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2012 Year-End Tax Planning

The 2012 year-end tax planning process is one of the most challenging in memory. This dynamic is caused by the confluence of the outcome of the recent election and the uncertainty about legislative activity during either the "lame duck" or early January congressional sessions.

Nevertheless, we have included some thoughts that we hope our clients and other readers will find useful, which represent our perspective on the situation. We plan on issuing more comprehensive individual and business tax planning letters in late December when, perhaps, we may have some greater certainty about some issues and provisions.

We have also included some brief comments of the recently passed California Proposition 30 and the tax impacts of that Proposition for 2012 and subsequent years.

Individual Tax Planning:

Potential Sunset of "Bush-era" Tax Cuts and California Proposition 30 – This parenthetical phrase refers collectively to certain tax laws enacted in 2001 and 2003, which accounted for over 30 major changes to the Tax Code. The 2010 Tax Relief Act extended the reduced individual tax rates provided for under this legislation. We have attached a schedule at the end of this letter which reflects the differences in the tax rates should no extension occur.

The passing of Proposition 30 in California on November 6, 2012, resulted in two new tax provisions. The first is an increase in California Sales Tax to 7.5% from 7.25%. The increase will be effective January 1, 2013 and continue through December 31, 2016.

In addition, Proposition 30 creates three new high-income tax brackets for taxpayers with taxable income exceeding certain limits as follows:

Single taxpayers and married filing separate-

- 10.3% tax rate on taxable income over $250,000 but less than $300,000
- 11.3% tax rate on taxable income over $300,000 but less than $500,000
- 12.3% tax rate on taxable income over $500,000

Married taxpayers-

- 10.3% tax rate on taxable income over $500,000 but less than $600,000
- 11.3% tax rate on taxable income over $600,000 but less than $1,000,000
- 12.3% tax rate on taxable income over $1,000,000

These new tax brackets, effective, RETROACTIVELY, to January 1, 2012 will continue for 7 years through 2018. The only "good news" is that taxpayers will not be required to "catch up" for the tax increase in the first three quarters, by increasing the fourth quarter estimate. Taxpayers will also not receive an underpayment penalty to the extent that the underpayment was created or increased by the passage of Proposition 30.

Strategy: It will be extremely important for taxpayers to prepare tax projections for 2012 and 2013 and consider whether "discretionary" income should be received and tax deductible expenses paid, this year or next. For federal tax purposes, it may be beneficial to generate higher taxable income in 2012; however, the federal rate benefit may be wholly or partially offset by additional California tax. Furthermore, alternative minimum tax (AMT) may limit or negate any benefit from payment of certain expenses, such as state income taxes, real and personal property taxes, and miscellaneous itemized deductions. Consideration should also be given to the purchase of high dollar value items before December 31,2012 to save on sales taxes with due consideration as to tax impact of any business property acquisitions.

Capital Gains – Qualified capital gains are scheduled to be taxed at higher rates (0 or 15% to 2012; 10 or 20% in 2013) starting in 2013. California will still tax net capital gains at the same rates as ordinary income.

Strategy: Consider harvesting capital losses, being mindful of the wash sales rules, to offset existing capital gains. Consider generating long-term capital gains, where such gains would otherwise be recognized in future years, while the tax rates are currently very low. Be mindful of the higher California marginal tax rates, which may reduce the federal savings associated with triggering such gains.

Dividends – The current 0%/15% tax rates are schedule to expire after 2012 and be taxed at ordinary income tax rates in 2013, as high as 39.6%. Moreover, such income may be subject to the new Medicare contribution tax next year.

Strategy: Qualified corporations may want to consider declaring and paying a special dividend to shareholders prior to January 1, 2013.

