CPA

Client Tax Letter

Tax Saving and Planning Strategies *from your* Trusted Business Advisor[sm]

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Reducing Uncertainty, Increasing Complexity

Each April, most Americans file their income tax returns for the previous year. By this time next year, in April 2014, you'll be filing your tax return for 2013—and the rules will be governed by the American Taxpayer Relief Act of 2012, the last minute deal that averted the so-called "fiscal cliff."

The good news is that large portions of this new law are permanent, or at least as permanent as any tax law can be. The major portions of the law won't "sunset," so the nation won't have to relive the uncertainty about tax law that captured headlines in December 2010 and December 2012.

In addition, many taxpayers will not face major changes under the new law. It's true that Social Security payroll taxes will rise for all workers, but that partial "holiday" was a temporary measure in effect during 2011 and 2012 to spur a slow economy. The income and estate tax benefits from earlier in this century largely remain in effect.

The catch? Taxpayers with higher incomes face a variety of higher taxes. Those taxes are imposed at different levels of income and on different types of income: adjusted gross income (AGI), modified adjusted gross income (MAGI), and taxable income. Owners of S corporations and limited liability companies (LLCs) who report business net income on their personal tax returns may be especially vulnerable to the higher rates. Similarly, taxpayers who report much higher income in a given year, perhaps because of a Roth IRA conversion or an asset sale, might have to wrestle with the higher rates and increased complexity of the new law. ■

What's Inside

Restoring a Higher Tax Bracket

For several years, through 2012, Americans paid income tax at six rates, ranging from 10% to 35%. Now, a higher rate has been added: 39.6%, which was the highest income tax rate as recently as 2000. In 2013, the 39.6% rate is imposed on income over

- $400,000 for single taxpayers,
- $450,000 for married couples filing joint returns and surviving spouses,
- $225,000 for married individuals filing separately, and
- $425,000 for heads of households.

The 39.6% tax rate, like all tax rates, is imposed on taxable income. That's the number you report after taking tax deductions.

Example 1: Ross Austin, a single taxpayer, has total income of $520,000 in 2013. After deductions, Ross has taxable income of $480,000. Thus, $80,000 of his income will be taxed at the maximum 39.6% rate.

When 39.6% = 20%

Prior tax legislation capped the tax on most long-term capital gains at 15%. Taxpayers also owed no more than 15% on qualified dividends, which include most dividends paid to investors. The new law retains this relatively low ceiling for most people. However, taxpayers who have taxable income in excess of the 39.6% rate threshold will owe 20% tax on their long-term gains and their qualified dividends to the extent that these gains and dividends would otherwise be taxed at the 39.6% rate.

Example 2: Ross Austin from example 1 has a $60,000 net long-term capital gain in 2013. Ross has $480,000 of taxable income, which is $80,000 over the threshold for the top bracket, so Ross owes 20% tax on his $60,000 capital gain.

Suppose, though, that Ross has a $100,000 long-term gain this year. Ross is $80,000 over the relevant threshold, so $80,000 of his gain will be taxed at the maximum 20% rate, whereas the other $20,000 of his gain will be taxed at 15%.

Shifting gears

Taxpayers below these higher income thresholds will continue to owe tax at rates as low as 10%. Moreover, taxpayers in low tax brackets will owe 0% on taxable long-term capital gains and qualified dividends. Therefore, income shifting strategies have a greater payoff now than they have had recently for high-income taxpayers. If you report substantial income, you may save more tax now by shifting income to children just beginning their career or to retired parents. Our office can go over these and other tax reduction strategies. ■

Lower Incomes, Higher Taxes

As explained in the previous article, "Restoring a Higher Tax Bracket," individuals with taxable income over $400,000 and married couples who exceed $450,000 generally will be the ones paying the restored 39.6% top income tax rate, as well as higher tax on long-term capital gains and qualified dividends. However, such taxpayers aren't the only ones facing tax increases. Some people with lower incomes also will owe two taxes that reappear in the new law.

Eroding exemptions

Prior law included a phaseout of personal exemptions for taxpayers with high incomes. That phaseout had been—yes—phased out in recent years. Now, the original phaseout has returned, as a permanent feature of the tax law. In 2013, this phaseout will affect people with income over

- $250,000 for single taxpayers,
- $300,000 for married couples filing joint returns and surviving spouses,
- $150,000 for married individuals filing separately, and
- $275,000 for heads of households.

