Miller Verchota, Inc.
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Advances in Tax Planning

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What's Inside

Plan With a Certain Amount of Certainty

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. ■

Restoring a Higher Tax Bracket

For several years, through 2012, Americans paid income tax at six rates, ranging from 10% to 35%. Now, a higher rate has been added: 39.6%, which was the highest income tax rate as recently as 2000. In 2013, the 39.6% rate is imposed on income over

- $400,000 for single taxpayers,
- $450,000 for married couples filing joint returns and surviving spouses,
- $225,000 for married individuals filing separately, and
- $425,000 for heads of households.

The 39.6% tax rate, like all tax rates, is imposed on taxable income. That's the number you report after taking tax deductions.

Example 1: Ross Austin, a single taxpayer, has total income of $520,000 in 2013. After deductions, Ross has taxable income of $480,000.
Thus, $80,000 of his income will be taxed at the maximum 39.6% rate.

When 39.6% = 20%
Prior tax legislation capped the tax on most long-term capital gains at 15%. Taxpayers also owed no more than 15% on qualified dividends, which include most dividends paid to investors. The new law retains this relatively low ceiling for most people. However, taxpayers who have taxable

income in excess of the 39.6% rate threshold will owe 20% tax on their long-term gains and their qualified dividends to the extent that these gains and dividends would otherwise be taxed at the 39.6% rate.

Example 2: Ross Austin from example 1 has a $60,000 net long-term capital gain in 2013. Ross has $480,000 of taxable income, which is $80,000 over the threshold for the top bracket, so Ross owes 20% tax on his $60,000 capital gain.

Suppose, though, that Ross has a $100,000 long-term gain this year. Ross is $80,000 over the relevant threshold, so $80,000 of his gain will be taxed at the maximum 20% rate, whereas the other $20,000 of his gain will be taxed at 15%.

Shifting gears

Taxpayers below these higher income thresholds will continue to owe tax at rates as low as 10%. Moreover, taxpayers in low tax brackets will owe 0% on taxable long-term capital gains and qualified dividends. Therefore, income shifting strategies have a greater payoff now than they have had recently for high-income taxpayers. If you report substantial income, you may save more tax now by shifting income to children just beginning their career or to retired parents. Our office can go over these and other tax reduction strategies. ■

Lower Incomes, Higher Taxes

As explained in the previous article, "Restoring a Higher Tax Bracket," individuals with taxable income over $400,000 and married couples who exceed $450,000 generally will be the ones paying the restored 39.6% top income tax rate, as well as higher tax on long-term capital gains and qualified dividends. However, such taxpayers aren't the only ones facing tax increases. Some people with lower incomes also will owe two taxes that reappear in the new law.

Eroding exemptions

Prior law included a phaseout of personal exemptions for taxpayers with high incomes. That phaseout had been—yes—phased out in recent years. Now, the original phaseout has returned, as a permanent feature of the tax law. In 2013, this phaseout will affect people with income over

- $250,000 for single taxpayers,
- $300,000 for married couples filing joint returns and surviving spouses,
- $150,000 for married individuals filing separately, and
- $275,000 for heads of households.

As you can see, these income thresholds are lower than the thresholds for the 39.6% top tax bracket. They also refer to adjusted gross income (AGI), the number you report on the bottom of the first page of your tax return, before you take itemized deductions. Therefore, people with taxable income far from the 39.6% bracket may owe more tax because their personal exemptions are devalued. Generally, for each $2,500 (or fraction thereof) of AGI taxpayers are over their threshold, they will lose 2% of their personal exemptions. They can lose up to 80% of their exemptions this way.

Example 1: Sarah and Todd Bailey have two young children, so they can claim four exemptions. Personal exemptions are $3,900 per person in 2013, so the Baileys could claim $15,600 in deductions for their four exemptions. If the Baileys' AGI in 2013 is $330,000, they

are $30,000 over the relevant threshold, which is 12 times $2,500. Twelve times 2% equals 24%, so the Baileys personal exemptions would be reduced by 24%, from $15,600 to $11,856.

Declining deductions

The same income thresholds apply to the phaseout of itemized deductions. Under this provision, itemized deductions will be reduced by an amount equal to 3% of a taxpayer's AGI over the relevant threshold. Thus, if the Baileys have AGI of $330,000, which is $30,000 over their threshold, they will lose $900 of their itemized deductions: 3% of $30,000. (Deductions for medical expenses, investment interest, casualty or theft losses, and wagering losses are excluded from the calculation.) Again, high-income taxpayers can lose as much as 80% of their itemized deductions.

Sustaining the surtax

In the new tax law, Congress took no action regarding the 3.8% Medicare surtax, included in prior health insurance legislation. This tax took effect in 2013, affecting people who top these income levels:

- $250,000 for married couples filing joint returns and surviving spouses
- $125,000 for married individuals filing separately, and
- $200,000 for all other single taxpayers

For this surtax, the thresholds are based on modified adjusted gross income (MAGI), which is AGI plus any net foreign income. For many taxpayers, MAGI will be the same as AGI.

As you can see, lowering your AGI may be able to help you reduce or eliminate the 3.8% surtax and the two phaseouts described in this article. Tactics that lower AGI, such as taking capital losses and maximizing deductible contributions to retirement plans, may also lower your exposure to these taxes. ■

Jumbo Nest Eggs

At year-end 2012, Americans held $5.4 trillion in IRAs, versus $5.1 trillion in defined-contribution plans, which include 401(k)s.

Plan for Your Deductions

Maximizing Medical Deductions

Under federal health insurance legislation, you'll probably find it more difficult to claim medical expenses as itemized deductions on Schedule A of your tax return, beginning in 2013. You'll get deductions only for expenses that exceed 10% of your adjusted gross income (AGI), up from 7.5% in prior years. (Through 2016, the threshold will remain at 7.5% of AGI if you or your spouse is age 65 or older at the close of the tax year.)

You cannot include medical expenses that were paid by insurance companies or other sources. This is true whether the payments were made directly to you, the person receiving the medical services (that is, your spouse or dependent), or to the provider of the medical services.

