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Year-End Tax Planning In 2012

Year-end tax planning is always important, but this year it is especially difficult because of uncertainty about what the tax laws will be for 2013. The Bush-era tax cuts are scheduled to expire on December 31 and the President and Congress have once again delayed taking any action. No one knows which, if any, of the Bush era tax cuts will be extended or which, if any, will be allowed to lapse, in whole or in part. Almost everyone, however, is expecting that taxes will increase because of the large deficit between the federal government's spending and its revenue.

While we wait to see what the President and Congress agree on, right now our clients have some exceptional planning opportunities that may soon be gone. We can help them plan with the 2012 opportunities we have, and we can create plans flexible enough to adapt to whatever the President and Congress do. In addition, there are new taxes that we know will apply January 1 that must be planned for. All members of the advisory team need to stay informed and alert to changes in order to help clients at this critical time.

In this issue of *The Wealth Counselor*, we will discuss possible and known changes in the tax laws for 2013, strategies for income and estate tax planning, and some planning opportunities that should be taken advantage of now, before they disappear.

Expiration of Bush-Era Tax Cuts Will Mean Higher Taxes for Everyone
If the President and Congress do not act before the end of the year, the Bush-era income tax cuts will expire along with the December 2010 transfer tax increases (estate, gift, and generation-skipping transfer [GST] taxes) and those tax laws will revert to what they were in 2001. If that happens:

* The 10% income tax bracket will be eliminated and the rates in the current 25% and higher income tax bracket will all increase.
* The marginal income tax rate for top earners will increase from 35% to 39.6% plus a Medicare surtax (discussed below).
* The long-term capital gains tax rate will increase from 15% to 20%.
* Dividends will be taxed as ordinary income instead of at 15%. For top earners, this means dividends will be taxed at 39.6% plus a Medicare surtax.
* Lower income bracket taxpayers (those now in the 10% and 15% brackets) will no longer be exempt from paying tax on capital gains and dividends.
* The estate tax exemption will go from $5.12 million to $1 million. Assets over the exempt amount, currently taxed at 35%, will be taxed at graduated rates starting at 35% and going up to 55%. This means more assets will be taxed at higher rates.
* The same thing will happen to the gift tax exemption.
* The generation-skipping transfer tax exemption will go from $5.12 million to $1 million, adjusted for inflation, and the rate will increase from 35% to 55%.
* Many other tax provisions will also become less generous.

New Tax Rules for 2013
We already know that these new tax rules will go into effect on January 1, 2013:

* A 0.9% Medicare surtax on a taxpayer's wages over $200,000 if single, $250,000 for joint filers. Withholding begins when earnings exceed $200,000 regardless of marital status. This additional tax also applies to net earnings from self-employment. This additional tax is not imposed on the employer.
* A 3.8% Medicare surtax on net investment income for singles with MAGI (modified adjusted gross income) over $200,000, $250,000 for joint filers; $11,950 for estates

and trusts. This tax applies to the *lower of* total net investment income for the year or MAGI over the applicable threshold.

> ***Planning Tip:*** Be sure to determine what is part of net investment income and what is excluded. Also, note the lower threshold of just $11,950 for estates and trusts; careful selection of year-end for estates and trusts can allow for up to 11 more months free from this tax.

* Itemized medical expenses will be deductible only to the extent they exceed 10% of AGI. Those age 65 and older can continue to use the 7.5% AGI floor through 2016. The 10% floor continues to apply for AMT purposes.
* Flexible Spending Account salary reduction contributions are capped at $2,500.