As you can see, these income thresholds are lower than the thresholds for the 39.6% top tax bracket. They also refer to adjusted gross income (AGI), the number you report on the bottom of the first page of your tax return, before you take itemized deductions. Therefore, people with taxable income far from the 39.6% bracket may owe more tax

because their personal exemptions are devalued. Generally, for each $2,500 (or fraction thereof) of AGI taxpayers are over their threshold, they will lose 2% of their personal

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exemptions. They can lose up to 80% of their exemptions this way.

Example 1: Sarah and Todd Bailey have two young children, so they can claim four exemptions. Personal exemptions are $3,900 per person in 2013, so the Baileys could claim $15,600 in deductions for their four exemptions. If the Baileys' AGI in 2013 is $330,000, they are $30,000 over the relevant threshold, which is 12 times $2,500. Twelve times 2% equals 24%, so the Baileys personal exemptions would be reduced by 24%, from $15,600 to $11,856.

Declining deductions

The same income thresholds apply to the phaseout of itemized deductions. Under this provision, itemized deductions will be reduced by an amount equal to 3% of a taxpayer's AGI over the relevant threshold. Thus, if the Baileys have AGI of $330,000, which is $30,000 over their threshold, they will lose $900 of their itemized deductions: 3% of $30,000. (Deductions for medical expenses, investment interest, casualty or theft losses, and wagering losses are excluded from the calculation.) Again, high-income taxpayers can lose as much as 80% of their itemized deductions.

Sustaining the surtax

In the new tax law, Congress took no action regarding the 3.8% Medicare surtax, included in prior health insurance legislation. As explained in the fourth quarter 2012 *CPA Client Tax Letter*, this tax takes effect in 2013, affecting people who top these income levels:

- $250,000 for married couples filing joint returns and surviving spouses
- $125,000 for married individuals filing separately, and
- $200,000 for all other single taxpayers

For this surtax, the thresholds are based on modified adjusted gross income (MAGI), which is AGI plus any net foreign income. For many taxpayers, MAGI will be the same as AGI.

As you can see, lowering your AGI may be able to help you reduce or eliminate the 3.8% surtax and the two phaseouts described in this article. Tactics that lower AGI, such as taking capital losses and maximizing deductible contributions to retirement plans, may also lower your exposure to these taxes. ■

Estate and Gift Taxes Have Been Clarified

A single, unified exemption is available to taxpayers for the estate and gift taxes. A taxpayer can use the exemption to offset otherwise taxable lifetime gifts, and the taxpayer's estate can use the amount remaining at his or her death to offset otherwise taxable bequests.

The amount of the exemption was a major issue throughout 2012. That exemption was set at $5 million, adjusted for inflation. The inflation-adjusted amount for 2012 was $5.12 million. At that level, relatively few estates owed federal estate tax. However, the law in effect during 2012 called for the exemption to return to its 2003 level of $1 million in 2013. That would have exposed many estates to federal estate tax, with rates as high as 55%.

Instead, Congress largely left the 2012 estate and gift tax rules in place. The unified federal estate and gift tax exemption for 2013 and future years has been permanently set at $5 million adjusted for inflation, with the inflation-adjusted amount for 2013 being $5.25 million. Therefore, estates of people who die with a net worth under $5.25 million and did not make significant gifts during their lifetime generally will not have to pay estate tax.

The only major estate tax change in the new law regards the maximum federal estate tax rate, which has been increased from 35% in 2012 to 40% in 2013 and subsequent years.

Example 1: Anna Carter dies in 2013, when the exemption is $5.25 million. Anna did not use any of her exemption amount on gifts during her lifetime and leaves an estate

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valued at $6 million. The $750,000 over the exemption amount will be taxed at the maximum rate of 40%, so Anna's estate will owe $300,000 (40% of $750,000) in federal estate tax.

Preserving portability

With a $5.25 million federal estate and gift tax exemption amount, a married couple that does not use the exemption to offset any lifetime gifts can potentially leave up to $10.5 million in assets free of estate tax. In fact, the new tax law makes that simpler to do than has been the case in the past because Congress made permanent what had been a temporary "portability" provision. In prior years, lack of portability created problems for many married couples.

Example 2: Barry and Carla Duncan, a married couple, had total assets of $8 million. Barry died in 2009 and left all of his assets to Carla. Because one spouse's bequest to the other spouse typically avoids estate tax, regardless of the amount, no estate tax was due.

Assume Carla dies in 2013 with an $8 million estate, and she did not use any of her exemption amount on lifetime gifts. She'll be $2.75 million over the $5.25 million exemption amount, and her estate will owe $1.1 million in federal tax, at a 40% rate.

