



# 2013 TAX PLANNING GUIDE

Year-round strategies to make  
the tax laws work for you



## Tax law changes make planning both complicated and critical

*Last year, tax planning was a major challenge because of uncertainty about whether significant tax increases scheduled for 2013 would go into effect. On Jan. 1, 2013, Congress passed the American Taxpayer Relief Act of 2012 (ATRA), which prevented income tax rate increases for most taxpayers. It also addressed many expired tax breaks for individuals and businesses, the alternative minimum tax (AMT) and the estate tax.*

*But ATRA didn't provide as much relief to higher-income taxpayers. While they'll enjoy the benefits of the extended lower rates on a portion of their income, many will see rate hikes on income exceeding certain thresholds. Expanded Medicare taxes also will affect higher-income taxpayers this year. In addition, even though many of ATRA's provisions are "permanent," this simply means that the provisions don't have expiration dates. Congress can still pass additional changes affecting your tax liability this year or in future years.*

*So in 2013, tax planning continues to be a complicated and critical task. This guide is intended to help you familiarize yourself with key tax law changes and make the most of the tax-savings opportunities available to you. But we don't have room here to cover all strategies that may apply to your situation. So please contact your tax advisor to learn the best ways to minimize your tax liability for 2013 and beyond.*

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## Should tax law changes affect your planning this year?

*ATRA made lower ordinary-income tax rates permanent for most taxpayers, but some previously in the 35% bracket now face the 39.6% rate's return. ATRA also brought back a reduction on many deductions. It kicks in when adjusted gross income (AGI) exceeds \$250,000 (singles), \$275,000 (heads of households) or \$300,000 (joint filers). Whether or not you're affected by these tax increases, you may want to implement the traditional timing strategies of deferring income and accelerating deductible expenses to reduce, or at least defer, tax.*

### The AMT

When planning for deductions, the first step is to consider the AMT — a separate tax system that limits some deductions and doesn't permit others, such as:

- State and local income tax deductions,
- Property tax deductions, and
- Miscellaneous itemized deductions subject to the 2% of AGI floor, such as investment expenses and unreimbursed employee business expenses.

You must pay the AMT if your AMT liability exceeds your regular tax liability. You may be able to time income and deductions to avoid the AMT, reduce its impact or even take advantage of its lower maximum rate. (See Chart 6 on page 16.) ATRA has made planning a little easier because it includes long-term AMT relief.

Before the act, unlike the regular tax system, the AMT system wasn't regularly adjusted for inflation. Instead, Congress had to legislate any adjustments. Typically, it did so via an increase in the AMT exemptions. ATRA has set higher exemptions *permanently*, indexing them — as well as the AMT brackets — for inflation going forward.

### Home-related breaks

Consider both deductions and exclusions:

**Property tax deduction.** Before paying your bill early to accelerate the itemized deduction into 2013, review

your AMT situation. If you're subject to the AMT, you'll lose the benefit of the deduction for the prepayment.

**Mortgage interest deduction.** You generally can deduct interest on up to a combined total of \$1 million of mortgage debt incurred to purchase, build or improve your principal residence and a second residence. Points paid related to your *principal* residence also may be deductible.

**Home equity debt interest deduction.** Interest on home equity debt used for any purpose (debt limit of \$100,000) may be deductible. So consider using a

home equity loan or line of credit to pay off credit cards or auto loans, for which interest isn't deductible and rates may be higher. **Warning:** Beware of the AMT — if the home equity debt isn't used for home improvements, the interest isn't deductible for AMT purposes.

**Home office deduction.** If your use of a home office is for your employer's benefit and it's the only use of the space, you generally can deduct a portion of your mortgage interest, property taxes, insurance, utilities and certain other expenses, as well as the depreciation allocable to the office space. Or you may be able to take the new, simpler,

### WHAT'S NEW!

#### Additional Medicare tax now applies to higher earners

**Who's affected:** Taxpayers with earned income exceeding certain thresholds.

**Key changes:** Under the health care act, starting in 2013, taxpayers must pay an additional 0.9% Medicare tax on FICA wages and self-employment income exceeding \$200,000 per year (\$250,000 for joint filers and \$125,000 for married filing separately). Employers are obligated to withhold the additional tax beginning in the pay period when wages exceed \$200,000 for the calendar year — without regard to an employee's filing status or income from other sources. So your employer might withhold the tax even if you aren't liable for it — or it might *not* withhold the tax even though you *are* liable for it.

**Planning tips:** You may be able to implement timing strategies to avoid or minimize the additional tax. If you *don't* owe the tax but your employer *is* withholding it, you can claim a credit on your 2013 income tax return. If you *do* owe the tax but your employer *isn't* withholding it, consider filing a W-4 to request additional *income* tax withholding, which can be used to cover the shortfall and avoid interest and penalties.



“safe harbor” deduction. (Contact your tax advisor for details.) Home office expenses are a miscellaneous itemized deduction, which means you’ll enjoy a tax benefit only if these expenses plus your other miscellaneous itemized expenses exceed 2% of your AGI. (If you’re self-employed, see page 11.)

**Home sale gain exclusion.** When you sell your principal residence, you can exclude up to \$250,000 (\$500,000 for joint filers) of gain if you meet certain tests. **Warning:** Gain that’s allocable to a period of “nonqualified” use generally isn’t excludable.

**Home sale loss deduction.** Losses on the sale of a principal residence aren’t deductible. But if part of your home is rented or used exclusively for your business, the loss attributable to that portion will be deductible, subject to various limitations.

**Debt forgiveness exclusion.** Homeowners who receive debt forgiveness in a foreclosure, short sale or mortgage workout for a principal residence generally don’t have to pay federal income taxes on that forgiveness. **Warning:** As of this writing, this break is scheduled to expire after 2013.

**Rental income exclusion.** If you rent out all or a portion of your principal residence or second home for less than 15 days, you don’t have to report the income. But expenses directly associated with the rental, such as advertising and cleaning, won’t be deductible.

### Health-care-related breaks

If your medical expenses exceed 10% of your AGI, you can deduct the excess amount. Eligible expenses include:

- Health insurance premiums,
- Long-term care insurance premiums (limits apply),
- Medical and dental services, and
- Prescription drugs.

Consider “bunching” nonurgent medical procedures and other controllable expenses into one year to exceed the 10% floor. **Warning:** Before 2013, the floor was only 7.5% for regular tax

### CASE STUDY I

### Benefiting from the sales tax deduction

Hugo mentions to his tax advisor that he’s thinking about buying a new car but is undecided on whether to make the purchase in 2013 or hold off a year. His advisor suggests there may be a tax advantage to making the purchase this year.

ATRA extended the break allowing taxpayers to take an itemized deduction for state and local *sales* taxes in lieu of state and local *income* taxes — but only through 2013. The deduction is valuable to those who reside in states with no or low income tax, and it can also benefit taxpayers in other states who purchase a major item, such as a car or boat.

Hugo’s advisor estimates that Hugo’s state and local income tax liability for 2013 will be \$3,000 and that, based on what Hugo expects to spend on his car, the sales tax would also be \$3,000. That may sound like a wash, but the advisor reminds Hugo that, if he elects to deduct sales tax, he can deduct *all* of the sales tax he pays during the year, not just the tax on the car purchase. And Hugo doesn’t even have to keep receipts and track all the sales tax he actually pays. His deduction can be determined by using an IRS sales tax calculator that will base the deduction on Hugo’s income and the sales tax rates in his locale plus the tax he actually pays on his car purchase.

purposes, making it easier to exceed. Taxpayers age 65 and older can still enjoy that 7.5% floor through 2016. The floor for AMT purposes, however, is 10% for *all* taxpayers (the same as it was before 2013).

