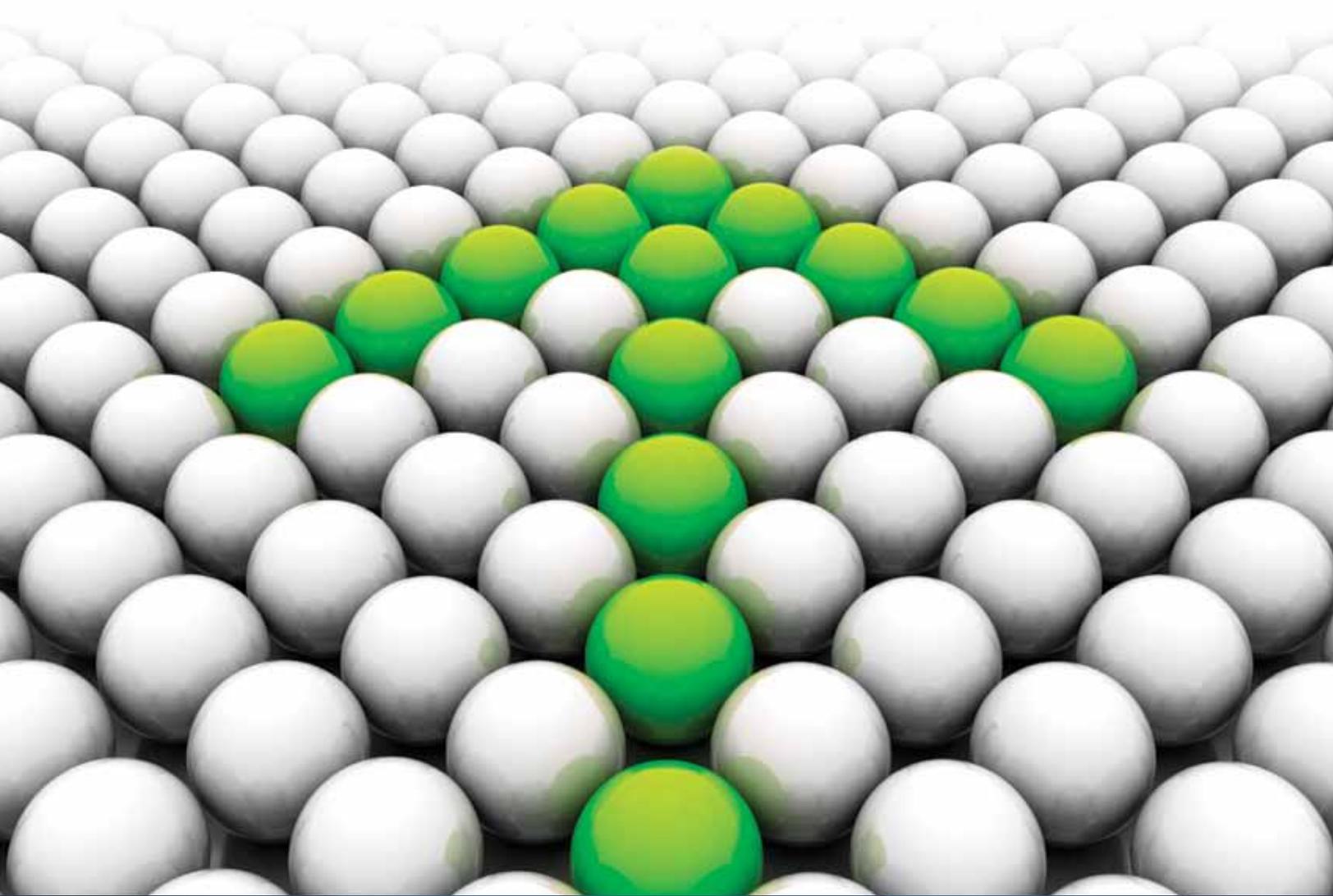


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About the AICPA Personal Financial Planning Section

The AICPA's Personal Financial Planning (PFP) Section is the premier provider of information, tools, advocacy and guidance for CPAs who specialize in providing estate, tax, retirement, risk management and investment planning advice to individuals and closely held entities. The primary objective of the PFP Section is to support its members by providing resources that enable them to perform valuable personal financial planning services in the highest professional manner. Members of this section broaden their technical expertise, improve their professional competence and receive resources to deliver high-quality, profitable PFP services. For more information and education on many of the topics covered in this publication, visit our [PFP web seminar archive](#), [PFP Practice Center](#), [Advanced PFP Conference recordings](#), and the AICPA PFP Section homepage at aicpa.org/PFP.

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Chapter 33

Year-End and New Year Tax Planning

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¶3301 Overview

Year-end tax planning presents important tax-saving opportunities for financial planners and their individual and business clients. Usually the planning should begin early in the last quarter of the tax year. This time is usually late enough to have a good picture of the year. In addition, a financial planner will have a fair basis for predicting the client's income and deductions for the next year.

