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Sent: Tuesday, October 29, 2013 8:33 AM
To: Jack Burson
Subject: CPA Client Bulletin - November E-Newsletter

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Client Bulletin

Smart Tax, Business & Planning Ideas *from your* **Trusted Business Advisor**SM

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November 2013

Special Issue: 2013 Tax Planning Roundup

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Planning for "Permanent" Tax Laws

The American Taxpayer Relief Act of 2012 (ATRA) was signed into law earlier this year. Many provisions of this tax law are permanent, or at least they'll be permanent until they're changed. Thus, they have no "sunset" date, so you can plan with some normalcy as we near the end of 2013.

ATRA's main provisions cover both income and estate taxes. On the income tax side, the law—along with provisions of health insurance legislation that took effect in 2013—widened the gap between taxpayers deemed to have high incomes and those with lower incomes. Speaking generally, taxpayers with annual income over $200,000 may have to be concerned with higher tax rates, additional taxes, and phaseouts of tax benefits. Taxpayers with lower incomes will continue to enjoy relatively low rates. Therefore, year-end tax planning should include efforts to reduce gross income, for high bracket taxpayers, while perhaps recognizing taxable income in low brackets.

In terms of estate tax, ATRA relieves most individuals and families from concerns about federal estate tax. However, residents of states with state estate tax still can engage in tax planning. Moreover, some traditional estate

planning strategies can offer income tax savings now and in the future.

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Year-End Tax Planning for Investors

As of this writing, the U.S. stock market is near record levels, heading for its fifth straight year of positive returns. Therefore, you might not have many opportunities for tax loss harvesting in 2013. Nevertheless, if you still hold stocks depressed from the crash of 2008-2009, this may be a good time to take capital losses.

Bonds drop back

The bond market has retreated in 2013, so you might have losses on individual bonds and bond funds. Especially for upper income investors, taking losses on bonds by year-end might save tax.

Example 1: Doug Harris has taxable income over $450,000 in 2013. Consequently, he faces a 20% tax rate on long-term capital gains in 2013. Doug also will owe a 3.8% surtax on net investment income, under the Affordable Care Act. Counting state income tax as well as a phaseout of itemized deductions and personal exemptions, Doug might owe 30% in tax on long-term capital gains.

In December, Doug tallies his capital gains and losses for the year so far; he also contacts his mutual funds to ask about expected capital gains distribution in 2013. Counting his net long-term capital gains in 2013 and expected mutual fund distributions, Doug anticipates reporting $40,000 of gains for the year, so he could owe $12,000 in tax on those gains at an effective 30% rate.

Instead, Doug sells enough investments to incur $50,000 worth of losses by year-end 2013. Now, he has a $10,000 net loss to report for the year. Under the tax code, Doug can deduct up to $3,000 worth of net capital losses for the year. Instead of owing $12,000 on net gains, Doug has a $3,000 loss.

Doug's loss will reduce his taxable income, which is taxed at a combined federal and state marginal rate of more than 40%. Thus, a reported $3,000 net capital loss will save Doug more than $1,200 of income tax, altogether, when he files his 2013 return next year. After deducting $3,000 for 2013, Doug will have a $7,000 remaining net capital loss that he can carry over to future years.

Watch out for wash sales

To take his capital losses, Doug Harris sold securities. He wants to reinvest the money he received. However, if Doug immediately repurchases the same securities he sold, or if he buys securities that are substantially identical, he won't be able to deduct the capital losses on his 2013 tax return.

In order to avoid a so-called "wash sale," Doug has a few options. He can hold the money in cash for at least 31 days. Then Doug can buy anything he wants, including the securities he sold for a loss.

As another alternative, Doug can reinvest right away, as long as he avoids purchasing the assets he sold at a loss. If Doug sold a long-term bond fund from one company at a loss, he can immediately buy a long-term bond fund from a different company. As long as the second fund does not hold the same bonds as the first fund, Doug won't have a wash sale.

Swap and shop

In a year when bonds have lost value, such as 2013, bond swapping emerges as a viable strategy. A bond swap is not a trade, like an exchange of baseball cards. In a bond swap, an investor sells bonds and buys similar bonds.