Also remember that expenses that are reimbursed (or reimbursable) by insurance or paid through one of the following accounts aren’t deductible:

**1. HSA.** If you’re covered by qualified high-deductible health insurance, a Health Savings Account allows contributions of pretax income (or deductible after-tax contributions) up to \$3,250 for self-only coverage and \$6,450 for family coverage (for 2013), plus an additional \$1,000 if you’re age 55 or older. HSAs bear interest or are invested and can grow tax-deferred similar to an IRA. Withdrawals for qualified medical expenses are tax-free, and you can carry over a balance from year to year.

**2. FSA.** You can redirect pretax income to an employer-sponsored Flexible Spending Account up to an employer-determined limit — not to exceed \$2,500 for plan years beginning in 2013. The plan pays or reimburses you for qualified medical expenses. What you don’t use by the end of the plan year, you generally lose. If you have an HSA, your FSA is limited to funding certain “permitted” expenses.

### Charitable donations

Donations to qualified charities are generally fully deductible for both regular tax and AMT purposes, and they may be the easiest deductible expense to time to your tax advantage. For large donations, discuss with your tax advisor which assets to give and the best ways to give them. For example:

**Appreciated assets.** Publicly traded stock and other securities you’ve held more than one year can make one of the best charitable gifts. Why? Because you can deduct the current fair market value and avoid the capital gains tax you’d pay if you sold the property. **Warning:** Donations of such property are subject to tighter deduction limits. Excess contributions can be carried forward for up to five years.

**CRTs.** For a given term, a charitable remainder trust pays an amount to you annually (some of which generally is taxable). At the term’s end, the CRT’s remaining assets pass to one or more charities. When you fund the CRT, you receive an income tax deduction. If you contribute appreciated assets, you also can minimize and defer capital gains tax. You can name someone other than yourself as income beneficiary or fund the CRT at your death, but the tax consequences will be different. ■

## Tax-saving outlook brighter for parents and students

If you're a parent, a student or even a grandparent, valuable deductions, credits and tax-advantaged savings opportunities may be available to you or to your family members. Some child- and education-related breaks had been scheduled to become less beneficial in 2013, but the tax-saving outlook is now brighter because ATRA extended most enhancements — in many cases, making them permanent.

### Child and adoption credits

Tax credits reduce your tax bill dollar-for-dollar, so make sure you're taking every credit you're entitled to. For each child under age 17 at the end of the year, you may be able to claim a \$1,000 child credit.

If you adopt in 2013, you may qualify for an adoption credit or an employer adoption assistance program income exclusion; both are \$12,970 per eligible child. Some enhancements to these credits had been scheduled to expire after 2012, but ATRA made them permanent. (Contact your tax advisor for details.)

**Warning:** These credits phase out for higher-income taxpayers. (See Chart 1.)

### Child care expenses

A couple of tax breaks can help you offset these costs:

**Tax credit.** For children under age 13 or other qualifying dependents, you may be eligible for a credit for a portion of your dependent care expenses. Eligible expenses are limited to \$3,000 for one dependent and \$6,000 for two or more. Income-based limits reduce the credit but don't phase it out altogether. (See Chart 1.) The credit's value had been scheduled to drop in 2013, but ATRA made higher limits permanent.

**FSA.** You can contribute up to \$5,000 pretax to an employer-sponsored child and dependent care Flexible Spending

CHART 1

### 2013 family and education tax breaks: Are you eligible?

Tax break	Modified adjusted gross income phaseout range	
	Single filer	Joint filer
Child credit <sup>1</sup>	\$ 75,000 – \$ 95,000	\$ 110,000 – \$ 130,000
Adoption credit	\$ 194,580 – \$ 234,580	\$ 194,580 – \$ 234,580
Child or dependent care credit <sup>2</sup>	\$ 15,000 – \$ 43,000	\$ 15,000 – \$ 43,000
ESA contribution	\$ 95,000 – \$ 110,000	\$ 190,000 – \$ 220,000
American Opportunity credit	\$ 80,000 – \$ 90,000	\$ 160,000 – \$ 180,000
Lifetime Learning credit	\$ 53,000 – \$ 63,000	\$ 107,000 – \$ 127,000
Student loan interest deduction	\$ 60,000 – \$ 75,000	\$ 125,000 – \$ 155,000

<sup>1</sup> Assumes one child. The phaseout end is higher for families with more than one eligible child.

<sup>2</sup> The phaseout is based on AGI rather than MAGI. The credit doesn't phase out altogether, but the minimum credit percentage of 20% applies to AGIs above \$43,000.

Account. The plan pays or reimburses you for these expenses. You can't use those same expenses to claim a tax credit.

### IRAs for teens

IRAs can be perfect for teenagers because they likely will have many years to let their accounts grow tax-deferred or tax-free. The 2013 contribution limit is the lesser of \$5,500 (up from \$5,000 in 2012) or 100% of earned income. Traditional IRA contributions generally are deductible, but distributions will be taxed. On the other hand, Roth IRA contributions aren't deductible, but qualified distributions will be tax-free.

Choosing a Roth IRA is typically a no-brainer if a teen doesn't earn income that exceeds the standard deduction (\$6,100 for 2013 for single taxpayers), because he or she will likely gain no benefit from the ability to deduct a traditional IRA contribution. (For more on IRAs, see page 12.)

If your children or grandchildren don't want to invest their hard-earned money, consider *giving* them the amount they're eligible to contribute — but keep the gift tax in mind. (See page 14.) If they don't have earned income and you own a business, consider hiring them. As the business owner, you can deduct their pay, and other tax benefits may apply.

**Warning:** The children must be paid





in line with what you'd pay nonfamily employees for the same work.

### The “kiddie tax”

The “kiddie tax” applies to children under age 19 as well as to full-time students under age 24 (unless the students provide more than half of their own support from earned income).

For children subject to the tax, any unearned income beyond \$2,000 (for 2013) is taxed at their parents' marginal rate rather than their own, likely lower, rate. Keep this in mind before transferring income-generating assets to them.

### 529 plans

If you're saving for college, consider a Section 529 plan. You can choose a prepaid tuition program to secure current tuition rates or a tax-advantaged savings plan to fund college expenses:

- Contributions aren't deductible for federal purposes, but plan assets can grow tax-deferred.
- Distributions used to pay qualified expenses (such as tuition, mandatory fees, books, equipment, supplies and, generally, room and board) are income-tax-free for federal purposes and typically for state purposes as well.
- The plans typically offer high contribution limits, and there are no income limits for contributing.
- There's generally no beneficiary age limit for contributions or distributions.

- You remain in control of the account, even after the child is of legal age.
- You can make tax-free rollovers to another qualifying family member.
- The plans provide estate planning benefits: A special break for 529 plans allows you to front-load five years' worth of annual gift tax exclusions and make a \$70,000 contribution (or \$140,000 if you split the gift with your spouse).

The biggest downsides may be that your investment options — and when you can change them — are limited.

