Goldburd & Co. LLP
Certified Public Accountants

TAX TALK

Winter 2012

It's that time of year where we should think about preparing an estimate of your current year tax liability or calculate the expected taxable income or loss of your business and determine if there is anything we can do before the end of the year to mitigate or reduce any potential tax liability for 2012.

Individuals

There are several things to consider when doing year-end tax planning: taking advantage of expiring tax provisions, deferring income into the following year or accelerating income into the current year, and accelerating expenses into the current year or deferring them into the following year.

The proper strategy depends on whether or not you anticipate income increasing substantially in the following year or whether you anticipate a significant change in expenses in the following year. And probably the biggest unknown, at the moment, is whether or not the individual tax rate will change in 2013 - and if it does, in which direction it will go.

There are some very favorable tax provisions that are scheduled to expire at the end of 2012 and some potentially unfavorable provisions that become effective in 2013. For example, individual tax rates are scheduled to rise on January 1 to a top rate of 39.6 percent, and the limitations on both itemized deductions and the personal and dependency exemptions are scheduled to return for high-income individuals. Also, the maximum capital gains rate that applies to sales or exchanges for most capital assets - that is, capital assets other than those in the 28 percent rate group (collectibles) or the 25 percent rate group (unrecaptured gain attributed to depreciated real property) - is scheduled to increase to 20 percent (10 percent if the taxpayer is in the 15 percent income tax bracket). Further, a new .9 percent tax on earned income and a 3.8 percent tax on investment income take effect in 2013 for certain high-income individuals. Thus, depending on your projected income for 2013, we may need to revise your withholdings or increase your estimated tax payments for 2013 to take these changes into consideration.

While the following are some of the actions we should consider, the focus should not be entirely on tax savings. These strategies should be adopted only if they make sense in the context of your total economic picture.

Accelerating Income into 2012

While we don't know if the tax rate changes scheduled to take effect on January 1, 2013, will actually occur, if we anticipate that the tax rates will go up next year for your tax bracket, or if we just want to lock into the current year tax rate, it would be prudent to accelerate income into the 2012 tax year. Some options include:

(1) if you own a traditional IRA or a SEP IRA, converting it into a Roth IRA and recognizing the conversion income this year;
(2) taking IRA distributions this year rather than next year;
(3) selling stocks or other assets with taxable gains this year;
(4) if you are self employed with receivables on hand, trying to get clients or customers to pay before year end; and
(5) settling lawsuits or insurance claims that will generate income.

Deferring Income into 2013

If we anticipate that tax rates for your income bracket will go down in 2013, or that your income will go down next year, it may be prudent to defer income into the 2013 tax year. Some options include:

(1) if you are due a year-end bonus, asking your employer to pay the bonus in January 2013;
(2) if you are considering selling assets that will generate a gain, postponing the sale until 2013;
(3) delaying the exercise of any stock options you may have;
(4) if you are selling property, considering an installment sale;
(5) consider parking investments in deferred annuities;
(6) establishing an IRA, if you are within certain income requirements; and
(7) if your employer has a 401(k) plan, consider putting the maximum salary allowed into it before year end.
However, with respect to deferring the sale of stock or other property, the scheduled increase in capital gain rates after December 31, 2012, should be taken into account.

Deferring Deductions into 2013

Once again, if we expect tax rates to increase next year, or if you anticipate a substantial increase in taxable income next year, we may want to explore deferring deductions into 2013 by looking at the following:

(1) postponing year-end charitable contributions, property tax payments, and medical and dental expense payments until next year; and

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(2) postponing the sale of any loss-generating property.

However, with respect to postponing the payment of medical and dental expenses, the scheduled increase in the threshold for deducting such expenses (from 7.5 percent of AGI to 10 percent of AGI for taxpayers under 65) should be considered.