To remedy such outcomes, Congress created a temporary portability provision for 2011, a provision that's now a permanent part of the tax code. With portability, any unused portion of a deceased spouse's exemption amount can be used by the surviving spouse's estate. Originally, Congress created this portability opportunity only for deaths in 2011 and 2012. The new law makes portability permanent.

Example 3: If Barry Duncan had died in January 2013, leaving all of his assets to Carla, he would have left $5.25 million of his exemption unused. That amount can be transferred to Carla, if Barry's executor makes a timely election to do so on a properly filed estate tax return, IRS Form 706. If Carla then dies in December 2013 without using any of her exemption for gifts, her estate would have a total exemption of $10.5 million (her own $5.25 million exemption and a similar one from Barry). Carla's $8 million estate wouldn't be taxed by the federal government, for a $1.1 million tax saving.

The new tax law also preserves the federal tax deduction for state estate taxes. This provision should remind you that estates may owe state estate tax even if they are exempt from federal estate tax.

Example 4: Edward Franklin dies in 2013 with a $3 million estate, so he owes no federal estate tax. However, Edward's home state exempts only $1 million of assets from state estate tax. His estate is $2 million over the threshold; depending on the state's tax rates, Edward's estate may owe many thousands of dollars in state estate tax.

The bottom line is that you should not ignore estate tax planning, even if you have little concern about federal estate tax. Our office can work with you on strategies to reduce exposure to estate tax, state or federal.

Generous gifts

As noted above, you can use your unified federal estate and gift tax exemption amount to offset otherwise taxable lifetime gifts, thus reducing the amount of gift tax you have to pay. However, using the exemption for lifetime gifts reduces the amount of the exemption available to your estate to offset otherwise taxable bequests and reduce the amount of the estate tax.

Example 5: Nancy Harris has never made any taxable gifts. In 2013, she gives $1 million to her daughter Lisa. The first $14,000 of that gift is tax free, covered by the annual gift tax exclusion for 2013. The other $986,000 is considered a taxable gift but Nancy owes no gift tax because of the lifetime gift tax exemption. After making the gift, Nancy's lifetime gift-tax exemption is $4,264,000: her original $5,250,000 exemption minus the taxable gift of $986,000. That $4,264,000 exemption, indexed for future inflation, can shelter future gifts or bequests from tax.

What's more, the concept of portability, explained earlier in this article, also applies to gift tax, so once a surviving spouse has increased his or her exemption by the deceased spouse's unused exemption amount, that increased amount can be used to offset either gift or estate tax.

Example 6: Assume that the transfer tax exemption, which is $5.25 million in 2013, rises to $6 million in a future year, and the annual gift tax exclusion remains $14,000. Nancy Harris dies that same year, having made no additional taxable gifts. Nancy leaves all of her assets to her husband, Pete, thus incurring no estate tax. In this scenario, Nancy's unused exemption is $5,014,000: her $6 million exemption minus $986,000 in taxable gifts.

Assume that Pete has not made any taxable gifts. Pete could have a total exemption of $11,014,000 in this example, including Nancy's unused amount. Pete could make up to $11,014,000 in tax-free gifts, and when he died, any unused gift tax exemption would be available to provide estate tax shelter.

In addition, the generation skipping transfer (GST) tax exemption also is $5.25 million in 2013, indexed to inflation. However, portability does not apply to the GST tax. ■

Breaks for Business Owners

Several provisions of the new tax law apply to businesses. For the most part, these provisions extend previous law, often through 2013, while some are retroactive to 2012.

First-year equipment deductions

Under Section 179 of the tax code, businesses can take a first-year "expensing" deduction for equipment placed in service, rather than spread depreciation deductions over several years. Thus, equipment purchasers get the tax benefits more rapidly, which makes them more valuable.

Throughout 2012, business owners believed the expensing limitation for the year would be $139,000 of equipment, with a phaseout, dollar for dollar, starting with $560,000 of purchases. The new tax law sets the expensing limit at $500,000, with a phaseout beginning at $2 million. The higher limits apply retroactively to 2012 as well as to 2013.

Example 1: Smith Corp. buys $400,000 worth of equipment in 2013. It can take a $400,000 deduction, under Section 179.

Example 2: Jones Corp. buys $2.2 million worth of equipment in 2013. Therefore, Jones Corp. is in the phaseout range by $200,000. Consequently, the company's first-year deduction will be reduced from the maximum $500,000 to an allowable $300,000.

In 2014, the Section 179 deduction is scheduled to drop to a $25,000 maximum, with a phaseout beginning at $200,000 of purchases. However, Congress has consistently agreed to increase these amounts substantially, with short-term extenders.