### Education credits and deductions

If you have children in college now, are currently in school yourself or are paying off student loans, you may be eligible for a credit or deduction:

**American Opportunity credit.** This tax break covers 100% of the first \$2,000 of tuition and related expenses and 25% of the next \$2,000 of expenses. The maximum credit, *per student*, is \$2,500 per year for the first four years of postsecondary education. The credit

had been scheduled to revert to the less beneficial Hope credit after 2012, but ATRA extended the enhanced credit through 2017.

**Lifetime Learning credit.** If you're paying postsecondary education expenses beyond the first four years, you may be eligible for the Lifetime Learning credit (up to \$2,000 *per tax return*).

**Tuition and fees deduction.** If you don't qualify for one of the credits because your income is too high, you might be eligible to *deduct* up to \$4,000 of qualified higher education tuition and fees. **Warning:** ATRA extended this break only through 2013.

### Student loan interest deduction.

If you're paying off student loans, you may be able to deduct up to \$2,500 of interest (per tax return). ATRA made certain enhancements to the deduction permanent; contact your tax advisor for details.

**Warning:** Income-based phaseouts apply to these breaks (see Chart 1), and expenses paid with distributions from 529 plans or ESAs (see “What's new!” below) can't be used to claim them. ■

## WHAT'S NEW!

### Valuable ESA benefits made permanent

**Who's affected:** Taxpayers saving for education expenses.

**Key changes:** Coverdell Education Savings Accounts (ESAs) are similar to 529 savings plans in that contributions aren't deductible for federal purposes, but plan assets can grow tax-deferred and distributions used to pay qualified education expenses are income-tax-free.

One of the biggest ESA advantages over 529 plans has been that tax-free distributions aren't limited to college expenses; they also can fund elementary and secondary school costs. This favorable treatment had been scheduled to expire after 2012, but ATRA made it permanent. ATRA also made permanent the \$2,000 per beneficiary annual ESA contribution limit, which had been scheduled to drop to \$500 for 2013.

**Planning tips:** ESAs are worth considering if you want to fund elementary or secondary education expenses or would like to have direct control over how and where your contributions are invested. But even the \$2,000 contribution limit is quite low, and contributions are further limited based on income. (See Chart 1.) Also, contributions generally can be made only for the benefit of a child under age 18. Amounts left in an ESA when the beneficiary turns age 30 generally must be distributed within 30 days, and any earnings may be subject to tax and a 10% penalty.

## Tax planning for investments gets even more complicated this year

*While tax consequences should never drive investment decisions, it's critical that they be considered — especially this year. Tax treatment of investments has always varied based on a variety of factors. In recent years, uncertainty about what would happen with rates that had been set to expire after 2012 further complicated matters. ATRA made rates permanent, but that doesn't mean tax planning for investments will be simpler in 2013. Higher-income taxpayers may face more taxes on their investment income in the form of the returning 20% top long-term capital gains rate and a new 3.8% Medicare tax — kicking in at different income levels based on different definitions of income.*

### Capital gains tax and timing

Although time, not timing, is generally the key to long-term investment success, timing can have a dramatic impact on the tax consequences of investment activities. A taxpayer's long-term capital gains rate can be as much as 20 percentage points lower than his or her ordinary-income rate. The long-term gains rate applies to investments held for more than 12 months. The applicable rate depends on the taxpayer's income level and the type of asset. (See Chart 2.)

Holding on to an investment until you've owned it more than a year may help substantially cut tax on any gain. Here are some other tax-saving strategies related to timing:

**Use unrealized losses to absorb gains.** To determine capital gains tax liability, realized capital gains are netted against any realized capital losses. If you've cashed in some big gains during the year and want to reduce your 2013 tax liability, before year end look for unrealized losses in your portfolio and consider selling them to offset your gains.

**Avoid wash sales.** If you want to achieve a tax loss with minimal change in your portfolio's asset allocation, keep in mind the wash sale rule. It prevents

you from taking a loss on a security if you buy a substantially identical security (or option to buy such a security) within 30 days before or after you sell the security that created the loss. You can recognize the loss only when you sell the replacement security.

Fortunately, there are ways to avoid triggering the wash sale rule and still achieve your goals. For example, you can immediately buy securities of a different company in the same industry or shares in a mutual fund that holds securities much like the ones you sold.

Or, you may wait 31 days to repurchase the same security. Alternatively, before selling the security, you can purchase additional shares of that security equal to the number you want to sell at a loss, and then wait 31 days to sell the original portion.

**Swap your bonds.** With a bond swap, you sell a bond, take a loss and then immediately buy another bond of similar quality and duration from a different issuer. Generally, the wash sale rule doesn't apply because the bonds aren't considered substantially identical. Thus,

### WHAT'S NEW!

#### Will you owe the 3.8% Medicare tax on investment income?

**Who's affected:** Investors with income exceeding certain thresholds.

**Key changes:** Under the health care act, starting in 2013, taxpayers with modified adjusted gross income (MAGI) over \$200,000 per year (\$250,000 for joint filers and \$125,000 for married filing separately) may owe a new Medicare contribution tax, also referred to as the "net investment income tax" (NIIT). The tax equals 3.8% of the lesser of your net investment income or the amount by which your MAGI exceeds the applicable threshold. The rules on what is and isn't included in net investment income are somewhat complex, so consult your tax advisor for more information.

**Planning tips:** Many of the strategies that can help you save or defer income tax on your investments can also help you avoid or defer NIIT liability. And because the threshold for the NIIT is based on MAGI, strategies that reduce your MAGI — such as making retirement plan contributions (see page 12) — can also help you avoid or reduce NIIT liability.



you achieve a tax loss with virtually no change in economic position.

**Mind your mutual funds.** Mutual funds with high turnover rates can create income that's taxed at ordinary-income rates. Choosing funds that provide primarily long-term gains can save you more tax dollars because of the lower long-term rates.

**See if a loved one qualifies for the 0% rate.** ATRA made permanent the 0% rate for long-term gain that would be taxed at 10% or 15% based on the taxpayer's ordinary-income rate. If you have adult children in one of these tax brackets, consider transferring appreciated assets to them so they can enjoy the 0% rate. This strategy can be even more powerful if you'd be subject to the 3.8% Medicare contribution tax (see "What's new!" at left) or the 20% long-term capital gains rate if you sold the assets.

**Warning:** If the child will be under age 24 on Dec. 31, first make sure he or she won't be subject to the "kiddie tax." (See page 5.) Also, consider any gift tax consequences. (See page 14.)

### Loss carryovers

If net losses exceed net gains, you can deduct only \$3,000 (\$1,500 for married taxpayers filing separately) of the net losses per year against ordinary income (such as wages, self-employment and business income, and interest).

You can carry forward excess losses indefinitely. Loss carryovers can be a powerful tax-saving tool in future years if you have a large investment portfolio, real estate holdings or a closely held business that might generate substantial future capital gains.

But if you don't expect substantial future gains, it could take a long time to fully absorb a large loss carryover. So, from a tax perspective, you may not want to sell an investment at a loss if you won't have enough gains to absorb most of it. (Remember, however, that capital gains distributions from mutual funds can also absorb capital losses.) Plus, if you hold on to the investment, it may recover the lost value.