A common objective of year-end planning is to shift a part of this year's tax burden to the next year. A taxpayer shifts income to the next year by deferring receipt (or accrual) of some income until next year or by accelerating deductions from next year to this year, or both. The real advantage of the tax deferral is that it gives the taxpayer continued use of funds that would otherwise have gone to pay taxes. The use of the funds for a longer time can be a decided benefit.

However, a taxpayer must weigh the benefit of having the funds for a longer period against the cost of the strategies required to receive it.

If a client must postpone the receipt of cash or spend cash to get a tax deduction, the lost use of this money must be measured against the use of the tax money deferred. Of course, if the client can get a deduction without spending cash, the benefit is obvious. Examples include a bad-debt deduction or a loss on a securities transaction.

There are two other important points about tax deferral: (1) The client cannot assume that he or she is going to have the use of the tax dollars saved for the full year. The client should consider the impact of estimated taxes. Depending on various factors, the client might have to pay the tax dollars saved this year in quarterly installments next year. (2) If the effect of deferral is to push the client into a higher bracket next year, he or she might pay more in total taxes for the two years than if matters had been left alone.

The other key objective in year-end tax planning is to level out taxable income from one year to the next. In a progressive income tax system such as ours, the tax bite is minimized by keeping income level. If the client expects that next year's income will be higher, he or she should accelerate some of next year's income into this year and postpone some of this year's tax deductions until next year. If the client expects a drop in next year's income, then he or she should reverse the process, by postponing income while accelerating deductions.

As with the tax deferral approach, the financial planner should work with the client to perform a cost/benefit analysis. When the client is increasing cash income and postponing cash layouts, he or she is getting the use of more money. How much is that worth to the client and how much does he or she have to pay in added taxes to get it? How much will the leveling off save overall? Complicating this analysis is the potential impact of the alternative minimum tax, which can cause deductions against regular income to be added back to alternative minimum taxable income, and result in alternative minimum tax liability.

Another important objective of year-end planning is to reduce or avoid the penalty for underpayment of estimated taxes.

.01 Impact of Tax Legislation

One factor that can dramatically affect a decision to accelerate or postpone income or deductions is the passage of tax legislation. Most pieces of major tax legislation have provisions that will in some way significantly affect how taxpayers treat particular items of income and deduction. Some provisions in new tax legislation take effect on the first day of the year. Other provisions often take effect on specific dates. Where provisions take effect on the first of the year, the financial planner is presented with an unusually fertile ground for unearthing year-end planning strategies.

A recent trend in tax legislation has been to enact temporary tax breaks to provide tax relief for a limited period of time or to encourage certain investments. For example, a number of such provisions are currently scheduled to expire at or near the end of 2012, including lower regular income tax rates, lower tax rates on capital gains and qualified dividends, etc. Some tax breaks enacted temporarily have already expired, such as the first-time homebuyer credit for homes purchased before December 31, 2009,¹ and the itemized and standard deductions for sales or excise taxes on qualified motor vehicles purchased before January 1, 2010.² Congress increased the 50 percent "bonus" first-year depreciation allowance for property placed in service to 100 percent for property placed in service before January 1, 2012, and extended the 50 percent bonus depreciation opportunity for property placed in service prior to January 1, 2013.³ Consequently, taxpayers should factor these "limited time offers" into their year-end tax plans. In addition, 2013 introduces new Medicare taxes on earned income and on net investment income for persons over certain prescribed adjusted gross income thresholds (\$200,000 single filers; \$250,000 for married persons filing jointly). All of this will certainly have an effect on 2012 year end planning.

In fact, 2012 offers a set of special challenges to the financial planner. There is still a great deal of uncertainty about what will be the final tax law for 2013. Will the so-called "Bush Tax Cuts" be allowed to expire and will taxes rise for everyone, or will they be extended beyond 2012 with the tax rates remaining the same for 2013 as they are for 2012? Will the Bush Tax Cuts be extended for only a portion of the population and not for all taxpayers? If only partially extended, what will be the dividing line between the "winners" and "losers"? Will a variety of "extenders" be passed to continue a number of popular tax deductions and credits which have not yet been extended for 2012 taxes, or will they be allowed to expire and not be available to taxpayers for the year 2012?

It is within this context and atmosphere of uncertainty that the financial planner must advise his or her clients about year-end planning for 2012 and what to do for 2013. It is hoped that all of this uncertainty will be resolved and cleared up well before the end of 2012, so that planning can take place in an orderly fashion. But there is a chance that because of politics and an election year, that will not be the case. What, then, is the financial planner to tell the clients to do?

