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TAX AND BUSINESS Alert™

October 2013

Fourth Quarter Tax Planning

For many individuals, the ordinary federal income tax rates for 2013 will be the same as last year· 10%, 15%, 25%, 28%, 33%, and 35% However, the so-called fiscal cliff legislation passed early this year increased the maximum rate for higher-income individuals to 39.6% (up from 35%). This change only affects taxpayers with taxable income above $400,000 for singles, $450,000 for married joint-filing couples, $425,000 for heads of households, and $225,000 for married individuals who file separate returns. Higher-income individuals can also get hit by the new additional 0.9% Medicare tax and the 3.8% net investment income tax (3.8% NIIT), which can result in a higher-than-advertised federal tax rate for 2013.

Despite these tax increases, the current federal income tax environment remains relatively favorable by historical standards. This article presents some tax planning ideas to consider this fall that may apply to you and/or your family. Note that it is critical to evaluate all tax planning strategies in light of the alternative minimum tax (AMT).

Leverage Standard Deduction by Bunching Deductible Expenditures

If your 2013 itemized deductions are likely to be just under, or just over, the standard deduction amount, consider bunching together expenditures for itemized deduction items every other year, while claiming the standard deduction in the intervening years. The 2013 standard deduction is $12,200 for married joint filers, $6,100 for single filers, and $8,950 for heads of households.

For example, say you're 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 2014 property taxes by December 31 of this year, you could claim $16,000 of itemized deductions on your 2013 return ($4,000 of 2013 property taxes, plus another $4,000 for the 2014 property tax bill, plus the $8,000 of mortgage interest). Next year, you would only have about $8,000 of mortgage interest, but you could claim the standard deduction (it will probably be around $12,500 for 2014). 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 include charitable donations and state income tax payments.

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Consider Deferring Income

It may pay to defer some taxable income from this year into next year if you expect to be in the same or lower tax bracket in 2014. For example,

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Tax Calendar

October 15—Personal returns that received an automatic six-month extension must be filed today and any tax, interest, and penalties due must be paid.

—Electing large partnerships that received an additional six-month extension must file their Forms 1065-B today.

—If the monthly deposit rule applies, employers must deposit the tax for payments in September for social security, Medicare, withheld income tax, and nonpayroll withholding.

October 31—The third quarter Form 941 (Employer's Quarterly Federal Tax Return) is due today and any undeposited tax must be deposited. (If your tax liability is less than $2,500, you can pay it in full with a timely filed return.) If you deposited the tax for the quarter in full and on time, you have until November 12 to file the return.

—If you have employees, a federal unemployment tax (FUTA) deposit is due if the FUTA liability through September exceeds $500.

November 15—If the monthly deposit rule applies, employers must deposit the tax for payments in October for social security, Medicare, withheld income tax, and nonpayroll withholding.

December 16—Calendar-year corporations must deposit the fourth installment of estimated income tax for 2013.

—If the monthly deposit rule applies, employers must deposit the tax for payments in November for social security, Medicare, withheld income tax, and nonpayroll withholding.

At-risk Rules for a Closely Held Corporation

The at-risk rules may limit the amount of loss you can deduct from investment in your closely held corporation. The amount of loss a corporation may recognize from an activity is limited to the amount that is at risk for that activity at the close of the tax year. Any losses limited by the at-risk rules are not forfeited—they are carried forward and may be used in a later year when you obtain a sufficient amount at risk to cover it.

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The amount you have at risk in an activity includes the cash and property you contribute to it, amounts borrowed for use in the activity if the corporation is liable for repayment, and amounts borrowed for use in the activity to the extent the corporation has pledged property other than property used in the activity as security for the borrowed amount (to the extent of the net FMV of the corporation's interest). With respect to the contributed property, however, you count the basis you had in it, not its value. That is, if you contributed land with a basis (cost) of $10,000 and a value of $25,000, your at-risk amount will only be $10,000, not the $25,000 value.

Unfortunately, these rules are not the only ones that may limit your tax benefits from losses in your closely held corporation. You may also be subject to rules limiting losses claimed from passive activities. Additionally, if you hold your interest as a partner or S corporation shareholder, your losses may be limited to your basis in your interest under special rules applicable to partnerships and S corporations.