## CHART 2 What's the maximum capital gains tax rate?

Assets held	2012	2013 <sup>1</sup>
12 months or less ( <i>short term</i> )	35%	39.6% <sup>2</sup>
More than 12 months ( <i>long term</i> )	15%	20% <sup>2</sup>
<b>Some key exceptions</b>		
Long-term gain on collectibles, such as artwork and antiques	28%	28%
Long-term gain attributable to certain recapture of prior depreciation on real property	25%	25%
Long-term gain that would be taxed at 15% or less based on the taxpayer's ordinary-income rate	0%	0%
<sup>1</sup> In addition, under the 2010 health care act, a new 3.8% Medicare contribution tax applies to net investment income to the extent that modified adjusted gross income (MAGI) exceeds \$200,000 (singles and heads of households) or \$250,000 (married couples filing jointly).		
<sup>2</sup> Rate increase over 2012 applies only to those with taxable income exceeding \$400,000 (singles), \$425,000 (heads of households) or \$450,000 (married couples filing jointly).		

Nevertheless, if you're ready to divest yourself of a poorly performing investment because you think it will continue to lose value — or because your investment objective or risk tolerance has changed — don't hesitate solely for tax reasons.

### Beyond gains and losses

With some types of investments, you'll have more tax consequences to consider than just gains and losses:

#### Dividend-producing investments.

ATRA made permanent the favorable long-term capital gains tax treatment of qualified dividends. Such dividends had been scheduled to return to being taxed at higher, ordinary-income tax rates in 2013. **Warning:** Higher-income taxpayers will still see a tax increase on qualified dividends if they're subject to the new 3.8% Medicare contribution tax (see "What's new!" at left) or the return of the 20% long-term capital gains rate.

#### Interest-producing investments.

Interest income generally is taxed at ordinary-income rates. So, in terms of income investments, stocks that pay qualified dividends may be more attractive tax-wise than, for example, CDs or money market accounts. But nontax issues must be considered as well, such as investment risk and diversification.

**Bonds.** These also produce interest income, but the tax treatment varies:

- Interest on U.S. government bonds is taxable on federal returns but generally exempt on state and local returns.
- Interest on state and local government bonds is excludable on federal returns. If the bonds were issued in your home state, interest also may be excludable on your state return.
- Tax-exempt interest from certain private-activity municipal bonds can trigger or increase the alternative minimum tax (AMT — see page 2) in some situations.
- Corporate bond interest is fully taxable for federal and state purposes.
- Bonds (except U.S. savings bonds) with original issue discount (OID) build up "interest" as they rise toward maturity. You're generally considered to earn a portion of that interest annually — even though the bonds don't pay this interest annually — and you must pay tax on it.

**Stock options.** Before exercising (or postponing exercise of) options or selling stock purchased via an exercise, consult your tax advisor about the complicated rules that may trigger regular tax or AMT liability. He or she can help you plan accordingly. ■



## A mix of good and bad tax news requires careful planning

*The good news: Many breaks — and break enhancements — for businesses have been extended by ATRA. The bad news: Flow-through entities, such as partnerships, limited liability companies (LLCs) and S corporations, may be affected by ATRA's increase to the top ordinary-income tax rates for individuals, from 35% to 39.6%. So businesses need to plan carefully to take advantage of the breaks available to them this year while minimizing the impact of higher rates if applicable.*

### Projecting income

Projecting your business's income for this year and next will allow you to time income and deductions to your advantage. It's generally — but not always — better to defer tax, so consider:

**Deferring income to next year.** If your business uses the cash method of accounting, you can defer billing for products or services. If you use the accrual method, you can delay shipping products or delivering services.

**Accelerating deductible expenses into the current year.** If you're a cash-basis taxpayer, you may make a state estimated tax payment before Dec. 31, so you can deduct it this year rather than next. But consider the alternative minimum tax (AMT) consequences first. Both cash- and accrual-basis taxpayers can charge expenses on a credit card and deduct them in the year charged, regardless of when the credit card bill is paid.

**Warning:** Don't let tax considerations get in the way of sound business decisions. For example, think twice about these strategies if you're experiencing a low-income year. Their negative impact on your cash flow may not be worth the potential tax benefit.

**Taking the opposite approach.** If it's likely you'll be in a higher tax bracket next year, accelerating income and deferring deductible expenses may save you more tax.

### Depreciation

For assets with a useful life of more than one year, you generally must depreciate the cost over a period of years. In most cases, the Modified Accelerated Cost Recovery System (MACRS) will be preferable to the straight-line method because you'll get larger deductions in the early years of an asset's life.

But if you make more than 40% of the year's asset purchases in the last quarter, you could be subject to the typically less favorable midquarter convention. Careful planning can help you maximize depreciation deductions in the year of purchase.

Other depreciation-related breaks and strategies also are available:

**50% bonus depreciation.** ATRA extended this additional first-year depreciation allowance, generally to qualifying assets acquired and placed in service in 2013 (2014 for certain long-lived and transportation property). Qualified assets include *new* tangible property with a recovery period of 20 years or less (such as office furniture, equipment and company-owned vehicles), off-the-shelf computer software, water utility property and qualified leasehold-improvement property.

Corporations can accelerate certain credits in lieu of claiming bonus depreciation for qualified assets acquired and

placed in service through Dec. 31, 2013. (For certain long-lived and transportation property, the deadline is Dec. 31, 2014.)

If you're eligible for full Section 179 expensing (see "What's new!" at right), it may provide a greater benefit because it can allow you to deduct 100% of an asset acquisition's cost. Plus, generally only Sec. 179 expensing is available for *used* property. However, bonus depreciation may benefit more taxpayers than Sec. 179 expensing, because it isn't subject to any asset purchase limit or net income requirement. Also consider state tax consequences.

**Accelerated depreciation.** ATRA revived through 2013 the break allowing a shortened recovery period of 15 years — rather than 39 years — for qualified leasehold-improvement, restaurant and retail-improvement property.

**Cost segregation study.** If you've recently purchased or built a building or are remodeling existing space, consider a cost segregation study. It identifies property components and related costs that can be depreciated much faster, perhaps dramatically increasing your current deductions. Typical assets that qualify include decorative fixtures, security equipment, parking lots and landscaping.

The benefit of a cost segregation study may be limited in certain circumstances — for example, if the business is subject



to the AMT or is located in a state that doesn't follow federal depreciation rules.

### Vehicle-related deductions

Business-related vehicle expenses can be deducted using the mileage-rate method (56.5 cents per mile driven in 2013) or the actual-cost method (total out-of-pocket expenses for fuel, insurance and repairs, plus depreciation).

Purchases of *new or used* vehicles may be eligible for Sec. 179 expensing (see "What's new!" below) and purchases of *new* vehicles may be eligible for bonus depreciation. However, many rules and limits apply.

For example, the normal Sec. 179 expensing limit generally applies to vehicles weighing more than 14,000 pounds, but the limit is only \$25,000 for SUVs weighing more than 6,000 pounds but no more than 14,000 pounds.

Vehicles weighing 6,000 pounds or less don't satisfy the SUV definition and thus are subject to the passenger automobile limits. For autos placed in service in 2013, the depreciation limit is \$3,160. The limit is increased by \$8,000 for vehicles eligible for bonus depreciation. The amount that may be deducted under the combination of MACRS depreciation, Sec. 179 and bonus depreciation rules for the first year is limited under the luxury auto rules.

In addition, if a vehicle is used for business and personal purposes, the associated expenses, including depreciation, must be allocated between deductible business use and nondeductible personal use. The depreciation limit is reduced if the business use is less than 100%. If business use is 50% or less, you can't use Sec. 179 expensing, bonus depreciation or the accelerated regular MACRS; you must use the straight-line method.