Accelerating Deductions into 2012

If you expect your income to decrease next year, and if we expect tax rates to stay the same for your tax bracket, we should accelerate what deductions we can into the current year. Some options include:

(1) consider prepaying your property taxes in December;
(2) consider making your January mortgage payment in December;
(3) if you are going to owe state income taxes, so long as you are not subject to the Alternative Minimum Tax (see below), consider making up any shortfall in December rather than waiting until after the new year;
(4) since medical expenses are deductible only to the extent they exceed 7.5 percent of your adjusted gross income (AGI), if you have large medical bills not covered by insurance, bunching them into one year may help overcome this threshold;
(5) making any large charitable contributions in 2012, rather than 2013;
(6) selling some or all of your loss stocks; and
(7) if you qualify for a health savings account, consider setting one up and making the maximum contribution allowable.

As previously noted, there is a change in the threshold for deducting medical expenses in 2013 for taxpayers under 65. Thus, accelerating medical expenses into 2012 to the extent possible is especially important for individuals under age 65 because the threshold increases from 7.5 percent to 10 percent of AGI in 2013. Also note that after 2012, the amount reimbursable under a health flexible spending arrangement for each 12-month coverage period is limited to $2,500 (subject to indexing for inflation after 2013).

Alternative Minimum Tax

If you are subject to the alternative minimum tax (AMT), your deductions may be limited. While Congress has generally increased the AMT exemption each year, it has not yet done so for 2012. As a result, more individuals may be subject to the AMT than in prior years. Thus, if we anticipate that you will be subject to the AMT, we need to consider the timing of deductible expenses that may be limited under AMT.

Expiring Tax Provisions or Reductions in Credits

Besides the expiration of the reduced capital gains rates, the increase in the top tax rate, the return of the limitations on itemized deductions and personal and dependent exemptions for high income individuals, as mentioned above, the following are some important tax provisions that are scheduled to expire at the end of 2012:

(1) the 10 percent individual income tax rate;
(2) the American Opportunity tax credit;
(3) the increase of the standard deduction for married filers;
(4) the exclusion from income of the discharge of debt on a principal residence;
(5) certain advantageous student loan interest deductions; and
(6) the taxation of qualified dividends at capital gain rates.

Life Events

Certain life events can also affect your tax situation. If you've gotten married or divorced, had a birth or death in the family, lost or changed jobs, or retired during the year, we need to discuss the tax implications of these events.

Miscellaneous Items

Some additional miscellaneous items to consider:

(1) If you have a health flexible spending account with a balance, remember to spend it before year end (unless your employer allows you to go until March 15, 2013, in which case you'll have until then).
(2) If you own a vacation home that you rented out, we need to look at the number of days it was used for business versus pleasure to see if there is anything we can do to maximize tax savings with respect to that property. For example, if you spent less than 14 days at the home, it may make sense to spend a couple more days and have the house qualify as a second residence, with the interest being deductible. As a rental home, rental expenses, including interest, are limited to rental income.

(3) We should also consider if there is any income that could be shifted to a child so that the income is paid at the child's rate.
(4) If you have any foreign assets, there are reporting requirements and a tax form to fill out. Noncompliance carries stiff penalties.

Hurricane Sandy

On November 16, 2012, the IRS announced that it will allow taxpayers who have been adversely affected by Hurricane Sandy to take hardship distributions or loans from their retirement plans (Announcement 2012-44). To qualify under the announcement, hardship distributions made on account of a hardship resulting from Hurricane Sandy must be made on or after October 26, 2012, and no later than February 1, 2013.

The relief applies to any Sec. 401(a), 403(a), or 403(b) plan that could, if it contained enabling language, make hardship distributions. It also applies to any Sec. 457(b) plan maintained by an eligible employer, and any hardship arising from Hurricane Sandy will be treated as an “unforeseeable emergency” for purposes of distributions from such plans.