Example 2: Linda Powers holds $100,000 worth of municipal bonds that she

On Line Accountant

Trusted Advice

Taking Expensing Deductions

- To qualify for the Section 179 expensing deduction, the property must have been acquired for use in the company's trade or business.
- Property you acquire only for the production of income, such as investment property, rental property (if renting property is not your trade or business), and property that produces royalties, does not qualify.
- When you use property for both business and nonbusiness purposes, you can elect the Section 179 deduction only if you use the property more than 50% for business in the year you place it in service.
- If you use the property more than 50% for business, multiply the cost of the property by the percentage of business use. Then you can use the resulting business cost to calculate your Section 179 deduction.

bought 4 years ago at par. The bonds mature in 15 years, they have an A rating, and the coupon rate is 6%. Those bonds are now worth $90,000.

Linda sells those bonds and uses the $90,000 to buy municipal bonds from a different issuer. The new bonds, which mature in 15 years, also have an A rating and a 6% coupon. Thus, Linda gets a $10,000 capital loss, for tax purposes, yet her portfolio is essentially unchanged. Typically, if you acquire a bond with a different issuer, maturity, or coupon rate, your bond swap won't be considered a wash sale.

Nothing doing

As explained, you may be able to reap tax advantages by selling securities at a loss. In other situations, you might save tax by selling securities at a gain; that's because ATRA made the 0% tax rate a permanent part of the Internal Revenue Code. In 2013, income from qualified dividends and long-term capital gains are taxed at 0%, for certain taxpayers. To get that 0%, you must be a single taxpayer with taxable income (after deductions) no higher than $36,250, or up to $72,500 on a joint return.

Example 3: Matt Allen bought shares in a stock fund in 2009 for $20,000. Those shares are now worth $35,000, and Matt fears a market correction. If he sells those shares, he would owe 15% on the long-term capital gain; Matt's modified adjusted gross income (MAGI) is over $200,000, so he also will owe the 3.8% Medicare surtax.

Instead, Matt gives the shares to his retired parents, who generally report about $50,000 of taxable income on their tax return. The senior Allens sell the shares and owe no tax on the $15,000 gain because their taxable income is still below $72,500 for the year.

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Year-End Tax Planning for Retirement

For most workers, contributing to an employer sponsored retirement plan usually is a good idea. In 2013, since passage of ATRA, making full contributions to plans such as 401(k)s can be an especially valuable tactic for high-income workers who are close to retirement. These contributions reduce gross income and taxable income, thus, decreasing your exposure to all the taxes imposed on people in high brackets. Ideally, you'll take distributions in a lower tax bracket once you stop working.

In 2013, most people can contribute up to $17,500 to 401(k) s and similar plans. If you'll be 50 or older by December 31, the ceiling is $23,000. Check to make sure you're contributing as much as your budget permits, up to the annual ceiling. On the other hand, young workers with relatively low incomes might minimize deductible 401(k) contributions for the year, putting in enough to get a full employer match but saving money beyond that for a 2013 Roth IRA contribution by next April 15. All Roth IRA distributions will be tax-free after 5 years and after age 59½.

Conversion factors

The tax code now contains many income-based tax provisions. For example, individuals with modified adjusted gross income (MAGI) over $200,000 ($250,000 on joint returns) may have to contend with a 3.8% surtax on net investment income. Other provisions take effect at various income levels. Therefore, it can be crucial to avoid going over these thresholds.

One way to fine tune your MAGI, AGI, and taxable income amounts is to execute a full Roth IRA conversion at year-end 2013. Any time until October 15, 2014, you can recharacterize (reverse) all or part of that conversion to arrive at precise income levels.

Example 1: Ian Martin has $300,000 in his traditional IRA. In December 2013, he converts the entire amount to a Roth IRA. When Ian has his 2013 tax return prepared, he asks his CPA to determine the Roth IRA conversion with the ideal tax result. Ian's CPA determines that a $75,000 conversion (25% of the original conversion) will keep Ian and his wife, Alicia, in the 28% tax bracket, which goes up to $223,050 of taxable income on a joint return in 2013.

