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Client Bulletin

Smart Tax, Business & Planning Ideas *from your* Trusted Business Advisor[sm]

November 2014

A Tale of Two Couples

As always, savvy planning in the last quarter of the year can pay off in lower taxes next year when you file your return. Some tax planning is fundamental: most people will benefit by accelerating tax deductions into 2014, while deferring income into 2015. Yet, there is now a distinct divide between taxpayers reporting high income and all other Americans. Generally speaking, as a result of recent legislation, if your annual income is over $200,000 you must cope with far more tax complexity than other taxpayers face.

Example 1: Wendy and Victor Taylor have $120,000 of income this year, before any deductions. They are in the 25% federal income tax bracket, so tax deductions will save them 25 cents on the dollar and they'll owe 25 cents per dollar on any additional income they'll report, up to the top of the 25% tax bracket. The Taylors will owe 15% tax on qualified dividends (most dividends are qualified) from stocks and stock funds as well as 15% on long-term capital gains.

Example 2: Sharon and Rick Palmer have combined taxable income that runs over $600,000 per year, which puts them into the top 39.6% tax bracket this year. (That rate applies to married couples with taxable income over $457,600 in 2014.) As top bracket taxpayers, the Palmers owe 20% on qualified dividends and long-term gains.

The Palmers also may owe a 3.8% net investment income tax (NIIT), sometimes called a Medicare surtax, because their modified adjusted gross income (MAGI) is over $250,000 on a joint tax return. This couple also will lose some tax benefits from their exemptions and itemized deductions because their AGI is over $305,050 this year. Moreover, the Palmers will owe an extra 0.9% in payroll tax on earned income over $250,000.

The income thresholds will vary for single filers and for those who choose another filing status but the principle is constant. High-income taxpayers have to deal with more tax code provisions and larger tax payments. All taxpayers can benefit from year-end planning, but

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those who fall into any of the "high-income" categories in today's tax law have the most to gain from timely actions.

In 2014, many high income taxpayers were flabbergasted to see how much they owed in tax on their 2013 returns, versus their 2012 tax obligation. The new wrinkles that have been added to the tax code have made a huge difference for many people. Forethought and planning could have saved substantial amounts. It's too late now to save on your 2013 tax bill but you still havetime,until December 31, to take actions that will reduce the tax you'll owe for 2014. ■

Year-End Investment Tax Planning

The good news, for many people, is that 2014 is shaping up as another positive year for stocks, as of this writing. Stocks have advanced substantially since their low point in early 2009, and many investors are now sitting on large paper gains.

The bad news? The grim tidings haven't come yet, but many investors fear that they will. Stocks have come crashing down from previous bull markets in early 2000 and late 2008—that might happen again in 2015, 2016 or 2017. No one can accurately predict what tomorrow will bring, but many observers see the stock market as overvalued now, likely to fall back.

Thus, investors might want to take some stock gains now, as a precaution against possible future price declines. In fact, some investors already may have taken gains as the market indexes reached record highs.

Taking gains in taxable accounts can trigger income tax, though. As noted previously in this issue in the article, "A Tale of Two Couples," high-income taxpayers could owe 20% on long-term capital gains, plus a 3.8% surtax and any applicable state tax. What's more, adding to your income might trigger other taxes elsewhere on your return.

Looking for losses

The traditional solution is to take capital losses as well as gains.

Example 1: Counting trades already made this year, trades he'd like to make by year-end and anticipated distributions from his stock funds, Nick Morton expects to have a total of $20,000 in long-term capital gains in 2014. If Nick has $25,000 worth of losses in his portfolio, he could take them by year-end and wind up with a $5,000 net capital loss for the year.

With a net capital loss, Nick would owe no tax on the gains he has taken and plans to take. He could deduct $3,000 of capital losses (the maximum allowed) from his income on his 2014 tax return, cutting his tax bill, and carry over the excess $2,000 capital loss for tax benefits in future years.