### Manufacturers' deduction

The manufacturers' deduction, also called the "Section 199" or "domestic production activities deduction," is 9% of the lesser of qualified production activities income or taxable income.

The deduction is also limited to 50% of W-2 wages paid by the taxpayer that are allocable to domestic production gross receipts.

The deduction is available to traditional manufacturers and to businesses engaged in activities such as construction, engineering, architecture, computer software production and agricultural processing. It isn't allowed in determining net self-employment earnings and generally can't reduce net income below zero. But it can be used against the AMT.

### Employee benefits

Offering a variety of benefits not only can help you attract and retain the best employees, but also may save tax:

**Qualified deferred compensation plans.** These include pension, profit-sharing, SEP and 401(k) plans, as well as SIMPLEs. You take a tax deduction for your contributions to employees' accounts, and the plans offer tax-deferred

savings benefits for employees. (For more on the benefits to employees, see page 12.) Certain small employers may also be eligible for a credit when setting up a plan. (See "Tax credits" on page 10.)

**HSAs and FSAs.** If you provide employees with qualified high-deductible health insurance, you can also offer them Health Savings Accounts. Regardless of the type of health insurance you provide, you can offer Flexible Spending Accounts for health care. (See "Health-care-related breaks" on page 3.) If you have employees who incur day care expenses, consider offering FSAs for child and dependent care. (See "Child care expenses" on page 4.)

**Fringe benefits.** Some fringe benefits — such as employee discounts, group term-life insurance (up to \$50,000 annually per person), parking and mass transit / van pooling (up to \$245 per month), and health insurance — aren't included in employee income. Yet the employer can

#### WHAT'S NEW!

### Enhanced Sec. 179 expensing extended through 2013

**Who's affected:** Businesses that have made or are considering asset purchases or certain property improvements.

**Key changes:** This election allows you to deduct (rather than depreciate over a number of years) the cost of purchasing such assets as equipment, furniture and off-the-shelf computer software. ATRA extended through 2013 the higher expensing limit of \$500,000. The break begins to phase out dollar-for-dollar when total asset acquisitions for the tax year exceed \$2 million. ATRA also extended through 2013 the break allowing up to \$250,000 of Sec. 179 expensing to be applied to qualified leasehold-improvement, restaurant and retail-improvement property.

You can claim the Sec. 179 election only to offset net income, not to reduce it below zero to create a net operating loss. (See "NOLs" on page 10.) If your asset purchases for the year will exceed the phaseout threshold or your net income, consider 50% bonus depreciation. (See page 8.) It may provide greater tax savings because it has no asset purchase limit or net income requirement. But generally only Sec. 179 expensing can be applied to *used* assets. Also consider state tax consequences.

**Planning tips:** The Sec. 179 expensing limit and phaseout threshold are scheduled to drop to \$25,000 and \$200,000, respectively, in 2014. Sec. 179 expensing for qualified leasehold-improvement, restaurant and retail-improvement property is set to expire Dec. 31, 2013. If you're anticipating major asset purchases or property improvements in the next year or two that would qualify, you may want to time them so you can benefit from enhanced Sec. 179 expensing while it's available.

still receive a deduction for the portion, if any, of the benefit it pays and typically avoid payroll tax as well. Certain small businesses providing health care coverage may be eligible for a tax *credit*. (See “Tax credits” below.)

**Warning:** Beginning in 2015, if you’re considered a large employer and don’t offer full-time employees sufficient health care coverage, you could be at risk for penalties under the health care act. The effective date has already been extended once, the rules are complex, and additional IRS guidance is expected. Contact your tax advisor for the latest information.

**NQDC.** Nonqualified deferred compensation plans generally aren’t subject to nondiscrimination rules, so they can be used to provide substantial benefits to key employees. But the employer generally doesn’t get a deduction for NQDC plan contributions until the employee recognizes the income.

### NOLs

A net operating loss occurs when operating expenses and other deductions for the year exceed revenues. Generally, an NOL may be carried back two years to generate a refund. Any loss not absorbed is carried forward up to 20 years to offset income.

Carrying back an NOL may provide a needed influx of cash. But you can elect to forgo the carryback if carrying the entire loss forward may be more beneficial, such as if you expect your income to increase substantially or tax rates to go up.

### Tax credits

Tax credits reduce tax liability dollar-for-dollar, making them particularly valuable. Numerous types of credits are available to businesses. Here are a few to consider:

**Health care coverage credit for small businesses.** For tax years 2010 to 2013, the maximum credit is 35% of group health coverage premiums paid by the employer, provided it contributes at least 50% of the total premium or of a benchmark premium. The full credit is available for employers with 10 or fewer full-time equivalent employees (FTEs) and average annual wages of less than

\$25,000 per employee. Partial credits are available on a sliding scale to businesses with fewer than 25 FTEs and average annual wages of less than \$50,000.

**Retirement plan credit.** Small employers (generally those with 100 or fewer employees) that create a retirement plan may be eligible for a \$500 credit per year for three years. The credit is limited to 50% of qualified startup costs.

**Work Opportunity credit.** This credit, designed to encourage hiring from certain disadvantaged groups, had expired Dec. 31, 2011, for most groups, and an expanded credit for qualifying veterans had expired Dec. 31, 2012. ATRA has extended the credit for most eligible groups through 2013.

Examples of qualifying groups include food stamp recipients, ex-felons and nondisabled veterans who’ve been unemployed for four weeks or more, but less than six months. For hiring from these groups, the credit generally equals 40% of the first \$6,000 of wages paid, for a maximum credit of \$2,400 per qualifying employee.

A larger credit of up to \$4,800 may be available for hiring disabled veterans. And, if you hire veterans who’ve been unemployed for six months or more in the preceding year, the maximum credits are even greater: \$5,600 for *nondisabled* veterans and \$9,600 for disabled veterans.

**Other credits.** Examples of other expired credits that ATRA extended through 2013 include various energy-related credits, the new markets credit and the empowerment zone credit. Contact your tax advisor to learn which credits might apply to you.

### Business structure

Income taxation and owner liability are the main factors that differentiate one business structure from another. (See Chart 3 to compare the tax treatments.) Many businesses choose entities that combine flow-through taxation with limited liability, namely limited liability companies (LLCs) and S corporations.

After ATRA, the top individual rate is higher (39.6%) than the top corporate rate (generally 35%), which might

## WHAT’S NEW!

### Research credit revived through 2013

**Who’s affected:** Businesses that have increased, or are considering increasing, their research activities.

**Key changes:** This credit (also commonly referred to as the “research and development” or “research and experimentation” credit) had expired after 2011, but ATRA extended it through 2013. The credit is for increases in a wide variety of research activities, not just laboratory experiments. For example, activities intended to develop or enhance product performance, manufacturing processes or information technology may qualify. But certain activities are excluded.

Wages for researchers, the cost of research supplies and the cost of computer licensing for research purposes are among those expenses that may qualify. The *traditional* research credit is equal to 20% of qualified research expenses over a defined base amount related to your gross receipts and previous research spending. The *simplified* credit is equal to 14% of qualified spending for that year that’s over 50% of your qualified research expenses for the previous three years.

