Chapter 33

Year-End and New Year Tax Planning

¶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 client should 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 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[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.

.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 2011. Inflation adjusted amounts can be found in Rev. Proc. 2010-40.[4]

- **Roth IRA contributions.** Phased out beginning at AGI of $169,000 for married couples filing jointly ($0 for married persons filing separately) or $107,000 for single taxpayers.[5]
- **Contributions to Coverdell Education Savings Accounts.** Phased out beginning at AGI of $190,000 for married couples ($95,000 for single taxpayers).[6]

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[1] IRC § 36.
[2] IRC §§ 63, 164.
[3] IRC § 168, as extended by the 2010 Tax Reform Act.
[4] 2008-45 IRB 1107 (October 16, 2008).
[5] IRC § 408A(c)(3).
[6] IRC § 530(c)(1)(A)(i).

- **American Opportunity credit.** Phased out beginning at AGI of $160,000 for married couples ($80,000 for single taxpayers).[7]
- **Lifetime Learning credit.** Phased out beginning at AGI of $100,000 for married couples ($50,000 for single taxpayers).[8] These amounts are indexed for inflation.[9]
- **Child tax credit.** Phased out beginning at AGI of $110,000 for married couples ($75,000 for single taxpayers and $55,000 for married filing separately).[10] These amounts are not adjusted for inflation.
- **Education loan interest deduction.** Phased out beginning at AGI of $120,000 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 at AGI of $90,000 for married couples filing jointly or qualifying widow(er)s. The phase out threshold is $56,000 for a single taxpayer. The phase out threshold for a taxpayer who is not an active participant but whose spouse is an active participant is $169,000.[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 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 at AGI of $106,650 for married couples filing jointly ($71,100 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]

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

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[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).
[21] IRC § 67.
[22] IRC § 213(a).

theft losses[23] 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]

¶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 opportunities for an individual to postpone income are limited. 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
- 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 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]

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[23] IRC § 165(h).
[24] IRC § 170.
[25] IRC § 55.
[26] IRC § 168.
[27] IRC § 55(b)(1)(A)(i).
[28] IRC § 1.
[29] IRC § 220.
[30] IRC § 223.

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. In such cases, 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.

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. 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.
- 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 2010 is 15 percent. For taxpayers in the 10-percent or 15-percent marginal rate brackets for ordinary income, the tax rate for

[31] IRC § 451 and Reg. § 1.451-2.
[32] IRC § 461(g).

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. 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.

¶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 2010 and 2011 and indexed to 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]

.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 income tax return. 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]

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[33] 1997-2 CB 309.
[34] IRC § 2503(b) and IRC § 2513.
[35] IRC § 170.
[36] IRC § 267.

.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 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 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.

.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. 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 subject to the kiddie tax. On the other hand, shifting dividend income might not be a good strategy in many cases. 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.

.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 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 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

[37] IRC § 1015(a).
[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).

to himself or herself and withhold 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 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.

To reduce AGI, consider the following:

- IRA contributions (deductible and nondeductible)
- 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

[43] IRC § 162(a).

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 Fund

The earlier in the year the client contributes to the fund, 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.

.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.

[44] IRC § 3121(b)(3)(A).

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