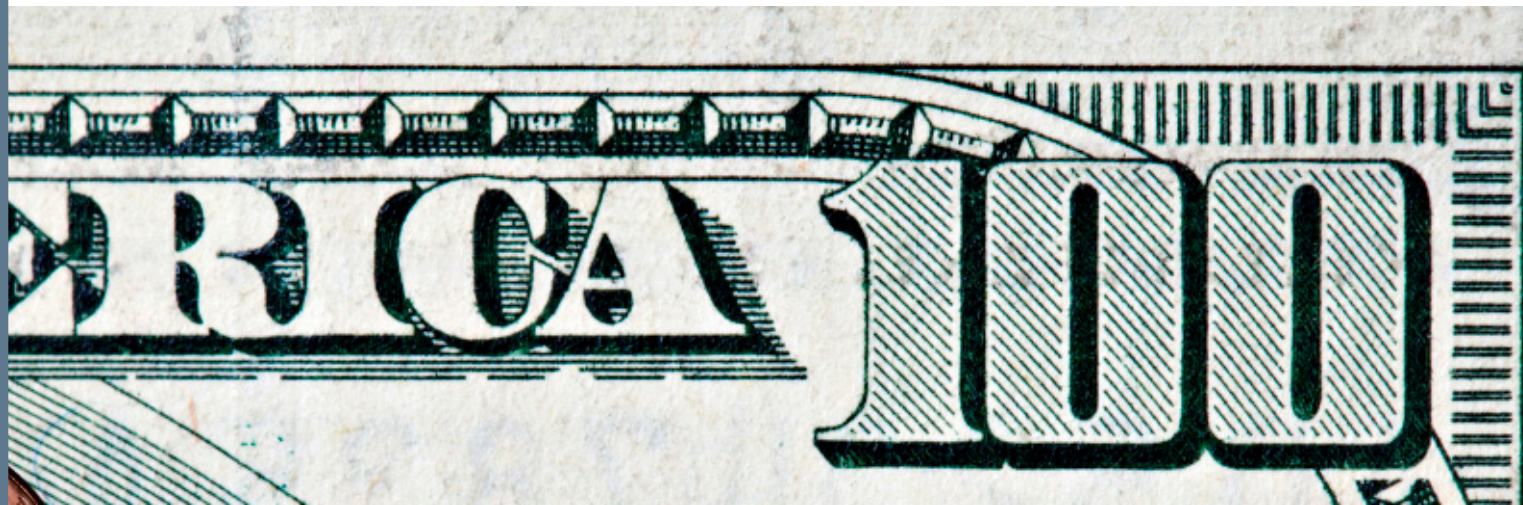
Managing the AMT – When undertaking tax planning, both regular and AMT tax liabilities need to be evaluated. At times, certain deductions may need to be shifted between years to manage the alternative minimum tax.

Considering compensation and billing – Compensation earned in 2012 but paid during 2013 will be taxable in 2013, but deductibility by your employer is not necessarily driven by the timing of payment. This combination allows for tax planning opportunities around the payment of year-end bonuses and December wages. However, should tax rates rise as planned, a bonus paid in 2012 in lieu of 2013 may save tax dollars.

If your business operates on the cash method, the timing of receipts and disbursements factors heavily into your current-year income, which opens up tax planning opportunities. Constructive receipt rules complicate this planning tool, so ask your tax adviser to walk you through situations in which the rules on timing of payments may benefit you or your business.

Paying estimated state income taxes – The payment timing of the fourth quarter estimated state tax payment, generally due Jan. 15, 2013, has some flexibility. It may be paid before year-end for a current-year federal itemized deduction. The alternative minimum tax should be considered before employing this tax planning tool because state income taxes are not deductible for AMT purposes.

Fulfilling charitable goals – An alternative to cash donations is the contribution of appreciated assets. When contributing assets, you can deduct the fair market value of certain property and avoid paying taxes on the appreciation. However, if you would like to donate securities that have declined in value, you will likely want to sell them first to realize the loss and then gift the proceeds to your



organization of choice. In some circumstances, particularly when there is expiring capital loss or charitable carryforwards, a direct donation may not be the most effective tax planning tool.

Funding retirement plans – For retirement contributions to qualify for a deduction in 2012,

contributions must be in place

usually before the end of the year. The exceptions to the rule are IRAs and SEP (simplified employee pension) plans. An IRA can be created and funded by April 15, 2013, and a SEP, by the extended due date of your tax return.

Although limited in applicability to varying degrees, a powerful tax planning tool is available to those eligible for IRA or SEP plans, providing a significant window into 2013 to plan for 2012.