These loss limitation rules are complex and may be further complicated by how they interrelate. Please contact us if you have questions on how these rules may apply to your specific situation.

if you're self-employed 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 2014. 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 are affected by unfavorable phase-out rules that reduce or eliminate various tax breaks (child tax credit, education tax credits, and so on). By deferring income every other year, you may be able to take more advantage of these breaks.

Time Investment Gains and Losses

For many individuals, the 2013 federal tax rates on long-term capital gains are the same as last year· either 0% or 15%. However, the maximum rate for higher-income individuals is now 20% (up from 15% last year). This change only affects taxpayers with taxable income above $400,000 for singles, $450,000 for married joint-filing couples, $425,000 for heads of households, and $225,000 for married individuals filing separately. Higher-income individuals can also get hit by the new 3.8% NIIT on net investment income, which can result in a maximum 23.8% federal income tax rate on 2013 long-term gains.

As you evaluate investments held in your taxable brokerage firm accounts, consider the tax impact of selling appreciated securities (currently worth more than you paid for them). For most taxpayers, the federal tax rate on long-term capital gains is still much lower than the rate on short-term gains. Therefore, it often makes sense to hold appreciated securities for at least a year and a day before selling to qualify for the lower long-term gain tax rate.

Biting the bullet and selling some loser securities (currently worth less than you paid for them) before year-end can also be a tax-smart idea. The resulting capital losses will offset capital gains from other sales this year, including high-taxed short-term gains from securities owned for one year or less. For 2013,

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the maximum rate on short-term gains is 39.6%, and the 3.8% NIIT may also apply, which can result in an effective rate of up to 43.4% However, you don't need to worry about paying a high rate on short-term gains that can be sheltered with capital losses (you will pay 0% on gains that can be sheltered).

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If capital losses for this year exceed capital gains, you will have a net capital loss for 2013. You can use that net capital loss to shelter up to $3,000 of this year's high-taxed ordinary income ($1,500 if you're married and file separately). Any excess net capital loss is carried forward to next year.

Selling enough loser securities to create a bigger net capital loss that exceeds what you can use this year might also make sense. You can carry forward the excess capital loss to 2014 and beyond and use it to shelter both short-term gains and long-term gains recognized in those years. Note that the wash sale rules can limit the deduction for securities losses.

Make Charitable Donations from Your IRA

IRA owners and beneficiaries who have reached age 70½ are permitted to make cash donations of up to $100,000 to IRS-approved public charities directly out of their IRAs. These so-called qualified charitable distributions (QCDs) are federal-income-tax-free to you, but you get no itemized charitable write-off on your Form 1040. That's okay, because the tax-free treatment of QCDs equates to an immediate 100% federal income tax deduction without having to worry about restrictions that can delay itemized charitable write-offs.

Note: To qualify for this special tax break, the funds must be transferred directly from your IRA to the charity. Also, this favorable provision will expire at the end of this year unless Congress extends it.

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Retirement Plan Loans

If you are unable to borrow from a bank or other outside source, your qualified retirement plan may be a good option. IRS guidelines permit a limited amount of borrowing from corporate qualified retirement plans, including 401(k) plans. In general, borrowings are limited to 50% of the participant's account balance up to a maximum of $50,000 and must be repaid within five years (unless the loan proceeds are used to purchase a principal residence). Hardship withdrawals (different from a loan, which must be repaid to the plan) from 401(k) plans are also permissible in certain circumstances. However, hardship withdrawals are taxable and subject to a 10% penalty if made before age 59½.

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Tax law generally prohibits borrowing from IRAs. However, a distribution from an IRA followed by a redeposit of the funds into the same account or another IRA within 60 days of receipt of the funds will qualify as a tax-free rollover transaction. Once you have made such a tax-free rollover, you must wait at least one year from the date of receipt of the amount withdrawn from that particular IRA before becoming eligible to participate in another similar transaction. This once-per-year rule is applied individually to each IRA. Therefore, a person who has more than one IRA may make a rollover once per year on each account. Your use of the funds for the 60-day rollover period is, in effect, a short-term loan. It is recommended that you not implement this strategy without careful planning.