That is, Nick could do all this if he has $25,000 of losses in his portfolio. After a lengthy bull market, however, Nick might not have losses to take. Even if Nick had taken huge amounts of losses in 2008–2009, when the market crashed, he might have used them all by now, offsetting gains and deducting losses in the intervening years.

What might Nick do if he has no old losses to use and no opportunity to take new losses? He might donate the stocks he plans to sell to charity (see the article, "Year-End Charitable Tax Planning" later in this issue). Nick also might give shares to family members in lower tax brackets (see the article, "Year-End Family Tax Planning," later in this issue).

If none of these various strategies are practical for dealing with Nick's capital gains, he might simply postpone taking any more gains until January 2015. That approach won't decrease his 2014 tax bill, but it will give Nick a full year to develop strategies to avoid tax on those gains. ■

Year-End Charitable Tax Planning

Donating appreciated assets (including securities) can be a thoughtful tactic for people who can't offset capital gains with capital losses.

Example 1: Lynn Knight invested $8,000 in an aggressive stock fund in 2009. The shares are now worth $20,000, thanks to some excellent selections, but Lynn believes it is time to take her gains. Selling the shares would generate a $12,000 long-term capital gain, costing Lynn thousands of dollars in tax.

In our scenario, Lynn has no old or new capital losses she can use to offset her gains. She does have a commitment to donate $10,000 each year to her alma mater. Therefore, she donates her $20,000 of fund shares in December 2014,

notifying the school that she is making her contributions for 2014 and 2015.

With this maneuver, Lynn receives a $20,000 charitable tax deduction for 2014 while avoiding tax on the disposition of the appreciated shares. Meanwhile, the $20,000 she would have sent to the college is still in Lynn's bank account, so she can use the money to reinvest in assets she believes have investment appeal now.

Simple strategy

The method described here probably will work well for a single $20,000 donation of appreciated securities, as described. All Lynn has to do is get the appropriate account number from her alma mater and notify the fund company to make the transfer by year-end, for a 2014 deduction.

Things would be different, though, if Lynn wanted to make a $1,000 charitable contribution to 20 different charities. To use her appreciated fund shares, she would have to deal with a huge amount of paperwork, getting the information from each charity and forwarding it to the fund company.

In such a situation, you can use a donor advised fund (DAF) to handle multiple transfers with ease. Many financial firms and community foundations offer a DAF.

Example 2: Intending to make multiple donations, Lynn has the fund company transfer her $20,000 worth of shares to a DAF she has specified. If she acts by year-end, Lynn will get the $20,000 tax deduction for 2014,

she'll avoid capital gains tax and she'll have cash in the bank to reinvest.

After the transfer, the DAF can sell the shares and put the $20,000 into Lynn's account. Then Lynn (the donor) can advise the fund to send $1,000 to Charity A, $1,000 to Charity B, and so on. Even if this process runs into 2015 and future years, Lynn won't lose her 2014 charitable tax deduction. ■

Year-End Family Tax Planning

Besides donating appreciated securities to charity, another solution for avoiding highly taxed capital gains on these securities is to transfer the relevant assets to a family member in a lower tax bracket. The recipient might be able to sell and pay little or no tax on the sale.

Example: Grace Fulton invested $10,000 in ABC Corp. shares years ago. The shares are now worth $18,000; Grace fears the trading price of ABC will drop, so she'd like to sell the shares. However, Grace will face a significant tax bill if she takes an $8,000 long-term capital gain.

Therefore, Grace gives the shares to her son Eric, who sells them. Grace's basis in the shares ($10,000) and her holding period (longer than a year) carry over to Eric, so he reports an $8,000 long-term capital gain. As long as Eric will owe less tax on a sale than Grace would have owed, the Fulton family will come out ahead.