Example 1: Joel Gordon, age 45, has AGI of $100,000 in 2013 and $12,000 of unreimbursed medical expenses. The 10% threshold for Joel is $10,000, so he can deduct $2,000 of his medical bills. Under prior law, his 7.5% threshold would have been $7,500, and Joel could have claimed $4,500 in medical deductions.

The 10% solution

Even with a higher threshold, you shouldn't give up on deducting medical expenses. Good recordkeeping and a knowledge of the rules can help you go over the 10% level in some years. In particular, you should be sure to track items, such as the following:

Health insurance premiums. Even if you're covered by an employer plan at work, you probably are contributing to the cost of your insurance. Many employers require some form of cost sharing, and employees' share of the total has been increasing. If your contributions are withheld from your paychecks and are paid with your own after-tax dollars, don't forget to include those amounts in your total outlays. (Note that many people have pre-tax dollars withheld, in which case they are not deductible.)

Seniors are likely to be in a similar situation regarding Medicare, the federal government's health insurance program that mainly covers individuals 65 and older. You can include the premiums you pay for Medicare Part B (medical costs) and Part D (prescription drugs). Often, the government takes those costs from your Social Security checks, so you might not realize you've paid them. Medicare Part B costs over $1,200 a year, so you should be sure to count the money withheld from Social Security for such premiums.

In addition to ordinary health insurance, you also can include premiums you pay for long-term care insurance (subject to age-based limits), dental insurance, and contact lens coverage in the medical outlays you report as itemized deductions on Schedule A.

Instead of deducting health insurance premiums as itemized deductions on Schedule A, if you are self-employed, a partner in a partnership, or a more than 2% shareholder of an S corporation, you not only can deduct your health insurance premiums, you can take the deduction "above the line" on page 1 of your tax return. There is no AGI threshold for these deductions; in fact, your self-employed health insurance deductions reduce your AGI, which may help you deduct other medical expenses.

Dependents' costs. You can include medical costs you pay for yourself and your spouse. You also can count the medical costs you incur for someone who was your dependent either at the time the medical services were provided or at the time you paid the bill. The person must be either a "qualifying child" or a "qualifying relative," generally someone who depends on you for the necessities of life. The specific definitions are complex; our office can help you determine whether someone is a dependent for purposes of the medical expense deduction.

Transportation. You can include in your medical expenses outlays for transportation that was primarily for, and essential to, medical care. Such travel can be by bus, taxi, train, or plane. When you're taking a child for needed medical care, count those costs as well.

In addition, you can include your actual out-of-pocket for medical trips by car, such as gas and oil. As an alternative, you can calculate the deductible transportation expense amount by adding up the number of miles you travel for medical reasons and multiplying the total miles by the standard medical mileage rate, which is 24 cents a mile in 2013. You can add parking fees and tolls to your medical expenses, whether you use actual expenses or the standard mileage rate. Medical travel doesn't include commuting to and from work or travel for the general improvement of your health.

On the house

Amounts you pay for special equipment installed in your home, or for home improvements, can be included if the main purpose is medical care for you, your spouse, or a dependent. To justify the deduction, you should have a written recommendation from a doctor, prescribing the equipment or home improvement to treat a specific medical condition. IRS examples include access ramps, wider doorways, and elevators, but it's also possible to get deductions for a swimming pool or central air conditioning, if you proceed correctly. The cost of permanent improvements may be included as a medical expense, but you must reduce the deduction by any increase in the home's value. If the improvement does not increase the value of your home, the entire cost of the improvement can be deducted as a medical expense.

Example 2: Lynn Johnson has a severe form of arthritis, and her doctor tells her to swim regularly to regain her range of motion. Lynn decides to install a pool in her home.

Lynn begins by having her house appraised. After her home pool has been installed, Lynn gets another appraisal. She can claim the difference between the amount she has spent and the increase in her home's value as a medical deduction.

Say Lynn spends $40,000 installing her pool. The before-and-after appraisals indicate her home's value went from $350,000 to $375,000 as a result of the improvement. Thus, Lynn spent $40,000, and her house appreciated by $25,000. She can claim the $15,000 difference as a medical expense, which may allow her to take an itemized medical deduction. ■

Tax Breaks for Supporting a Parent

The fabled Baby Boom began in 1946, right after World War II. Therefore, the oldest Baby Boomers reached 66 in 2012, which is now the full retirement age for Social Security. As millions of Boomers near and reach retirement, however, many are feeling family-related financial strains.

A survey by Ameriprise Financial found that many Boomers provide aid to their elderly parents. For example, 22% of respondents help their parents to buy groceries, 15% aid with

medical bills, and 14% contribute to outlays for utility bills. Some Boomers reported that these expenses have reduced the amount they save for their own retirement.

Tax threshold

If you are in the previously mentioned situation, you should try to take advantage of all possible tax benefits. The money you save in taxes may be invested for your retirement.

For example, you might be able to claim a dependency exemption for a parent you're supporting. You'll get a tax deduction of $3,900 in 2013 (estimated as of this writing) for each exemption you claim. Depending on your tax bracket, you might save well over $1,000 for each dependent.

To get a dependency exemption for a parent as a "qualifying relative," you must pass several tests. For example, your dependent must have less than an estimated $3,900 in gross income this year. Tax-exempt income doesn't count as gross income, and that includes certain Social Security benefits.

Example 1: Ken and Carol Grant help to support Carol's widowed mother, Helen. In 2013, Helen collects $8,000 in Social Security benefits. Her only other income comes from bank account interest, which is minimal.

Under the tax code, a single taxpayer owes no income tax on Social Security benefits if *combined income* (adjusted gross income plus nontaxable interest plus half of Social Security benefits) is less than $25,000. Helen's total is under the threshold, so her Social Security benefits are not taxable and not included for this calculation. Thus, Helen meets the income test to be treated as a dependent.

Counting costs

Besides the income test, you must provide over half of the dependent's support. That is, you must pay more than 50% of the amounts spent on the other person's food, lodging, clothing, education, medical and dental care, recreation, transportation, and similar necessities.

Example 2: In 2013, Carol's mother, Helen, spends a total of $18,000 for necessary living expenses listed previously. If Ken and Carol provide over 50% of that amount—$9,000—they pass this test for claiming Helen as a dependent.