Perhaps the "safest" course is to assume that that tax law issues will not be resolved until late 2012 or even beyond that time, and the higher tax rates scheduled to take effect for 2013 will, in

¹ IRC § 36.

² IRC §§ 63, 164.

³ IRC § 168, as extended by the 2010 Tax Reform Act.

fact, take place. If this is the case, planning would then suggest accelerating income into 2012 and deferring deductions into 2013. This would allow income to be taxed at the lower 2012 rates, and deductions would be worth more at the higher 2013 rates. With the affirmance by the U.S. Supreme Court of the Affordable Care Act, the new Medicare taxes (noted above and discussed further in this Chapter below) are likely to take effect in 2013, suggesting that clients need to be mindful of the levels of both their earned income and their net investment income.

There are some specific steps that financial planners should consider as the end of 2012 approaches, especially if it appears that some or possibly all clients will be subjected to higher tax rates in 2013. Among the steps to consider are the following:

- Accelerate income into 2012 and defer deductions until 2013.
- Harvest capital gains. A taxpayer can sell stock in which there is a gain in 2012, lock in the 15 percent capital gains rate, and, if desired, repurchase the same stock immediately. There is no “wash sale rule” for gains. If the client waits until 2013 to sell, the effective tax rate on the gain may be 23.8 percent instead of 15 percent (that would be the combined rate of the 20 percent capital gains tax and the 3.8 percent Medicare tax on net investment income).
- Consider converting a traditional IRA to a Roth IRA. The 2012 tax rate on the conversion will not exceed 35 percent. Also, there will not be required distributions from the Roth IRA in future years. IRA withdrawals, required once the client reaches age 70½ and possibly needed sooner, while not considered net investment income, will still increase the client’s adjusted gross income, and may help push the client over the Medicare tax AGI threshold.
- Look at the client’s investment allocations. Income that is tax exempt (municipal bonds) will both avoid the higher tax rates and not be considered net investment income.
- Consider using S corporations to pay the business owner a modest salary (to minimize exposure to self-employment and Medicare taxes on compensation) and a more generous dividend, since distributions from active businesses are not net investment income for purposes of the new Medicare tax.
- Consider investments such as depreciable real estate where the depreciation deduction may offset a portion of the rental income, or investments focused more on growth than current income.
- Consider installment sales—either elect out of the installment method for a 2012 sale and pay all the tax on the gain at the 2012 rates, or utilize installment sale treatment to stretch out reporting of a gain.
- Consider the use of a like kind exchange (Code Sec. 1031) to defer reporting of a gain on the sale of investment property.
- Consider voluntary withdrawals from IRAs and qualified retirement plans, so long as they will not be subject to the 10 percent excise tax.

.02 Manipulating AGI

A taxpayer might need to accelerate income or defer it in order to meet adjusted gross income (AGI) limitations that accompany certain tax benefits. For example, a taxpayer may wish to lower his or her AGI to take advantage of several tax benefits tied to AGI, including the following based on limitations for the year 2012. Inflation adjusted amounts can be found in Rev. Proc. 2011-52.⁴

- **Roth IRA contributions.** Phased out beginning in 2012 at AGI of \$173,000 for married couples filing jointly (\$0 for married persons filing separately) or \$110,000 for single taxpayers.⁵

⁴ 2011-45 IRB (October 21, 2011 and November 7, 2011).

⁵ IRC § 408A(c)(3).

- **Contributions to Coverdell Education Savings Accounts.** Phased out beginning in 2012 at AGI of \$190,000 for married couples (\$95,000 for single taxpayers).⁶
- **American Opportunity credit.** Phased out beginning in 2012 at AGI of \$160,000 for married couples (\$80,000 for single taxpayers).⁷
- **Lifetime Learning credit.** Phased out beginning in 2012 at AGI of \$104,000 for married couples (\$52,000 for single taxpayers).⁸ These amounts are indexed for inflation.⁹
- **Child tax credit.** Phased out beginning in 2012 at AGI of \$110,000 for married couples (\$75,000 for single taxpayers and \$55,000 for married persons filing separately).¹⁰ These amounts are not adjusted for inflation.
- **Education loan interest deduction.** Phased out beginning in 2012 at AGI of \$125,000 for married couples (\$60,000 for single taxpayers).¹¹ These amounts are adjusted for inflation.¹²
- **Personal and dependency exemptions.** The former phase out of the personal and dependency exemptions is repealed for 2011 through 2012. The phase out is scheduled to return for 2013.¹³
- **Certain itemized deductions.** The three percent phase-out of certain itemized deductions (the “Pease deduction”) is repealed for 2010 through 2012. The phase out rule is supposed to return for 2013.¹⁴ Itemized deductions not subject to reduction include deductions for medical expenses, investment interest, casualty losses, and wagering losses (to the extent of winnings).¹⁵
- **IRA contributions for active qualified plan participants.** Phased out beginning in 2012 at AGI of \$92,000 for married couples filing jointly or qualifying widow(er)s. The phase out threshold begins at \$58,000 for a single taxpayer. The phase out threshold for a taxpayer who is not an active participant but whose spouse is an active participant begins at \$173,000.¹⁶
- **Social Security income.** Up to 85 percent includible in gross income if AGI exceeds certain amounts (based on formulas).¹⁷
- **Credit for household and dependent care services necessary for gainful employment.** Commonly called the child care credit, it decreases in 2012 for AGI of more than \$15,000 and levels out at AGI in excess of \$43,000, for both married couples filing jointly and single taxpayers.¹⁸
- **Interest exemption for savings bonds used for qualified higher education expenses.** Phased out beginning in 2012 at AGI of \$109,250 for married couples filing jointly (\$72,850 for other returns).¹⁹
- **Exception to the passive loss deduction limitation for active participants.** Phased out starting at AGI of \$100,000 for both married couples filing jointly and single taxpayers (a higher limit applies if rehabilitation tax credits were utilized).²⁰