Contribution limits for 2012 are as follows:

	Limit	Limit with Catch-up
401(k)	\$17,000	\$22,500
IRA	5,000	6,000
Simple IRA	11,500	14,000
Self-employed	50,000	55,500

Individuals with earned income are generally eligible to contribute to traditional IRAs. However, claiming a deduction for your contribution is a bit more complicated.



If you and your spouse are not covered by an employer's plan, you are eligible to deduct your contributions, subject to the contribution limits in the table on the previous page. If you or your spouse is active in an employer-sponsored plan, your contributions are deductible only to the extent your overall income is below certain thresholds.

The deductibility of the contributions of an active plan participant phases out as follows:

Filing Status	Adjusted Gross Income Phaseout Range
Single	\$58,000-\$68,000
Married filing jointly	\$92,000-\$112,000
Married filing separately	\$0-\$10,000
Spousal IRA	\$173,000-\$183,000

Eligibility to contribute to a Roth IRA is also dependent on income level. Contributions remain deductible if your modified adjusted gross income for 2012 is between \$110,000 and \$125,000 for single filers and \$173,000 and \$183,000 for joint filers.

Converting to a Roth IRA – Roth IRAs have long-term advantages over traditional IRAs because money grows and can be distributed tax free. Some taxpayers find that the benefits of tax-free withdrawals in the future are in line to be greater than the tax cost on conversion.

Converting before-tax earning plans – 401(k)s, traditional IRAs, etc. – to the after-tax Roth IRA creates taxable income in the year of conversion. The

upfront tax cost does not make conversion the right answer for every taxpayer, but for taxpayers with certain circumstances, conversion can be an extremely powerful tool.





In addition to the general consideration in times of rising rates, if you have any of the circumstances below, which will offset the income and/or tax on the conversion, it may be time to consider conversion:

- ▲ Current-year losses
- ▲ Loss carryforwards
- ▲ Charitable contribution carryforwards
- ▲ Current-year tax credits
- ▲ Tax credit carryforwards

Paying with credit cards – As a reminder, paying tax-deductible expenditures, including charitable contributions, with a credit card secures the deduction in the current year, even if you do not actually pay the credit card company until the following year.

Deducting losses from pass-through entities – If you are expecting a 2012 loss from a partnership, LLC or S corporation, ensuring that you have sufficient tax basis will help to secure your ability to deduct the loss. You may be able to increase your tax basis prior to year-end, but given the rates for 2013 as enacted, you might want to purposely avoid doing so until 2013 to push the loss into the higher rates of 2013.

Managing suspended passive activity losses – The most common passive activity is rental real estate, but it could also be a trade or business in which you do not materially participate. Losses from passive activities are limited and frequently carried over into future years. If you own a passive activity with a suspended loss and do not expect sufficient passive income in 2012 to allow you to deduct that loss, you can dispose of the activity prior to year-end to free up the suspended loss for use against other income. Keep in mind though that these losses may prove more valuable in future years if rates are higher.

Paying education expenses – If you pay higher educational expenses, the scheduled expiration of the American Opportunity Tax Credit at the end of 2012 is something to keep in mind. The credit is calculated as the sum of 100 percent of the first \$2,000 of qualified expenses and 25 percent of the next \$2,000 of qualified expenses, subject to income limits. If you have not qualified for the maximum credit in 2012, consider prepaying 2013 educational expenses before the end of 2012. Note that the Lifetime Learning Credit is not scheduled to expire at the end of the year.

Qualified Expenses	Credit	Maximum Credit
First \$2,000	100%	\$2,000
Next \$2,000	25%	500
Over \$4,000	0%	0
Maximum Credit		\$2,500

Maximizing the benefit of itemized deductions – It may make sense to accelerate or defer deductions across years, allowing you to benefit from the standard deduction in one year, while itemizing your deductions in the other. This approach is also helpful for deductions subject to an income limitation. Be mindful of the limitation on itemized deductions that is set to reappear in 2013 and may limit your ability to fully benefit from deductions.



Capital gains and losses

You should consider a few basic rules when planning for capital gain or loss transactions:

- ▲ Gains and losses from securities sales generally are recognized on the trade date as opposed to the settlement date. So, a December trade will be a 2012 transaction, even if the settlement date is in the following year.
- ▲ Sales at a loss reduce other capital gains, and a net capital loss in excess of capital gains of up to \$3,000 is available to be used to offset other income, with excess losses being carried forward to future years.
- ▲ Before you sell an asset to recognize a gain, check your holding period. Capital assets held for over a year are eligible for a significantly lower tax rate than those held less than a year.

Gains – For many investors, it may make sense to harvest capital gains in 2012 to take advantage of the current lower rates. Harvesting can be done without changing overall investment strategy because sales of appreciated assets can be immediately reinvested as you choose, including in identical property.

