Tax Tips

By Sidney Kess

Year-End Tax Planning for Individuals and Businesses

Now that the final quarter of the year is under way, it is an ideal time to focus on year-end tax planning to minimize taxes for this year and be better positioned for next year's taxes. The government's shutdown may not have a direct impact on planning, but inflation adjustments, expiring provisions, and other factors will affect tax planning at this time.

Overview

As a general rule, year-end planning is a multi-year exercise, taking into account current tax rules, rules for next year, and the taxpayer's income and expenses now and anticipated for the future. For individuals, projections for cost of living adjustments (COLAs) to dozens of tax rules for 2014 are modest. For example, the personal exemption likely will rise only $50. Similarly small increases are projected for tax brackets, the standard deduction, the alternative minimum tax exemption, and income thresholds for Roth IRA contributions. Official COLAs may not be released until later in the year, but this should not dramatically change from projections; thus they can be used for planning purposes.

Defer income. For most taxpayers, deferring income postpones taxation and the tax bill for a year. Income deferral can be used for:

- Year-end bonuses if the employer offers a deferred compensation option.

- Capital gains by not actualizing profits this year. Of course, this tax strategy should be only one factor in investment decisions; don't forego market opportunities solely to secure tax savings.
- Business income of cash basis self-employed individuals, who may want to delay year-end billing so that payment is received (and becomes taxable) in 2014. Again, this strategy should not be used if funds are needed for cash flow purposes or if there is any risk of collections by delaying the billing.

Harvest capital losses. Individuals holding securities that have declined in value may want to actualize losses for tax advantage. Capital losses on the sale of securities can offset capital gains, dollar for dollar. Capital losses in excess of capital gains can offset up to $3,000 of ordinary income ($1,500 for married persons filing separately). Capital losses in excess of these limits can be carried forward indefinitely to offset gains (and limited ordinary income) in future years. "Banking" capital losses may yield sizable tax savings in the future (especially if an individual expects to be in a higher tax bracket next year).

Make transfers to relatives in low tax brackets. Those in the 10% or 15% tax bracket pay no tax on long-term capital gains and qualified dividends. Thus, an elderly parent in a low tax bracket can dispose of gifted appreciated securities, leaving more after-tax income in the family. ***Beware:*** Don't make transfers to children subject to the "kiddie tax" (Code Sec. 1(g)); it will not achieve the tax savings.

Taking into account new rules for 2013

There are a number of tax rules that premiered in 2013 and can have a serious impact on an individual's tax bill for the year. These rules include:

Higher tax rates on top filers. There is a new 39.6% tax bracket for the wealthiest individuals (last year the top rate was 35%) (Code Sec. 1). These individuals also pay 20% on long-term capital gains and qualified dividends (last year the top rate was 15%) (Code Sec. 1(h)). The impact of these higher tax rates means such individuals should use every tax-saving strategy to minimize taxable income. This can include:

- Using salary deferral options, including contributions to 401(k) plans, flexible spending accounts, and deferred compensation plans.
- Using installment reporting for sales of eligible property to spread the gain over the period in which installments are received.
- Investing in tax-exempt bonds.

Additional Medicare tax on earned income. This tax of 0.9% applies to earned income over a threshold amount that depends on filing status ($200,000 for singles; $250,000 for joint filers; and $125,000 for married persons filing separately) (Code Sec. 3101(b)(2)). This additional tax can impact year-end bonuses. Employees are subject to withholding once taxable compensation exceeds $200,000 (regardless of filing status). Those who think they won't have sufficient taxes withheld (for example, they work for two employers and wages at each job do not exceed the threshold even though their total earnings exceed the threshold) can increase income tax withholding and apply it to the additional Medicare tax when they file their personal income tax returns. Self-

employed individuals with net earnings from self-employment exceeding the applicable threshold should increase estimated for the year to cover this new Medicare tax. New Form 8959, *Additional Medicare Tax,* will be used to figure this additional tax; it is attached to Form 1040.

Additional Medicare tax on net investment income (NII tax). This tax of 3.8% applies to the lesser of net investment income (investment income minus investment expenses) or modified adjusted gross income in excess of the applicable threshold amount (the same threshold as the one used for the additional Medicare tax on earned income (Code Sec. 1411).

Determine now which income received by an individual is treated as investment income for purposes of this tax. For example, those who own an interest in a pass-through entity (e.g., S corporation) may convert investment income to noninvestment income by materially participating in the activities of the business. Again, if this tax is projected, it should be taken into account when figuring wage withholding and/or estimated taxes. New Form 8960, *Net Investment Income Tax – Individuals, Estates, and Trusts,* will be used to figure this additional tax; it too is attached to Form 1040.