3.8 Percent Medicare Contribution Tax - On January 1, 2013, a Medicare surtax will be imposed on "net investment income" (NII). For individuals, the Medicare surtax is based on the lesser of the taxpayer's NII or "modified adjusted gross income" (MAGI) above a specified threshold. The MAGI thresholds are:

- $250,000 for married taxpayers filing jointly
- ◦$200,000 for single

NII includes:

- Gross income from interest, dividends, annuities, royalties and rents, provided this income is not derived in the ordinary course of an active trade or business
- Gross income from a trade or business that is a passive activity
- Gross income from a trade or business of trading in financial instruments or commodities; and
- Net gain from the disposition of property, other than property held in an active trade or business

NII excludes:

- Distributions from qualified retirement plans or IRAs
- Veterans benefits
- Gain excluded on sale of principal residence
- Interest on tax exempt bonds

Strategies: Consideration should be given to considering the following:

- Do not postpone the first year IRA distribution to 2013 on reaching age 70.5
- Trust returns are also subject to the Medicare Contribution Tax. Trust income will often reach the highest tax brackets much quicker than individuals. Make sure that all income has been distributed from the trust before year end.

Additional 0.9 Percent Medicare Tax - Also effective January 1, 2013, higher income individuals will be subject to an additional 0.9 percent HI (Medicare) tax. This additional Medicare tax should not be confused with the 3.8 percent Medicare surtax. The additional Medicare tax means that the portion of wages received in connection with employment in excess of $200,000 ($250,000 for married couples filing jointly) will be subject to a 2.35 percent Medicare tax rate (currently 1.45%). The additional Medicare tax also applies to the self-employed.

Strategy: Taxpayers may want to explore the possibility of accelerating income into 2012

End of Payroll Tax Holiday - For the past two years, an employee's share of Old Age, Survivors and Disability Insurance (OASDI) tax has been reduced from 6.2 percent to 4.2 percent (with comparable relief for the self-employed). Under current law, that reduction is scheduled to expire after December 31, 2012. On January 1, 2013, the employee's share of OASDI taxes will revert to 6.2 percent, effectively increasing payroll taxes across the board.

Strategy: Taxpayers may want to explore the possibility of accelerating bonuses and wages into 2012.

Alternative Minimum Tax - The alternative minimum tax rates (26 and 28 percent on the excess of alternative minimum taxable income over the applicable exemption amount) are not scheduled to change in 2013. However, exposure to the AMT may change as a result of the scheduled increase in tax rates. Because the determination of AMT liability requires a comparison between regular tax and AMT computations, the higher regular tax rates post-2012 may help lower AMT exposure by the same amount.

However, taxpayers should not ignore the possibility of being subject to the AMT, as this may negate certain year-end tax strategies. For example, if income and deductions are manipulated to reduce regular tax liability, AMT for 2012 may increase because of differences in the income and deductions allowed for AMT purposes.

As in past years, taxpayers are waiting to see if Congress will enact an AMT "patch" for 2012. The last patch, which provided for increased exemption amounts and use of the nonrefundable personal credits against AMT liability, expired after 2011. If another "patch" is not enacted by Congress, the AMT exemption will drop from $74,450 (married taxpayers filing jointly) in 2011 to $45,000 in 2012

Personal Exemption/Itemized Deduction Phase outs - Higher income taxpayers may also be subject to the return of the personal exemption phase-out and the so-called Pease limitation on itemized deductions. Both of these provisions were repealed through 2012. However, they are scheduled to return after 2012 unless the repeal is extended.

Revival of the personal exemption phase-out rules would reduce or eliminate the deduction for personal exemptions for higher income taxpayers starting at phase-out amounts that, adjusted for inflation, would start at $267,200 AGI for joint filers and $178,150 for single filers.

In addition, return of the Pease limitation on itemized deductions (named for the member of Congress who sponsored the legislation) would reduce itemized deductions by the lesser of:

◦Three percent of the amount of the taxpayer's AGI in excess of a threshold inflation-adjusted amount projected for 2013 to be $178,150 (joint filers), or
◦80 percent of the itemized deductions otherwise allowable for the tax year.

