

Year-End Tax Tips for Individuals



New tax legislation has brought greater certainty to year-end planning, but also created new challenges.

There is still time to set up an appointment for year-end planning. Meet with a tax professional if you have had any major changes during 2013 or are expecting major financial changes in such as retirement or inheritances, to name just two.

Taxpayer Relief Act

In January 2013, Congress passed the American Taxpayer Relief Act of 2012, which made permanent many, but not all, of the Bush-era tax cuts and also some tax benefits enacted during the Obama Administration.

In 2013, two new taxes also kicked in: a 3.8-percent net investment income (NII) surtax and a 0.9-percent Additional Medicare Tax. In addition, the U.S. Supreme Court declared the federal government's denial of recognition of same-sex marriage (DOMA) unconstitutional, opening the door to allowing married same-sex couples to file joint federal tax returns and take advantage of other tax benefits available to married couples.

Beginning in 2014, some of the most far-reaching provisions of the Affordable Care Act become effective: the individual mandate, the start of Marketplaces to obtain insurance, and a special tax credit to help offset the cost of insurance.

Expiring Incentives

Make sure you are aware of some generous but temporary tax incentives available in 2013 but that may vanish in 2014. They include:

- The \$250 above-the-line annual deduction for a professional educator's qualified unreimbursed expenses, including books, supplies, computers, and software.
- The exclusion from gross income for discharges of qualified principal residence indebtedness.
- The itemized deduction for mortgage insurance premiums.
- The election to claim an itemized deduction for state and local general sales taxes in lieu of state and local income taxes.

- The exclusion from gross income of qualified charitable distributions from an IRA for individuals aged 70½ or older.
- The residential energy property credit (lifetime limit remains at \$500, and no more than \$200 of the credit amount can be attributed to exterior windows and skylights).

New Taxes and Rates

Some people may be surprised that they owe additional taxes in 2013, even with the extension of the Bush-era tax cuts. Three new taxes are:

Additional Medicare Tax. This applies to wages and self-employment income above thresholds of \$250,000 for married couples filing joint returns and \$200,000 for single individuals. One way to reduce the sting of any Additional Medicare Tax liability is to withhold an additional amount of income tax.

The 39.6 percent top tax rate. Revived by the Taxpayer Relief Act, this rate has starting points of \$450,000 for married couples filing jointly and surviving spouses, \$425,000 for heads of households, \$400,000 for single filers and \$225,000 for married couples filing separately. The Relief Act also revived the personal exemption phaseout and the limitation on itemized deductions for higher-income individuals. Starting in 2013, the Act also sets the top rate for capital gains and dividends to 20 percent. This top rate aligns itself with the levels where the new 39.6 percent income tax rate bracket starts: capital gains and dividends to the extent they would be otherwise taxed at the 39.6 percent rate as marginal ordinary income will be taxed at the 20 percent rate.

Alternative minimum tax. For 2013, permanent alternative minimum tax (AMT) exemption amounts, annually adjusted for inflation and provided by the Relief Act, are:

- \$80,800 for married taxpayers filing jointly and surviving spouses;
- \$51,900 for unmarried taxpayers and heads of household, other than surviving spouses; and
- \$40,400 for married taxpayers filing separately.

Exemptions for the AMT are phased out as taxpayers reach high levels of alternative minimum taxable income (AMTI). Generally, the exemption amounts are phased out by an amount equal to 25 percent of the amount by which an individual's AMTI exceeds a threshold level. Beginning in 2013, threshold amounts for calculating the exemption phaseout are adjusted for inflation as follows:

- \$153,900 for married taxpayers filing jointly and surviving spouses (complete phaseout at \$477,100);
- \$115,400 for unmarried taxpayers and heads of household, other than surviving spouses (complete phaseout at \$323,000); and
- \$76,950 for married taxpayers filing separately (complete phaseout at \$238,550).

The 3.8-percent Net Investment Income (NII) surtax. This applies broadly to individuals, estates and trusts that have certain investment income above set amounts, including a \$250,000 threshold for married couples filing jointly and \$200,000 for single filers. NII includes investment income reduced by certain investment-related expenses, such as investment interest expense, investment brokerage fees, royalty-related expenses, and state and local taxes allocable to items included in net investment income.

Health-Care Changes

The Affordable Care Act, a sea-change to our traditional image of health insurance, requires individuals (unless exempt) to either carry minimum essential health care coverage or make a shared responsibility payment (also known as a penalty).

Most employer-sponsored health insurance is deemed to be minimum essential coverage, as is coverage provided by Medicare, Medicaid and other government programs. Self-employed individuals and small-business owners should revisit their health insurance coverage, if any, before year-end and weigh the benefits and costs of obtaining coverage in a public Marketplace (or a private insurance exchange) for themselves and their employees.

Small businesses may be eligible for a tax credit to help pay for health insurance. Individuals may qualify for a premium assistance tax credit, refundable and payable in advance, to offset the cost of coverage.

Individuals with health flexible spending accounts (FSAs) and similar arrangements should take a look at their spending habits for 2013 and predict how they will use these tax-favored funds in the future. In 2013, the maximum salary-reduction contribution to a health FSA is \$2,500. Health FSAs have strict use-it-or-lose-it rules, and the cost of over-the-counter drugs cannot be reimbursed with health FSA dollars unless you obtain a prescription (there are some exceptions).

Increased medical expense threshold. In 2013, the threshold for the itemized deduction for unreimbursed medical expenses increases from 7.5 percent of AGI to 10 percent of AGI for regular income tax purposes. For AMT purposes, medical expenses remain deductible only to the extent they exceed 10 percent of AGI. However, taxpayers (or their spouses) who are age 65 and older before the close of the tax year are exempt from the increased threshold of 10 percent for the 2013 through 2016 tax years. These taxpayers can continue to deduct qualified medical expenses that exceed 7.5 percent of AGI.

