Midyear Tax Planning: Warnings and Important Points

Keiter
Your Opportunity Advisors

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Thanks to the extension of the so-called Bush tax cuts through 2012, the current federal income tax environment remains favorable through year-end. That said, now is the time to take advantage because we do not know what tax rates will be in 2013 and beyond. *The information below presents some tax planning warnings and important points to consider this summer while you have time to think. Some of the ideas may apply to you, some to family members, and others to your business. See Pages 2 through 4 for detailed explanations and planning tips.*

Midyear Tax Planning

Warnings

Deferred Income

› If you think the Bush tax cuts will be allowed to expire at the end of this year, the income deferral drill may not be advisable this time around. That is because pushing income from 2012 into 2013 could expose you to higher marginal tax rates next year. If you are convinced you will pay higher rates next year, consider taking the opposite of the traditional approach by accelerating income into this year and deferring deductions until next year. That way, more income will be taxed at this year's lower rates.

Bunching Deductible Expenditures

› If you think you will pay a higher tax rate next year, you may want to claim the standard deduction this year and bunch your itemized deductions into 2013 where they can offset the higher taxed income.. This will boost your overall tax savings for the two years combined.

0% Tax Rate on Investment Income

› If you give securities to someone who is under age 24, the Kiddie Tax rules could potentially cause some of the resulting capital gains and dividends to be taxed at the parent's higher rates instead of at the gift recipient's lower rates, which would defeat the purpose. Please contact us if you have questions about the Kiddie Tax.

› Be aware that if you give away assets worth over $13,000 during 2012 to an individual gift recipient, it will generally reduce your $5.12 million unified federal gift and estate tax exemption. However, you and your spouse can together give away up to $26,000 without reducing your exemptions.

Important Points

Time Investment Gains and Losses

› Selling enough loser securities to create a bigger net capital loss that exceeds what you can use this year might make sense. You can carry forward the excess net capital loss to 2013 and later years and use it to shelter both short-term gains and long-term gains recognized in those years. That will give you extra investing flexibility in 2013 and beyond because you won't have to hold appreciated securities for over a year to get better tax results. Remember: The maximum federal income tax rate on long-term capital gains is scheduled to increase to 20% starting in 2013 (up from the current 15%) while the maximum rate on short-term gains is scheduled to increase to 39.6% (up from the current 35%). Contact us if you want help in identifying the best tax-smart options in a world where future tax rates are uncertain.

Business Tax Breaks

› Watch out if your business is already expected to have a tax loss for the year (or close) before considering any Section 179 deduction. Reason: You cannot claim a Section 179 write-off that would create or increase an overall business tax loss. Please contact us if you think this might be an issue for your operation.

› 50% bonus depreciation deductions can create or increase a Net Operating Loss (NOL) for your business's 2012 tax year. You can then carry back the NOL to 2011 and/or 2010 and collect a refund of taxes paid in one or both those years. Please contact us for details on the interaction between asset additions and NOLs.

Consider Deferring Income or Doing the Opposite

It may pay to defer some taxable income from this year into next year, especially if you expect to be in a lower tax bracket in 2013. For example, if you're in business for yourself and a cash-method taxpayer, you can postpone taxable income by waiting until late in the year to send out some client invoices. That way, you won't receive payment for them until early 2013. You can also postpone taxable income by accelerating some deductible business expenditures into this year. Both moves will defer taxable income from this year until next year. Deferring income may also be helpful if you're affected by unfavorable phase-out rules that reduce or eliminate various tax breaks (child tax credit, education tax credits, and so forth). By deferring income every other year, you may be able to take more advantage of these breaks every other year.

Leverage Standard Deduction by Bunching Deductible Expenditures

Are your 2012 itemized deductions likely to be just under, or just over, the standard deduction amount? If so, consider the strategy of bunching together expenditures for itemized deduction items every other year, while claiming the standard deduction in the intervening years. The 2012 standard deduction for married joint filers is $11,900; the magic number for single and married filing separate filers is $5,950; it's $8,700 for heads of households.