Strategy: Taxpayers should watch AGI limitations when determining deductions and credits to report in 2012/2013. Taxpayers should consider paying deductible items in 2013 when tax rates are higher and could result in a more advantageous tax benefit.

Education: American Opportunity Tax Credit. In 2009, Congress enhanced the Hope education credit and renamed it the American Opportunity Tax Credit (AOTC). The temporary enhancements, including a maximum credit of $2,500, availability of the credit for the first four years of post-secondary education, and partial refundability for qualified taxpayers, are scheduled to expire after 2012. Under current law, less generous amounts will be available with the revived Hope education credit.

Coverdell Education Savings Accounts. Similar to IRAs, Coverdell Education Savings Accounts (Coverdell ESAs) are accounts established to pay for qualified education expenses. Under current law, the maximum annual contribution to a Coverdell ESA is $2,000, and qualified education expenses include elementary and secondary school expenses. Unless extended, the maximum annual contribution for a Coverdell ESA is scheduled to decrease to $500 after 2012.

Employer-Provided Education Assistance. Under current law, qualified employer-provided education assistance of up to $5,250 may be excluded from income and employment taxes. However, the 2010 Tax Relief Act only made the exclusion available through 2012.

Student Loan Interest. Individual taxpayers with MAGI below $75,000 ($150,000 for married couples filing a joint return) may be eligible to deduct interest paid on qualified education loans up to a maximum deduction of $2,500, subject to income phase-out rules. The enhanced treatment for the student loan interest deduction is scheduled to expire after 2012. The student loan interest deduction would be limited to the first 60 months of payment.

Higher Education Tuition Deduction. The above-the-line higher education tuition deduction expired after 2011. The maximum $4,000 deduction was available for qualified tuition and fees at post-secondary institutions, subject to income phase outs.

Child Tax Credit - Taxpayers who claim the child tax credit need to plan for its scheduled reduction after 2012. Absent Congressional action, the child tax credit, at $1,000 per eligible child for 2012, will be $500 per eligible child, effective January 1, 2013

Sales Tax Deduction - Before 2012, qualified taxpayers could deduct state and local general sales taxes in lieu of deducting state and local income taxes. The 2010 Tax Relief Act last extended the optional itemized deduction for state and local general sales taxes, which had been available since 2004, to tax years 2010 and 2011. Unless extended again, the deduction for state and local general sales taxes will not be available for tax year 2012 and beyond.

Qualified Mortgage Insurance Premiums - For the period 2007 through 2011, premiums paid for qualified mortgage insurance could be treated as qualified residence interest and deducted as an itemized deduction, subject to certain restrictions. Renewal of this tax break into 2012 is uncertain at this time.

Estate/Gift Tax Planning - Few areas of the Tax Code are fraught with as much uncertainty as the federal estate and gift taxes. Through the end of this year individual taxpayers can complete lifetime transfers of up to $5.2 million without tax with excess transfers taxes at 35%. Starting in 2013 the lifetime transfer tax exemption is reduced to $1 million and the maximum tax rate increases to 55%. Given the election results and the President's desire to lower the estate and gift tax exemption for 2013 from the current 21012 levels, there may be a considerable opportunity cost for failing to use the current gift tax exemption before year end.

Strategy: A comprehensive estate plan should be implemented to take advantage of this opportunity to transfer $5 million out of an individual's estate. This transfer could ultimately save over $2 million in estate taxes. Individuals should consider transferring real estate or investments to their beneficiaries now to avoid the estate taxes later.

BUSINESS TAX PLANNING:

Code Sec. 179 expensing - Code Sec. 179 gives businesses the option of claiming a deduction for the cost of qualified property all in its first year of use rather than claiming depreciation over a period of years. For 2010 and 2011, the Code Sec. 179 dollar limitation was $500,000 with a $2 million investment ceiling. The dollar limitation for 2012 is $139,000 with a $560,000 investment ceiling. Under current law, the Code Sec. 179 dollar limit is scheduled to drop to $25,000 for 2013 with a $200,000 investment ceiling.