⁶ IRC § 530(c)(1)(A)(i).

⁷ IRC § 25A as amended by the American Recovery and Reinvestment Act of 2009 (P.L. 111-5). The American Opportunity credit is an expanded version of the Hope Scholarship credit that is available for tax years beginning in 2009 and 2010.

⁸ IRC § 25A(d)(2)(A).

⁹ IRC § 25A(h)(2)(A).

¹⁰ IRC § 24(b).

¹¹ IRC § 221(b)(2)(B).

¹² IRC § 221(g).

¹³ IRC § 151(d).

¹⁴ IRC § 68.

¹⁵ IRC § 68(c).

¹⁶ IRC § 219(g)(3)(B).

¹⁷ IRC § 86.

¹⁸ IRC § 21(a).

¹⁹ IRC § 135.

²⁰ IRC § 469(i).

Planning Pointer.

The 2-percent AGI floor for miscellaneous itemized deductions,²¹ the 7.5-percent floor on medical expense deductions,²² and the 10-percent floor on casualty and theft losses²³ decrease as AGI decreases. Thus, lowering AGI allows more expenses to be deductible. On the other hand, lowering AGI may reduce the charitable deduction because the deduction is generally limited to 50 percent of AGI (30 percent for capital gain property and 20 percent for property given to private foundations).²⁴

.03 Alternative Minimum Tax Considerations

For those within range of the alternative minimum tax,²⁵ the need for year-end tax planning becomes particularly acute. Such individuals may find themselves in a situation where further deductions against their regular income only serve to expose them to alternative minimum tax liability. Thus, any additional deductions would be wasted. To avoid loss of these deductions, the client could shift the deductions, or part of them, to a year in which they would provide a tax benefit. Alternatively, the strategy might be to limit the deduction in the first place. For example, the client could use alternative depreciation, rather than regular depreciation (MACRS), in appropriate situations.²⁶

If the client cannot avoid the alternative minimum tax, a different strategy can save taxes: accelerate income into the year when the alternative minimum tax is due. The rate of tax on extra income subject to AMT is either 26 percent or 28 percent,²⁷ compared to a regular tax top rate of 35 percent through 2012.²⁸ Another planning strategy is to attempt to alternate years when deductions are high—then low—to try to address the alternative minimum tax issues. For example, consider bunching deductions for state and local income taxes by paying large estimated tax payments in December of a particular year, and pay real estate taxes for the next year in December as well. That will bunch the deductions in the early year, and avoid making the payments in the second year to possibly reduce AMT liability for the second year.

¶3305 Planning Methods

After the individual decides whether to postpone or accelerate income or deductions, he or she then looks for ways and means to accomplish the chosen objective.

.01 Postponing Income

The traditional opportunities for an individual to postpone income are limited. As noted above, whether these planning techniques will be advisable for the 2012-2013 planning year end may depend upon what is done legislatively, if anything, before the end of 2012. Some key methods include the following:

- Postponing the sale of investments at a profit.
- Making installment sales of property that qualify for installment reporting, thereby deferring all or a portion of the gain over to subsequent years.
- Deferring compensation under a plan.

²¹ IRC § 67.

²² IRC § 213(a).

²³ IRC § 165(h).

²⁴ IRC § 170.

²⁵ IRC § 55.

²⁶ IRC § 168.

²⁷ IRC § 55(b)(1)(A)(i).

²⁸ IRC § 1.