Real problems

This scenario can work in real life, but there are some issues to keep in mind. For one, gifts over $14,000 to any one recipient in 2014 may trigger the requirement to file a gift tax return. There may not be any gift tax owed, due to a $5.34 million lifetime gift tax exemption, but there can be paperwork requirements and the potential loss of estate tax benefits.

Moreover, the so-called kiddie tax limits the advantage of transferring assets to youngsters before a sale. In 2014, "kiddies" are taxed at their own tax rate on their first $2,000 of unearned income and generally owe little or no tax on the income. Beyond that $2,000, though, unearned income is taxed at the parent's rate. Thus, if Eric Fulton has an $8,000 long-term gain from a stock sale and no other unearned income in 2014, $2,000 would get favorable tax treatment, but the other $6,000 would be taxed at his mother Grace's rate.

The key question, then, relates to which youngsters are considered kiddies. Generally, that includes children 18 or younger. Kiddie tax status persists until age 24 for full-time students who provide less than half of their own support.

Did You Know?

In Italy, a high income family loses 49.4% of its earnings to taxes, the most among the world's leading economies. The next highest taxing countries are India (44.1%), the U.K. (42.7%), France (41.9%), and Canada (41.9%). The U.S. ranks 8th on this list, with a tax bite of 39.5%, assuming payment of New York State income tax.

Source: bbc.com

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Consequently, the strategy described in example 1 would offer little benefit if Eric is a college student this year, age 23, living nearby and spending most of his time going to class or studying.

If Eric is age 24, though, going to graduate school, the story can have a happier ending. Instead of selling the stock and paying tax on the gain, Grace can give the shares to Eric, who can make the sale this year. In 2014, a single taxpayer can have taxable income (after deductions) up to $36,900 and owe 0% on long-term capital gains. (The 0% tax rate for such taxpayers also applies to most stock dividend income.) As a result, Eric could keep all $18,000 from the stock sale and use the untaxed dollars to pay his school bills.

In 2014, the 0% rate on long-term capital gains also applies to married couples reporting up to $73,800 on a joint tax return. Therefore, transferring appreciated securities to family members with low to moderate income can be a substantial tax saver. Such gifts might be made to a married son or daughter who is buying a home, for example, or to retired parents who need financial help. However, as with all financial decisions, you should think carefully about all possible outcomes before giving away assets. ■

Year-End Retirement Tax Planning

One reliable way to reduce the impact of higher tax rates, surtaxes, phaseouts and so on is to make tax deductible contributions to retirement plans. In 2014, the maximum salary (and tax) deferral for 401(k) and similar plans is $17,500, or $23,000 if you are 50 or older. If you are not maximizing such contributions already, consider increasing the amount by year-end.

Business owners, professionals, and self-employed individuals may be able to make even larger deductible contributions to retirement plans. Often, the deadline to create such a plan for the year is December 31, even though the actual contributions may be deferred for several months. Our office can help you determine which type of plan would be best for you and your employees.

Refining Roth IRAs

The end of the year is often a good time to convert a traditional IRA to a Roth IRA. All Roth IRA distributions are tax-free after five years, if you are at least age 59½. What's more, the five year clock starts on January 1 of the conversion year. Thus, a December 2014 conversion will have a January 1, 2014, start date for this purpose and reach the five-year mark on January 1, 2019, just over four years from now.

The downside of a Roth IRA conversion is that you must pay income tax on all pretax dollars you move from your traditional IRA to a Roth IRA. Converting can be extremely taxing.

Example 1: Diane Carson is a single taxpayer with $150,000 of taxable income in 2014, before any Roth IRA conversion. If Diane converts her traditional IRA, which contains $250,000 in pretax dollars, to a Roth IRA, she will report $400,000 of taxable income on her tax return. The added income will be taxed mostly at a 33% rate so Diane will owe more than $80,000 in tax on the conversion.

