



2013 Tax Planning Guide

YEAR-ROUND STRATEGIES TO MAKE THE TAX LAWS WORK FOR YOU



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2013 tax increases make effective planning more important than ever

Tax planning last year involved preparing for significant tax increases scheduled for 2013, though there was uncertainty about whether those increases would be allowed to 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.

But ATRA didn't provide as much relief to higher-income taxpayers. While you'll enjoy the benefits of the extended lower rates on at least a portion of your income, you may see rate hikes on income exceeding certain thresholds. These hikes — combined with expanded Medicare taxes that go into effect this year under the 2010 health care act — could cause you to face significantly higher taxes in 2013. 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, effective tax planning is more important than ever. 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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Start planning *now* to minimize impact of tax hikes



Higher-income taxpayers will see a variety of tax increases on their “ordinary income” this year. Ordinary income generally includes salary, income from self-employment or business activities, interest, and distributions from tax-deferred retirement accounts. But ordinary income isn’t all taxed the same way. For example, some types of ordinary income are subject to employment tax; others aren’t. And if you’re subject to the AMT, your ordinary income will be taxed differently. By starting to plan now, you may be able to take steps that will minimize the impact of tax hikes on your ordinary income.

AMT triggers

The top AMT rate is only 28%, compared to the top regular ordinary-income tax rate of 39.6%. (See Chart 7 on page 24.) But the AMT rate typically applies to a higher taxable income base.

So before taking action to time income and expenses, determine whether you’re already likely to be subject to the AMT — or whether the actions you’re considering might trigger it. Many deductions used to calculate

regular tax aren’t allowed under the AMT (see Chart 1) and thus can trigger AMT liability. Some income items also might trigger or increase AMT liability:

- Long-term capital gains and dividend income, even though they’re taxed at the same rate for both regular tax and AMT purposes,
- Accelerated depreciation adjustments and related gain or loss differences when assets are sold, and
- Tax-exempt interest on certain private-activity municipal bonds. (For an exception, see the AMT Alert on page 11.)

Finally, in certain situations exercising incentive stock options (ISOs) can trigger significant AMT liability. (See the AMT Alert on page 7.)

WHAT’S NEW!

You may face an additional 0.9% Medicare tax this year

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: If your wages or self-employment income varies significantly from year to year or you’re close to the threshold for triggering the additional Medicare tax, income timing strategies may help you avoid or minimize the tax. For example, if you’re an employee, perhaps you can time when you receive a bonus, or you can defer or accelerate the exercise of stock options. If you’re self-employed, you may have flexibility on when you purchase new equipment or invoice customers. If you’re a shareholder-employee of an S corporation, you might save tax by adjusting how much you receive as salary vs. distributions. (See “Owner-employees” on page 5.)

You also should consider the withholding rules. 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.

Avoiding or reducing AMT

With proper planning, you may be able to avoid the AMT, reduce its impact or even take advantage of its lower maximum rate. 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 sets higher exemptions *permanently*, indexing them — as well as the AMT brackets — for inflation going forward.

Even with long-term AMT relief in place, it's critical to work with your tax advisor to assess whether:

You could be subject to the AMT *this* year. Consider accelerating income into this year, which may allow you to benefit from the lower maximum AMT rate. And deferring expenses you can't deduct for AMT purposes may allow you to preserve those deductions. If you also defer expenses you *can* deduct for AMT purposes, the deductions may become more valuable because of the higher maximum regular tax rate. Finally, carefully consider the tax consequences of exercising ISOs.

You could be subject to the AMT *next* year. Consider taking the opposite approach. For instance, defer income to next year, because you'll likely pay a relatively lower AMT rate. And prepay expenses that will be deductible this year but that won't help you next year because they're not deductible for AMT purposes. Also, before year end consider selling any private-activity municipal bonds whose interest could be subject to the AMT.

If you pay AMT in one year on deferral items, such as depreciation adjustments, passive activity adjustments or the tax preference on ISO exercises, you may be entitled to a credit in a subsequent year. In effect, this takes into account timing differences that reverse in later years.

Timing income and expenses

Smart timing of income and expenses can reduce your tax liability, and poor timing can unnecessarily increase it. When you don't expect to be subject to the AMT in the current year or the next year, deferring income to the next year and accelerating deductible expenses into the current year typically is a good idea. Why? Because it will defer tax, which is usually beneficial.