If Helen lives with Ken and Carol, the Grants will find it easier to pass this 50% support test. That's because they can include the fair rental value of the housing they provide in the total of their contributions. If Helen would pay $1,000 a month to rent comparable lodging from a third party, yet she lives with the Grants rent free, then Ken and Carol can include that $1,000 a month in the support they provide: $12,000 a year.

Addition to deductions

If your parent qualifies as a dependent, the tax savings may go beyond the dependency exemption. You also might be able to get a medical deduction. Money you spend for a dependent parent's qualified health care costs can be added to your own medical bills, increasing your chances for an itemized medical deduction. You also may be able to include a parent's medical expenses on your tax return even if that parent is not a dependent, as long as you provided over half of his or her support during the year.

The income and support tests, as described, are the keys to claiming a parent as a dependent for tax purposes. Other criteria apply; some taxpayers may receive reduced exemption

amounts, depending on current law, and some taxpayers are shut out from any dependency exemptions.

In essence, the rules in this area are quite complex, even by the standards of the Internal Revenue Code. Our office can help you deal with all the fine print and show you how to claim parents or other loved ones as dependents, if that would be practical.

Multiple method

In some families, more than one sibling will help to support an elderly parent. Then, no one taxpayer may qualify for the dependency exemption.

Example 3*:* While the Grants help to support Carol Grant's mother, as described, Carol's brother Jeff also helps their mother, Helen, to make ends meet. Even though Jeff and the Grants together provide over 50% of Helen's support this year, neither taxpayer is over the 50% mark.

In such a situation, if all other hurdles are cleared, the contributing parties can agree to allocate the dependency exemption to one taxpayer. The taxpayer claiming the exemption must receive from each taxpayer eligible to claim the exemption a signed statement waiving his or her right to claim the person as a dependent for the year. The taxpayer claiming the exemption must attach to his or her return for the year he or she is claiming the exemption a statement that (1) identifies all the taxpayers eligible to claim the person as a dependent and (2) indicates that he or she has received a signed waiver statement from each of these taxpayers. IRS Form 2120 can be used for this purpose.

Assuming they contribute equal amounts, Jeff and the Grants can alternate so that they take turns claiming Helen as a dependent every other year. ■

IRS Approves Simpler Home Office Deductions

Deducting legitimate expenses for a home office isn't easy, but it can be done. Millions of taxpayers (including self-employed individuals and business owners) claim such deductions each year. Moreover, the process may be easier for 2013 and future years, thanks to an IRS ruling.

In Revenue Procedure 2013-13, the IRS spelled out an optional method to report expenses for business use of your home. The process is simple, to say the least: you find the size of your home office and multiply the square footage by $5.

Example: Sarah Williams keeps an office in her home. She measures the space at 225 square feet. Multiplying 225 by $5, Sarah calculates and claims a deduction of $1,125 on her 2013 income tax return. The IRS calls this a safe harbor method, meaning that Sarah doesn't need to show $1,125 of expenses related to the business use of the home.

Assessing the advantages

Simplicity is the prime advantage of the safe harbor method. Under prior law, taxpayers had to fill out IRS Form 8829, which has more than 40 lines, in order to claim home office deductions. If you use the safe harbor method, you won't have to deal with Form 8829. You can, if you wish, go back and forth between Form 8829 and the new safe harbor method, from one year to the next.

What's more, you also can deduct other expenses of your business that are not related to the business use of your home. Such deductions could include advertising and supplies, for example. In addition, if you itemize expenses on Schedule A of Form 1040, you can include all

of your mortgage expenses, real estate taxes, and casualty losses. Taxpayers using Form 8829 must allocate such expenses between business and personal use.

Now for the negatives

Using the safe harbor method will be simpler but may not be better. Under the new rules, the home office deduction is limited to home offices of 300 square feet, for a maximum deduction of $1,500. That's true even if your home office is larger.

When you use this safe harbor deduction, you can't take depreciation deductions for your home office.

Altogether, it's possible that your annual deductions will be less, if you use the safe harbor method, compared to the deductions you can claim by filling out Form 8829. Maximizing business expenses on Form 8829 may have secondary benefits, too. You'll reduce your business income, which may decrease your self-employment tax obligation. You'll also reduce your adjusted gross income, which may generate more tax deductions and tax credits elsewhere on your tax return.

Ground rules

Regardless of whether you use Form 8829 or the safe harbor method, you'll have to pass certain tests to qualify for home office deductions. For example, the space in your home that's used as an office must be used regularly and exclusively for business. After clearing this hurdle, a home office must be either the principal place of business; a place used by patients, clients, or customers in the normal course of business; or in a separate structure where business is conducted. If you're an employee, you'll be entitled to a home office deduction only if the office is for the convenience of your employer. In any case, your home office deduction can't exceed the gross income from the related business.

Our office can help you determine whether the safe harbor option is desirable for you. ■

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, 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. ■

Plan for Your Business

Using the Work Opportunity Tax Credit

Among the business related provisions of the American Taxpayer Relief Act of 2013, the work opportunity tax credit (WOTC) was extended retroactively, for 2012, and also through 2013. Under the WOTC, employers can receive federal tax credits for hiring and retaining workers from specific groups of individuals that have been designated as facing significant barriers to employment.

Taking credit
If your company hires a worker covered by the WOTC, the tax credit you can claim will depend on the target group of the individual, the amount you pay him or her for the first year of

employment, and the number of hours that individual worked. Here are the basic rules. If an employee works

- at least 120 hours, you can claim a tax credit of 25% of the individual's first year wages.
- at least 400 hours, you can claim a tax credit of 40% of the individual's first year wages.

Generally, the maximum tax credit is $2,400. That ceiling applies if you hire food stamp recipients, certain residents of a federally designated Enterprise Community, Renewal Community, Rural Renewal County or Empowerment Zone, individuals in certain vocational rehab programs, ex-felons, or recipients of Supplemental Security Income benefits. If you hired a qualified summer youth employee (i.e., a 16 or 17-year-old who lives in an Empowerment Zone, an Enterprise Community, or a Renewal Community) to work for your company between May 1 and September 15, the maximum tax credit is $1,200.