**Planning tips:** Because the research credit is scheduled to expire Dec. 31, 2013, this may be a good year to increase your research activities to help ensure you can take advantage of the credit. But it’s also possible the credit will be extended again, or even made permanent. Determining which activities and expenses qualify and calculating the credit can be complicated, so consult your tax advisor to learn whether and to what extent you can benefit.

affect business structure decisions. For tax or other reasons, a structure change may be beneficial in certain situations, but there also may be unwelcome tax consequences. Your tax advisor can help you determine whether a change would make sense for your company.

Some tax differences between structures may provide tax planning opportunities, such as differences related to salary vs. distributions/dividends:

**S corporations.** To reduce their employment taxes, shareholder-employees may want to keep their salaries relatively low and increase their distributions of company income — which generally isn't taxed at the corporate level and generally won't be subject to the new 3.8% Medicare contribution tax on net investment income. (See "What's new!" on page 6.) But to avoid potential back taxes and penalties, shareholder-employees must take a "reasonable" salary. What's considered "reasonable" is determined by the specific facts and circumstances, but it's generally what the company would pay an outsider to perform the same services.

**C corporations.** Shareholder-employees may prefer to take more income as salary as opposed to dividends if the overall tax paid by both the corporation and the shareholder-employee might be less. Salary is deductible at the corporate level, though it will be subject to employment taxes, including the new additional 0.9% Medicare tax to the extent the shareholder-employee's wages exceed the applicable threshold. (See "What's new!" on page 2.) Dividends aren't deductible at the corporate level and are taxed at the shareholder level but not subject to employment taxes — though they could be subject to the 3.8% Medicare contribution tax.

**Warning:** The IRS is cracking down on misclassification of corporate payments to shareholder-employees, so tread carefully.

## Sale or acquisition

Whether you're selling your business as part of an exit strategy or acquiring another company to help grow your business, the tax consequences can

### CHART 3 Income tax differences based on business structure

Flow-through entity or sole proprietorship	C corporation
One level of taxation: The business's income flows through to the owner(s).	Two levels of taxation: The business is taxed on income, and then shareholders are taxed on any dividends they receive.
Losses flow through to the owner(s).	Losses remain at the corporate level.
The top individual tax rate is 39.6% (up from 35% in 2012).	The top corporate tax rate is generally 35% <sup>1</sup> , and the top rate on qualified dividends is 20%.
<sup>1</sup> See Chart 7 on page 16 for exceptions.	

have a major impact on the transaction's success or failure. Here are a few key tax considerations:

**Asset vs. stock sale.** With a corporation, sellers typically prefer a stock sale for the capital gains treatment and to avoid double taxation. (For more on capital gains tax, see "Capital gains tax and timing" on page 6.) Buyers generally want an asset sale to maximize future depreciation write-offs and avoid potential liabilities.

**Tax-deferred transfer vs. taxable sale.** A transfer of *corporation* ownership can be tax-deferred if made solely in exchange for stock or securities of the recipient corporation in a qualifying reorganization. But the transaction must comply with strict rules.

Although it's generally better to postpone tax, there are some advantages to a taxable sale:

- The parties don't have to meet the technical requirements of a tax-deferred transfer.
- The seller doesn't have to worry about the quality of buyer stock or other business risks of a tax-deferred transfer.
- The buyer enjoys a stepped-up basis in its acquisition's assets and doesn't have to deal with the seller as a continuing equity owner.

**Installment sale.** A taxable sale may be structured as an installment sale, due to the buyer's lack of sufficient cash or the seller's desire to spread the gain over a number of years (which may be especially beneficial if it would allow the seller to

stay under the thresholds for triggering the 3.8% Medicare contribution tax or the 20% long-term capital gains rate) — or when the buyer pays a contingent amount based on the business's performance. But an installment sale can backfire on the seller. For example:

- Depreciation recapture must be reported as gain in the year of sale, no matter how much cash the seller receives.
- If tax rates increase, the overall tax could wind up being more.

Of course, tax consequences are only one of many important considerations when planning a sale or acquisition.

## The self-employed

If you're self-employed, you can deduct 100% of health insurance costs for yourself, your spouse and your dependents. This above-the-line deduction is limited to your net self-employment income. You also can take an above-the-line deduction for contributions made to a retirement plan and, if you're eligible, an HSA for yourself.

You pay both the employee and employer portions of employment taxes on your self-employment income, and the employer portion of the tax paid (6.2% for Social Security tax and 1.45% for Medicare tax) is deductible above the line.

And you may be able to deduct home office expenses against your self-employment income. (See "Home office deduction" on page 2.) ▶

## Build and preserve your nest egg with tax-smart planning

*Retirement planning is one area that was only minimally affected by ATRA. But that doesn't mean it shouldn't be an important element in your tax planning this year. Tax-advantaged retirement plans can help you build and preserve your nest egg — but only if you contribute as much as possible, carefully consider your traditional vs. Roth options, and are tax-smart when making withdrawals. Maximizing your contributions to a traditional plan could even keep you from being pushed into a higher tax bracket or becoming subject to the new 3.8% Medicare contribution tax on net investment income.*

### 401(k)s and other employer plans

Contributing to a traditional employer-sponsored defined contribution plan is usually a good first step:

- Contributions are typically pretax, reducing your taxable income.
- Plan assets can grow tax-deferred — meaning you pay no income tax until you take distributions.
- Your employer may match some or all of your contributions pretax.

Chart 4 shows the 2013 employee contribution limits. Because of tax-deferred compounding, increasing your contributions sooner rather than later can have a significant impact on the size of your nest egg at retirement. If, however, you're age 50 or older and didn't contribute much when you were younger, you may be able to partially

make up for lost time with "catch-up" contributions. (See Case Study II.)

If your employer offers a match, at *minimum* contribute the amount necessary to get the maximum match so you don't miss out on that "free" money.

### More tax-deferred options

In certain situations, other tax-deferred savings options may be available:

**You're a business owner or self-employed.** You may be able to set up a plan that allows you to make much larger contributions. You might not have to make 2013 contributions, or even set up the plan, before year end.

**Your employer doesn't offer a retirement plan.** Consider a traditional IRA. You can likely deduct your contributions, though your deduction may be limited if your spouse participates

in an employer-sponsored plan. You can make 2013 contributions as late as April 15, 2014. (See Chart 4 for contribution limits.)

### Roth options

A potential downside of tax-deferred saving is that you'll have to pay taxes when you make withdrawals at retirement. Roth plans, however, allow tax-free distributions; the tradeoff is that contributions to these plans don't reduce your current-year taxable income:

**1. Roth IRAs.** Your annual contribution limit (see Chart 4) is reduced by any traditional IRA contributions you make for the year. An income-based phaseout may also reduce or eliminate your ability to contribute. But estate planning advantages are an added benefit: Unlike other retirement plans, Roth IRAs don't require you to take distributions during your life, so you can let the entire balance grow tax-free over your lifetime for the benefit of your heirs.

**2. Roth conversions.** If you have a traditional IRA, consider whether you might benefit from converting some or all of it to a Roth IRA. A conversion can allow you to turn *tax-deferred* future growth into *tax-free* growth and take advantage of a Roth IRA's estate planning benefits. There's no income-based limit on who can convert to a Roth IRA.

**CHART 4 Retirement plan contribution limits for 2013**

	Regular contribution	Catch-up contribution <sup>1</sup>
Traditional and Roth IRAs	\$ 5,500	\$1,000
401(k)s, 403(b)s, 457s and SARSEPs <sup>2</sup>	\$17,500	\$5,500
SIMPLEs	\$12,000	\$2,500

<sup>1</sup> For taxpayers age 50 or older by the end of the tax year.