But when you expect to be in a *higher* tax bracket next year — or you expect tax rates to go up — the opposite approach may be beneficial: Accelerating income will allow more income to be taxed at your current year's lower rate. And deferring expenses will make

CHART 1 Regular tax vs. AMT: What's deductible?			
Expense	Regular tax	AMT	For more information
State and local income tax or state and local sales tax	●		See "Timing income and expenses" below and "Sales tax deduction" on page 4.
Property tax	●		See "Home-related deductions" on page 12.
Mortgage interest	●	●	See "Home-related deductions" on page 12.
Interest on home equity debt not used to improve your principal residence	●		See "Home-related deductions" on page 12.
Investment interest	●	●	See "Investment interest expense" on page 11.
Professional fees	●		See "Miscellaneous itemized deductions" below.
Investment expenses	●		See "Miscellaneous itemized deductions" below.
Unreimbursed employee business expenses	●		See "Miscellaneous itemized deductions" below.
Medical expenses	●	●	See "Health-care-related breaks" on page 4.
Charitable contributions	●	●	See page 16.

the deductions more valuable, because deductions save more tax when you're subject to a higher tax rate.

The AGI-based itemized deduction reduction has returned for 2013. (See "What's new!" on page 5.) Its impact should be taken into account when considering timing strategies.

Whatever the reason behind your desire to time income and expenses, here are some income items whose timing you may be able to control:

- Bonuses,
- Consulting or other self-employment income,
- U.S. Treasury bill income, and
- Retirement plan distributions, to the extent not required. (See page 21.)

And here are some potentially controllable expenses:

- State and local income taxes,
- Property taxes,
- Mortgage interest,

- Margin interest, and
- Charitable contributions.

Warning: Prepaid expenses can generally be deducted only in the year to which they apply. For example, you can prepay (by Dec. 31) property taxes that relate to this year but that are due next year, and deduct the payment on your return for this year. But you generally can't prepay property taxes that relate to next year and deduct the payment on this year's return.

Miscellaneous itemized deductions

Many expenses that may qualify as miscellaneous itemized deductions are deductible for regular tax purposes only to the extent they exceed, in aggregate, 2% of your AGI. Bunching these expenses into a single year may allow you to exceed this "floor."

As the year progresses, record your potential deductions to date. If they're close to — or they already exceed — the 2% floor, consider paying accrued

WHAT'S NEW!

Top ordinary-income tax rate of 39.6% returns in 2013

Who's affected: Higher-income taxpayers.

Key changes: Under ATRA, the top 39.6% ordinary-income tax rate returns in 2013. It doesn't, however, apply to everyone who previously was in the top bracket of 35%. The 39.6% rate kicks in when taxable income exceeds \$400,000 for singles, \$425,000 for heads of households and \$450,000 for married couples filing jointly. This means that, for certain filing statuses, the income range to which the 35% rate applies is now very small. (See Chart 7 on page 24.)

Planning tips: If your income is close to the 39.6% rate threshold, timing strategies (see page 3) may allow you to stay under it. If your income is well beyond the threshold, you may not be able to avoid the rate. But accelerating deductible expenses and deferring income can allow you to reduce its impact, and thus your tax bill, in 2013. This may be particularly beneficial if tax reform results in lower rates in the future. On the other hand, it's also possible tax rates could go up, in which case such strategies could be costly. Consult your tax advisor about the strategies that make the most sense for your particular situation.

expenses and incurring and paying additional expenses by Dec. 31, such as:

- Deductible investment expenses, including advisory fees, custodial fees and publications,
- Professional fees, such as tax planning and preparation, accounting, and certain legal fees, and
- Unreimbursed employee business expenses, including travel, meals, entertainment and vehicle costs.

AMT ALERT! Miscellaneous itemized deductions subject to the 2% floor aren't deductible for AMT purposes. So don't bunch them into a year when you may be subject to the AMT.

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

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.

Warning: Before 2013, employers could set whatever limit they wanted — so your contribution limit may have dropped substantially this year.

Sales tax deduction

ATRA has extended through 2013 the break allowing you to take an itemized deduction for state and local *sales* taxes in lieu of state and local *income* taxes. The deduction can be valuable if you reside in a state with no or low income tax or you purchase a major item, such as a car or boat.

Except for major purchases, you don't have to keep receipts and track all the sales tax you actually pay. Your deduction can be determined using an IRS sales tax calculator that will base the deduction on your income and the sales tax rates in your locale plus the tax you actually pay on major purchases.

If you're considering a major purchase, you may want to make it this year to ensure you can take advantage of the sales tax deduction, in case it isn't extended again. Check with your tax advisor for the latest information.

Employment taxes

In addition to income tax, you must pay Social Security and Medicare taxes on earned income, such as salary and bonuses. For 2011 and 2012, the employee portion of the Social Security tax had been reduced from 6.2% to 4.2%, but this payroll tax break hasn't been extended to 2013. So taxpayers will see a two percentage point Social Security tax increase on earned income up to the Social Security wage base of \$113,700 (up from \$110,100 for 2012).