As explained in the following paragraphs, two other categories of employees have higher maximum WOTC credits.

Hiring veterans

You may be able to claim the WOTC if your company hires a veteran who served on active duty (not including training) in the U.S. Armed Forces for more than 180 days or has been discharged or released from active duty because of a service related disability. That person must not have been on active duty (not including training) for more than 90 days within the 60-day period before being hired.

To get the tax credit, your company must hire a veteran who meets certain other criteria, such as being a member of a family receiving food stamps, having a service related disability, or having a lengthy period of unemployment. The maximum WOTC is $2,400 for hiring a qualified veteran unemployed for at least 4 weeks but less than 6 months during the 1-year period ending on the hiring date. The maximum credit is increased to $5,600 for hiring a qualified veteran unemployed for at least 6 months or more during the 1-year period ending on the hiring date. For hiring a veteran who has been on food stamps for at least a 3-month period ending during the 12-month period ending on the hiring date, the maximum credit is $2,400.

Special rules apply to veterans entitled to compensation for a service related disability. If such a veteran is hired by your company within 1 year of leaving the service, your company can receive a tax credit up to $4,800. If such a veteran was unemployed for at least 6 months during the 1-year period ending on the date of hiring, you can receive a credit up to $9,600.

Veteran Target Group	**Maximum Tax Credit**
Receives food stamps	$2,400
Entitled to compensation for service-connected disability	
Hired for one year from leaving service	$4,800
Unemployed at least 6 months	$9,600
Unemployed	
At least 4 weeks	$2,400
At least 6 months	$5,600
Source: U.S. Department of Labor	

Hiring members of needy families
Temporary Assistance to Needy Families (TANF) is a federal program. If you hire a short-term TANF recipient—any member of a family that received TANF benefits for 9 of the 18 months before being hired—the maximum WOTC is $2,400.

Your company also can hire a long-term TANF recipient. That's someone from a family meeting any of the following conditions:

- The family received TANF benefits during the 18-month period ending on the hiring date.
- The family received TANF benefits for at least 18 months after August 5, 1997. The employee's hiring date must be no more than 2 years after the earliest 18-month period.
- The family stopped being eligible for TANF payments during the past two years because a federal or state law limited the time those payments could be made.

If your company hires an employee from the long-term TANF group, it can take the WOTC over two years.

- If the individual works at least 120 hours in the first year, the employer may claim a tax credit equal to 40% of first-year wages.
- If the individual works at least 400 hours in the second year, the employer may claim a tax credit equal to 50% of second-year wages.

Companies that hire long-term TANF recipients can take a WOTC up to a total of $9,000, over those two years.

To apply for the WOTC, your company must fill out and submit several IRS and Labor Dept. forms. Our office can help you handle the paperwork and claim the tax credit.■

Passing the Tests for Entertainment Deductions

If you're a business owner, you probably entertain customers, prospects, employees, suppliers, and others. Such outlays may be deductible, whereas others are in a grey area. If you know the rules, you can support your deductions and withstand IRS scrutiny.

Direct action
To be deductible, entertainment expenses must pass either the so-called "directly related" or "associated" tests. Either way, expenses must be both ordinary and necessary to your business. Typically, activities that are commonly used and helpful in some way will be considered ordinary and necessary.

Example 1: Eli Smith, who owns the Smith Co., takes his marketing vice president, Carol Jones, to lunch at a local restaurant to discuss the launch of a new product. Because this lunch takes place in a clear business setting, the cost probably is tax deductible. However, like most entertainment expenses, Smith Co. can deduct only 50% of the total cost.

Even if you merely take someone out to lunch, you should be able to show that the main purpose of the outing was related to your business. The IRS says that you must have talked about business matters during the meal, and you must have had a specific business benefit in mind. In order to demonstrate your actions and your intent, in case you're ever questioned, you should keep some type of log in which you record all the details right after you entertain, including your

business purpose. For example, your business purpose could be taking long-term and newly hired employees out to lunch in order to build interpersonal relationships.

Note: You don't have to show a successful result, such as closing a deal, but you need to have a valid business reason for entertaining.

Associated activity

The IRS states that business entertaining in a setting that offers "substantial distractions" won't meet the directly related test. Such settings include nightclubs, ball games, golf courses, and so on.

In those situations, you may qualify for tax deductions if the entertainment is associated with your trade or business. You must have a "substantial business discussion" directly before or after the outing.

In order for a business conversation to be substantial, you must be able to show that you were actively engaged with the other party or parties to get a specific business benefit. The business discussion must be substantial, in relation to the entertainment, so a brief request for an order may not justify deducting hundreds of dollars in basketball tickets.

As long as the conversation takes place on the same day as the entertainment, the IRS considers it to be held directly before or after the entertainment. Again, you should keep a log to record such activities.

What if the entertainment and the business discussion are not held on the same day? A deduction might still be justified, depending on the specific facts and circumstances. You may have more leeway if you are entertaining people who traveled to meet you.

Example 2: Three top executives from the Collins Co. come in from out of town to discuss a proposed business venture with the Smith Co. They arrive Monday afternoon, and Eli Smith takes all three to a basketball game Monday night. On Tuesday, Eli has a substantial conversation with the visiting executives, going over the proposal. The IRS has said that the game generally may be considered to have taken place directly before the discussion, so the ticket costs can meet the associated test. Here, Eli probably is on solid ground for deducting 50% of his outlays.

Our office can help you create a recordkeeping plan to support your entertainment deductions. ■

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.■

TRUSTED ADVICE

- 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.

Plan for Your Investments

Cashing In on Foreign Stocks

Many investors who seek income are turning to dividend paying stocks. While bank accounts and money market funds pay meager amounts, the dividend yield on the S&P 500 is around 2%. That's the average yield, so many established companies are paying 3%, 4%, or even more to shareholders. Moreover, stock market investors have the potential for future growth and, as explained later in this article, typically receive favorable tax treatment on dividend income.

