RE: 2012 Tax Planning for Individuals

Dear Client:

The year 2012 began with great uncertainty over federal tax policy and now that uncertainty appears to be far from any long-term resolution. As 2012 draws to a close, many of you are asking how you can plan in light of the uncertainty surrounding the fate of the Bush-era tax cuts and other expiring tax incentives.

Expiring incentives

Individual tax rates are scheduled to increase across-the-board with the highest rate jumping from 35% to 39.6%. The current 10% rate will expire and the marriage penalty relief will sunset. The current favorable capital gains and dividends tax rates (15% for those in the 25% bracket and zero for all others) will expire. Limitations on itemized deductions and personal exemptions for higher income taxpayers will be revived. The child tax credit will be cut in half. The alternative minimum tax (AMT) looms for many with the expiring "patch". There are countless other incentives that will either disappear or be substantially reduced.

Income/deduction shifting

Instead of shifting income into a future year, you may want to recognize income in 2012, when lower tax rates are available. Another strategy is to explore if certain deductions should be more evenly divided between 2012 and 2013, and which deductions may qualify for AMT purposes.

The threshold to claim an itemized deduction for unreimbursed medical expenses increases from 7.5 percent of adjusted gross income (AGI) to 10% of AGI beginning in 2013, although a special exemption applies for taxpayers age 65 and older through 2016. And while many medical expenses cannot be timed for tax-deduction purposes, batching expenses into 2012 may make it more likely that the expenses will exceed that threshold.

Harvesting losses

Now is a good time to consider tax loss harvesting strategies to offset current gains or to accumulate losses to offset future gains (which may be taxed at a higher rate). However, you cannot just sell at a loss and then rebuy the investment immediately. The "wash sale rule" generally prohibits you from claiming a tax loss on a security if you repurchase the same or a substantially identical asset within 30 days of the sale.

Education credits

If you have higher education expenses, you may want to pre-pay 2013 expenses before year-end to take advantage of the American Opportunity Tax Credit before it expires. Keep in mind there are income limits, so this strategy may not work for you. The reduced benefit Hope credit will return in 2013. The Lifetime Learning Credit is NOT scheduled to expire after 2012.

The federal tuition deduction expired after 2011.

Student loan interest will be limited to the first 60 months of the loan and the AGI phaseouts will go down significantly to $40,000-$55,000 for single and $60,000-$75,000 for joint returns.

New Medicare taxes

The Patient Protection and Affordable Care Act imposes an additional 0.9% Medicare tax on wages and self-employment income in excess of a $200,000 threshold for single and $250,000 threshold for married taxpayers. The Act also added a 3.8% Medicare contribution tax imposed on the lesser of an individual's net investment income for the year or modified adjusted gross income in excess of the same thresholds above.

The net investment income subject to this new 3.8% Medicare tax will NOT include interest on tax-exempt bonds, veteran's benefits, and excluded gain from the sale of a principal residence but DOES include passive (not active) income or loss from rental activities, limited liability companies, partnerships, and S corporations.

Taxable distributions from qualified retirement plans including IRA's will NOT be part of the net investment income, but will be part of MAGI. ROTH distributions will not be included in either.

2013 paycheck issues

Health flexible spending arrangements (such as Cornell Select Benefits) will be limited to $2,500, down from $5,000 allowed in 2012. The income tax withholding rates will be increased to reflect the tax rate changes. Also the current two percent reduction in FICA will expire. Now is a good time to review if you will be having too much or too little withheld.

Required minimum distributions

Be sure to take your required minimum distributions from qualified retirement plans for 2012. Keep in mind that brokers are not required to notify you of the required minimum distribution from inherited retirement accounts.

Roth conversions

If you converted an individual retirement account (IRA) to a Roth IRA in 2010, you were given an option: recognize all income in 2010 or defer that income, half into 2011 and half into 2012. If you elected to defer that income into 2011 and 2012, do not forget to figure that income into your year-end planning for 2012.

If you initiated a Roth conversion earlier in 2012 and that Roth account has declined in value since then, you should consider a "Roth reconversion." Reconverting your Roth IRA back to a regular IRA before year-end will allow you to avoid paying income tax on an account balance at its higher value.

Finally, if you have not yet made a Roth conversion, doing so at year-end 2012 might be an opportunity worth serious consideration. Variables include your present income tax bracket, how close you are to retirement, and your access to other funds both to pay the conversion tax and to delay distributions from your Roth account later.

Life changes

Marriage, divorce, the birth of a child, a change in job or loss of a job, retirement, and death are just some of the life events that may trigger a need for changes to tax reporting and year-end tax planning.

Looking ahead

During the summer of 2012 both the House and Senate passed competing bills designed to extend many of the expiring tax incentives. However, at this time it is increasingly unlikely that the fate of all the expiring tax provisions will be decided by the lame-duck Congress after the November elections. At best they might agree on a one-year extension which would just push the uncertainty out another year.

Today's uncertainty makes doing nothing or adopting a wait and see attitude very tempting. Multi-year tax planning, which takes into account a variety of possibly scenarios and outcomes, however, can provide a win-win combination irrespective of what happens. Please contact our office for more details on how we can customize a tax strategy for you.

Sincerely,

Sciarabba Walker