- Postponing the receipt of distributions from a pension or profit-sharing plan until next year or taking annuity payments.
- Giving income-producing property to family members age 19 or over (unless they are full time students under age 24) before the right to income ripens.
- Delaying billing customers or clients until the beginning of the new year.
- Delaying the completion of sales and contracts, finishing construction jobs, etc.
- Purchasing Treasury bills, certificates of deposit, and other investments that will mature in the next year (provided that the taxpayer is a cash-basis taxpayer).
- Making additional contributions to qualified plans or IRAs, if available.
- Making additional contributions to an Archer Medical Savings Account (MSA)²⁹ or health savings account (HSA).³⁰

If the employer, for reasons of his or her own, defers payment of a year-end bonus until January, the employee recognizes the income in the new year. But the employer must not give the employee a choice as to when payment is to be made because the employee would then be deemed to be in constructive receipt when the choice is presented, unless the payment is subject to a substantial risk of forfeiture, in which case deferral is proper until the risk of forfeiture ends. In the more typical cases where the employee is given a choice of timing, the employee must report the income in the prior year when the employee constructively received it.³¹

.02 Accelerating Income

One of the practical ways an individual has to accelerate income is to make profitable sales of assets this year instead of next year. Again, as indicated above, harvesting capital gains in 2012 may prove to be an excellent planning strategy to lock in the 15 percent capital gains rate.

A redemption of U.S. savings bonds can accelerate interest income. Distributions from traditional IRAs or qualified plans can be accelerated. Dividends can be taken out of a closely held corporation. Sending bills to clients early enough so collection during the current year is expected might be an effective way to accelerate income. Similarly, completing sales, contracts, and construction jobs may help.

.03 Postponing Deductions

Here are the major ways of postponing deductions:

- Delay the sale of a loss investment.
- Delay payment of deductible items (if doing so does not impair credit standing or incur late charges).
- Postpone charitable contributions.

.04 Accelerating Deductions

An individual may accelerate into this year certain deductions he or she would otherwise take next year. These strategies would not be recommended if the tax rates increase for the subsequent year over what they are in the current year. He or she may accelerate deductions by doing the following:

- Double up on charitable contributions, making next year's and this year's currently; a pledge will not do.

²⁹ IRC § 220.

³⁰ IRC § 223.

³¹ IRC § 451 and Reg. § 1.451-2.

- Take losses on investments.
- Prepay state or city income taxes. Where the taxing authority has the estimated tax system, this will generate a deduction. If the taxing authority does not have such a system, prepayment will be deductible if the authority accepts it as *payment*, not merely as a deposit against future tax.
- Prepay property taxes. The IRS will allow a deduction for prepayment of property taxes if the taxing authority accepts amounts tendered as payment, not as a deposit against future taxes.
- Incur above-the-line expenses early, such as moving expenses or self-employed health insurance premiums.

In general, a deduction for prepaid interest is allowable only in the tax year in which the interest is earned or accrued.³²

¶3310 Year-End Planning for Securities Transactions

The tax rate for most net capital gains realized through the end of 2012 is 15 percent. For taxpayers in the 10-percent or 15-percent marginal rate brackets for ordinary income, the tax rate for most net capital gains realized in tax years 2008 through 2012 is 0 percent. For tax years beginning in 2013 and later, the tax rates of 20 percent and 15 percent on net capital gains that were in effect before the Jobs and Growth Tax Relief Reconciliation Act of 2003 will apply once again. In addition, the new Medicare Tax of 3.8 percent on net investment income will be applicable in 2013. This tax will apply to single taxpayers with adjusted gross income over \$200,000, married taxpayers filing joint returns with adjusted gross income over \$250,000, and married persons filing separately with adjusted gross income over \$125,000. It will apply to trusts and estates with adjusted gross income of approximately \$12,000.

A net capital gain is the excess of a net long-term capital gain over any net short-term capital loss. However, a rate of 28 percent applies to long-term capital gains from sales or exchanges of collectibles, and a rate of 25 percent applies to unrecaptured Code Sec. 1250 gain (depreciation recapture on real estate). Losses for each long-term tax-rate group will be used to offset gains within the group. If a long-term tax-rate group has a net loss, the loss will be used first to offset net gain for the highest long-term tax-rate group, then to offset the next highest tax-rate group, and so on.

Example 33.1. Bob Smith has a net loss for the 15-percent tax-rate group. That net loss will be used first to offset any net gain in the 28-percent group, and then net gain in the 25-percent group (gains on depreciation recapture under Code Sec. 1250).

A carryover of a net long-term capital loss from a prior year can be used first to offset net gain for the long-term highest tax-rate group, and so on.

A net short-term capital loss (that is, a net loss from capital transactions involving holding periods of one year or less) can be used to first offset net gain for the highest long-term tax-rate group, and so on.