If the idea of investing in dividend paying stocks appeals to you, consider allocating a portion of your portfolio to foreign stocks that make such payouts to shareholders. The benchmark Morgan Stanley Capital International (MSCI) EAFE Index, which tracks the performance of large companies based in Europe, Australasia, and the Far East, has a dividend yield over 3%, as of this writing. Thus, foreign stocks not only can diversify your portfolio, they may offer dividends higher than the yields on U.S. issues.

U.S. investors who want to invest in foreign stocks have several options. You can invest in American Depositary Receipts (ADRs), for example. ADRs, which represent ownership of equity shares in a foreign company, trade on U.S. exchanges or over-the-counter, so you can buy or sell them as you would with domestic stocks. Rather than buying individual foreign issues, you can invest in a fund holding foreign stocks. Choices include familiar mutual funds; closed-end funds, which trade on a stock exchange between investors; and exchange-traded funds (ETFs), which track a specific stock index.

Tax traps

Selected carefully, dividend paying foreign stocks and funds that hold such issues may play a valuable role in a diversified portfolio. However, you should be aware of two tax issues these investments may raise.

Dividends may not qualify for low tax rates. Qualified dividends enjoy favorable tax rates. Most investors pay 15% tax on such dividends, whereas high and low bracket investors pay 20% and 0%, respectively. On dividends that are not qualified, though, investors pay tax at higher rates, ranging from 10% to 39.6%.

Typically, dividends from ADRs qualify for the low tax rates. Similarly, dividends from companies based in countries that have specific types of tax treaties with the U.S. also can qualify. Not all foreign stock dividends are from such countries, though. If you invest in a fund that receives nonqualified dividends from the stocks it owns, some of your dividend income may be taxed at high, ordinary tax rates, rather than the lower rate on qualified dividends.

Foreign tax withholding can reduce your yield. When foreign companies pay dividends to investors from other countries, some money may be withheld to cover the income tax obligation to the host country. The amount of withholding varies from country to country, depending on factors such as local law, tax treaties with the United States, and whether the stock is held in an IRA.

Example: Luke Miller invests in ADR shares that pay a dividend equivalent to $1,000 in U.S. dollars in 2013. The company represented by the ADR is based in a country that requires 15% withholding on dividends paid to U.S. investors. Thus, Luke receives $850 in dividend income in 2013 from that ADR, after $150 of withholding. If the posted yield on that stock is 5%, Luke actually receives the equivalent of a 4.25% dividend.

Foreign stock funds also withhold dividends in this manner. If your foreign stock or fund dividend income is subject to withholding, you may be able to get some IRS relief. One approach is to deduct the amount withheld (and thus paid to a foreign government) as an itemized deduction on Schedule A of your tax return. You can include such foreign taxes along with other deductible tax payments.

However, you'll receive only partial tax relief from an itemized deduction. If Luke is in a 28% tax bracket, for instance, a $150 deduction for foreign taxes paid saves him only $42 in tax: 28% of $150. Also, high-income taxpayers might lose some tax benefits under a new law that devalues some itemized deductions.

Taking credit

Instead of deducting the foreign tax you've paid, you may prefer to claim a credit for those taxes. (See the "Credit Check" Trusted Advice column for more information.) Generally, for foreign tax paid up to $300 ($600 for married couples filing a joint tax return), you can claim the credit on your Form 1040 tax return. Luke Miller, for example, could use the tactic to reduce his tax bill by the $150 of foreign dividends withheld from his investment income.

If you have a larger amount of foreign dividends withheld in a given year, you generally must file IRS Form 1116 to claim a tax credit. This form can be complex, but our office can help you provide the information necessary to get the credit.

Unfortunately, neither the tax credit nor the itemized deduction for foreign taxes paid will help if you hold your dividend-paying foreign stocks in a tax-deferred retirement account, such as an IRA. Luke, in our example, would wind up with a 4.25% dividend yield, not a 5% yield, if he holds his ADR in an IRA.

If the dividends you receive are qualified dividends, you may prefer to hold foreign dividend paying stocks in a taxable account. You'll be able to use the low tax rates on qualified dividends, and you can take a deduction or a tax credit to address the impact of any foreign tax withholding.■

TRUSTED ADVICE
Credit Check

- A tax credit reduces your tax obligation, dollar for dollar, while a tax deduction reduces your income subject to tax. Thus, a tax credit is more valuable.
- You can claim the foreign tax credit even if you do not itemize deductions on Schedule A of your tax return. You are allowed to take the standard deduction in addition to this tax credit, if this tactic provides more tax savings.
- If you take the foreign tax credit and the foreign taxes you pay exceed the credit you're allowed, you may be able to carry forward or carry back the excess amount to another tax year.

Real Estate Investing With REITs

As the memory of the financial crisis recedes, the real estate market shows signs of recovery. You may believe excellent investment opportunities exist now—and that might be the case. Nevertheless, you may be reluctant to buy investment property. Inexperienced investors can make costly mistakes, property management will be either expensive or time consuming, major commitments of capital might be required, and investment real estate is illiquid.

For any or all of those reasons, you may consider investing in real estate investment trusts (REITs) as an alternative. You can buy and sell many different REITs, just as you'd trade shares of common stocks. A given REIT can be diversified, and REIT funds provide even more diversification. What's more, you can invest in REITs with only a few thousand dollars.

Real differences

Broadly speaking, REITs fall into two categories.

Equity REITs own one or more properties. Often, they specialize in various types of real estate. One REIT might own only office buildings, for example, while another REIT might own shopping centers.

Mortgage REITs own debt instruments. They buy existing mortgages, collect payments from borrowers, and pass the money through to investors.

Some REITs are hybrids, owning both properties and mortgages.

Investment implications

In a way, all REITs are hybrids. Equity REITs, for instance, reflect the performance of both the real estate market and the stock market. In a strong real estate market, property values rise. Higher property values, in turn, tend to boost the prices of REIT shares.

On the other hand, a stock market crash can sink equity REITs. From May 2008 to February 2009, for example, the Financial Times Stock Exchange National Association of Real Estate Investment Trusts (FTSE NAREIT) U.S. Equity REIT Index fell by 62%, as the stock market collapsed. The values of the office buildings, shopping centers, and other properties held by REITs may not have dropped to the same degree. (Since that bottom, more than four years ago, this equity REIT index has more than tripled. As of this writing, it is 28% higher than in May 2008.)