Warning: All earned income is subject to the 2.9% Medicare tax (split equally between the employee and the employer). And beginning in 2013, many higher-income taxpayers will pay additional Medicare taxes. (See "What's new!" on page 2.)

Self-employment taxes

If you're self-employed, you pay both the employee and employer portions

of employment taxes on your self-employment income. Fortunately, there's no employer portion for the additional 0.9% Medicare tax. (See "What's new!" on page 2.) The employer portion of self-employment taxes paid (6.2% for Social Security tax and 1.45% for Medicare tax) is deductible above the line.

As a self-employed taxpayer, you may benefit from other above-the-line deductions as well. You can deduct 100% of health insurance costs for yourself, your spouse and your dependents, up to your net self-employment income. You also can deduct contributions to a retirement plan and, if you're eligible, an HSA for yourself. Above-the-line deductions are particularly valuable because they reduce your AGI and MAGI, which are the triggers for certain additional taxes and the phaseouts of many tax breaks.

Owner-employees

There are special considerations if you're a business owner who also works in the business, depending on its structure:

Partnerships and limited liability companies.

Generally, all trade or

business income that flows through to you for income tax purposes is subject to self-employment taxes — even if the income isn't actually distributed to you. But such income may not be subject to self-employment taxes if you're a limited partner or an LLC member whose ownership is equivalent to a limited partnership interest. Whether the additional 0.9% Medicare tax on earned income or the new 3.8% Medicare contribution tax on net investment income (see "What's new!" on page 9) will apply also is complex to determine. So, check with your tax advisor.

S corporations. Only income you receive as salary is subject to employment taxes and, if applicable, the 0.9% Medicare tax. To reduce these taxes, you may want to keep your salary relatively (but not unreasonably) low and increase your distributions of company income (which generally isn't taxed at the corporate level or subject to the 0.9% or 3.8% Medicare tax).

C corporations. Only income you receive as salary (which is deductible at the corporate level) is subject to

employment taxes and, if applicable, the 0.9% Medicare tax. Nevertheless, you may prefer to take more income as salary as opposed to dividends (which aren't deductible at the corporate level, but are taxed at the shareholder level and could be subject to the 3.8% Medicare tax) if the overall tax paid by both the corporation and you would be less.

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

Estimated payments and withholding

You can be subject to penalties if you don't pay enough tax during the year through estimated tax payments and withholding. Here are some strategies to help you avoid underpayment penalties:

Know the minimum payment rules.

For you to avoid penalties, your estimated payments and withholding must equal at least 90% of your tax liability for 2013 or 110% of your 2012 tax (100% if your 2012 AGI was \$150,000 or less or, if married filing separately, \$75,000 or less).

Use the annualized income installment method.

This method often benefits taxpayers who have large variability in income by month due to bonuses, investment gains and losses, or seasonal income (especially if it's skewed toward the end of the year). Annualizing computes the tax due based on income, gains, losses and deductions through each estimated tax period.

Estimate your tax liability and increase withholding.

If you determine you've underpaid, consider having the tax shortfall withheld from your salary or year end bonus by Dec. 31. Because withholding is considered to have been paid ratably throughout the year, this is often a better strategy than making up the difference with an increased quarterly tax payment, which may still leave you exposed to penalties for earlier quarters.

Warning: You also could incur interest and penalties if you're subject to the new 0.9% Medicare tax on earned income and it isn't withheld from your pay. (See "What's new!" on page 2.) ▶

WHAT'S NEW!

Deduction reduction and exemption phaseout are back

Who's affected: Higher-income taxpayers.

Key changes: The AGI-based reduction on certain itemized deductions and phaseout of personal exemptions had been reduced for 2006 through 2009 and eliminated for 2010 through 2012. ATRA allows both limits to fully return in 2013, and sets thresholds for them of \$250,000 (singles), \$275,000 (heads of households) and \$300,000 (married filing jointly). This provides some tax savings over what would have occurred without the act, because the 2013 thresholds would have been significantly lower. (The thresholds will be annually indexed for inflation.)

The itemized deduction limitation reduces otherwise allowable deductions by 3% of the amount by which a taxpayer's AGI exceeds the applicable threshold (not to exceed 80% of otherwise allowable deductions). It doesn't apply, however, to deductions for medical expenses, investment interest, or casualty, theft or wagering losses.

The personal exemption phaseout reduces exemptions by 2% for each \$2,500 (or portion thereof) by which a taxpayer's AGI exceeds the applicable threshold (2% for each \$1,250 for married taxpayers filing separately).

Planning tips: If your AGI is close to the threshold, AGI-reduction strategies (such as making retirement plan and HSA contributions) may allow you to stay under it. If that's not possible, consider the reduced tax benefit of the affected deductions before implementing strategies to accelerate or defer deductible expenses.

