

Re: 2012 Year-End Tax Planning For Individuals

Dear Client:

2012 began with great uncertainty over federal tax policy and now, with the end of the year approaching, that uncertainty appears to be far from any long-term resolution. A host of reduced tax rates, credits, deductions, and other incentives (collectively called the "Bush-era" tax cuts) are scheduled to expire after December 31, 2012. To further complicate planning, over 50 tax extenders are up for renewal, either having expired at the end of 2011 or scheduled to expire after 2012. At the same time, the federal government will be under sequestration, which imposes across-the-board spending cuts after 2012. The combination of all these events has many referring to 2013 as "taxmeggedon."

Expiring incentives

Effective January 1, 2013, the individual income tax rates, without further Congressional action, are scheduled to increase across-the-board, with the highest rate jumping from 35 percent to 39.6 percent. The current 10 percent rate will expire and marriage penalty relief will sunset. Additionally, the current tax-favorable capital gains and dividends tax rates (15 percent for taxpayers in the 25 percent bracket rate and above and zero percent for all other taxpayers) are scheduled to expire. Higher income taxpayers will also be subject to revived limitations on itemized deductions and their personal exemptions. The child tax credit, one of the most popular incentives in the Tax Code, will be cut in half. Millions of taxpayers would be liable for the alternative minimum tax (AMT) because of expiration of the AMT "patch." Countless other incentives for individuals would either disappear or be substantially reduced after 2012. While a divided Congress may indeed act to prevent some or all of these tax increases, a year-end planning strategy that protects against "worst-case" situations may be especially wise to consider this year.

Year-end planning

Income tax withholding. Expiration of the reduced individual tax rates will have an immediate impact. Income tax withholding on payrolls will immediately reflect the increased rates. One strategy to avoid being surprised in 2013 is to adjust your income tax withholding. Keep in mind that the current two percent payroll tax holiday is also scheduled to expire after 2012 so it is a good time to review if you are having too much or too little federal income tax withheld from your pay.

As mentioned, traditional year-end planning techniques should be considered along with some variations on those strategies. Instead of shifting income into a future year, taxpayers may want to recognize income in 2012, when lower tax rates are available, rather than shift income to 2013. Another valuable year-end strategy is to "run the numbers" for regular tax liability and AMT liability. Taxpayers may want to explore if certain deductions should be more evenly divided between 2012 and 2013, and which deductions may qualify, or will not be as valuable, for AMT purposes.

Harvesting losses. Now is also a good time to consider tax loss harvesting strategies to offset current gains or to accumulate losses to offset future gains (which may be taxed at a higher rate). The first consideration is to identify whether an investment qualifies for either a short-term or long-term capital gains status, because you must first balance short-term gains with short-term losses and long-term ones with long-term losses. Remember also that the "wash sale rule" generally prohibits you from claiming a tax-deductible loss on a security if you repurchase the same or a substantially identical asset within 30 days of the sale.

Education expenses. Taxpayers with higher educational expenses may want to consider the scheduled expiration of the American Opportunity Tax Credit (AOTC) after 2012 in their plans. The AOTC (an enhanced version of the HOPE education credit) reaches 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 possible, pre-paying 2013 educational expenses before year-end 2012 could make the expenses eligible for the AOTC before it expires. Another popular education tax incentive, the Lifetime Learning Credit, is not scheduled to expire after 2012.

Job search expenses. Some expenses related to a job search may be tax deductible. There is one important limitation: the expenses must be spent on a job search in your current occupation. You may not deduct expenses you incur while looking for a job in a new occupation. Examples of job search expenses are unreimbursed employment and outplacement agency fees you pay while looking for a job in your present occupation. Travel expenses to look for a new job may be deductible. The amount of job search expenses that you can claim on your tax return is limited. You can claim the amount of expenses only to the extent that they, together with other "miscellaneous" deductions exceed two percent of your adjusted gross income.