<sup>2</sup> Includes Roth versions where applicable.

**Note:** Other factors may further limit your maximum contribution.

But the converted amount is taxable in the year of the conversion.

Whether a conversion makes sense for you depends on factors such as your age, whether the conversion would push you into a higher income tax bracket or trigger the Medicare contribution tax on your net investment income (see “What’s new!” on page 6), whether you can afford to pay the tax on the conversion, your tax bracket now and expected tax bracket in retirement, and whether you’ll need the IRA funds in retirement.

**3. “Back door” Roth IRAs.** If the income-based phaseout prevents you from making Roth IRA contributions and you *don’t* have a traditional IRA, consider setting up a traditional account and making a nondeductible contribution to it. You can then wait until the transaction clears and convert the traditional account to a Roth account. The only tax due will be on any growth in the account between the time you made the contribution and the date of conversion.

**4. Roth 401(k), Roth 403(b), and Roth 457 plans.** If the plan allows it, you may designate some or all of your contributions as Roth contributions. (Any employer match will be made to a traditional plan.) No income-based phaseout applies, so even high-income taxpayers can contribute. Under ATRA, plans can now more broadly permit employees to convert some or all of their existing traditional plan to a Roth plan.

### Early withdrawals

Early withdrawals from retirement plans generally should be a last resort. With a few exceptions, distributions before age 59½ are subject to a 10% penalty on top of any income tax that ordinarily would be due on a withdrawal. This means that you can lose a substantial amount to taxes and penalties. Additionally, you’ll lose the potential tax-deferred future growth on the withdrawn amount.

If you must make an early withdrawal and you have a Roth account, consider withdrawing from that. You can withdraw up to your contribution amount

## CASE STUDY II Making the most of catch-up contributions

Maureen is 49 and for the last few years has been making the maximum 401(k) plan contribution. But she got a late start saving for retirement, so she’s looking for additional ways to build her nest egg. Because she’ll turn 50 this year, her tax advisor suggests she start making “catch-up” contributions.

Catch-up contributions are extra amounts taxpayers age 50 or older (by the end of the tax year) can contribute to retirement accounts. The catch-up contribution limit depends on the type of retirement plan. (See Chart 4.)

How much of a difference can it make to take full advantage of catch-up contributions? Let’s say Maureen makes her maximum \$5,500 catch-up contribution to her traditional 401(k) for 2013. She then continues making that same \$5,500 contribution for the next 14 years, until she reaches age 65. Even at a relatively low return rate of 4%, she’ll still see a notable increase in her nest egg. And the increase will be even greater if she continues to make the maximum catch-up contribution as it rises under inflation indexing.

Total contributions	\$82,500
Value in 15 years	\$114,500

**Note:** This example is for illustrative purposes only and isn’t a guarantee of future results. Values are approximate.

free of tax and penalty. Another option, if your employer-sponsored plan allows it, is to take a plan loan. You’ll have to pay it back with interest and make regular principal payments, but you won’t be subject to current taxes or penalties.

Early distribution rules are also important to be aware of if you change jobs or retire and receive a lump-sum retirement plan distribution. To avoid the early-withdrawal penalty and other negative tax consequences, request a direct rollover from your old plan to your new plan or IRA.

Otherwise, you’ll need to make an indirect rollover within 60 days to avoid tax and potential penalties. **Warning:** The check you receive from your old plan may be net of 20% federal income tax withholding. If you don’t roll over the gross amount (making up for the withheld amount with other funds), you’ll be subject to income tax — and potentially the 10% penalty — on the difference.

### Required minimum distributions

After you reach age 70½, you must take annual required minimum distributions (RMDs) from your IRAs (except Roth IRAs) and, generally, from your defined contribution plans. If you don’t

comply, you can owe a penalty equal to 50% of the amount you should have withdrawn but didn’t. You can avoid the RMD rule for a non-IRA Roth plan by rolling the funds into a Roth IRA.

So, should you take distributions between ages 59½ and 70½, or take more than the RMD after age 70½? Distributions in any year your tax bracket is low may be beneficial. But also consider the lost future tax-deferred growth and, if applicable, whether the distribution could: 1) cause your Social Security payments to become taxable, 2) increase income-based Medicare premiums and prescription drug charges, or 3) affect other deductions or credits with income-based limits.

**Warning:** While retirement plan distributions aren’t subject to the health care act’s new 0.9% or 3.8% Medicare taxes, they *are* included in your modified adjusted gross income (MAGI) and thus could trigger or increase the 3.8% tax on net investment income, because the thresholds for that tax are based on MAGI.

If you’ve inherited a retirement plan, consult your tax advisor regarding the applicable distribution rules. ▶

## More certainty comes to estate planning

*Estate planning may be a little less challenging now that we have more certainty about the future of estate, gift and generation-skipping transfer (GST) taxes. ATRA makes exemptions and rates for these taxes, as well as certain related breaks, permanent. Estate taxes will increase somewhat, but not as much as they would have without the legislation. And the permanence will make it easier to determine how to make the most of your exemptions and keep taxes to a minimum while achieving your other estate planning goals. However, it's important to keep in mind that "permanent" is a relative term — it simply means there are no expiration dates. Congress could still pass legislation making estate tax law changes.*

### Estate tax

Under ATRA, for 2013 and future years, the top estate tax rate will be 40%. This is a five percentage point increase over the 2012 rate. But it's significantly less than the 55% rate that was scheduled to return for 2013, and it's still quite low historically.

The estate tax exemption will continue to be an annually inflation-adjusted \$5 million, so for 2013 it's \$5.25 million. This will provide significant tax savings over the \$1 million exemption that had been scheduled to return for 2013.

It's important to review your estate plan in light of these changes. It's possible the exemption and rate changes could have unintended consequences on your plan. A review will allow you to make the most of available exemptions and ensure your assets will be distributed according to your wishes.

### Gift tax

The gift tax continues to follow the estate tax exemption and rates. (See Chart 5.) Any gift tax exemption used during life reduces the estate tax exemption available at death.

You can exclude certain gifts of up to \$14,000 per recipient each year (\$28,000 per recipient if your spouse elects to split the gift with you or

you're giving community property) without using up any of your gift tax exemption. This reflects an inflation adjustment over the \$13,000 annual exclusion that had applied for the last few years. (The exclusion increases only in \$1,000 increments, so it typically goes up only every few years.)

### GST tax

The GST tax generally applies to transfers (both during life and at death) made to people more than one generation below you, such as your grandchildren. This is in addition to any gift or estate tax due. The GST tax continues to follow the estate tax exemption and top rate. (See Chart 5.)

#### WHAT'S NEW!

### Exemption portability for married couples now permanent

**Who's affected:** Married couples and their loved ones.

**Key changes:** If one spouse dies and part (or all) of his or her estate tax exemption is unused at his or her death, the estate can elect to permit the surviving spouse to use the deceased spouse's remaining estate tax exemption. Before ATRA, this "portability" had been available only if a spouse died in 2011 or 2012. And even this relief was somewhat hollow, because it provided a benefit only if the surviving spouse made gifts using the exemption, or died, by the end of 2012. ATRA makes portability permanent. Be aware, however, that portability is available only for the most recently deceased spouse, doesn't apply to the GST tax exemption, isn't recognized by some states, and must be elected on an estate tax return for the deceased spouse — even if no tax is due.