Same-Sex Marriage Ruling

The same-sex marriage ruling states that same-sex couples who are legally married in a state that recognizes their marriage are considered married for federal tax purposes, regardless of whether their state recognizes same-sex marriage. Although this ruling was effective September 16, 2013, it is applied retroactively for 2013. As a result, in 2013 and all future years, legally married same-sex couples must file their federal income tax returns as married filing jointly or married filing separately. Refund claims can still be filed for tax years 2010, 2011 and 2012.

The ruling opens the door for same-sex married couples to enjoy all of the federal tax-related benefits previously available only to opposite-sex married couples. Any same-sex marriage legally entered into in one of the 50 states, the District of Columbia, a U.S. territory or a foreign country is covered by the ruling. These benefits include (but are not limited to):

- Income tax benefits such as marriage penalty relief
- Estate and gift tax benefits
- Married filing jointly or separately filing status and standard deduction
- Claiming personal and dependency exemptions and child-driven credits
- Taxpayer-friendly employee benefits
- Spousal IRAs

Higher Income Filing

Beginning in 2013, the itemized deduction phaseout reduces itemized deductions when AGI exceeds the following threshold amounts, which will be adjusted for inflation beginning in 2014:

- \$300,000 for married taxpayers filing jointly and surviving spouses
- \$275,000 for heads of households
- \$250,000 for unmarried taxpayers who are not surviving spouses or heads of households
- \$150,000 for married taxpayers filing separately (equal to one-half of the amount for a joint return or surviving spouse, after any adjustment for inflation).

Revival of the personal exemption phaseout rules reduces or eliminates the deduction for personal exemptions for higher income taxpayers. Under the personal exemption phaseout, the total amount of exemptions that may be claimed by a taxpayer is reduced by 2 percent for each \$2,500, or portion thereof (2 percent for each \$1,250 for married couples filing separate returns) by which the taxpayer's AGI exceeds the applicable threshold. The same threshold limits above apply to the personal exemption phaseout.

Planning for Gifts

Gift-giving is an often overlooked year-end planning strategy. For 2013, individuals can make tax-free gifts, with no tax consequences for the giver or the recipient, of up to \$14,000 to any individual. Married couples may split their gifts to each recipient, which effectively raises the tax-free gift to \$28,000. Gifts between spouses are always tax-free unless one spouse is not a U.S. citizen, in which case the first \$143,000 in gifts made in 2013 are tax-free.

Special rules for gifts made for medical care and education can be a valuable component of a year-end tax strategy, especially for individuals who want to help a family member or friend. Monetary gifts directly to a college to pay tuition or to a medical service provider are tax-free to the person making the gift and the person benefitting from education or medical care.

Gifts to charity also are frequently made at year's end. Through the end of 2013, taxpayers age 70½ and older can make a tax-free distribution of up to \$100,000 from individual retirement accounts to a charity, though individuals taking this option cannot claim a deduction for the charitable gift.

Saving for Retirement

For 2013, contributions to an IRA max out at \$5,500, with a \$1,000 catch-up amount allowed for individuals over age 50. The maximum amount that can be contributed to a Roth IRA begins to decrease once a taxpayer's adjusted gross income crosses a certain threshold.

For example, married couples filing jointly will begin to see their contributions begin to phase out when their AGI hits \$178,000. Once their AGI reaches \$188,000 or more, they can no longer contribute to a Roth IRA. For single filers the corresponding income thresholds for 2013 are \$112,000 and \$127,000. For tax purposes, contributions for 2013 may be made until April 15, 2014.

Child-Driven Benefits

Adoption credit and adoption assistance programs. Two tax provisions assist taxpayers who adopt children: a tax credit, and an income exclusion for employer-paid or reimbursed adoption expenses. Effective in 2013, the maximum amount of the adoption credit and the income exclusion amount are made permanent. In 2013, both the maximum adoption credit and the maximum income exclusion amount are \$12,970 (as adjusted for inflation).

Child and dependent care (CDC) credit. The increased credit amounts and higher expense limits for the CDC are permanently extended. For 2013, the maximum amount of qualifying expenses to which the credit may be applied is \$3,000 for individuals with one qualifying child or dependent (for a maximum credit of \$1,050), or \$6,000 for individuals with two or more qualifying children or dependents (for a maximum credit of \$2,100). For taxpayers with AGI between \$15,000 and \$43,000, the 35 percent credit rate is reduced by one percentage point for each \$2,000 of AGI until the credit percentage is 20 percent for taxpayers with AGI of \$43,000.

Traditional Tax Planning

As always, tax planning requires a combination of multi-layered strategies, taking into account a variety of possible scenarios and outcomes.

Income deferral and deduction/credit acceleration techniques may be used to reduce an individual taxpayer's income tax liability:

- Defer billings and collections
- Receive bonuses earned for 2013 in 2014
- Sell appreciated assets in 2014
- Offset tax losses against current gains (loss harvesting)
- Postpone the redemption of U.S. Savings Bonds
- Declare any special dividends in 2014
- Delay Roth conversions to 2014
- Defer debt forgiveness income if possible
- Minimize retirement distributions
- Execute like-kind exchange transactions
- Take corporate liquidation distributions in 2014

Deduction/credit acceleration techniques:

- Bunch itemized deductions into 2013/Standard deduction into 2014
- Accelerate bill payments into 2013
- Pay last state estimated tax installment in 2013 instead of 2014
- Minimize the effect of AGI limitations on deductions/credits
- Maximize net investment interest deductions
- Match passive activity income and losses