Gifts. Gift-giving as a year-end tax strategy should not be overlooked. The annual gift tax exclusion per recipient for which no gift tax is due is \$13,000 for 2012. Married couples may make combined tax-free gifts of \$26,000 to each recipient. Use of the lifetime gift tax exclusion amount (\$5.12 million for 2012) should also be considered. Without Congressional action, the exclusion amount drops to \$1 million in 2013.

Charitable giving. For many individuals, charitable giving is also a part of their year-end tax strategy. Under current law, the so-called "Pease limitation" (named for the member of Congress who sponsored the law) is scheduled to be revived after 2012. The Pease limitation generally requires higher income individuals to reduce their tax deductions by certain amounts, including their charitable deduction. A special rule for contributing IRA assets to a charity by individuals age 70 ½ and older expired after 2011 but could be renewed for 2012.

New Medicare taxes

In 2013, two new taxes kick-in. The Patient Protection and Affordable Care Act (PPACA) imposes an additional 0.9 percent Medicare tax on wages and self-employment income and a 3.8 percent Medicare contribution tax. The 3.8 percent Medicare contribution tax will apply after 2012 to single individuals with a modified adjusted gross income (MAGI) in excess of \$200,000 and married taxpayers with an MAGI in excess of \$250,000. MAGI for purposes of the Medicare contribution tax includes wages, salaries, tips, and other compensation, dividend and interest income, business and farm income, realized capital gains, and income from a variety of other passive activities and certain foreign earned income. For individuals liable for the tax, the amount of tax owed will be equal to 3.8 percent multiplied by the lesser of (1) net investment income or (2) the amount by which their MAGI

exceeds the \$200,000/\$250,000 thresholds. Taxpayers with MAGIs below the \$200,000/\$250,000 thresholds will not be subject to the 3.8 percent tax.

More changes for 2013

Many employers with health flexible spending arrangements (health FSAs) limit salary reduction contributions to between \$2,500 and \$5,000. Effective 2013, the PPACA 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. Individuals with unused health FSA dollars should consider spending them before year-end, or a 2 ½ month grace period if applicable, to avoid the "use it or lose it" rule. Keep in mind that health FSA dollars cannot be used for over-the-counter medications (except for insulin) after 2011.

Additionally, the threshold to claim an itemized deduction for unreimbursed medical expenses increases from 7.5 percent of adjusted gross income (AGI) to 10 percent of AGI after 2012. The PPACA provides a temporary exception for individuals (or their spouses) who are age 65 and older. This exception ends after 2017. While many medical expenses cannot be timed for tax-deduction purposes, batching expenses into 2012, when the threshold is 7.5 percent, may make it more likely that the expenses will exceed that threshold.

Looking ahead

In July 2012, the House and Senate passed competing bills to extend many of the expiring incentives one more year. Both bills would extend the current income tax rates (10, 15, 25, 28, 33, and 35 percent) through 2013. The House bill would extend the current capital gains and dividends treatment but the Senate bill would extend the tax favorable rates only for individuals with incomes below \$200,000 (families with incomes below \$250,000). For income in excess of \$200,000/\$250,000 the tax rate on capital gains and dividends would be 20 percent. Both bills would extend the \$1,000 child tax credit through 2013 and provide for an AMT patch for 2012 (the House bill also provides an AMT patch for 2013).

At this time, it is increasingly likely that the fate of all the expiring tax provisions will be decided by the lame-duck Congress after the November elections. Although the House and Senate bills passed in July differ, they have many points in common; the most important being that lawmakers could agree on a one-year extension of the Bush-era tax cuts. However, some observers anticipate no resolution until January 2013 or beyond.

Today's uncertainty makes doing nothing or adopting a wait and see attitude very tempting. Multi-year tax planning, which takes into account a variety of possible scenarios and outcomes, however, can provide a win-win combination irrespective of what happens. Please contact our office for more details on how we can customize a tax strategy for you in uncertain times.

Sincerely yours,

As 2012 draws to a close, many taxpayers are asking how they can plan in light of the uncertainty surrounding the fate of the Bush-era tax cuts and other expiring tax incentives. The following sample

client letter can be emailed or mailed to alert individual clients to the benefits of year-end tax planning. (09/07/2012)