Planning for restricted stock, stock options and NQDC gets even more complicated

If you're an executive or other key employee, you might be rewarded for your contributions to your company's success with restricted stock, stock options or nonqualified deferred compensation (NQDC). The tax planning for these forms of compensation, however, is generally more complicated than for salaries, bonuses and traditional employee benefits. And planning gets even more complicated this year, because of the potential impact of higher tax rates and expanded Medicare taxes.

Restricted stock

Restricted stock is stock that's granted subject to a substantial risk of forfeiture. Income recognition is normally deferred until the stock is no longer subject to that risk or you sell it. You then pay taxes based on the stock's fair market value (FMV) when the restriction lapses and at your ordinary-income rate.

But you can instead make a Section 83(b) election to recognize ordinary income when you receive the stock. This election, which you must make within 30 days after receiving the stock, can be beneficial if the income at the grant date is negligible or the stock is likely to appreciate significantly before income would otherwise be recognized. Why? Because the election allows you to convert future appreciation from ordinary income to long-term capital gains income and defer it until the stock is sold.

There are some potential disadvantages of a Sec. 83(b) election, however: First, you must prepay tax in the current year — and you could trigger or increase your exposure to the 39.6% ordinary-income tax rate (see "What's new!" on page 4) or the additional 0.9% Medicare tax (see "What's new!" at right). But if a company is in the earlier stages of development, the income recognized may be small.

Second, any taxes you pay because of the election can't be refunded if you

eventually forfeit the stock or you sell it at a decreased value. But you'd have a capital loss when you forfeited or sold the stock.

Work with your tax advisor to map out whether the Sec. 83(b) election is appropriate for you in each particular situation.

Incentive stock options

ISOs receive tax-favored treatment but must comply with many rules. ISOs allow you to buy company stock in the future (but before a set expiration date) at a fixed price equal to or greater than the stock's FMV at the date of the grant.

WHAT'S NEW!

You could owe expanded Medicare taxes on your exec comp

Who's affected: Higher-income taxpayers.

Key changes: The following types of executive compensation are considered FICA income so could be subject to the 0.9% additional Medicare tax (see "What's new!" on page 2):

- Fair market value (FMV) of restricted stock once the stock is no longer subject to risk of forfeiture or it's sold,
- FMV of restricted stock when it's awarded if you make a Section 83(b) election,
- Bargain element of nonqualified stock options when exercised, and
- Nonqualified deferred compensation once the services have been performed and there's no longer a substantial risk of forfeiture.

And the following types of gains will be included in net investment income and could trigger or increase exposure to the new 3.8% Medicare contribution tax (see "What's new!" on page 9):

- Gain on sale of restricted stock if you'd made the Sec. 83(b) election, and
- Gain on sale of stock from ISO exercise if you meet the holding requirements.

Planning tips: When determining the best strategy for your executive compensation income, consider not just the income tax consequences but also the Medicare tax consequences. With smart timing, you may be able to reduce or avoid exposure to the expanded tax.



CASE STUDY I

Restricted stock units may provide planning advantages

Lauren recently was awarded restricted stock units (RSUs), which are contractual rights to receive stock (or its cash value) after the award has vested. She'd received restricted stock from a previous employer and wanted to know how the tax treatment of RSUs differed — and whether there were any special strategies she should consider. So she consulted her tax advisor.

Her advisor explained that, unlike restricted stock, RSUs aren't eligible for the Section 83(b) election. So there's no opportunity to convert ordinary income into capital gains.

But they do offer a limited ability to defer income taxes: Unlike restricted stock, which becomes taxable immediately upon vesting, RSUs aren't taxable until the employee actually receives the stock. So rather than having the stock delivered immediately upon vesting, Lauren may be able to arrange with her employer to delay delivery, which will defer her income tax — and may allow her to reduce or avoid exposure to the 0.9% additional Medicare tax (because the RSUs are treated as FICA income). However, any income deferral must satisfy the strict requirements of Internal Revenue Code (IRC) Section 409A.

Therefore, ISOs don't provide a benefit until the stock appreciates in value. If it does, you can buy shares at a price *below* what they're then trading for, as long as you've satisfied the applicable ISO holding periods. Here are the key tax consequences:

- You owe no tax when ISOs are granted.
- You owe no regular income tax when you exercise the ISOs.
- If you sell the stock *after* holding the shares at least one year from the exercise date and two years from the grant date, you pay tax on the sale at your long-term capital gains rate.
- If you sell the stock *before* long-term capital gains treatment applies, a "disqualifying disposition" occurs and any gain is taxed as compensation at ordinary-income rates.

AMT ALERT! In the year of exercise, a tax "preference" item is created for the difference between the stock's FMV and the exercise price (the "bargain element") that can trigger the AMT. A future AMT credit, however, should mitigate this AMT hit. Consult your tax advisor because the rules are complex.

