

## 2012 TAX PLANNING

This summary compliments the longer 2011 Tax Letter – it “connects the dots” by presenting simple ideas & strategies. Much of what occurs regarding taxes just “happens.” The 2011 Tax Letter hopefully helps provide a better understanding but frequently we have little or no control over the timing, results, amounts, reporting, etc. This offers suggestions for areas where there may be some control.

Here’s a list of some important tax provisions that are scheduled to expire after 2011:

- Credits for nonbusiness energy property
- \$250 deduction for educator expenses
- Itemized Deduction for sales tax in lieu of state income taxes
- Deduction for qualified tuition expenses
- Deduction for mortgage insurance
- IRA to charity exclusion
- Credit for Retained Workers
- Social Security tax cut (after February, 2012)
- 100% bonus-depreciation
- \$500,000 sec. 179 (depreciation) expense limited to \$139,000 in 2012
- 15-year write-off for certain qualified property (restaurant, retail & LHI)

Here’s a list of some important tax provisions that expire after 2012:

- 15% tax rate on qualified dividends & long-term capital gains
- Personal exemption & itemized deduction phase-out’s eliminated
- The American Opportunity Tax Credit
- Expanded Child Tax Credit
- 3<sup>rd</sup> child Earned Income Tax Credit
- The Adoption Credit
- Deduction for student loan interest
- Bonus depreciation
- Sec. 179 (depreciation) expense limited to \$25,000 going forward
- \$8,000 first-year auto depreciation

Beginning 2013, the following are set to take effect:

1. Additional .9% Hospital Insurance (HI) tax on wages
2. Additional 3.8% HI tax on net investment income
3. Itemized medical expense deduction floor increases from 7.5% of AGI to 10%

Regarding estate & gift taxes:

4. The applicable exclusion amount reverts from \$5,120,000 to \$1,000,000
5. The maximum rate will increase to 55% from 35%
6. The “portability” feature, allowing the surviving spouse to utilize the unused

**IRS Circular 230 Disclosure: Tax advice contained in this communication (including any attachments) is neither intended nor written to be used, and cannot be used, to avoid penalties under the Internal Revenue Code or to promote, market or recommend to anyone a transaction or matter addressed in this communication.**

exclusion of the deceased spouse, disappears.

2013 will be the first “non-Bush tax cuts year” since 2000. Much of what his administration & Congress put in place will sunset in 2012 & 2013. That, coupled with an exploding federal deficit, appears to be creating a path toward less taxpayer-friendly laws & rates. However, when laws become less friendly, creative planning generally starts to thrive.

Here are some factors to consider:

1. Tax Rates. 2012 rates stay the same as 2011. However, most the 2013 brackets are slated to rise 3% or more each.
2. New taxes in 2013 make 2012 an important year to do some planning.
3. Timing & recognition of income & the ability to control it.  
Timing & recognition of deductions & the ability to control them.
4. Cash v. accrual base situations & options.

## INDIVIDUALS

The current marginal individual income tax rates are scheduled to increase as follows:

Current 2010 – 2012 marginal rate	10%	15%	25%	28%	33%	35%
Scheduled 2013 increase	N/A	15%	28%	31%	36%	39.6%

- 1) Historical wisdom says defer income & accelerate deductions. With the new taxes & rate increases in 2013, that rule might not apply. While deferring income and/or increasing deductions delays paying taxes, knowing that the delay will cost you more may not be a wise strategy, particularly for income subject to the new tax on investment income. Therefore, accelerating income into 2012 and/or delaying deductions may make sense.
- 2) Health Savings Accounts (HSA's) are “medical IRA's, allowing a tax deduction for money contributed to an account for future medical expenses. Distributions used for medical expenses are not taxed.
- 3) Bunching medical expenses together may be a good tax as well as health insurance strategy. Medical expenses are deductible A) If you itemize & B) To the extent they exceed 7.5% of your adjusted gross income. Therefore, accumulating expenses in the same year, rather than spreading them over multiple years may allow a deduction. A similar strategy may be employed for other itemized deductions, such as state or property taxes. However, be careful of Alternative Minimum Tax (AMT).

## Investing

- 4) Favorable Dividend & Capital Gain Rates. Through 2012, qualified dividends & most capital gains will be taxed at a 15% rate, some capital gains even being tax-free. In 2013, the lower qualified dividend rate will disappear & the capital gain rate will

**IRS Circular 230 Disclosure: Tax advice contained in this communication (including any attachments) is neither intended nor written to be used, and cannot be used, to avoid penalties under the Internal Revenue Code or to promote, market or recommend to anyone a transaction or matter addressed in this communication.**