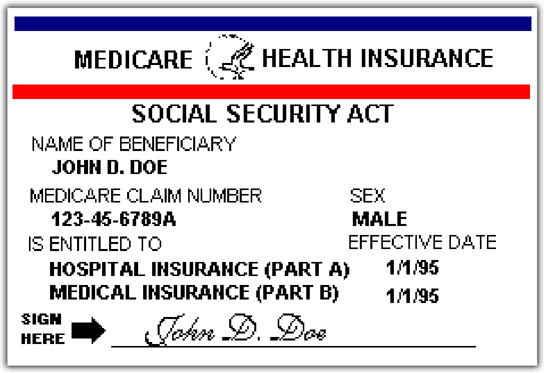
To make a loan or hardship distribution, a qualified employer plan that does not provide for them must be amended to provide for loans or hardship distributions no later than the end of the first plan year beginning after December 31, 2012.

Businesses

While there is still a lot of uncertainty as to which way tax rates will go in 2013, there are several tax provisions and credits that can help reduce your business income this year, many of which either expire at the end of this year or are significantly reduced next year. We should evaluate whether your business can take advantage of any of these. However, the focus should not be entirely on tax savings, but rather on whether or not an action otherwise makes good financial sense. The following are some tax-savings initiatives that you may want to consider before the close of the year.

New 3.8 Percent Medicare Tax

Beginning in 2013, a Medicare contribution tax of 3.8 percent applies to the lesser of (1) net investment income; or (2) the excess of modified adjusted gross income over a threshold amount.



The threshold amount is $250,000 in the case of individuals filing a joint return or a surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case. Modified adjusted gross income is adjusted gross income increased by the amount excluded from income as foreign earned income (net of the deductions and exclusions disallowed with respect to the foreign earned income).

In the case of an estate or trust, the tax is 3.8 percent of the lesser of:
(1) undistributed net investment income or
(2) the excess of adjusted gross income over the dollar amount at which the highest income tax bracket applicable to an estate or trust begins.

Certain interests in a trade or business are subject to the tax. Specifically, investment income for purposes of the tax is the sum of (1) gross income from interest, dividends, annuities, royalties, and rents (other than income derived in the ordinary course of any trade or business to which the tax does not apply); (2) other gross income derived from any trade or business to which the tax applies; and (3) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business to which the tax does not apply.

In the case of a trade or business, the tax applies if (1) the trade or business is a passive activity with respect to the taxpayer; or (2) the trade or business consists of trading financial instruments or commodities.

The tax does not apply to other trades or businesses.
In the case of the disposition of a partnership interest or stock in an S corporation, gain or loss is taken into account only to the extent gain or loss would be taken into account by the partner or shareholder if the entity had sold all its properties for fair market value immediately before the disposition. Thus, only net gain or loss attributable to property held by the entity that is not property attributable to an active trade or business is taken into account. No guidance has been issued yet on the mechanics of actually applying this rule.

However, if you are contemplating the disposition of an interest in a partnership or S corporation in the near future and or not disposing of the interest this year, as opposed to next year, would produce any tax savings. Alternatively, we may want to explore ways to shelter such gain next year. Such strategies might include planning to keep your net investment income or modified adjusted gross income beneath the applicable threshold.

Tax Rates, Capital Gains &Losses, and Dividends

Probably the biggest unknown for 2013 is the direction that tax rates will go for ordinary income as well as capital gains. Currently, capital gains are generally taxed at a rate of (1) 15 percent, if the regular tax rate that would apply to the taxpayer is 25 percent or higher; and (2) 0 percent, if the regular tax rate that would apply to the taxpayer is lower than 25 percent. Higher tax rates apply to gain from collectibles, qualified small business stock, and unrecaptured Section 1250 gain. The maximum capital gains rate that applies to sales or exchanges of capital assets other than collectibles, qualified small business stock, and unrecaptured Section 1250 gain is scheduled to increase to 20 percent (10 percent if the taxpayer is in the 15 percent income tax bracket).