If you've received ISOs, plan carefully when to exercise them and whether

to immediately sell shares received from an exercise or to hold them. Waiting to exercise ISOs until just before the expiration date (when the stock value may be the highest, assuming the stock is appreciating) and holding on to the stock long enough to garner long-term capital gains treatment often is beneficial. But there's also market risk to consider. Plus, in several situations, acting earlier can be advantageous:

- Exercise early to start the holding period so you can sell and receive long-term capital gains treatment sooner.
- Exercise when the bargain element is small or when the market price is close to bottoming out to reduce or eliminate AMT liability.
- Exercise annually so you can buy only the number of shares that will achieve a breakeven point between the AMT and regular tax and thereby incur no additional tax.
- Sell in a disqualifying disposition and pay the higher ordinary-income rate to avoid the AMT on potentially disappearing appreciation.

On the negative side, exercising early accelerates the need for funds to buy the stock, exposes you to a loss if the shares' value drops below your exercise cost, and may create a tax cost if the

preference item from the exercise generates an AMT liability.

The timing of ISO exercises could also positively or negatively affect your liability for the 39.6% ordinary income tax rate (see "What's new!" on page 4), the 20% long-term capital gains rate (see "What's new!" on page 8) or the expanded Medicare taxes (see "What's new!" on page 6). With your tax advisor, evaluate the risks and crunch the numbers using various assumptions to determine the best strategy for you.

Nonqualified stock options

The tax treatment of NQSOs is different from the tax treatment of ISOs: NQSOs create compensation income (taxed at ordinary-income rates) on the bargain element when exercised (regardless of whether the stock is held or sold immediately), but they don't create an AMT preference item.

You may need to make estimated tax payments or increase withholding to fully cover the tax on the exercise. Keep in mind that an exercise could trigger or increase exposure to top tax rates and expanded Medicare taxes.

NQDC plans

These plans pay executives in the future for services to be currently performed. They differ from qualified plans, such as 401(k)s, in several ways. For example, unlike 401(k) plans, NQDC plans can favor highly compensated employees, but plan funding isn't protected from the employer's creditors. (For more on 401(k)s, see page 20.)

One important NQDC tax issue is that employment taxes (see page 4) are generally due once services have been performed and there's no longer a substantial risk of forfeiture — even though compensation may not be paid or recognized for income tax purposes until much later. So your employer may withhold your portion of the employment taxes from your salary or ask you to write a check for the liability. Or it may pay your portion, in which case you'll have additional taxable income. ▶

Will you pay more taxes on your investments this year?

For higher-income taxpayers, in many cases the answer will be “yes.” ATRA brings back the top long-term capital gains rate of 20%, and the 2010 health care act introduces a new 3.8% Medicare tax on net investment income. This means that investors subject to both taxes could see an 8.8 percentage point tax increase on some or all of their long-term capital gains and qualified dividends. While tax consequences should never be the primary driver of investment decisions, this year’s tax increases make it especially important that taxes be considered.

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 generally 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 on page 11.)

Holding on to an investment until you’ve owned it more than a year may help substantially cut tax on any gain.

Remember: Appreciating investments that don’t generate current income aren’t taxed until sold, deferring tax and perhaps allowing you to time the sale to your tax advantage — such as in a year when you have capital losses to absorb the capital gain. Or, 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.

AMT ALERT! Substantial net long-term capital gains can trigger the AMT.

The wash sale rule

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 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,
- Wait 31 days to repurchase the same security, or
- Before selling the security, 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.

WHAT’S NEW!

Top capital gains rates increase in 2013

Who’s affected: Higher-income investors holding appreciated or dividend-producing assets.

Key changes: Under ATRA, the top 20% long-term capital gains tax rate returns in 2013. It kicks in when taxable income exceeds \$400,000 for singles, \$425,000 for heads of households and \$450,000 for married couples filing jointly. These taxpayers also will see higher rates on their short-term capital gains, because the 39.6% ordinary-income rate returns for those with taxable incomes exceeding these same thresholds. (See “What’s new!” on page 4 for more details.)

Planning tips: If you could be subject to these taxes, smart timing of capital gains and losses, as well as the other strategies discussed in the “Investing” chapter, will be especially important. Because the threshold for the 20% long-term and 39.6% short-term capital gains rates are based on taxable income, strategies that reduce such income — such as timing income and expenses (see page 3) and making retirement plan contributions (see page 20) — might allow you to avoid triggering the higher rates. You also need to keep in mind the new 3.8% Medicare contribution tax on net investment income. It’s triggered at lower income levels, and based on a different definition of income, than the 20% and 39.6% rates. (See “What’s new!” on page 9.)