In this example, Diane has an excellent idea of what her taxable income will be for 2014. Her $150,000 of taxable income puts her in the 28% tax bracket, which goes up to $186,350 for single filers this year. Thus, Diane decides to convert $35,000 of her Roth IRA in 2014. She'll owe $9,800 in tax on the conversion (28% of $35,000), which she can pay with non-IRA funds. Over time, a series of such partial conversions can build up Diane's Roth IRA so that it can become a valuable source of tax-free retirement income.

Suppose, though, that Diane's taxable income varies from year to year. In that case, she might do a much larger Roth IRA conversion. A conversion in 2014 can be recharacterized (reversed) back to a traditional IRA, in whole or in part, until October 15, 2015.

Example 2: Diane converts $100,000 of her traditional IRA to a Roth IRA in 2014. When she has her tax return prepared in April 2015, Diane learns that her taxable income would be $166,350, without any income from the Roth IRA conversion.

As mentioned, the 28% tax bracket for a single filer goes up to $186,350 in 2014. Therefore, Diane can add $20,000 to her taxable income for the year, still taxed at 28%. Diane recharacterizes enough of her Roth

IRA conversion to leave her with a $20,000 Roth IRA conversion, in the 28% bracket. She can repeat this process every year, building up her Roth IRA at a relatively low tax cost. ■

Year-End Estate Tax Planning

Estate tax planning? With the federal estate tax exemption now at $5.34 million and likely to be even higher in 2015, few taxpayers need to plan for *federal* estate taxes. That's especially true if you're married because so-called exemption "portability" between spouses effectively gives couples the ability to bequeath up to $10.68 million to their loved ones in 2014, free of federal estate tax. Federal estate tax planning still can be extremely important for wealthy families, particularly those who control a closely held company they'd like to keep in the family, but such families probably need a fairly complex plan, one that might take many months to develop and approve.

Nevertheless, year-end estate tax planning can be helpful for many people, depending on where they live. Many states have estate or inheritance taxes, including some with exemption amounts far below $5.34 million. In such states, basic planning might save your heirs many thousands of dollars. Moreover, there is no guarantee that Congress won't lower the federal estate tax exemption in the future, so steps you take now might protect your descendants in the future.

Tackling the gift tax

Giving away assets you're not likely to use is one straightforward method of trimming your taxable estate. In 2014, the annual gift tax exclusion amount is $14,000. That means you can give up to $14,000 worth of assets to any number of recipients, with no tax consequences.

Example 1: Eve Drake gives $14,000 to her son Craig, $14,000 to her daughter Brenda, and $14,000 to her old college roommate who has fallen on hard times. These gifts remove $42,000 from Eve's estate yet she doesn't even have to file a gift tax return, assuming she has made no other gifts to these individuals in 2014. Eve could make 10 such gifts, or 20 such gifts or even more, if she wished, tax-free.

To qualify for the 2014 gift tax exclusion, checks must be cashed before the end of the year. Therefore, it's better to make such gifts well before December 31. If you write a check to someone who deposits it next January, that will be covered by the 2015 gift tax exclusion and you won't be able to make a different 2014 gift to that individual, covered by this year's exclusion.

Paired planning

The $14,000 annual gift tax exclusion is per person, so a married couple effectively can give up to $28,000 to each recipient this year, free of gift tax. Each spouse can make gifts up to $14,000 per recipient or one spouse can make the $28,000 gifts from a joint account. Even if only one spouse wants to make the double gift, that can be done with a process known as gift splitting.

Example 2: Eve Drake, who is married to her second husband Brett, would like to make gifts exceeding $14,000 to her children from her first marriage this year. Brett is not willing to contribute to the gifts but is willing to let Eve use his annual exclusion. Therefore, Eve gives $28,000 of her own money to her son and $28,000 to her daughter. Eve can file a gift tax return (IRS Form 709), on which Brett gives his consent to split gifts, so Brett has made a $14,000 gift to each person for tax purposes, if not in reality. This consent means that all gifts made by Eve or Brett during the calendar year will be split, for tax purposes.