While equity REITs are a mix of stocks and real estate, mortgage REITs combine the features of real estate and bonds. The yields paid to investors reflect interest rates on real estate

mortgages. These REIT shares, however, tend to trade with the bond market: if interest rates rise in the future, mortgage REIT shares probably will fall along with bond values.

Tax treatment

Under the U.S. tax code, REITs are required to pay investors at least 90% of their taxable income each year. This payout reduces or eliminates a REIT's obligation to pay corporate income tax. By comparison, dividends paid to investors by regular corporations may be taxed twice: both the company and the investor can owe tax on those dollars.

As a result of this tax treatment, REITs generally have relatively high yields. In 2013, equity REITs generally pay around 4% to investors. By comparison, the yield on the Standard & Poor's 500 Index of large company stocks is around 2%. Mortgage REITs currently yield about 7%, versus 3% for U.S. corporate bond indexes.

Besides the high yields, REIT investors may benefit from favorable tax treatment.

Example: Jill Young invests $10,000 to buy 200 shares of ABC Office Building REIT at $50 a share. In 2013, Jill receives a $400 (4%) dividend. On the IRS Form 1099- DIV that ABC sends to Jill, she sees that $100 is a long-term capital gain, $100 is ordinary income, and $200 is a return of capital. Therefore, Jill will owe tax on $100 at favorable capital gain tax rates and $100 at ordinary income rates. She'll owe no tax on her $200 return of capital. (Generally, REIT dividends do not get the special low tax rates on "qualified" dividends.)

Although Jill avoids tax on her $200 return of capital in this example, she must lower her basis by $200—$1 per share— to reflect her $200 return of capital. This reduction drops her basis from $50 to $49 and will increase the tax she will owe in the future on a profitable sale. Nevertheless, the REIT tax treatment works in Jill's favor, because she avoids paying ordinary income tax now and may owe tax on a future sale at lower capital gains rates.

Building out

The REIT universe is broad, covering many varieties of investments. Some REITs do not trade publicly; they might offer higher yields but also restrict your ability to sell for many years. Other REITs have been created outside the U.S. These global REITs may offer profit potential, in fast growing regions, but they also might have specific risks found in local markets.

Altogether, carefully selected REITs may deliver substantial cash flow, portfolio diversification, and participation in real estate growth. Be sure to look closely at any REIT before investing, so you're confident you understand the risks involved. ■

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 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. ■

Plan for Your Retirement

Social Security: The 8% Solution

In today's low yield world, you'll earn little interest by keeping your money in a bank account, a money market fund, or a high quality bond. Nevertheless, certain individuals can earn 8% a year, guaranteed by the federal government. If you are between age 62 and age 70, deferring the start of Social Security retirement benefits provides that return, which, for many people in that age group, makes waiting a savvy move.

Basic math

You can start to receive Social Security benefits as early as age 62. Before your full retirement age (FRA), though, you'll receive reduced benefits for the rest of your life. Say your full retirement age is 66, as it is for people born from 1943 to 1954 (age 59 to 70 this year). By starting your Social Security benefits at 62, you'll receive only 75% of your FRA benefit.

Example 1: Mark Jones has a work history that entitles him to $2,000 a month from Social Security at 66, his FRA. Instead, Mark starts his benefits at age 62. Mark will get $1,500 a month (75% of $2,000) for the rest of his life, plus any cost of living adjustments (COLAs).

Example 2: If Mark decides to wait until age 66, his FRA, he will get his basic $2,000 a month for the rest of his life, plus COLAs. Thus, by waiting 4 years, Mark increases his monthly benefit by $500—a 33.3% increase from $1,500 a month in example 1—which is about 8% a year for the 4 years he waited.

Patience is prudent

Beyond your FRA, deferring the start of Social Security will increase your benefits by 8% a year (actually, by ⅔ of 1% for each month beyond your FRA). This goes on until age 70; deferring benefits beyond 70 provides no additional cash flow.

Example 3: Mark Jones waits until age 70 to begin his Social Security benefits. This 4-year delay beyond his FRA increases Mark's check by 32%, from $2,000 to $2,640 a month, plus all the COLAs that took effect while he waited.

Altogether, waiting to start benefits increased Mark's monthly income from $1,500 at age 62 to $2,640 at age 70: a 76% increase in 8 years. That's a 76% return, guaranteed by the federal government.

Later than sooner

Waiting for Social Security has an obvious cost. If Mark Jones had started at age 62, with a reduced $1,500 monthly benefit, he would have collected $18,000 that year; by age 70, he would have collected $144,000 in benefits, plus COLAs. If Mark had started at age 66, receiving $2,000 a month, he would have received $96,000 plus COLAs in the 4 years before age 70.

When does it pay to take the money as soon as possible? When does it make sense to wait? Here are some guidelines:

Do you need the money? If Social Security benefits are necessary to maintain your lifestyle in retirement, you probably should take them.

How is your health? The shorter your life expectancy, the more likely you and your loved ones will be well served by taking the benefits while you can.

Assume, though, that Mark Jones is in good health with no pressing need for extra cash flow from Social Security. If he takes his benefits before age 70, he will pay tax and spend, save, or give away the after-tax amount. If he decides to reinvest, he'll either have to settle for a low yield or take investment risk in the hope of receiving a superior return.

For Mark, waiting in this example provides certain benefits. He'll earn an annual return of around 8%, plus COLAs, on his full (untaxed) Social Security benefit. The return from waiting will be longevity insurance: a reduced risk of running short of money if Mark lives into his 80s and beyond.

In addition, assume that Mark Jones is married and that his wife had lower lifetime earnings than Mark. In this case, Mark is entitled to a larger Social Security benefit than his wife. If Mark dies first, his widow will be entitled to his full Social Security benefit for the rest of her life, rather than her smaller benefit. Therefore, an older and higher earning spouse who waits to receive Social Security is essentially obtaining more life insurance for a surviving spouse. ■

Getting Started on a Succession Plan

As a successful business owner, you still may reach a point where life's realities are at odds with your career. Your health might decline, making it more difficult to keep up the pace, or you may just be tired of working so hard and decide to step aside.