Comment. Code Sec. 1(h) provides the tax rates on the various categories of capital gains. The IRS announced their interpretation of these rules in Notice 97-59.³³ Taxpayers could not get a much better interpretation of the rules on treatment of capital losses. From a year-end tax planning perspective, taxpayers who accelerate the recognition of a net loss in the 15-percent group can use it to offset net capital gains otherwise taxable at the 28-percent rate, rather than having to wait to use them to offset 15-percent rate gains in the next year.

³² IRC § 461(g).

³³ 1997-2 CB 309.

¶3315 Year-End Planning Ideas

Consider the following year-end financial planning ideas before the close of December.

.01 Gifts

The client could make as many annual exclusion (\$13,000 for 2012 and indexed annually for inflation) gifts to donees (double the amount of annual exclusion gifts if the client is married and the spouse consents to “split” the gifts) as he or she desires. The annual gift tax exclusion per donee is lost if not used before the end of the year.³⁴ The special opportunity available in 2012 to use at least a portion of the lifetime gifting exemption of \$5,120,000 per donor (\$10,240,000 for married couples splitting their gifts) should be considered. This exemption is scheduled to be reduced to \$1 million per donor in 2013, absent further legislation. It is certainly possible that 2012 will be the last year that such a generous gift tax exemption is available.

.02 Charities

Compute the maximum charitable income tax deduction that the client may be allowed for the year and advise the client to make charitable donations accordingly.³⁵

.03 Losses

If a client wants to recognize a year-end loss, he or she should not sell securities to a family member. Such a loss will not be allowed on the client's income tax return, since losses on sales to related parties are generally not recognized. For this purpose, a family member means a spouse, brother, sister, ancestor or lineal descendant. However, a loss realized on a sale to an in-law, aunt, uncle, nephew, niece, cousin, or unrelated person will be recognized.³⁶

.04 Spouse's Gains and Losses

If a client is married and files jointly, he or she should double-check each spouse's capital gains and losses. Capital gains realized by one spouse may be offset by capital losses incurred by the other. This rule applies even though each spouse owns securities in his or her own name.

.05 Basis

A client should not make a gift of stock or other property that has declined substantially in value since he or she bought it. If the client does so, the donee's basis for determining a loss is the lower of the donor's basis or the fair market value of the transferred property at the time of gift.³⁷ Thus, the client will probably do better if he or she sells the property, realizes a capital loss for tax purposes, and then makes a gift of the proceeds of sale.

.06 Dividend Income

To shift some dividend income to a lower bracket member of the family, a client could make a gift of the dividend-paying security before the year-end dividend is declared. It will then show up on the donee's income tax return, not the donor's. However, the client should keep in mind the income tax rules for minors and full-time students subject to the kiddie tax. Qualified dividends received through December 31, 2012, are generally taxed at 15 percent. For tax years 2008 through 2012, qualified dividends are taxed at 0 percent to taxpayers in the 10-percent or 15-percent rate brackets.

³⁴ IRC § 2503(b) and IRC § 2513.

³⁵ IRC § 170.

³⁶ IRC § 267.

³⁷ IRC § 1015(a).

.07 Keogh and SEP Plans

For self-employed individuals, a Keogh plan must be set up before the end of the year. However, a self-employed individual may establish a SEP plan up to the extended due date of his or her income tax return. A self-employed individual may make contributions to either plan up to the filing of a timely income tax return.

¶3320 Year-End Planning for Estimated Taxes

Generally, a taxpayer may avoid the penalty for underpayment of estimated taxes by making timely payments of estimated taxes that exceed 90 percent of the current year's tax liability or 100 percent of the prior year's tax liability.³⁸ To use the 100 percent of the prior year's tax liability exception, the taxpayer must have filed a tax return for the prior taxable year. In addition, the prior taxable year must have been a 12-month taxable year. However, if the taxpayer's AGI was greater than \$150,000 in the preceding year, the taxpayer must pay 110 percent of the prior year's tax liability in timely estimated payments to avoid the underpayment penalty.³⁹

The penalty does not apply if the gross tax liability minus withholding is less than \$1,000.⁴⁰ In addition, the penalty will not apply if the taxpayer did not have any tax liability in the preceding tax year if the preceding tax year was a 12-month year and the taxpayer was a U.S. citizen or resident for the preceding tax year.⁴¹ For this purpose, tax liability refers to gross tax liability rather than net tax due. The Code treats tax withheld as though paid in equal amounts on the due dates for estimated payments.⁴²

Thus, a taxpayer may be able to reduce or avoid the penalty for underpayment of estimated tax by having tax withheld late in the year. A taxpayer who owns a corporation can pay a bonus to himself or herself and withhold income tax to avoid or reduce the penalty. The bonus must qualify as reasonable compensation.⁴³

¶3325 New Year Planning

Tax planning is not limited to a particular time of year, but it is something that requires consideration throughout the year. In fact, the earlier the process begins, the easier the taxpayer can achieve maximum tax savings. A client should consider the following planning opportunities because they also represent wealth-building strategies.