Alternatively, you can do a bond swap, where 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, you can achieve a tax loss with virtually no change in economic position.

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. But 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 any more investments 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 an investment, it may recover its lost value.

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.

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 Medicare contribution tax or the 20% long-term capital gains rate if you sold the assets.

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 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 20) — can also help you avoid or reduce NIIT liability.

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 19.) Also consider any gift tax consequences. (See page 22.)

Paying attention to details

If you don't pay attention to the details, the tax consequences of a sale may be different from what you expect. For example, the trade date, not the settlement date, of publicly traded securities determines the year in which you recognize the gain or loss.

And if you bought the same security at different times and prices and want to sell high-tax-basis shares to reduce gain or increase a loss and offset other gains, be sure to specifically identify which block of shares is being sold.

Mutual funds

Investing in mutual funds is an easy way to diversify your portfolio. But beware of the tax pitfalls. First, 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.

Second, earnings on mutual funds are typically reinvested, and unless you (or your investment advisor) keep track of

these additions and increase your basis accordingly, you may report more gain than required when you sell the fund. Since 2012, brokerage firms have been required to track (and report to the IRS) your cost basis in mutual funds acquired during the tax year.

Third, buying equity mutual fund shares later in the year can be costly tax-wise. Such funds often declare a large capital gains distribution at year end. If you own the shares on the distribution's record date, you'll be taxed on the full distribution amount even if it includes significant gains realized by the fund *before* you owned the shares. And you'll pay tax on those gains in the current year — even if you reinvest the distribution.

Small business stock

By purchasing stock in certain small businesses, you can diversify your portfolio. You also may enjoy preferential tax treatment:

Conversion of capital loss to ordinary loss. If you sell qualifying Section 1244 small business stock at a loss, you can treat up to \$50,000 (\$100,000, if married filing jointly) as an ordinary, rather than a capital, loss — regardless of your holding period. This means you can use it to offset ordinary income, reducing your tax by as much as 39.6% of this portion of the loss. Sec. 1244 applies



only if total capital invested isn't more than \$1 million.

Tax-free gain rollovers. If within 60 days of selling qualified small business (QSB) stock you buy other QSB stock with the proceeds, you can defer the tax on your gain until you dispose of the new stock. The rolled-over gain reduces your basis in the new stock. For determining long-term capital gains treatment, the new stock's holding period includes the holding period of the stock you sold. To be a QSB, a business must be engaged in an active trade or business and must not have assets that exceed \$50 million.

Exclusion of gain. Generally, taxpayers selling QSB stock are allowed to exclude up to 50% of their gain if they've held the stock for more than five years. But, depending on the acquisition date, the exclusion may be greater: The exclusion

is 75% for stock acquired after Feb. 17, 2009, and before Sept. 28, 2010, and 100% for stock acquired after Sept. 27, 2010, and before Jan. 1, 2014. (The latter acquisition deadline had been Dec. 31, 2011, but ATRA retroactively extended it. This can be a powerful tax-saving tool, especially for higher-income taxpayers. See Case Study II below.)

The taxable portion of any QSB gain will be subject to the lesser of your ordinary-income rate or 28%, rather than the normal long-term gains rate. (See Chart 2.) Thus, if the 28% rate and the 50% exclusion apply, the effective rate on the QSB gain will be 14% ($28\% \times 50\%$).

Keep in mind that all three of these tax benefits are subject to additional requirements and limits. Consult your tax and financial advisors to be sure an investment in small business stock is right for you.

Passive activities

If you've invested in a trade or business in which you don't materially participate, remember the passive activity rules. Why? Passive activity *income* may be subject to the 3.8% Medicare contribution tax on net investment income (see "What's new!" on page 9), and passive activity *losses* generally are deductible only against income from other passive activities. You can carry forward disallowed losses to the following year, subject to the same limits.

To avoid passive activity treatment, typically you must participate in a trade or business more than 500 hours during the year or demonstrate that your involvement constitutes substantially all of the participation in the activity. (Special rules apply to real estate; see page 13.) If you don't pass this test, consider:

Increasing your involvement. If you can exceed 500 hours, the activity no longer will be subject to passive activity rules. If the business is structured as a limited liability company (LLC), proposed IRS regulations may make it easier for you to meet the material participation requirement. Check with your tax advisor for the latest information.

Grouping activities. You may be able to group certain activities together to be treated as one activity for tax purposes and exceed the 500-hour threshold. But the rules are complex, and there are potential downsides to consider.

Disposing of the activity. This generally allows you to deduct all passive losses — including any loss on disposition (subject to basis and capital loss limitations). But, again, the rules are complex.