Over the limit

What if Eve makes larger gifts—say, $30,000 to both of her children? Chances are that she won't have to pay gift tax because there's a $5.34 million lifetime gift tax exemption.

Example 3: Eve gives $30,000 to her son and $30,000 to her daughter in 2014. When Eve files a gift tax return, the first $14,000 of both gifts is covered by the annual exclusion, but the other $16,000 of both gifts—$32,000 altogether—is covered by her lifetime exemption. Assuming that Eve has not made over $5.34 million of such countable gifts, she won't owe gift tax. However, at Eve's death, all such countable gifts will be subtracted from that year's estate tax exemption, so her estate may owe estate tax at a 40% tax rate on bequests over the exemption limit.

This example illustrates what might happen if appreciated assets are given to children or parents for sale in a lower tax bracket, as described in this issue's article about family tax planning. Even if you give $50,000 or $100,000 worth of assets to a single individual, it's unlikely you'll owe gift tax. You'll have to file a gift tax return and your lifetime gift/estate exemption will be reduced, but you or your estate may not actually owe any tax, if today's generous exemptions remain in effect. ■

Year-End Business Tax Planning

As of this this writing, the status of equipment expensing for 2014 is unclear. The same is true for bonus depreciation. The ongoing uncertainty on these issues may have an impact on your year-end plans to acquire business equipment.

Section 179 of the tax code allows certain types of equipment to be expensed: the purchase price is fully tax deductible when the item is placed in service, rather than deducted over a multi-year depreciation schedule. New and used equipment qualify for this tax benefit, with some exceptions (such as real estate).

In recent years, Congress has consistently expanded the reach of Section 179. By 2013, up to $500,000 of purchases of equipment eligible for the deduction could be expensed; a business could buy up to $2 million worth of eligible equipment that year before losing any of this benefit.

Example 1: In 2013, DEF Corp. bought $2,085,000 of business equipment eligible for the Section 179 expense deduction and elected to not take bonus depreciation on the equipment. This was $85,000 over the Section 179 limit, so DEF could deduct only $415,000 (the $500,000 ceiling minus $85,000) as an expense in 2013 under Section 179. DEF must recover the other $1,670,000 of the costs of its 2013 purchases through depreciation methods.

The $500,000 and $2 million limits for Section 179 expired after 2013. Under current law, the 2014 limit for expensing is $25,000 worth of purchases (plus an inflation adjustment) with a phaseout beginning at $200,000 worth of purchases.

Similarly, bonus depreciation was available for new equipment until expiration after 2013. This provision allowed a 50% depreciation deduction on purchases of new equipment, before using an extended schedule to depreciate the balance. Currently, bonus depreciation is not permitted in 2014.

Dealing with doubts

Both houses of Congress have indicated interest in restoring an expanded Section 179 deduction as well as bonus depreciation for 2014. However, any updates probably won't be announced until late in the year. If that's the case, how should business owners and self-employed individuals proceed?

Start by acquiring any equipment that your company truly needs for current and future profitability. If your business needs the item now, buy it now, and deduct the cost as the tax law permits.

If the timing isn't urgent, consider limiting purchases to those that will bring 2014 acquisitions up to $25,000, which will be the Section 179 ceiling if no extension is passed. Contact our office in late November or early December for an update on relevant legislation.

Keep in mind that equipment must be placed in service by the end of 2014 to qualify for depreciation deductions (if reinstated) or expensing this year, so merely paying for equipment in 2014 does not entitle you to a deduction. However, this also means that you can get the 2014 tax benefits for equipment placed in service in 2014 even if you defer payment for the equipment until 2015. ■

TAX CALENDAR

NOVEMBER 2014

November 10

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the third quarter of 2014. This due date applies only if you deposited the tax for the quarter in full and on time.

November 17

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

DECEMBER 2014

December 15

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 2014.

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