.01 Reducing AGI

The reduction of adjusted gross income (AGI) can be important because of the impact of Code Sec. 68, which reduces itemized deductions (except medical, casualty, theft, investment interest and wagering losses) for taxpayers with AGI in excess of specified phase-out amounts. The reduction of itemized deductions (the "Pease" deduction) has been suspended through 2012 and is scheduled to resume in 2013.

Reduction of AGI is also important because of the phase-out of personal exemptions on AGI in excess of specified phase-out thresholds. This phase-out has been suspended through 2012 and is scheduled to resume in 2013. Once the phase-out is restored, the personal exemption amount will be completely phased out for some taxpayers.

³⁸ IRC § 6654(d)(1)(B).

³⁹ IRC § 6654(d)(1)(C).

⁴⁰ IRC § 6654(e)(1).

⁴¹ IRC § 6654(e)(2).

⁴² IRC § 6654(g)(1).

⁴³ IRC § 162(a).

To reduce AGI, consider the following:

- Traditional IRA contributions.
- Salary reduction plans (401k plans and 403b plans).
- Keogh contributions.
- SEP plan contributions.
- SIMPLE plan contributions.
- Use of pretax dollars to fund a flexible spending account, an Archer medical savings account, or a health savings account.
- Voluntary contributions to a qualified plan (takes income earned on contributions out of an individual's gross income).
- Deferred compensation arrangements.
- Tax-exempt income.
- Converting taxable earned income into tax-favored fringe benefits, such as accident and health insurance, group-term life insurance, company below-market loans, educational assistance, and company services and products acquired at discounts.

Note. The earlier in the year the taxpayer takes these steps, the greater the benefits.

.02 Family Gifts

A taxpayer can make gifts of income-producing property to family members to remove the income from the property from his or her gross income.

.03 Capital Gains

Income from most net capital gains realized through the end of 2012 is taxed at a maximum rate of 15 percent. However, for taxpayers in the 10 percent and 15 percent regular tax brackets, the capital gain rate is only zero percent for 2008 through 2012. Consider transferring capital assets held for more than one year to family members who may be eligible for the zero percent bracket to eliminate tax on the gains. (Be careful of transfers to children who may be subject to the kiddie tax).

.04 Personal Interest

Convert nondeductible personal interest to deductible qualified residence interest through the use of a home equity loan.

.05 College Savings Plan

The earlier in the year the client contributes to the plan (a Section 529 plan), the better. Interest (or other return) on the contributed funds will not be taxed to the client or to the beneficiary of the college fund.

.06 Employment of Family Members

Owners of family businesses receive tax deductions on compensation paid to family members. In addition, wages paid to one's child under the age of 18 are exempt from FICA tax.⁴⁴ Senior family members under age 66 who receive Social Security benefits may have compensation tailored to minimize loss of benefits. Social Security recipients who are age 66 or older no longer lose Social Security benefits because of compensation.

⁴⁴ IRC § 3121(b)(3)(A).

.07 Minimum Distributions from Retirement Plans

Delaying the receipt of the required minimum distributions for persons who have attained age 70½ until year-end allows the taxpayer to take full advantage of tax deferral.

.08 Use of Installment Sale

Can defer payment of tax and possibly reduce tax for those who will be eligible for the lowest capital gain tax rate when the payments are received.

.09 Dependency

Faced with the possible phase out of a dependent's exemption, a taxpayer may want to consider discontinuing the individual's dependent status. This will enable the former dependent to claim his or her own personal exemption, lower-bracket tax status, and the full standard deduction. If the dependent is of college age, not claiming the person as a dependent may allow the person to be eligible for an available tuition deduction or credit, as the law may permit.

¶3330 Understanding and Planning for the 2013 Medicare Tax on Net Investment Income

A new Medicare tax is part of the Affordable Care Act. The new tax has been referred to as the "Health Care Surtax". It will apply for tax years beginning January 1, 2013.

.01 How will this new tax work?

A new Medicare surtax of 3.8 percent will be assessed on the lesser of a taxpayer's net investment income (NII) or the excess of the taxpayer's Modified Adjusted Gross Income (MAGI) over what is referred to as the "threshold amount".

.02 What is considered to be net investment income?

For purposes of this new tax, net investment income includes the following items:

- Interest.
- Dividends.
- Capital Gains.
- Rental income.
- Royalty income.
- Annuities.
- Passive Activity income.

Net investment income does not include the following items:

- Wages, salaries and income from self-employment.
- Income derived from the conduct of an active trade or business.
- Distributions from IRAs or from qualified retirement plans.
- Income which is described as interest, dividends, capital gains, rents, and royalties if such income is derived from the conduct of an active trade or business.

.03 What is meant by “Modified Adjusted Gross Income” and what is the “threshold amount”?