For example, say you are a joint filer whose only itemized deductions are about $4,000 of annual property taxes and about $8,000 of home mortgage interest. If you prepay your 2013 property taxes by December 31 of this year, you could claim $16,000 of itemized deductions on your 2012 return ($4,000 of 2012 property taxes, plus another $4,000 for the 2013 property tax bill, plus the $8,000 of mortgage interest). Next year, you would only have the $8,000 of interest, but you could claim the standard deduction (it will probably around $12,500 for 2013). Following this strategy will cut your taxable income by a meaningful amount over the two-year period (this year and next). You can repeat the drill all over again in future years.

Examples of other deductible items that can be bunched together every other year to lower your taxes include charitable donations and state income tax payments.

Take Advantage of 0% Rate on Investment Income

For 2012, the federal income tax rate on long-term capital gains and qualified dividends is 0% when they fall within the 10% or 15% federal income tax rate brackets. This will be the case to the extent your taxable income (including long-term capital gains and qualified dividends) does not exceed $70,700 if you are married and file jointly ($35,350 if you are single). While your income may be too high to benefit from the 0% rate, you may have children, grandchildren, or other loved ones who will be in one of the bottom two brackets. If so, consider giving them some appreciated stock or mutual fund shares that they can then sell and pay 0% tax on the resulting long-term gains. Gains will be long-term as long as your ownership period plus the gift recipient's ownership period (before he or she sells) equals at least a year and a day.

Giving away stocks that pay dividends is another tax-smart idea. As long as the dividends fall within the gift recipient's 10% or 15% rate bracket, they will be federal-income-tax-free.

If the Bush tax cuts are allowed to expire at year-end, the minimum tax rate on 2013 long-term gains for these taxpayers will be 10% (or 8% for gains from certain investments held for over five year), while the minimum rate on 2013 dividends will be 15%. So, consider doing what you need to do to take advantage of the 0% rate this year. Next year, it might be history.

Time Investment Gains and Losses and Consider Being Bold about It

As you evaluate investments held in your taxable brokerage firm accounts, consider the impact of selling appreciated securities this year. The maximum federal income tax rate on long-term capital gains from 2012 sales is only 15%. Therefore, it often makes sense to hold appreciated securities for at least a year and a day before selling. On the other hand, now may be a good time to cash in some long-term winners to benefit from today's historically low capital gains tax rates.

For the Charitably Inclined: Sell Loser Shares and Give Away the Resulting Cash; Give Away Winner Shares

Say you want to make some gifts to favorite relatives (who may be hurting financially) and/or favorite charities. You can make gifts in conjunction with an overall revamping of your holdings of stocks and equity mutual fund shares held in taxable brokerage firm accounts. Here's how to get the best tax results from your generosity.

Gifts to Relatives. *Do not* give away loser shares (currently worth less than what you paid for them). Instead sell the shares, and take advantage of the resulting capital losses. Then, give the cash sales proceeds to the relative. *Do* give away winner shares to relatives. Most likely, they will pay lower tax rates than you would pay if you sold the same shares. In fact, relatives who are in the 10% or 15% federal income tax brackets will generally pay a 0% federal tax rate on long-term gains from shares that were held for over a year before being sold in 2012. (For purposes of meeting the more-than-one-year rule for gifted shares, you get to count your ownership period plus the recipient relative's ownership period, however brief.) Even if the shares are held for one year or less before being sold, your relative will probably pay a lower tax rate than you would (typically only 10% or 15%). However, beware of one thing before employing this give-away-winner-shares strategy. Gains recognized by a relative who is under age 24 may be taxed at his or her parent's higher rates under the so-called Kiddie Tax rules (contact us if you are concerned about this issue).