Whatever the reason, you probably plan to sell your business and use the proceeds to help finance your retirement. However, waiting until the last minute can be a trap. If you are eager to sell and move on with your life, you'll be in a poor position to negotiate terms with prospective buyers.

Realize reality

Your chances of selling your company for its full value will increase if you develop a succession plan, and such a plan will be more effective if you begin years before an anticipated sale. A viable succession plan has many moving parts, but one way to start is to get a reasonable idea of what your company is worth.

You may have heard that another company in your industry was sold for a certain price or that businesses in your industry sell for X times net operating income. Thus, you have an idea of what a buyer would pay for your company. Your expectations, though, may prove to be

inaccurate. In most cases, buyers will look at your company as a unique collection of products, services, customers, and employees, and they will make an offer based on their estimate of future profitability.

Consequently, you should have your company valued by a knowledgeable appraiser, ideally a few years before putting it up for sale. Look for someone experienced in appraising companies in your industry. You'll probably have to pay several thousands of dollars for such a valuation, but you'll know what you reasonably can expect to receive, and you might get ideas about how you can make your company more attractive to bidders.

Select a successor

When you're ready to sell, you can just put your company on the market or contact a business broker. With this approach, though, you may not know who'll be taking over your company. Will the new owner antagonize long-term employees or customers? If the deal calls for a buyout over time, will the new owner keep the company healthy enough to make the ongoing payments to you?

Such considerations may lead you to choose your successor as part of your succession plan. Your first thought might be a relative, assuming that person is capable and enthusiastic about taking over. Keeping your business in the family may not be possible, though.

You may consider a current employee. Promoting from within can ensure that your successor already is familiar with your company's staff, customers, and suppliers.

If you don't already have a relative or current employee in mind, you can hire someone to groom for an eventual buyout. Whatever path you choose, it is best to start planning early. ■

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. ■

Plan for Your Family and Estate

Estate and Gift Taxes Have Been Clarified

A single, unified exemption is available to taxpayers for the estate and gift taxes. A taxpayer can use the exemption to offset otherwise taxable lifetime gifts, and the taxpayer's estate can use the amount remaining at his or her death to offset otherwise taxable bequests.

The amount of the exemption was a major issue throughout 2012. That exemption was set at $5 million, adjusted for inflation. The inflation-adjusted amount for 2012 was $5.12 million. At that level, relatively few estates owed federal estate tax. However, the law in effect during 2012 called for the exemption to return to its 2003 level of $1 million in 2013. That would have exposed many estates to federal estate tax, with rates as high as 55%.

Instead, Congress largely left the 2012 estate and gift tax rules in place. The unified federal estate and gift tax exemption for 2013 and future years has been permanently set at $5 million adjusted for inflation, with the inflation-adjusted amount for 2013 being $5.25 million. Therefore, estates of people who die with a net worth under $5.25 million and did not make significant gifts during their lifetime generally will not have to pay estate tax.

The only major estate tax change in the new law regards the maximum federal estate tax rate, which has been increased from 35% in 2012 to 40% in 2013 and subsequent years.

Example 1: Anna Carter dies in 2013, when the exemption is $5.25 million. Anna did not use any of her exemption amount on gifts during her lifetime and leaves an estate valued at $6 million. The $750,000 over the exemption amount will be taxed at the maximum rate of 40%, so Anna's estate will owe $300,000 (40% of $750,000) in federal estate tax.

Preserving portability

With a $5.25 million federal estate and gift tax exemption amount, a married couple that does not use the exemption to offset any lifetime gifts can potentially leave up to $10.5 million in assets free of estate tax. In fact, the new tax law makes that simpler to do than has been the case in the past because Congress made permanent what had been a temporary "portability" provision. In prior years, lack of portability created problems for many married couples.

Example 2: Barry and Carla Duncan, a married couple, had total assets of $8 million.

Did You Know?

Indexed universal life (IUL) sales, as a percent of total universal life sales, increased from 18% in 2009 to 40% through the first nine months of 2012. With IUL, the policy's cash value increase is fully or partially based on a stock market index. Such policies may offer upside potential and downside protection.

Source: Milliman

Barry died in 2009 and left all of his assets to Carla. Because one spouse's bequest to the other spouse typically avoids estate tax, regardless of the amount, no estate tax was due.

Assume Carla dies in 2013 with an $8 million estate, and she did not use any of her exemption amount on lifetime gifts. She'll be $2.75 million over the $5.25 million exemption amount, and her estate will owe $1.1 million in federal tax, at a 40% rate.

To remedy such outcomes, Congress created a temporary portability provision for 2011, a provision that's now a permanent part of the tax code. With portability, any unused portion of a deceased spouse's exemption amount can be used by the surviving spouse's estate. Originally, Congress created this portability opportunity only for deaths in 2011 and 2012. The new law makes portability permanent.

Example 3: If Barry Duncan had died in January 2013, leaving all of his assets to Carla, he would have left $5.25 million of his exemption unused. That amount can be transferred to Carla, if Barry's executor makes a timely election to do so on a properly filed estate tax return, IRS Form 706. If Carla then dies in December 2013 without using any of her exemption for gifts, her estate would have a total exemption of $10.5 million (her own $5.25 million exemption and a similar one from Barry). Carla's $8 million estate wouldn't be taxed by the federal government, for a $1.1 million tax saving.

The new tax law also preserves the federal tax deduction for state estate taxes. This provision should remind you that estates may owe state estate tax even if they are exempt from federal estate tax.

Example 4: Edward Franklin dies in 2013 with a $3 million estate, so he owes no federal estate tax. However, Edward's home state exempts only $1 million of assets from state estate tax. His estate is $2 million over the threshold; depending on the state's tax rates, Edward's estate may owe many thousands of dollars in state estate tax.

The bottom line is that you should not ignore estate tax planning, even if you have little concern about federal estate tax. Our office can work with you on strategies to reduce exposure to estate tax, state or federal.

Generous gifts

As noted above, you can use your unified federal estate and gift tax exemption amount to offset otherwise taxable lifetime gifts, thus reducing the amount of gift tax you have to pay. However, using the exemption for lifetime gifts reduces the amount of the exemption available to your estate to offset otherwise taxable bequests and reduce the amount of the estate tax.