By harvesting the gains in 2012, you may pay a lower tax rate, but the tax rate savings should be weighed against the time value of money to determine the right plan for you.

In some cases, the most advantageous decision will be clear without analysis. If you happen to be in the zero percent long-term capital gains bracket (check with your tax adviser), 2012 gain harvesting will almost always be favorable from a tax perspective. Gain harvesting often makes sense also if you intend to sell the investment in 2013 or 2014 anyway because the time value of the tax deferral would be small compared to the tax savings.

However, if you are currently in the 15 percent long-term capital gain bracket and plan to pass the investment on to your heirs with a stepped-up basis at your death, there is no benefit to recognizing the gain now.

Losses – Now is also a good time to consider tax loss harvesting strategies to offset current gains. A consideration of loss harvesting involves a number of factors, including the matching of losses. The first step must be balancing short-term gains with short-term losses and long-term gains with long-term losses before generating excess losses.





In addition, the “wash sale” rule generally prohibits you from claiming a deductible loss on a security if you repurchase the same or a substantially identical asset within 30 days before or after the sale.

Installment sales – Selling an asset at a gain and collecting the proceeds in future years may allow you to defer part of the income until the years in which you receive the payments. Although a popular and effective tax planning tool, the financial risk must be weighed against potential tax benefits. Since you will be financing the sale yourself, you could be faced with collection challenges down the road. For 2012 sales, you may want to elect out of the installment sale method and report the entire gain this year to forgo higher future rates.

Estate and gift tax planning

Absent congressional action, the \$5.12 million estate and gift tax exemptions and current top tax rate of 35 percent will revert to a \$1 million exemption with a top tax rate of 55 percent beginning Jan. 1, 2013. Moreover, the estate tax exemption will no longer be portable between spouses.



Because of the reversion to a lower exemption and a higher tax rate, what could be a once-in-a-lifetime opportunity exists to transfer significant assets to the younger generation without incurring any estate and gift tax.

The annual gift tax exclusion for 2012 remains at \$13,000. It is expected to rise to \$14,000 for 2013.

If you are married, you can avoid federal gift tax ramifications by gifting up to \$26,000 per donee, or recipient, in 2012 under the gift-splitting rules. Annual gifting is a relatively simple method to reduce your taxable estate.

For example, if you and your spouse have two children, with gift-splitting you can give each child \$26,000 in late December and another \$28,000 in early January. If your children are married and you have grandchildren, the opportunity increases dramatically.



Transfers of appreciating assets outright to the next generation or through such techniques as grantor retained annuity trusts or sales to defective trusts may allow you to transfer significant wealth, with little or no tax cost. A



well-planned gift in 2012 has the potential to transfer significant wealth out of your estate but should always be evaluated alongside future cash flow and the need to find the plan that best supports your goals.

Along with the high gift tax exemption, the generation-skipping transfer tax exemption is also \$5.12 million during 2012. So, the door is open to bypass children and transfer significant wealth to future generations.

Medical expenditure planning

Many employers with health flexible spending arrangements (health FSAs) limit salary reduction contributions to between \$2,500 and \$5,000. Effective 2013, the healthcare act requires health FSAs under a cafeteria plan to limit contributions through salary reductions to \$2,500. After 2013, the \$2,500 limitation is scheduled to be adjusted for inflation.



If you have unused health FSA dollars, you should consider spending them before Dec. 31, 2012 – or March 15, 2013, if the 2½-month grace period applies – to avoid the “use it or lose it” rule. Keep in mind that health FSA dollars can no longer be used for over-the-counter medications except insulin.

In addition, the threshold to claim an itemized deduction for unreimbursed medical expenses increases from 7½ percent of adjusted gross income to 10 percent of adjusted gross income after 2012. The healthcare act provides a temporary exception to the increased percentage through 2017 for individuals or their spouses who are age 65 and older.

While many medical expenses cannot be timed for tax-deduction purposes, batching expenses into 2012, when the threshold is 7½ percent of adjusted gross income, may make it more likely that the expenses will exceed that threshold.

Business Tax Strategies

Retirement plans for your business

Starting a small business retirement savings plan is often easier than you think.

And a retirement plan can offer significant tax advantages:

- ▲ Employer contributions are deductible from the employer's income.
- ▲ Employee contributions are not taxed until distributed to the employee.
- ▲ Investments in the program grow tax-deferred until they're withdrawn.
- ▲ The tax law offers a nominal incentive of a \$500-per-year tax credit to small employers for the first three years of a new SEP, Simple or other retirement plan to cover the initial setup expenses.

Section 179 expensing

IRS Code Section 179 provides businesses the option of claiming a full deduction for the cost of qualified



property in its first year of use rather than claiming depreciation over a set period of years. For 2012, the Section 179 dollar limitation is \$139,000 with a \$560,000 investment limitation.