Estimated COLAs for 2013

* Tax brackets would increase by about 2.5%. Note: There will be a 10% bracket only if Bush-era cuts are extended.
* Personal exemption would increase from $3,800 to $3,900. A phase-out of personal exemptions would again apply if Bush-era cuts are not extended. (There has been no phase-out since 2010.)
* Standard deductions are expected to increase:
    * *Singles*: $6,100 (up from $5,950)
    * *Heads of household*: $8,950 (up from $8,700)
    * *Joint filers*: $12,200 (up from $11,900)
    * *Dependents*: $1,000 or earned income plus $350 (up from $950 or earned income plus $300)
    * *Additional amounts for age and/or blindness*: $1,500 for unmarried (up from $1,450); $1,200 for married filers (up from $1,150)
* Long-term care insurance taken into account for the itemized medical deduction rises to $360 for those under age 40 and to $4,550 for those over age 70 (up from $350 and $4,370, respectively).
    * Per diem exclusion for long-term care insurance proceeds will be $320 (up from $310)
* Itemized deduction phase-out will apply unless the Bush-era tax cuts are extended.
* Adoption credit will be $12,770 (up from $12,650) *if* Bush-era tax cuts are extended. If not extended, the credit falls to $5,000 ($6,000 for a special needs child).
* Exclusion of interest on U.S. savings bonds redeemed for higher education; MAGI threshold increased.
* Foreign earned income exclusion will be $97,600 (up from $95,100).
* IRAs and Roth IRAs contribution limit increased to $5,500 (up from $5,000 first set in 2009); those age 50 or older by year end can add another $1,000. MAGI limit on making Roth IRA contributions increased. MAGI limit on making deductible IRA contribution by active participants increased.
* Annual gift tax exclusion will be $14,000 per donee (up from $13,000); joint gifts by married couples up to $28,000 per donee.
* Lump-sum contribution to 529 plan will be up to $70,000 using the five-year gift tax rule (up from $65,000).
* U.S. person receiving foreign gifts must file a gift tax return for gifts exceeding $15,102.

Planning Strategies for Income Taxes

Here are some strategies for December 2012:

Assess the client's current tax picture. Review capital gains and losses already realized for 2012 (including carryovers). Check mutual fund payouts for 2012 (usually available from fund managers by November). Determine whether there will likely be a year-end bonus.

Take action for capital gain and loss planning. Actualize gains and losses on securities in taxable accounts as desired to the extent possible within the accounts. Sell investment real estate this year. Determine whether and how much of ISOs to exercise before the end of the year, being sure to consider AMT. Watch the wash sale rule when harvesting losses.

Planning Tip: Clients will probably want to sell assets in 2012 if they will need the proceeds over the next several years. A $100,000 long-term gain in 2012 will generate $15,000 in taxes; but the same gain in 2013 will generate about $25,000 in taxes as a consequence of scaled-back itemized deductions, the 3.8% surtax and a higher capital gains rate.

Planning Tip: Pull interest income into 2012 and push interest expense into 2013 where possible. For wealthiest clients, their income tax rate will increase from 35% to 43.4%, barring action in Washington.

Take action for dividends. Watch the holding period to nail down the capital gain rate on qualified dividends. Take into account reinvested dividends in figuring the basis of stock/mutual fund shares sold in 2012. Sale of a stock in December that will pay a dividend in January or February could be a good strategy.

Planning Tip: The "wash sale" rule does not apply to gain harvesting, so a stock sold realizing a gain can be added back to the client's portfolio immediately.

Take action for retirement accounts. Consider converting IRAs to Roth IRAs. All resulting income must be reported in the conversion. (Remember to factor in the 50% conversion income from conversions made in 2010.) Remind clients to take their 2012 Required Minimum Distributions. Assess whether to roll over qualified plan distributions or pay tax on them in 2012.

Planning Tip: Watch for the possible retroactive extension of the ability to make the $100,000 direct transfer from IRA to charity for those age 70 1/2 and older.

Take action for deductible expenses. Pull some deductions into 2012 and push some into 2013. Consider incurring unreimbursed medical costs (such as Lasik eye surgery and dental implants) before year end in light of the increased floor for itemizing medical expenses (7.5% goes to 10%). Consider a Health Savings Account; a full-year contribution for 2012 can be made as long as there is coverage under a high-deductible health plan for December and coverage continues for a set period. For other deductions, offsetting 2013 income may result in larger savings if the Bush era tax cuts applicable to them expire.

Planning Tip: Make charitable deductions now; the phase-out on high-income taxpayers may apply in 2013 unless Congress keeps the status quo.

Planning Tip: Don't prepay state and local income taxes or property taxes if subject to the AMT. (If Congress has not enacted a "patch" by the end of the year, use the 2011 exemption amounts to make projections.)

Take action for other income strategies. Determine whether to accelerate or defer compensation, including year-end bonuses, if this is an option. Adjust the fourth estimated tax payment to reflect year-end actions.