**Planning tips:** The portability election is simple and will provide flexibility if proper planning hasn't been done before the first spouse's death. But portability doesn't protect future growth on assets from estate tax like applying the exemption to a credit shelter trust does. Trusts offer other benefits as well, such as creditor protection, remarriage protection, GST tax planning and state estate tax benefits. So married couples should still consider setting up marital trusts — and transferring assets to each other to the extent necessary to fully fund them. Transfers to a spouse (during life or at death) are tax-free under the marital deduction, assuming he or she is a U.S. citizen.



ATRA also preserved certain GST tax protections, including deemed and retroactive allocation of GST tax exemptions, relief for late allocations, and the ability to sever trusts for GST tax purposes.

### State taxes

ATRA makes permanent the federal estate tax deduction (rather than a credit) for state estate taxes paid. Keep in mind that many states impose estate tax at a lower threshold than the federal government does.

To avoid unexpected tax liability or other unintended consequences, it's critical to consider state law. Consult a tax advisor with expertise on your particular state.

### Tax-smart giving

Giving away assets now will help reduce the size of your taxable estate. Here are some strategies for tax-smart giving:

**Choose gifts wisely.** Consider both estate and income tax consequences and the economic aspects of any gifts you'd like to make:

- To minimize *estate tax*, gift property with the greatest future appreciation potential.
- To minimize *your beneficiary's income tax*, gift property that hasn't already appreciated significantly since you've owned it.
- To minimize *your own income tax*, don't gift property that's declined in value. Instead, consider selling the property so you can take the tax loss and then gift the sale proceeds.

### Plan gifts to grandchildren carefully.

Annual exclusion gifts are generally exempt from the GST tax, so they also help you preserve your GST tax exemption for other transfers. For gifts that don't qualify for the exclusion to be tax-free, you generally must apply both your GST tax exemption and your gift tax exemption.

**Gift interests in your business.** If you own a business, you can leverage your gift tax exclusions and exemption by gifting ownership interests, which may

CHART 5 Transfer tax exemptions and highest rates				
Year	Estate tax exemption <sup>1</sup>	Gift tax exemption	GST tax exemption	Highest estate and gift tax rates and GST tax rate
2012	\$5.12 million	\$5.12 million	\$5.12 million	35%
2013	\$5.25 million	\$5.25 million	\$5.25 million	40%
Future years	Indexed for inflation	Indexed for inflation	Indexed for inflation	40%

<sup>1</sup> Less any gift tax exemption already used during life.

be eligible for valuation discounts. So, for example, if the discounts total 30%, in 2013 you can gift an ownership interest equal to as much as \$20,000 tax-free because the discounted value doesn't exceed the \$14,000 annual exclusion. **Warning:** The IRS may challenge the calculation; a professional, independent valuation is recommended.

**Gift FLP interests.** Another way to potentially benefit from valuation discounts is to set up a family limited partnership. You fund the FLP and then gift limited partnership interests. **Warning:** The IRS scrutinizes FLPs, so be sure to set up and operate yours properly.

### Pay tuition and medical expenses.

You may pay these expenses without the payment being treated as a taxable gift to the student or patient, as long as the payment is made directly to the provider.

**Make gifts to charity.** Donations to qualified charities aren't subject to gift taxes and may provide an income tax deduction. (See page 3.)

### Trusts

Trusts can provide significant tax savings while preserving some control over what happens to the transferred assets. You may want to consider these:

- A *credit shelter (or bypass) trust* can help minimize estate tax by taking advantage of both spouses' estate tax exemptions.
- A *qualified terminable interest property (QTIP) trust* can benefit first a surviving spouse and then children from a prior marriage.

- A *qualified personal residence trust (QPRT)* allows you to give your home to your children today — removing it from your taxable estate at a reduced tax cost (provided you survive the trust's term) — while you retain the right to live in it for a certain period.
- A *grantor-retained annuity trust (GRAT)* works similarly to a QPRT but allows you to transfer other assets; you receive payments from the trust for a certain period.

Finally, a GST — or “dynasty” — trust can help you leverage both your gift and GST tax exemptions, and it can be an excellent way to potentially lock in the currently high exemptions.



### Insurance

Along with protecting your family's financial future, life insurance can be used to pay estate taxes, equalize assets passing to children who aren't involved in a family business, or pass leveraged funds to heirs free of estate tax. Proceeds are generally income-tax-free to the beneficiary. And with proper planning, you can ensure proceeds aren't included in your taxable estate. ▶





**CHART 6** 2013 individual income tax rate schedules

Tax rate		Regular tax brackets			
		Single	Head of household	Married filing jointly or surviving spouse	Married filing separately
10%	\$	0 – \$ 8,925	\$ 0 – \$ 12,750	\$ 0 – \$ 17,850	\$ 0 – \$ 8,925
15%	\$	8,926 – \$ 36,250	\$ 12,751 – \$ 48,600	\$ 17,851 – \$ 72,500	\$ 8,926 – \$ 36,250
25%	\$	36,251 – \$ 87,850	\$ 48,601 – \$ 125,450	\$ 72,501 – \$ 146,400	\$ 36,251 – \$ 73,200
28%	\$	87,851 – \$ 183,250	\$ 125,451 – \$ 203,150	\$ 146,401 – \$ 223,050	\$ 73,201 – \$ 111,525
33%	\$	183,251 – \$ 398,350	\$ 203,151 – \$ 398,350	\$ 223,051 – \$ 398,350	\$ 111,526 – \$ 199,175
35%	\$	398,351 – \$ 400,000	\$ 398,351 – \$ 425,000	\$ 398,351 – \$ 450,000	\$ 199,176 – \$ 225,000
39.6%		Over \$ 400,000	Over \$ 425,000	Over \$ 450,000	Over \$ 225,000

  

Tax rate		AMT brackets			
		Single	Head of household	Married filing jointly or surviving spouse	Married filing separately
26%	\$	0 – \$ 179,500	\$ 0 – \$ 179,500	\$ 0 – \$ 179,500	\$ 0 – \$ 89,750
28%		Over \$ 179,500	Over \$ 179,500	Over \$ 179,500	Over \$ 89,750

  

AMT exemptions				
	Single	Head of household	Married filing jointly or surviving spouse	Married filing separately
Amount	\$ 51,900	\$ 51,900	\$ 80,800	\$ 40,400
Phaseout <sup>1</sup>	\$ 115,400 – \$ 323,000	\$ 115,400 – \$ 323,000	\$ 153,900 – \$ 477,100	\$ 76,950 – \$ 238,550

<sup>1</sup> The AMT income ranges over which the exemption phases out and only a partial exemption is available. The exemption is completely phased out if AMT income exceeds the top of the applicable range.

**Note:** Consult your tax advisor for AMT rates and exemptions for children subject to the “kiddie tax.”

**CHART 7** 2013 corporate income tax rate schedule

Tax rate	Tax brackets
15%	\$ 0 – \$ 50,000
25%	\$ 50,001 – \$ 75,000
34%	\$ 75,001 – \$ 100,000
39%	\$ 100,001 – \$ 335,000
34%	\$ 335,001 – \$ 10,000,000
35%	\$ 10,000,001 – \$ 15,000,000
38%	\$ 15,000,001 – \$ 18,333,333
35%	Over \$ 18,333,333

**Note:** Personal service corporations are taxed at a flat 35% rate.

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