The term “Modified Adjusted Gross Income” as used in the new law refers to adjusted gross income as calculated in accordance with the standard rules for determining adjusted gross income on Line 37 of Form 1040, plus the amount of the net foreign income exclusion amount, if any, that the taxpayer is entitled to claim.

The threshold amount is determined based on the filing status of the taxpayer. The threshold amount for married taxpayers filing joint returns is \$250,000. The threshold amount for married taxpayers filing separate returns is \$125,000. The threshold amount for single taxpayers is \$200,000. The threshold amount for trusts and estates is the annually indexed amount where the top rate of federal income tax begins, i.e. \$11,650 in 2012 and projected to be approximately \$12,000 in 2013.

Note that the threshold amounts are not indexed for inflation, with the exception of the threshold amount that will be applied in the case of trusts and estates. That suggests that more and more taxpayers will eventually become subject to this tax as compensation or earnings increase and inflation is taken into account.

Example 33.1. Tom and Terry Taxpayer are a married couple filing a joint return. Their net investment income for 2013 will be \$45,000. Their other income will be \$150,000. Assume no deductions. Their total Modified Adjusted Gross Income (MAGI) is \$195,000. They will not be subject to the new Medicare tax.

Example 33.2. Charles and Cara Citizen are a married couple filing a joint return. Their net investment income for 2013 will be \$10,000. Their other income will be \$280,000. Assume no deductions. Their total MAGI will be \$290,000. This exceeds the threshold amount of \$250,000. They will owe \$380 of new Medicare tax i.e. the lesser of 3.8 percent of their net investment income ($10,000 \times 3.8\% = \$380$) or the excess of MAGI over the threshold amount ($290,000 - 250,000 = 40,000 \times 3.8\% = \$1,520$).

.04 Is planning possible to limit or avoid the new Medicare tax?

There are two broad areas to address in planning. First, see if anything can be done to reduce the amount of the taxpayer's MAGI. This suggests such planning maneuvers as making maximum contributions to qualified retirement plans and deductible IRAs. It suggests consideration of conversion of a traditional IRA to a Roth IRA in 2012 while the effective income tax rates are lower and to remove the IRA withdrawals, whenever made, from the taxpayer's MAGI.

A second area of planning is to concentrate investments in those categories of income that will not be considered “net investment income”. Here, investment in tax-free municipal bonds may be suggested. Deferred annuities will not produce net investment income until the deferral period is over. Similarly, non-qualified deferred compensation plans will defer income, keeping it out of MAGI, and then when income is realized it will not be considered net investment income. The cash values of life insurance contracts and loans taken from such contracts are not considered net investment income. Real estate investments may produce rental income, but much or all of such income may be offset by depreciation deductions. Charitable remainder trusts can be used here. Payments from such trusts are not considered to be net investment income. Other techniques, such as the use of installment sales and like kind exchanges can be used to manage the timing and amounts of both MAGI and net investment income.

Special concerns may arise for beneficiaries of trusts and estates. There may be added pressure on fiduciaries to make discretionary distributions of income, especially when the beneficiary may not be liable for the new Medicare tax, and the entity will be so subject. The financial planner may suggest to trust grantors that they put instructions into their documents addressing how much discretion the fiduciary may exercise if there is distribution “pressure” from beneficiaries arising from concerns about this tax.

Additional Resources from the AICPA PFP Division

For more information on planning for the Medicare tax and other changes in 2013, PFP/PFS members may access the *Proactive Planning in Preparation for 2013 Toolkit* available on the PFP website (aicpa.org/PFP/ProactivePlanning). With so many unknowns in 2013 compounded by an election year, your clients need to take advantage of many financial planning avenues now to avoid missing crucial opportunities to protect their nest egg and increase their net worth. Use the following resources to help prepare your clients for the potential 2013 tax hikes:

- 2012 Capital Gains Harvesting Chart and many other planning flowcharts by Bob Keebler
- Seminar recordings and slide decks for *Proactive Planning in Preparation for 2013* webinar series
- Customizable client communication resources including sample client letters and PowerPoint presentations to illustrate issues and planning strategies
- Checklists to plan for the Medicare surtax for individuals, trusts, and estates
- Podcasts
- More than 50% discount on *Preparing Your Client for the 2013 Tax Increases: Tools, Tips and Tactics* by Bob Keebler (includes a calculator to determine whether gain harvesting makes sense for your clients)
- And more. . .

Resources will continually be added to this toolkit as they are available.

To access additional chapters of *The CPA's Guide to Financial and Estate Planning*, you must be a PFP Section member or PFS credential holder.

For more information on PFP Section membership, visit www.aicpa.org/PFPSectionOffer.

For more information on obtaining the PFS credential, visit www.aicpa.org/CPAFinancialSpecialist.