Higher threshold for itemized medical expenses. For 2013, only medical expenses in excess of 10% of adjusted gross income (AGI) can be deducted as an itemized deduction (Code Sec. 213(a)). The former 7.5%-of-AGI threshold applies only to those who are age 65 and older. An individual with significant medical expenses that are not covered by insurance or reimbursed by a medical account (such as a health savings account or a flexible spending account) may want to incur voluntary medical costs

before the end of the year in order to exceed the threshold and claim a medical deduction. Examples of voluntary costs include: prescription glasses, sunglasses, and contact lenses; Lasix eye surgery, and dental procedures (which may not otherwise be covered by insurance or reimbursements).

Charitable contributions. Those who itemize can boost write-offs by making donations before the end of the year. Keep two things in mind: 1) Obtain required substantiation (Code Sec. 170(f)) and 2) factor in the new phase-out of itemized deductions (Code Sec. 68) on the tax savings that donations will yield.

Using expiring rules for individuals

Numerous tax rules are scheduled to expire at the end of 2013. They may be extended by Congress, but budget woes could nix or delay any action in this regard. Here are some favorable rules to use while they are in effect.

IRA transfers to charity. Those who are age 70½ or older can transfer up to $100,000 directly from an IRA to a public charity (called a qualified charitable distribution) (Code Sec. 408(d)(8)(A)). The benefit: There is no current income tax, even if the transfer includes the required minimum distribution (RMD) for the year. What's more, by not including the RMD in adjusted gross income, the individual may be eligible for other tax breaks that are pegged to AGI. For example, it may minimize the extent to which Social Security benefits are taxable. Further, for higher-income taxpayers, this transfer may minimize the phase-out for personal exemptions and itemized deductions as well as minimize the additional Medicare Part B and D premiums for 2015 (which are based on 2013 AGI). ***Note:*** Individuals who took

advantage of a transitional rule (IR-2013-6, 1/16/13) to make IRA transfers in January 2013 that were credited to 2012 can make another transfer for 2013 before the end of the year.

Energy improvements. Adding insulation, storm doors and windows, and certain other energy-saving items to a principal residence can entitle the homeowner to a tax credit if the improvement is added before the end of this year (Code Sec. 25C).

Disposing of homes "underwater." With some exceptions, debt forgiveness usually results in taxable income. However, if a mortgage up to $2 million on a principal residence is forgiven before the end of 2013, no income results (Code Sec. 108(a)(1)(E)). Short-sales or other workouts accompanied by the cancellation of indebtedness should be completed by the end of December.

***Note*:** A complete list of expiring provisions can be found from the Joint Committee on Taxation (Report JCX-3-13).

Using expiring rules for businesses

Businesses have an even greater list of provisions that expire at the end of 2013 unless Congress extends them. Again, actions before the end of the year can secure tax savings for this year in case the rules are not extended for 2014.

Breaks for purchases of equipment and machinery and certain building improvements:

- First-year expensing (Sec. 179 deduction) of up to $500,000. Unless extended, the limit for 2014 will be $25,000.

- Bonus depreciation of 50% of qualified costs (Code Sec. 268(k)(5)). Unless extended, there will be no bonus depreciation allowance next year.
- Special breaks for qualified leasehold, retail, and restaurant improvements. These include expensing up to $250,000, eligibility for bonus depreciation, and a 15-year recovery period for depreciation of excess costs. Unless extended, such improvements made after this year will have to be depreciated over 39 years.

Employment-related tax breaks:

- Work opportunity credit (Code Sec. 51).
- Credit for wage differential payments made for reservists called to active duty (Code Sec. 45P).
- Indian employment credit (Code Sec. 45A).

Energy-related provisions:

- Deduction of $1.80 per square foot for efficient commercial properties (Code Sec. 179D).
- Tax credit for building energy-efficient homes (Code Sec. 45L) and manufacturing certain energy-efficient appliances (Code Sec.45M).

Other provisions:

- Issuing qualified small business stock (Code Sec. 1202) to investors and/or employees. These shareholders will be able to exclude 100% of their gain as long as the stock has been held more than five years. The exclusion is set to revert to the 50% limit in 2014 unless Congress extends the full exclusion.

- Donating appreciated property by S corporations (Code Sec. 1367(a)(1)). This move allows shareholders to adjust their basis in S stock by the corporation's adjusted basis in the property even though their share of the deduction for the donation is based on the property's fair market value.

Conclusion

Now is an ideal time for individuals and businesses to meet with tax advisors to assess their current tax positions and to learn what steps can be taken to favorably impact their tax bills. Income tax withholding and the final installment of estimated taxes can be adjusted to reflect tax-planning moves. Of course, year-end tax planning should stay flexible to account for last-minute tax changes that could be part of a debt ceiling agreement in Congress.