Thus, Ian recharacterizes 75% ($225,000/$300,000) of the amount then in his Roth IRA. That amount reverts to his traditional IRA. The Martins owe $21,000 in tax on the Roth IRA conversion: 28% times $75,000, which they can pay out of non-IRA funds. The Martins avoid moving into the 33% tax bracket; they also may avoid such extra taxes as the 3.8% Medicare surtax and the phaseout of itemized deductions.

Meanwhile, Ian has moved one-fourth of his traditional IRA to a Roth IRA. After 5 years and after age 59½, he can take completely tax-free distributions from his Roth IRA, regardless of future income tax rates. Under the tax code, all Roth IRA conversions have a January 1 starting date for the 5-year test. Thus, Ian's December 2013 conversion will meet that requirement in just over 4 years, in January 2018.

Divide and conquer

Ian's plan, as described, is good but could be better. Instead of one $300,000 Roth IRA conversion, he could convert his traditional IRA into multiple Roth IRAs, holding different investments. By converting the losers and letting the winners ride, Ian could improve his results from this so-called "look back" opportunity.

Example 2: At year-end 2013, Ian converts his $300,000 traditional IRA into a $100,000 Roth IRA holding domestic stock funds, a $100,000 Roth IRA holding foreign stock funds, and a $100,000 Roth IRA holding bond funds. In early October 2014, his domestic stock Roth IRA is worth $120,000, his international stock Roth IRA is worth $95,000, and his bond Roth IRA is worth $97,000.

Ian's CPA runs the numbers and says the ideal plan would be for Ian to recharacterize 75% of his original Roth IRA conversion. Thus, Ian recharacterizes the entire international Roth IRA, the entire bond Roth IRA, and $30,000 (25% of the amount originally converted plus 25% of the net income attributable to it) of his domestic stock Roth IRA.

By following this plan, Ian avoids paying tax on a $100,000 Roth IRA conversion to hold $95,000 worth of foreign stocks and he avoids paying tax on a $100,000 Roth IRA conversion to hold $97,000 worth of bonds. He winds up paying tax on a $75,000 Roth IRA conversion (75% of his original $100,000 conversion) to hold $90,000 worth of domestic stocks. Eventually, Ian may be able to withdraw that $15,000 in gains, tax-free.

That's the result from this split conversion. If Ian had just one Roth IRA, which grew from $300,000 to $312,000 before a $234,000 recharacterization (75% of the original amount converted plus 75% of the net income attributable to it), he would have paid tax on a $75,000 conversion (25% of his original $300,000 conversion) for a Roth IRA worth $78,000. Ian would have $3,000 of potential tax-free gains, not $15,000.

To execute this strategy, you can use any types of different investments in any number of Roth IRAs. Our office can help you calculate the most tax-efficient amount to recharacterize after one or more Roth IRA conversions. ■

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Year-End Estate Tax Planning

In 2013, the annual gift tax exclusion increased from $13,000 to $14,000. That is, each individual can give up to $14,000 worth of assets to any number of recipients with no tax consequences. (Married couples can give up to $28,000 per recipient.)

Example 1: Marjorie Palmer gives $14,000 to her son Nick, $14,000 to her daughter Olivia, and $10,000 to her friend Paula, whose home was severely damaged in a storm. Marjorie does not have to file a gift tax return, and she will not

lose any of her lifetime gift tax exemption or her estate tax exemption.

In this example, Marjorie's net worth is between $2 million and $3 million. She does not expect to owe federal estate tax, because the exemption is $5.25 million in 2013 and likely to increase in the future. However, Marjorie lives in a state where the estate tax exemption is $1 million. Thus, these gifts will trim her estate's eventual exposure to state estate tax.

People with much larger estates also should consider making gifts up to $14,000 by year-end to reduce future federal and possibly state estate tax. If you don't make the gift in 2013, you can't double up in 2014. That is, Marjorie can't give $28,000 to Nick in 2014 and spread that gift over 2013 and 2014 for gift tax purposes.

Income tax tactics

As federal estate tax concerns fade for most people, income taxes are rising for high bracket individuals and couples. Even if you are not concerned with state or federal estate tax, using the annual gift tax exclusion may help to reduce your income tax bill.