Gifts to Charities. The strategies for gifts to relatives work equally well for gifts to IRS-approved charities. Sell loser shares and claim the resulting tax-saving capital loss on your return. Then, give the cash sales proceeds to the charity and claim the resulting charitable write-off (assuming you itemize deductions). This strategy results in a double tax benefit (tax-saving capital loss plus tax-saving charitable contribution deduction). Give away winner shares to charity instead of giving cash. Here's why. For publicly traded shares that you've owned over a year, your charitable deduction equals the full current market value at the time of the gift. Plus, when you give winner shares away, you walk away from the related capital gains tax. This idea is another double tax-saver (you avoid capital gains tax on the winner shares, and you get a tax-saving charitable contribution write-off). Because the charitable organization is tax-exempt, it can sell your donated shares without owing anything to the IRS.

Convert Traditional IRA into Roth IRA

Here's the best scenario for this idea: Your traditional IRA is (or was) loaded with equities and has still not fully recovered from the beating taken during the 2008/2009 stock market meltdown. So your account is now worth less than it once was. Correspondingly, the tax hit from converting your traditional IRA into a Roth IRA right now would also be less than it would have been at the market peak. Why? Because a Roth conversion is treated as a taxable liquidation of your traditional IRA followed by a nondeductible contribution to the new Roth IRA. While even the reduced tax hit from converting is unwelcome, it may be a small price to pay for future tax savings. After the conversion, all the income and gains that accumulate in your Roth IRA, and all withdrawals, will be totally free of any federal income taxes—assuming you meet the tax-free withdrawal rules. In contrast, future withdrawals from a traditional IRA could be hit with tax rates that are higher than today's rates.

Of course conversion is not a no-brainer. You have to be satisfied that paying the up-front conversion tax bill makes sense in your circumstances. In particular, converting a big account all at once could push you into higher 2012 tax brackets, which would not be good. You must also make assumptions about future tax rates, how long you will leave the account untouched, the rate of return earned on your Roth IRA investments, and so forth. If the Roth conversion idea intrigues you, please contact us for a full analysis of the relevant variables.

Watch for Alternative Minimum Tax

While many recent tax-law changes have been helpful in reducing your regular federal income tax bill, they didn't do much to reduce the odds that you'll owe the dreaded Alternative Minimum Tax (AMT). Therefore, it's critical to evaluate all tax planning strategies in light of the AMT rules before actually making any moves. Because the AMT rules are complicated, you may want our assistance. We stand ready to help!

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Take Advantage of Generous But Temporary Business Tax Breaks

Several favorable business tax provisions have a limited shelf life that may dictate taking action between now and year-end. They include the following.

Bigger Section 179 Deduction. Your business may be able to take advantage of the temporarily increased Section 179 deduction. Under the Section 179 deduction privilege, an eligible business can often claim first-year depreciation write-offs for the entire cost of new and used equipment and software additions. For tax years beginning in 2012, the maximum Section 179 deduction is $139,000. For tax years beginning in 2013, however, the maximum deduction is scheduled to drop back to only $25,000.

50% First-year Bonus Depreciation. Above and beyond the Section 179 deduction, your business can also claim first-year bonus depreciation equal to 50% of the cost of most new (not used) equipment and software placed in service by December 31 of this year. For a new passenger auto or light truck that's used for business and is subject to the luxury auto depreciation limitations, the 50% bonus depreciation break increases the maximum first-year depreciation deduction by $8,000 for vehicles placed in service this year. The 50% bonus depreciation break will expire at year-end unless Congress extends it. Contact us if you want more details about this generous, but temporary, tax break.

Do Not Overlook Estate Planning

For 2012, the unified federal gift and estate tax exemption is a historically generous $5.12 million. However, the exemption will drop back to only $1 million in 2013 unless Congress takes action. In addition, the maximum federal estate tax rate for 2013 and beyond is scheduled to rise from the current 35% to a painfully high 55%. Therefore, planning to avoid or minimize the federal estate tax should still be part of your overall financial game plan. Even if you already have a good plan, it may need updating to reflect the current $5.12 million exemption and the uncertainty about next year's rules. Contact us for specifics.

Conclusion

As we said at the beginning, this letter is to get you started thinking about tax planning moves for the rest of this year. Please don't hesitate to contact us if you want more details or would like to schedule a tax planning strategy session.

L. Michael Gracik, Jr., CPA | Partner
804.273.6252 | mgracik@keitercpa.com

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