Example 5: Nancy Harris has never made any taxable gifts. In 2013, she gives $1 million to her daughter Lisa. The first $14,000 of that gift is tax free, covered by the annual gift tax exclusion for 2013. The other $986,000 is considered a taxable gift but Nancy owes no gift tax because of the lifetime gift tax exemption. After making the gift, Nancy's lifetime gift-tax exemption is $4,264,000: her original $5,250,000 exemption minus the taxable gift of $986,000. That $4,264,000 exemption, indexed for future inflation, can shelter future gifts or bequests from tax.

What's more, the concept of portability, explained earlier in this article, also applies to gift tax, so once a surviving spouse has increased his or her exemption by the deceased spouse's unused exemption amount, that increased amount can be used to offset either gift or estate tax.

Example 6: Assume that the transfer tax exemption, which is $5.25 million in 2013, rises to $6 million in a future year, and the annual gift tax exclusion remains $14,000. Nancy Harris dies that same year, having made no additional taxable gifts. Nancy leaves all of her assets to her husband, Pete, thus incurring no estate tax. In this scenario, Nancy's unused exemption is $5,014,000: her $6 million exemption minus $986,000 in taxable gifts.

Assume that Pete has not made any taxable gifts. Pete could have a total exemption of $11,014,000 in this example, including Nancy's unused amount. Pete could make up to $11,014,000 in tax-free gifts, and when he died, any unused gift tax exemption would be available to provide estate tax shelter.

In addition, the generation skipping transfer (GST) tax exemption also is $5.25 million in 2013, indexed to inflation. However, portability does not apply to the GST tax. ■

Tax Planning for Same-Sex Spouses

The Supreme Court ruled in June this year (*Windsor*, No. 12-307 (U.S. 6/26/13)) that Section 3 of the federal Defense of Marriage Act (DOMA) was unconstitutional. This decision has many consequences, including a major impact on tax law.

Under the *Windsor* decision, same-sex marriages will be recognized for federal tax purposes if the couple was married in a state that permits same-sex marriages and still lives in such a state. Further, on August 29, 2013, the U.S. Department of the Treasury and the IRS ruled that same-sex couples, legally married in jurisdictions that recognize their marriages, will be treated as married for federal tax purposes regardless of whether the couple lives in a jurisdiction that recognizes their marriage or not.

Example: Judy Adams and Kathy Benson were married in Maine and still live there, so they qualify for federal tax treatment as a married couple. The same would be true if they moved to Minnesota.

Even if this couple had moved to, say, Indiana, where such marriages are not allowed, their status would be the same because their marriage took place in a jurisdiction that recognizes same-sex marriage. Following are some of the key changes.

Income tax

Legally married couples can't file as single taxpayers. Instead, they can file joint returns or use the "married filing separately" status.

Generally, joint tax returns will produce a lower tax bill. However, if both spouses have high incomes, combining their earnings on a joint return may lead to a larger tax bill. Similarly, married individuals might be better off filing separately if one spouse has substantial itemized deductions, such as unreimbursed medical expenses.

Estate and gift tax

The Supreme Court's decision in *Windsor* actually resulted from an estate tax case. Edith Windsor brought the action, seeking to recover $363,000 in federal estate tax she had paid after her spouse's death in 2009.

Under federal law, a deduction (the marital deduction) generally is allowed for estate tax purposes for the value of bequests to a surviving spouse, regardless of the amount involved. The marital deduction makes it possible for spouses to leave assets to each other without incurring a federal estate tax obligation. Under the holding in *Windsor*, the marital deduction now applies to same-sex couples. Moreover, the "portability" section of the tax code now applies to same-sex married couples as well: the second spouse to die can use the other spouse's unused federal estate tax exemption, with proper planning.

Gifts between spouses now are also tax exempt. Thus, Judy Adams from our example can give her spouse, Kathy, more than $14,000 this year without having to be concerned about filing a gift tax return or losing some of her estate tax exemption. Moreover, unlimited tax-free gifts between spouses may give some same-sex couples more flexibility in their estate planning. Same-sex couples now can split gifts, too. If Judy wants to give her niece $28,000 this year, to help pay for college or buy a condo, Kathy can elect to absorb half the gift, for tax purposes, so neither spouse will have exceeded the current $14,000 annual gift tax exclusion.

Employee benefits

The Supreme Court's decision will also affect the tax treatment of employee benefits. Same-sex spouses who paid tax on imputed income from group health insurance coverage no longer will have to do so, for example. Medical expenses incurred by same-sex spouses now can qualify for pretax reimbursement from flexible savings accounts and health savings accounts.

Beyond health benefits, same-sex spouses have new status in relation to qualified retirement plans such as 401(k)s. In most cases, spouses are entitled to survivor benefits, to veto power over plan loans, and to joint pensions. A spouse's consent is usually necessary, therefore, if a married plan participant wants to name a nonspouse as primary retirement account beneficiary or wants to retire with a single life annuity.

Therefore, same-sex spouses should go over their employee benefits carefully. If a nonspouse is currently the retirement plan beneficiary, for instance, the plan participant should either name the spouse as the new primary beneficiary or obtain a written consent from the spouse to retain the nonspouse as the beneficiary, according to the plan's rules.

IRAs

As *Individual* Retirement Accounts, IRAs do not have the same spousal privileges and requirements that bind employer plans such as 401(k) s. Nevertheless, same-sex couples will enjoy some easing of IRA restrictions.

- **Contributions.** Individuals with no earned income can't contribute to IRAs. A worker's spouse can, however. Thus, if Judy works while Kathy stays home to do household tasks, both spouses can make full contributions to IRAs.
- **Distributions.** After age 70½, IRA owners must take taxable required minimum distributions (RMDs). An IRA owner with a spouse more than 10 years younger can take smaller RMDs, leaving more money in the tax deferred IRA.
- **Beneficiaries.** A surviving spouse can roll an inherited IRA to his or her own name, designate new beneficiaries, and perhaps delay RMDs. A nonspouse IRA beneficiary does not have this privilege. ■

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. ■