Example 2: Len and Karen Young have taxable income over $450,000 a year. Therefore, they owe a 20% tax on income from qualified dividends and a 3.8% Medicare surtax. Len gives $14,000 worth of dividend paying stocks to their daughter, Jill, who is a 25-year old graduate student with little income; Karen makes similar gifts. In January 2014, the senior Youngs repeat those gifts.

Altogether, Len and Karen transfer $56,000 of dividend paying stocks to Jill, who will owe 0% tax on those dividends as long as her income is low. Similarly, high bracket taxpayers might use the annual gift tax exclusion to transfer assets before a planned sale.

Example 3: Suppose that Len and Karen also have a son, Greg, who is buying a condo. The senior Youngs hold $100,000 worth of appreciated mutual funds they plan to sell at a long-term gain, fearing a correction, and they would like to help Greg buy the home.

Len and Karen could transfer $50,000 worth of the shares to Greg in December 2013 and another $50,000 worth of shares in January 2014. Each year, the couple's annual gift tax exclusions would cover $28,000 of the $50,000 gift, reducing the amount they would report on a gift tax return and reducing the impact on their gift and estate tax exemptions.

In this example, Greg could sell the appreciated shares and report the capital gain. Depending on the amount of the gain and Greg's taxable income, he might owe 0% on the sale. Even if Greg does not qualify for the 0% rate, he probably would owe 15% on the gain, less than his parents would owe in this example.

Thus, gifts of dividend paying stocks and appreciated assets can save income tax, especially if the gifts are to young adults or to retired parents with modest income. However, gifts to youngsters, including full-time students under age 24, may trigger the "kiddie tax"; in 2013, unearned income over $2,000 is taxed at the parent's rate, if reported by a so-called "kiddie." The kiddie-tax rules are complex, but our office can help you execute tax-efficient gifts to children and grandchildren. ■

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Year-End Tax Planning for Donations

Charitable contributions historically have provided tax benefits, and that may be especially true in 2013. Those contributions reduce your taxable income, which may keep you from moving into a higher tax bracket. Moreover, 2013 has been a rewarding year for investors, as reported previously in this issue, but taking gains that increase your gross income may trigger added taxes. Thus, giving appreciated securities held more than one year to charity can be an effective maneuver this year.

Example 1: Phil Roberts regularly donates $10,000 to his alma mater each year. He holds $20,000 worth of shares of ABC Mutual Fund, bought years ago for $10,000. Phil is considering selling the shares this year. Instead, Phil donates the $20,000 of fund shares to the university in December 2013, fulfilling his charitable intent for 2013 and 2014. With this donation, he gets a $20,000 tax deduction for 2013 and avoids tax on the $10,000 appreciation. In Phil's high tax bracket, federal and state taxes might have cost him around $3,000 on a sale generating a $10,000 long-term capital gain.

With this strategy, the $20,000 Phil would have donated in 2013 and 2014 stays in his checking account, so Phil can spend or reinvest that money. If you are interested in donating appreciated securities held more than a year, for a full tax deduction, contact the intended recipient. When you get the information from the charity, tell your financial adviser how the donation should be handled.

Multiple choice

The previously mentioned strategy can work well if Phil is making one $20,000 donation. Suppose, however, that Phil wants to make, say, donations of $2,000 to each of 10 different charities. Processing all those share transfers may be very cumbersome.

As an alternative, Phil can make a $20,000 donation to a donor advised fund. Many financial firms and community foundations offer such funds. Once the money is in the fund, Phil can simply advise the fund to make 10 $2,000 "grants" to his chosen charities. He can defer the grants until a future year and still get the upfront tax benefit if he transfers the shares to the donor advised fund in 2013.

Strategy for seniors

Although Congress made many recent tax law changes permanent, some provisions still must be renewed every year or two. For example, the so-called "IRA charitable rollover" is allowed in 2013 but its future fate is uncertain.

This tax benefit applies only to taxpayers age 70½ or older. If you are in that age group, you can transfer IRA money to a charity or charities of your choice, up to a total of $100,000 in 2013. Executed directly, such a transfer can satisfy your required minimum distribution (RMD) for the year.

Example 2: Eve Walker, age 75, has a large IRA. Although Eve does not need the money, she must take at least a $17,000 RMD from her IRA in 2013. So far this year, Eve has not taken any IRA distributions.