Take action for year-end strategies for businesses. Cash basis businesses should re-assess the standard strategy of deferring income and accelerating deductions. Purchase machinery and equipment before the end of 2012. (Section 179 deduction is set to decline in 2013 to $25,000 and the 50% bonus depreciation to end.) Review the business structure in light of business considerations as well as the additional Medicare taxes.

For C corporations, determine whether to pay dividends in 2012 if no deal is struck in Washington that will extend the favorable treatment of dividends; watch for excess accumulations; authorize charitable contributions before year end (C corporations can deduct them if paid within the first 2 1/2 months of 2013); review final estimated tax payment (if losses are expected for the year, adjust the final estimated tax payment and prepare to file a quick refund).

Strategies for Estate Planning

It is impossible to predict what will happen with transfer taxes and estate planning, but the climate in Washington is certainly different than it was in 2010 when the Bush tax cuts were extended for two years and the transfer tax exemptions were greatly increased during the extension period. Planners can, and really must, encourage their clients to use the planning tools that currently do exist as they are likely to change adversely in the near future.

Use the $5.12 transfer tax exemptions now. Estate tax and gift tax and GST tax exemptions are all currently linked at this historic level. However, most believe that even if the estate tax exemption stays higher (say, $3.5 million), the gift tax exemption will likely go down, perhaps all the way to $1 million. For many older clients with net estates between $1 million and $5 million, using the unified credits now can be excellent planning, especially if the exemptions are lowered in the next few years.

> ***Planning Tip:*** High basis assets can be put in a trust for the spouse now and for the children and/or grandchildren later. With low basis property, a switch to turn on a general power of appointment can be included in the trust so that if the surviving spouse has unified credit remaining at her death, the trustee can bring the lowest basis assets into the surviving spouse's estate.

Use the $5.12 million generation skipping transfer tax (GSTT) exemption now. This can provide significant savings in estate taxes over the generations. Under current law, several states have laws that permit creating trusts that can last forever.

Pay some gift tax now. The current gift/estate tax rate is 35%. If it increases to a top bracket of 55% in 2013, making gifts in 2012 can potentially save 20% on the tax rate for those who will have large taxable estates. Another benefit is the tax-inclusive nature of the estate tax whereas the gift tax is paid only on the amount of the gift.

Make gifts of family entities. For years, the IRS has been talking about getting the government to take away discounts on family entities. It would be smart planning to use this while we still have it.

Make gifts to dynasty trusts. President Obama has proposed a 90-year federal rule against perpetuities, which would take away the opportunity to create long lasting dynasty trusts. For very wealthy clients, these are critical to multi-generation wealth preservation and transfer.

Create spousal access trusts. A husband can create a trust now and his wife can have access to the trust assets until her death. A wife can also do this for her husband. However, these trusts must be created very carefully to make sure there are enough differences in them to avoid application of the "reciprocal trust" doctrine.

Use GRATS and Charitable Lead Trusts. Current low interest rates make these very attractive. President Obama has proposed limiting the minimum GRAT term to 10 years, eliminating the zeroed-out GRAT option, including grantor trust assets in taxable estates and gifts, and imposing a tax on trust distributions. Again, it would be smart to use these tools while we still have them.

> ***Planning Tip:*** Be careful with gift splitting; it is not permitted if the non-donor spouse is going to be a beneficiary of the trust.

> ***Planning Tip:*** Be sure to address the GST exemptions correctly when doing gift tax returns. Annual exclusion rules for the GST tax are different from those for the gift tax. Plus, automatic allocation rules are one of the Bush era provisions that are scheduled to end on December 31 and thereafter be treated "as if never enacted."

> ***Planning Tip:*** Use projections and illustrations to show clients how much they can save by acting now.

Conclusion
Yes, there is much uncertainty about our future tax laws, but there is much we do know about current laws. While we are waiting and watching, much can be done to help our clients take advantage of incredible tax-planning opportunities that may never exist again and to help them plan for the taxes we do know we will have in 2013.

To comply with the U.S. Treasury regulations, we must inform you that (i) any U.S. federal tax advice contained in this newsletter was not intended or written to be used, and cannot be used, by any person for the purpose of avoiding U.S. federal tax penalties that may be imposed on such person and (ii) each taxpayer should seek advice from their tax advisor based on the taxpayer's particular circumstances.

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