Looking at other activities. Another option if you have passive losses is to limit your participation in another activity that's generating income, so that you don't meet the 500 hours test, or invest in another income-producing trade or business that will be passive to

CASE STUDY II

Investing in QSB stock before year end can be a powerful long-term tax-saving strategy for higher-income taxpayers

Jonathan's income is high enough that he expects he'll be subject to both the top 20% long-term capital gains rate and the new 3.8% Medicare tax on net investment income going forward. His tax advisor suggests that he consider a tax-advantaged investment opportunity that, as of this writing, is available only through Dec. 31, 2013: Purchase qualified small business (QSB) stock and enjoy 100% exclusion on future gain. The catch is that Jonathan will have to hold on to the stock for more than five years. But the savings can be well worth it.

For example, say Jonathan invests \$100,000 in QSB stock in 2013. If, after the five-year mark passes, the stock has doubled in value, he can sell the stock for \$200,000 and pay no tax on the \$100,000 gain.

If instead he invested \$100,000 in non-QSB stock in 2013, but the stock still doubled in value in five years and he then sold it, he'd recognize a \$100,000 gain. Assuming that the gain would be subject to the 20% long-term capital gains rate and the 3.8% Medicare contribution tax, he'd pay \$23,800 in taxes.

An added benefit of purchasing QSB stock is that it will help diversify Jonathan's portfolio. For more information on small business stock, see page 9.

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

Assets held	2012	2013 ¹
12 months or less (<i>short term</i>)	35%	39.6% ²
More than 12 months (<i>long term</i>)	15%	20% ²
Some key exceptions		
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%
Gain on qualified small business stock held more than 5 years	14% ³	14% ³
Long-term gain that would be taxed at 15% or less based on the taxpayer's ordinary-income rate	0%	0%

¹ In addition, under the 2010 health care act, a new 3.8% Medicare 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).

² 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).

³ Effective rate based on 50% exclusion from a 28% rate.

you. Under both strategies, you'll have passive income that can absorb your passive losses.

Income 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 higher taxes on qualified dividends if they're subject to the new 3.8% Medicare contribution tax or the return of the 20% long-term capital gains rate.

Interest income generally is taxed at ordinary-income rates, which are now as high as 39.6%. So stocks that pay qualified dividends may be more attractive tax-wise than other income investments, such as CDs, money market accounts and bonds. But there are exceptions.

Some dividends, for example, are subject to ordinary-income rates. These may include certain dividends from:

- Real estate investment trusts (REITs),
- Regulated investment companies (RICs),

- Money market mutual funds, and
- Certain foreign investments.

The tax treatment of bond income varies. For example:

- 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.
- 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.

Keep in mind that state and municipal bonds usually pay a lower interest rate, but their rate of return may be higher than the after-tax rate of return for a taxable investment, depending on your tax rate. To compare apples to apples, calculate the tax-equivalent

yield, which incorporates tax savings into the municipal bond's yield. The formula is simple:

$$\text{Tax-equivalent yield} = \text{actual yield} / (1 - \text{your marginal tax rate}).$$

AMT ALERT! Tax-exempt interest from private-activity municipal bonds can trigger or increase AMT liability. However, any income from tax-exempt bonds issued in 2009 and 2010 (along with 2009 and 2010 re-fundings of bonds issued after Dec. 31, 2003, and before Jan. 1, 2009) is excluded from the AMT.

Investment interest expense

Investment interest — interest on debt used to buy assets held for investment, such as margin debt used to buy securities — is deductible for both regular tax and AMT purposes. But special rules apply.

Your investment interest deduction is limited to your net investment income, which, for the purposes of this deduction, generally includes taxable interest, nonqualified dividends and net short-term capital gains (but not long-term capital gains), reduced by other investment expenses. Any disallowed interest is carried forward, and you can deduct it in a later year if you have excess net investment income.

You may elect to treat net long-term capital gains or qualified dividends as investment income in order to deduct more of your investment interest. But if you do, that portion of the long-term capital gain or dividend will be taxed at ordinary-income rates.

Payments a short seller makes to the stock lender in lieu of dividends may be deductible as an investment interest expense. But interest on debt used to buy securities that pay tax-exempt income, such as municipal bonds, isn't deductible.

Also keep in mind that passive interest expense — interest on debt incurred to fund passive activity expenditures — becomes part of your overall passive activity income or loss, subject to limitations. ▶

Why tax planning for real estate is becoming more important

As the real estate market slowly recovers and potential taxes go up for many, tax planning for real estate — whether your home, your vacation home or a rental property — is becoming more important. Higher-income taxpayers could see the benefit of some of their home-related deductions reduced and face higher income tax rates plus the new 3.8% Medicare tax on real estate income and gains.

Home-related deductions

There are many tax benefits to home ownership — among them, various deductions. But the return of the itemized deduction reduction (see “What’s new!” on page 5) could reduce your benefit from these deductions:

Property tax deduction. If you’re looking to accelerate or defer deductions, property tax is one expense you may be able to time. (See page 3.)