The dollar limitation for 2013 is scheduled to drop to \$25,000, with a \$200,000 investment limitation. Businesses might want to consider accelerating scheduled purchases into 2012 to take advantage of the higher limits.

Companies that purchase qualifying property during 2012 have the deduction amount reduced dollar-for-dollar for purchases in excess of \$560,000. The deduction phases out completely for companies purchasing and placing in service more than \$699,000 of qualifying property during 2012.

Businesses with a fiscal year-end should note that the \$139,000 deduction limit applies to property purchased and placed in service during tax years beginning in 2012.

Bonus depreciation

Property not qualifying for an immediate tax write-off under the expensing election may qualify for an increased first-year depreciation deduction under bonus depreciation rules. This deduction is equal to 50 percent of the cost of qualifying property purchased and placed in service by Dec. 31, 2012. Unlike the



Section 179 deduction, bonus depreciation is not limited in amount or by an investment limitation, and it can create a current-year net operating loss.

To qualify for bonus depreciation, the property must be new. In addition, it must meet one of the following requirements:

- ▲ Have an applicable MACRS recovery period of 20 years or less
- ▲ Be water utility property or computer software not covered by the Section 197 amortization rules
- ▲ Qualify as leasehold improvement property

Cost segregation studies

Buildings and other real estate generally do not qualify for bonus depreciation or the expensing election. However, a cost segregation study may be able to identify qualifying property within the overall project that will qualify for an accelerated expensing provision.





Losses from pass-through entities

Economic pressures are causing many historically profitable businesses to experience operating losses. If you are an owner of a pass-through business entity operating as a partnership, LLC, S corporation or trust, and the business incurs a loss in 2012, you need to plan ahead to ensure the loss will be available for use on your personal tax return.

If your business activity is passive – generally a rental real estate activity or a business in which you do not materially participate – you may not be able to deduct the loss unless you also generate passive income. To deduct your losses, even those from businesses in which you materially participate, you must have sufficient basis.

There are steps that can be taken to increase your basis or the hours you devote to the business to allow for deductibility. Historically, leveraging this planning technique was simply a matter of determining how to release the loss for use, but this year, the timing of releasing the loss is also a critical consideration. Loss deductibility rules are complicated, and your tax adviser is best suited to help walk you through the complex loss rules.

Changes to repair regulations

Comprehensive repair and capitalization regulations issued by the IRS late in 2011 may open up planning opportunities.

The new temporary regulations revise the treatment of assets in a general asset account (GAA), making it the most desirable method to group depreciable

assets. Partial disposals of GAA assets are now allowed and include the recognition of retirements of building components.

A general asset account election can be made on the first year's Form 4562, while late elections may be made on Form 3115.



A new *de minimis* expensing rule allows a business to deduct certain amounts paid or incurred to acquire or produce a unit of tangible property if the company has all of the following:

- ▲ An Applicable Financial Statement (AFS)
- ▲ Written accounting procedures for expensing amounts paid or incurred for such property under certain dollar amounts
- ▲ Written accounting procedures that require the amounts to be treated as expenses on its AFS
- ▲ An overall ceiling limiting the total expenses a company may deduct under the *de minimis* rule

Making changes from previously acceptable accounting methods to comply with the new regulations requires filing for a change in accounting method by means of at least one Form 3115. Accounting policies and existing depreciation schedules should be reviewed to determine whether changes in accounting methods should be filed and adjustments taken. In many cases, the change will result in accelerated expensing.

Corporate dividends

Traditional C corporations face double taxation on distributed earnings. Profits are taxed at the corporate level and dividends paid out to shareholders are again subject to tax at the individual level. With the maximum 15 percent tax rate for qualified dividends during 2012 rising to 43.4 percent for 2013, this may be the year to consider paying out accumulated earnings that the corporation is not otherwise using.



Health insurance tax credit

A tax credit is available for an eligible small employer to purchase health insurance for employees.

To qualify as an eligible small employer, the company must:

- ▲ Pay for at least 50 percent of the premium cost for employees
- ▲ Generally have no more than 25 full-time equivalent employees employed during the year
- ▲ Pay its full-time equivalent employees annual wages averaging no more than \$50,000



Developing an overall tax strategy under ambiguous circumstances can feel daunting. But the deliberate, informed implementation of a plan now for what is known can also protect against what remains to be seen – as what is unknown becomes known. Please let us know how we can best support you as you navigate these uncertain times and plan for taxes in 2012 and beyond.

The technical information in this newsletter is necessarily brief. No final conclusion on these topics should be drawn without further review and consultation. Please be advised that, based on current IRS rules and standards, the information contained herein is not intended to be used, nor can it be used, for the avoidance of any tax penalty assessed by the IRS.

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