- probably increase to 20%. Coupled with the new HI tax of 3.8%, consider, if possible, accelerating gains into 2012.
- 5) For asset sales with large gains, consider an installment sale. Gain is recognized when money is received. The recognized (taxable) gain is the amount that is profit based on the gross profit calculated at the time of sale.
  - 6) If capital gains are being recognized, or if it make sense to turn "paper losses" (decrease in value but not yet sold) into recognized losses, it may be possible to sell the loss securities & then buy comparable ones. Wash sale rules (selling a security at a loss & buy the substantially same security within 30 days) can hinder that strategy. Some junk bonds can be sold at a loss & the proceeds immediately invested in similar, but not substantially identical, obligations, avoiding the wash sale issue & allowing continued collection of the related high interest.
  - 7) Gold is a collectible. The tax rate on long-term collectibles is 28%. All short-term gains are taxed at ordinary tax rates. Taxpayers in a lower tax bracket, i.e., 15%, that are selling gold, might want to try to create short-term, rather than long-term, gains. Also, wash sale rules don't apply to collectibles.
  - 8) Net Operating Losses (NOL's). Generally more of a business issue, NOL's can generally be carried back 2 years & forward 20. Carrying the loss back can result in a refund of prior-year taxes, potentially a more immediate benefit than carrying it forward. If an NOL is likely & carrying it back might make sense then it might also make sense to make it as large as possible, i.e., minimize income and/or increase deductions for the NOL year.
  - 9) Stock Contribution. Generally, contribution deductions are limited to the taxpayer's basis. However, there is an exception allowing the full market (appreciated) value deduction of stock on an established market to a private foundation
  - 10) Education Credits. If your income is too high to take advantage of the education credits, consider allowing the student (child) to receive the benefit. It's a "package deal", i.e., the student can't be claimed as a dependent. If the student has enough income it may make sense.

### **Retirement Planning**

- 11) Create or convert to a Roth IRA. Two solid tax reasons include:
  - a) Belief that future tax rates will be higher than today. A perceived lower tax rate today makes a current deduction less critical. Since the Roth, if properly handled, is not taxable upon distribution, less taxable income in the future makes more sense. Since income limitations for Roth conversions were removed in 2010, most people can do a conversion
  - b) Belief that investments will appreciate in the future. Paying tax on the lower, converted amount now then withdrawing the higher, non-taxable amount in the future also makes sense.
- 12) It may not be too late for self-employed people (& some others) to set up & deduct a Simplified Employee Pension (SEP) even after the tax year, i.e., 2011, has ended.

**IRS Circular 230 Disclosure: Tax advice contained in this communication (including any attachments) is neither intended nor written to be used, and cannot be used, to avoid penalties under the Internal Revenue Code or to promote, market or recommend to anyone a transaction or matter addressed in this communication.**

- 13) Utilize the Savers Credit. If your income is below certain thresholds, in addition to a deduction from income for contributions to a retirement plan a separate tax credit is available. For seniors, i.e., those receiving social security benefits, the possible benefits from an IRA contribution may include A) The IRA deduction B) The savers credit C) Reduced taxable social security from the reduced income.
- 14) Social security benefits received before full retirement age will be reduced if earned income exceeds a threshold. In 2012, for every \$2 of earned income received in excess of \$14,160, \$1 of benefits will be deducted. Plan accordingly.

### **Estate & Gift Planning**

- 15) The thresholds for taxation on estates & gifting are \$5 million through the end of 2012. The estate law for 2011 & 2012 allows a "portability" feature that allows the surviving spouse to utilize the unused exclusion amount of the predeceased spouse

### **BUSINESS**

- 1) Net Operating Losses (NOL's). Similar to individuals (above), NOL's can generally be carried back 2 years & forward 20. Carrying the loss back can result in a refund of prior-year taxes. If the strategy is to carry back it probably makes sense to make it as large as possible - minimize income and/or increase deductions for the NOL year. If the business is eligible, NOL planning should be done in unison with utilizing the Domestic Production Activity Deduction (DPAD). There's no DPAD with an NOL.
- 2) Determine if the business is in an economically-incentivized area, i.e., Enterprise Zone, Empower Zone, etc. Pasadena has an Enterprise Zone (the boundaries change periodically). California has some tremendous tax credits - up to \$35,000 (over 5 years) for a single employee!
- 3) Accelerating income & expenses. This can usually be done more easily in business than personally, particularly for businesses that operate on an accrual basis (invoicing creates income, being invoiced generally creates an expense). On an accrual basis, income & expenses don't involve cash. Completion or non-completion of a job, delivery or non-delivery of goods, etc. can also determine recognition.
- 4) Accruing bonuses. Payroll generally runs on a cash basis; however, an accrual basis corporation can deduct payroll at year-end as long as it is paid within 75 days of year-end. There are restrictions, i.e., the employee can't own more than 50% of the corporation's stock, it can't be to any shareholder of an S corporation. The employee isn't taxed on it until it's received.
- 5) California has suspended NOL deductions for 2011 & 2012 when corporate taxable income is \$300,000 or more & for individuals when federal modified adjusted gross income is \$300,000 or more. An entity that has an NOL carry forward that sells assets for a large gain needs to plan carefully, i.e., make sure that the gain in any year doesn't exceed \$300,000. An installment agreement may be an option.
- 6) Child employees. Under-18 children employed by a sole-proprietor parent are not subject to payroll taxes. There are some few planning opportunities:

**IRS Circular 230 Disclosure: Tax advice contained in this communication (including any attachments) is neither intended nor written to be used, and cannot be used, to avoid penalties under the Internal Revenue Code or to promote, market or recommend to anyone a transaction or matter addressed in this communication.**

- a) Deduction for the parent. If the child uses the money for purchasing what the parent would have normally purchased for the child (clothes, pizza, car insurance, etc.), those otherwise non-deductible purchases have now become deductible.
- b) Keep the wages low enough & the child won't be taxed on them.
- c) Keep the wages low enough & the child can still be claimed as a dependent.
- d) Have the child contribute to a retirement plan (IRA, SIMPLE etc.) which reduces the child's income & starts retirement savings early.

**IRS Circular 230 Disclosure: Tax advice contained in this communication (including any attachments) is neither intended nor written to be used, and cannot be used, to avoid penalties under the Internal Revenue Code or to promote, market or recommend to anyone a transaction or matter addressed in this communication.**