Eve typically donates $5,000 to each of her four favorite charities every year. This year, she transfers a total of $20,000 to the four charities from her IRA. The $20,000 distribution satisfies her $17,000 RMD for the year.

For these IRA charitable rollovers, Eve gets no charitable tax deduction. Why, then, should she do them? Because qualified charitable distributions do not count as taxable income. If Eve had taken her RMD for 2013, the $17,000 taxable withdrawal would have swollen her adjusted gross income (AGI) for 2013. A higher AGI, in turn, might have subjected Eve to special taxes or deprived her of certain tax benefits. ■

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Year-End Tax Planning for Business Owners

As mentioned previously, recent tax legislation contains several provisions that impose extra tax on high-income taxpayers, including those with income over $200,000. Often, such taxpayers are business owners. According to the National Federation of Independent Business, over 75% of all small businesses in the U.S. are taxed at the owner's individual rate. Many small companies are structured as S corporations, limited liability companies (LLCs), and other pass-through entities. With them, company profits are reported on the owner's tax return, so the owner may owe various additional taxes.

Buy now

Business owners in that situation may want to reduce business profits that flow through to their own tax return. One way to do so is to use Section 179 of the tax code, which lets businesses take a first year "expensing" deduction for equipment placed in service. The tax law that was passed early in 2013 set the expensing limit for this year at $500,000, with a dollar-for-dollar phaseout beginning at $2 million.

Example 1: ABC LLC buys $200,000 worth of equipment in December 2013, bringing the yearly total to $250,000. ABC can take a $250,000 expensing deduction, reducing the income that the LLC owners will report.

Suppose, though, that ABC buys a total of $2.1 million worth of equipment in 2013. ABC will be $100,000 over the phaseout base, so the company's first year deduction will be reduced from the maximum $500,000 to $400,000.

For 2014, the Section 179 deduction is now scheduled to drop to no more than $25,000, with a phaseout range starting at $200,000 of equipment purchases. Congress might increase those amounts, but for now it seems like loading up on

equipment purchases in late 2013 will be a savvy move.

Companies may take first-year expensing deductions under Section 179 for purchases of new or used equipment. Either way, the equipment must be placed in service by December 31 to qualify for a 2013 tax deduction. The day that you make the payment doesn't matter, for the purpose of this tax benefit, so you can actually pay for the equipment in 2014.

Other expenses

Besides purchasing equipment, business owners can take other steps at year-end to reduce company income and their 2013 tax bill. If you regularly pay bonuses to employees, you can pay them in December. Your company might be able to prepay state income tax and real estate property tax due early in 2014. You also might have the business make a charitable contribution by donating outdated equipment, including vehicles, or supplies to a school or another nonprofit organization that can use such items.

Retirement readiness

You also should check into your company's retirement plan, to see if it's ideal for your own personal purposes. If your company doesn't have a plan, you may still have time to set one up.

In 2013, the ceiling for contributions to a defined contribution plan is $51,000 per participant. Among defined contribution plans, profit sharing plans are popular. A profit sharing plan can include a Section 401(k) cash or deferred arrangement that allows employees to defer some of their salary while deferring income tax as well. The maximum $51,000 contribution, for high-income participants, can come from the employer and employee combined. Company contributions generally are tax-deductible.

Types of profit sharing plans include "age-weighted" and "new comparability" plans. These types of plans can be structured so that profit sharing contributions go largely to older, highly compensated employees, including owner-employees.

Example 2: DEF Co. has two co-owners in their late 50s and late 40s, respectively. The company's three other employees are younger, with relatively low salaries. A new comparability profit sharing plan might call for over $25,000 going to each owner's account one year while the other three employees receive company contributions under $2,000 apiece.

For any of these plans, you should consider the costs as well as the benefits. ■

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TAX CALENDAR

NOVEMBER 2013

November 12
Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the third quarter of 2013. This due date applies only if you deposited the tax for the quarter in full and on time.

November 15
Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in October if the monthly rule applies.

DECEMBER 2013

December 16
Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in November if the monthly rule applies.

Corporations. Deposit the fourth installment of estimated income tax for 2013.

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