Strategy: Businesses should consider accelerating purchases into 2012 to take advantage of the still generous Code Sec. 179 expensing. Qualified property must be tangible personal property, which one actively uses in one's business, and for which a depreciation deduction would be allowed. The amount that can be expensed depends upon the date the qualified property is placed in service; not when the qualified property is purchased or paid for. Additionally, Code Sec. 179 expensing is allowed for off-the-shelf computer software placed in service in tax years beginning before 2013.

Bonus depreciation - The first-year 50 percent bonus depreciation deduction is scheduled to expire after 2012 (2013 in the case of certain longer-production period property and certain transportation property). Unlike the Section 179 expense deduction, the bonus depreciation deduction is not limited to smaller companies or capped at a certain dollar level. To be eligible for bonus depreciation, qualified property must be depreciable under Modified Accelerated Cost Recovery System (MACRS) and have a recovery period of 20 years or less. The property must be new and placed in service before January 1, 2013 (January 1, 2014 for certain longer-production period property and certain transportation property).

Businesses also need to keep in mind the relationship of bonus depreciation and the vehicle depreciation dollar limits. Code Sec. 280F(a) imposes dollar limitations on the depreciation deduction for the year a taxpayer places a passenger automobile in service within a business, and for each succeeding year. Sport utility vehicles and pickup trucks with a gross vehicle weight rating in excess of 6,000 pounds are exempt from the luxury vehicle depreciation caps.

Expiring business tax incentives - Many temporary business tax incentives expired at the end of 2011. In past years, Congress has routinely extended these incentives, often retroactively, but this year may be different. Confronted with the federal budget deficit and across-the-board spending cuts scheduled to take effect in 2013, lawmakers may allow some of the business tax extenders to expire permanently. Certain extenders, however, have bipartisan support, and are likely to be extended. They include the Code Sec. 41 research tax credit, the Work Opportunity Tax Credit (WOTC), and 15-year recovery period for leasehold, restaurant and retail improvement property

Small employer health insurance credit - A potentially valuable tax incentive has often been overlooked by small businesses, according to reports. Employers with 10 or fewer full-time employees paying average annual wages of not more than $25,000 may be eligible for a maximum tax credit of 35 percent on health insurance premiums paid for tax years beginning in 2010 through 2013. Tax-exempt employers may be eligible for a maximum tax credit of 25 percent for tax years beginning in 2010 through 2013.

The credit is scheduled to climb to 50 percent of qualified premium costs paid by for-profit employers (35 percent for tax-exempt employers) for tax years beginning in 2014 and 2015. However, an employer may claim the tax credit after 2013 only if it offers one or more qualified health plans through a state insurance exchange.

Final Remarks-

Today's uncertainty makes doing nothing or adopting a wait and see attitude very tempting. Instead, multi-year tax planning, which takes into account a variety of possible scenarios and outcomes, should be built into one's approach.

Please contact our office for more details on developing a tax strategy in uncertain times that includes consideration of certain tax-advantaged steps that may be taken before December 31, 2012.

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Individual Income Tax Rates

Taxable Income Bracket	Rates for 2012
Single \$0 – \$8,700 Joint \$0 – \$17,400	10%
Single \$8,700 – \$35,350 Joint \$17,400 – \$70,700	15%
Single \$35,350 – \$85,650 Joint \$70,700 – \$142,700	25%
Single \$85,650 – \$178,650 Joint \$142,700 – \$217,450	28%
Single \$178,650 – \$388,350 Joint \$217,450 – \$388,350	33%
Over \$388,350	35%

Taxable Income Bracket	Scheduled Rates for 2013
Single \$0 – \$36,100 Joint \$0 – \$60,350	15%
Single \$36,100 – \$87,550 Joint \$60,350 – \$145,900	28%
Single \$87,550 – \$182,600 Joint \$145,900 – \$222,300	31%
Single \$182,600 – \$397,000 Joint \$222,300 – \$397,000	36%
Over \$397,000	39.6%