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SUGGESTIONS FOR PRESERVING WEALTH

2013 END OF YEAR TAX PLANNING

In 2012, income tax rates were anticipated to rise. Consequently, many taxpayers may have opted to accelerate income and defer deductions. The result would be an overall lower tax liability in 2012 and enhanced tax savings in 2013 due to the increase in deductions.

In 2013, as anticipated, the top marginal tax rate is 39.6%. Married couples who file jointly and have combined taxable income above $450,000 will enter the 39.6% tax bracket, as will unmarried individuals with incomes above $400,000. In 2013, tax rates are expected to remain the same in the near future. Tax planning for wage earners follows.

Wage earners have relatively few tax minimization strategies. One of the best strategies for wage earners is to maximize contributions to a 401(k) retirement plan. These contributions lower your current-year taxable income, and the earnings in the plan grow tax deferred. Admittedly, it is sometimes more difficult for wage earners to tax plan versus small business owners and self-employed individuals, which are discussed next.

Business owners or self-employed individuals have a little more flexibility in the timing of their compensation, as well as when they pay their business expenses. Typically, small business owners are cash basis taxpayers (i.e., income is taxed when cash is received/expenses are recognized when cash is paid). Self-employed taxpayers have a greater incentive to defer billing and collections until January 2014. On the other hand, taxpayers may be inclined to accelerate expense payments into 2013, since doing so will enable expenses to offset 2013 income, thus reducing overall tax liabilities. Be mindful that self-employment income may be subject to the new 0.9% Medicare surtax.

Another strategy for small business owners is to use ordinary losses from “active” business activities to offset income from other sources. When using losses to offset income from other sources, please be mindful that there will be some impact on self-employment taxes.

Special or “bonus” depreciation allows taxpayers to claim an additional deduction for certain tangible business property in the year it is placed in service. Taxpayers can generally deduct 50% of the cost of certain items placed in service during 2013. In 2014, bonus depreciation will not be allowed, unless Congress acts to extend this provision.

Another strategy for self-employed individuals may be to take advantage of contributions to retirement plans such as a Simplified Employee Pension Individual Retirement Account (SEP-IRA). Such individuals may be eligible to make a contribution up to the lower of

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$51,000 or 20% of net self-employment income after deducting self-employment tax. Making such a contribution will offset the ordinary income earned in 2013, which in turn will reduce an individual taxpayer's overall tax liability. The deadline for setting up and funding a SEP-IRA plan is as late as the due date of your 2013 individual income tax return, including extensions (October 15, 2014 if your return is extended). On the other hand, a self-employed individual can establish a solo 401(k) plan. Advantages that a 401(k) plan has over a SEP-IRA include the ability for the individual to take a loan from the plan, which is not allowed with IRA-type arrangements. The maximum total contribution an individual is allowed to make to a solo 401(k) plan is the same as that allowed for a SEP-IRA ($51,000); however, the percentage of income limitation on SEP-IRA plans and solo 401(k) plans is calculated differently. Therefore, individuals earning less than $200,000 in self-employment income may find that a solo 401(k) plan allows a higher contribution. Tax planning for retired individual follows.

For retired individuals, overall tax planning should take into account the timing of distributions from retirement plans. Certain qualified retirement plans allow an individual to receive a lump-sum payment instead of staggered annual payments. The form of payment one chooses should depend on current and future income. Also, any decision should involve whether the use of a lump-sum payment outweighs the investment potential one will forego if only a minimum distribution is taken.

Keep in mind portfolio income or income from interest, dividends, royalties, and capital gains have varying rates of tax. This type of income is generally taxed at ordinary income tax rates, except for qualified dividends and long-term capital gains.

There is little you can do to change the timing of interest or dividend payments from bond and equity investments, other than reorienting your portfolio to include tax exempt municipal bonds and possibly shifting less tax-efficient investments into retirement accounts, where the assets will grow tax deferred.

However, a portfolio income planning strategy frequently involves lending money to family members. If, for instance, a family member is seeking a mortgage, you may want to consider acting as the lender. Currently, the minimum rate that you would be required to charge the mortgage recipient is lower than the interest rate a financial institution would charge for a conventional loan. Be mindful that there are restrictions on entities holding first mortgages on investment property. Frequently, entities must be a registered mortgage broker or dealer in order to do so. Generally, individuals are allowed to do this, however.

Recall that Congress increased the favorable 15% long-term capital gains rate to 20% only for taxpayers in the top tax bracket beginning in 2013 (capital gains and losses result from the sale of an asset that is held for personal or investment purposes). Short-term capital gains realized on the sale of investments held for less than a year are taxed at the same tax rate as ordinary income. Careful planning will help you limit the impact of the increased tax rate on your long-term capital gains. Current-year capital losses will first be applied to offset capital gains that are in the same category as is the losses. Any additional loss will then be applied to gains in the other category. For example, long-term capital losses will first be applied against long-term capital gains. Any remaining net capital loss in the long-term category will then be applied against net short-term capital gains. Therefore, it may be prudent to employ a strategy that insures that your carry-over losses offset short-term capital gains when possible, regardless of whether those losses resulted from short-term or long-term transactions. If you have net capital losses overall in 2013, you may use up to $3,000 of the capital loss to offset ordinary income, with the rest of the loss carried forward to offset capital gains in future years.

Before 2013 ends, you and your financial advisor should review your portfolio to determine whether it makes sense to dispose of any capital assets to realize losses or accelerate gains.

For deductions, and as previously stated, many taxpayers chose to defer their deductions until 2013 in order to offset their 2013 income, which is taxable at the new, higher rates. Taxpayers should now consider the reverse course -- accelerate deductions into 2013, to the extent that tax benefits can be obtained.

The foregoing is just a brief summary of the many planning opportunities that may be available. Please consult your advisor or feel free to contact this office at 229/883-2441.