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2012 Year-end Tax Planning for Individuals

Year-end tax planning is always complicated by the uncertainty that the following year may bring and 2012 is no exception. Indeed, 2012 is one of the most challenging in recent memory for year-end tax planning. A combination of events – including possible expiration of some or all of the “Bush-era” tax cuts after 2012, the imposition of new so-called Medicare taxes on investment and wages, doubts about renewal of tax extenders, and the threat of massive across-the-board federal spending cuts – have many taxpayers asking how can they prepare for 2013 and beyond, and what to do before then. The short answer is to quickly become familiar with expiring tax incentives and what may replace them after 2012 and to plan accordingly.

“Bush-era” tax Cuts

The phrase “Bush-era” tax cuts is the collective term for the tax measures enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA). EGTRRA and JGTRRA made over 30 major changes to the Tax Code that are scheduled to sunset at the end of 2012.

Nothing adds complexity to year-end 2012 tax planning as much as uncertainty over the Bush-era reductions to individual tax rates. The 2010 Tax Relief Act extended the reduced individual income tax rates from the Bush-era tax cuts. Unless extended further, the reduced individual income tax rates will disappear after 2012 to be replaced by higher rates. The current 10, 15, 25, 28, 33 and 35 percent rate structure would be replaced by the higher pre-Bush 15, 28, 31, 36 and 39.6 percent rates.

Unless Congress takes action, the tax rates on qualified capital gains and dividends are also scheduled to increase significantly after 2012. The current favorable rates of zero percent for taxpayers in the 10 and 15 percent brackets and 15 percent for all other taxpayers will be replaced by pre-2003 rates of 10 percent for taxpayers in the 15 percent bracket and a maximum 20 percent rate for all others. In addition, dividends will be subject to the ordinary income tax rates. The maximum rate on five-year property will be 18 percent (8 percent for those in the 15 percent bracket).

3.8 Percent Medicare Contribution Tax

Taking effect immediately on January 1, 2013, the Medicare surtax will be imposed on a taxpayer's "net investment income" (NII) and will generally apply to passive income. The Medicare surtax also will apply to capital gains from the disposition of property. However, the Medicare surtax will not apply to income derived from a trade or business, or from the sale of property used in a trade or business. For individuals, the Medicare surtax is based on the lesser of the taxpayer's NII or the amount of "modified" adjusted gross income (MAGI) (AGI with foreign income added back) above a specified threshold.

The MAGI thresholds are:

- \$250,000 for married taxpayers filing jointly or a surviving spouse;
- \$125,000 for married taxpayers filing separately; and
- \$200,000 for single and head of household taxpayers.

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.

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 and \$125,000 for married couples filing separately) will be subject to a 2.35 percent Medicare tax rate. The additional Medicare tax is also applicable for the self-employed.

End of Payroll Tax Holiday

For the past two years, the employee's share of Old Age, Survivors and Disability Insurance (OASDI) taxes 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.

Alternative Minimum Tax

The alternative minimum tax (AMT) 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 sunset of the regular 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.

Personal Exemption/Itemized Deduction Phaseouts

Higher income taxpayers may also be subject to the return of the personal exemption phaseout 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 phaseout rules would reduce or eliminate the deduction for personal exemptions for higher income taxpayers starting at “phaseout” 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 (\$89,075) for a married individual filing separately), or
- 80 percent of the itemized deductions otherwise allowable for the tax year.

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.

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 phaseouts.

Other Tax Extenders for Individuals

- 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, 2103.
- 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.
- 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.
- Two incentives, the residential energy property credit, and the residential energy efficiency credit, are designed to reward taxpayers who, on the consumer level, make qualified energy improvements. The residential energy property credit expired after 2011. The residential energy efficiency credit is scheduled to expire after 2016.

Individual Tax Planning

Year-end planning for 2012 requires a combination of multi-layered strategies, taking into account a variety of possible scenarios and outcomes. Traditional year-end planning techniques nevertheless remain important. Particularly as applied to the special 2012 year-end circumstances discussed in this letter, the following income acceleration and reciprocal deduction/credit deferral techniques should be considered:

Income Acceleration:

- Sell outstanding installment contracts
- Receive bonuses before January
- Sell appreciated assets
- Redeem U.S. Savings Bonds
- Declare special dividend
- Complete Roth conversions
- Accelerate debt forgiveness income
- Maximize retirement distributions
- Accelerate billing and collections
- Avoid mandatory like-kind exchange treatment
- Take corporate liquidation distributions in 2012

Deductions/Credit Deferral

- Bunch itemized deductions into 2013/Standard deduction into 2012
- Postpone bill payments until 2013
- Pay last state estimated tax installment in 2013
- Postpone economic performance
- Watch AGI limitations on deductions/credits
- Watch net investment interest restrictions
- Match passive activity income and losses

Every tax situation is different and requires a careful and comprehensive plan. We can assist you in aligning traditional year-end techniques with strategies for dealing with the uncertainties created by Congress's delay in addressing sunseting tax rates and the extension of other major tax benefits. Please call our office for an appointment.