Bonus depreciation

In example 2, Jones Corp. buys $2.2 million of equipment in 2013 and expenses $300,000 of those purchases under Section 179 of the tax code. The remaining $1.9 million of equipment purchases must be depreciated.

Typically, businesses must spread depreciation deductions over several years. In recent years, though, "bonus depreciation" has allowed more rapid recovery of the cost of qualified property (which includes most equipment and machinery). The new tax law extends 50% bonus depreciation through 2013. Therefore, Jones Corp. may be able to take an additional first-year tax deduction of $950,000 (50% of $1.9 million) for its equipment purchases in 2013. The $950,000 balance will be deducted over a multiyear schedule.

Bonus depreciation applies only to new equipment. By contrast, businesses may take first-year expensing deductions under Section 179 for purchases of new or used equipment.

Credit check

Several other business-related provisions were extended through 2013 in the new tax law. They include the research tax credit, for increases in qualified R&D; the new markets tax credit, for certain investments in low income communities; and the work opportunity tax credit, for hiring individuals from certain groups with high rates of unemployment. Under the work opportunity tax credit, employers who hire a covered individual generally receive a tax credit equal to 40% of first-year wages, up to $6,000. The tax credit for hiring certain veterans can be as high as $9,600. ■

AMT Relief, Child Tax Credit, and More

The American Taxpayer Relief Act of 2012 is far ranging, with many other provisions that might affect taxpayers. They include the following:

- **Alternative minimum tax (AMT) exemption.** For years, Congress has increased the AMT exemption amount with a series of "patches." Without these increases, the exemption would have been lower and more taxpayers would owe the AMT.

  The new law sets the exemption amounts for 2012 at $78,750 for married couples filing joint returns and surviving spouses; at $39,375 for married taxpayers filing separately; and at $50,600 for individuals who are not married. In 2013, those amounts are $80,800, $40,400, and $51,900, respectively, and in subsequent years, they will increase with inflation.
- **Child tax credit.** This credit, which was due to fall to $500 in 2013, is now permanently set at $1,000. That $1,000 tax credit is per child under age 17. Income limits may prevent some parents from receiving some or all of this credit.
- **Equality for couples.** The new law maintains the rules aimed at eliminating the "marriage penalty." For example, the standard

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deduction for a single taxpayer in 2013 is $6,100; the new law assures that the standard deduction for married couples filing jointly will be twice as high: $12,200. If the new law had not passed, the standard deduction for couples would have been only $10,150.

Similarly, the 15% tax bracket for single taxpayers goes up to $36,250 of taxable income, and the new law will mean that bracket goes up to $72,500 for married couples filing jointly. Before the new law extended marriage penalty protection, couples would have moved from the 15% bracket to the 25% bracket with only $60,550 of taxable income.

- **Sales tax deduction.** People who itemize deductions on Schedule A of Form 1040 can deduct state and local income taxes paid. In recent years, itemizers have had the option of deducting state and local sales taxes paid, rather than state and local income taxes. The new law extends this option through 2013, providing an especially valuable benefit to residents of states with no income tax.
- **IRA charitable contributions.** Generally, taxpayers owe tax if they use IRA money for charitable donations, because IRA distributions must be included in income. In recent years, though, taxpayers 70½ or older have been able to make direct distributions from their IRAs of up to $100,000 to charity without including the distributions in income. The taxpayers didn't get a charitable contribution tax deduction, but they avoided increasing their adjusted gross income (AGI) by the amount of the distributions and the distributions were treated as part of their required minimum distributions.

The new law restores this tax benefit for 2012 and for 2013. An IRA owner can treat a contribution made to a qualified charity in January 2013 as a 2012 qualified charitable distribution, in many cases.

- **American Opportunity Tax Credit.** Ever since Congress replaced the Hope Scholarship tax credit with the more valuable AOTC in 2009, the AOTC has been a prime tax break. The new law extends the AOTC through 2017.

Under the AOTC, taxpayers may cut their tax bill by as much as $2,500 per student. To get the maximum credit, you must spend at least $4,000 per student in the relevant calendar year. You can count money spent for students in their first four years of post-high school education. The money you pay for tuition and related fees counts for calculating the tax credit, along with outlays for necessary books, supplies, and equipment but room and board costs don't count. Income limits prevent some taxpayers from claiming the AOTC.

Taxpayers who are not able to claim the AOTC may qualify for the deduction for qualified tuition and related expenses. That deduction, which may be as much as $4,000, although it expired after 2011, is now extended retroactively to 2012 and through 2013 as well. Also included in the new law are continued easing of the tax deduction for interest on student loans and maintenance of the $2,000 limit for annual contributions to Coverdell Education Savings Accounts. ■

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