Also, a special rule allows "qualified dividends" to be taxed at the capital gains rates. However, this special rule is scheduled to terminate at the end of 2012. After that, the distinction between qualified dividends and other ordinary dividends disappears, and all ordinary dividends will be taxed at ordinary income rates.

Thus, if you control a C corporation and want to take cash out of the corporation, you should consider paying a dividend to yourself in 2012 to the extent it otherwise makes financial sense to do so.

If you have a corporation you've been thinking of liquidating, doing so before year end would be preferable if the liquidation will result in a gain. You not only get the reduced capital gains rates on the gain, but you'll avoid the 3.8 percent Medicare tax on the amounts over the applicable threshold.

Section 179 Expenses Deduction

In 2012, your business can deduct up to $139,000 of Section 179 property placed in service during the tax year, subject to certain limitations. If the cost of Section 179 property placed in service during 2012 is more than $560,000, the Section 179 deduction is limited. Section 179 property is generally tangible personal property placed in service in your trade or business. It does not include buildings or land.

For 2013, the Section 179 deduction will be limited to $25,000, subject to certain limitations. If the cost of Section 179 property placed in service during 2013 is $200,000 or more, no Section 179 deduction is allowed.

Thus, if you are anticipating any large purchases in the next several months, it may be advantageous to accelerate such purchases into the current year to take advantage of this deduction. In the past, this deduction has been extended by tax legislation late in the year. While that may happen again, it is not something we can count on.

In addition, special limitations apply to sport utility vehicles (SUVs). Generally, any Sec. 179 deduction is limited to $25,000 for SUVs.

Bonus Depreciation

A 50-percent additional first-year depreciation deduction is available for qualified property placed in service before 2013. So if you are planning on purchasing depreciable property in early 2013, you may want to move the purchase up to December to take advantage of this tax benefit.
Although the additional first year depreciation deduction is generally scheduled to disappear after 2012, the placed-in-service date is extended through 2013 for certain long-lived property and transportation property.

Health Insurance Tax Credit for Covering Employees

If you are not already doing so, and if your small business qualifies, you might be eligible for a fairly significant tax credit for providing health insurance coverage to your employees. The credit can be as much as 35 percent of your insurance premium payments.

Work Opportunity Credit

A business is allowed a 40 percent credit for qualified first-year wages paid or incurred during the tax year to individuals who are members of a targeted group of employees. While this credit generally expired in 2011, it's still in effect for 2012, but not beyond that, in the case of qualified veterans that your business hires.

Adoption Assistance Programs

If your business currently has an adoption assistance program in place, the tax-free benefits of the program are scheduled to end this year. Thus, any amounts paid under the program in 2013 will be taxable to the employee and, thus, subject to income tax withholding.

Educational Assistance Program

If your business currently has an educational assistance program in place, the tax-free benefits of the program are scheduled to end this year. Thus, any amounts paid under the program in 2013 will be taxable to the employee and, thus, subject to income tax withholding, except to the extent the payments meet the requirements for a qualified scholarship or the payments are for job-related education that qualifies as a working condition fringe benefit.

Give us a call

All of the tax opportunities and considerations at this time of year can be a lot to remember, and the details of all these provisions can make it even more complicated. Fortunately, you won't have to remember all of them by yourself – that is why you hired us. The two most important pieces of tax advice for any year are to keep good records and ask questions. We look forward to hearing from you.

If you are projected to owe additional income tax, a tax projection can help determine which tax-minimizing strategies should be used before the end of the year to reduce or eliminate any tax due. If you are due a refund, we can ensure your tax return is filed as early as possible to allow you to receive your refund and enjoy your money more quickly.

If you need additional information on any of the above items or wish to speak with us directly about your tax picture for 2012, please do not hesitate to contact us at (212) 302-8970.

In addition if you feel that your friend or business associates could benefit from this newsletter, please feel free to pass it on to them.

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