AMT ALERT! Property tax isn’t deductible for AMT purposes. If you’re subject to the AMT this year, a prepayment may hurt you because you’ll lose the benefit of the deduction.

Mortgage interest deduction. You generally can deduct (for both regular tax and AMT purposes) 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.

AMT ALERT! If home equity debt isn’t used for home improvements,

the interest isn’t deductible for AMT purposes and could trigger or increase AMT liability.

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. Further, you can take a deduction for the depreciation allocable to the portion of your home used for the office. Or you may be able to take the new, simpler, “safe harbor” deduction. (Contact your tax advisor for details.) Either way, you can also deduct direct expenses, such as a business-only phone line and office supplies.

For employees, home office expenses are a miscellaneous itemized deduction.

This 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, however, you can deduct qualified home office expenses from your self-employment income. The 2% floor doesn’t apply.

Home rental rules

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.

If you rent out your principal residence or second home for 15 days or more, you’ll have to report the income. But you also may be entitled to deduct



some or all of your rental expenses — such as utilities, repairs, insurance and depreciation. Exactly what you can deduct depends on whether the home is classified as a rental property for tax purposes (based on the amount of personal vs. rental use):

Rental property. You can deduct rental expenses, including losses, subject to the real estate activity rules. (See below.) You can't deduct any interest that's attributable to your personal use of the home, but you can take the personal portion of property tax as an itemized deduction.

Nonrental property. You can deduct rental expenses only to the extent of your rental income. Any excess can be carried forward to offset rental income in future years. You also can take an itemized deduction for the personal portion of both mortgage interest and property taxes. In some situations, it may be beneficial to reduce personal use of a residence so it will be classified as a rental property.

Home sales

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. Gain that qualifies for exclusion will also be excluded from the new 3.8% Medicare contribution tax. To support an accurate tax basis, be sure to maintain thorough records, including information on your original cost and subsequent improvements, reduced by casualty losses and any depreciation you may have claimed based on business use. **Warning:** Gain that's allocable to a period of "nonqualified" use generally isn't excludable.

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.

Because a second home is ineligible for the gain exclusion, consider converting it to rental use before selling. It can be considered a business asset, and you may be able to defer tax on

WHAT'S NEW!

3 depreciation-related breaks extended, but only through 2013

Who's affected: Owners of leasehold, restaurant or retail properties.

Key changes: These breaks have been extended:

- **50% bonus depreciation.** ATRA extended this additional first-year depreciation allowance to qualifying leasehold improvements made in 2013.
- **Section 179 expensing.** ATRA revived through 2013 the election to deduct under Sec. 179 (rather than depreciate over a number of years) up to \$250,000 of qualified leasehold-improvement, restaurant and retail-improvement property. The break begins to phase out dollar-for-dollar when total asset acquisitions for the tax year exceed \$2 million.
- **Accelerated depreciation.** ATRA revived through 2013 the break allowing a shortened recovery period of 15 — rather than 39 — years for qualified leasehold-improvement, restaurant and retail-improvement property.

Planning tips: If you're anticipating investments in qualified property in the next year or two, you may want to time them to take advantage of these depreciation-related breaks while they're available.

any gains through an installment sale or a Section 1031 exchange. (See "Tax-deferral strategies for investment property" at right.) Or you may be able to deduct a loss, but only to the extent attributable to a decline in value *after* the conversion.

Real estate activity rules

Income and losses from investment real estate or rental property are passive by definition — unless you're a real estate professional. Why is this important? Passive income may be subject to the 3.8% Medicare tax, and passive losses are deductible only against passive income, with the excess being carried forward.

To qualify as a real estate professional, you must annually perform:

- More than 50% of your personal services in real property trades or businesses in which you materially participate, and
- More than 750 hours of service in these businesses during the year.

Each year stands on its own, and there are other nuances to be aware of. If you're concerned you'll fail either test and be subject to the 3.8% tax or stuck with passive losses, consider increasing

your hours so you'll meet the test. Keep in mind that special rules for spouses may help you meet the 750-hour test.

Tax-deferral strategies for investment property

It's possible to divest yourself of appreciated investment real estate but defer the tax liability. Such strategies may even help you keep your income low enough to avoid triggering the 3.8% Medicare contribution tax on net investment income and the 20% long-term capital gains rate. So plan carefully if you're considering a deferral strategy such as the following:

Installment sale. An installment sale allows you to defer gains by spreading them over several years as you receive the proceeds. **Warning:** Ordinary gain from certain depreciation recapture is recognized in the year of sale, even if no cash is received.

Sec. 1031 exchange. Also known as a "like-kind" exchange, this technique allows you to exchange one real estate investment property for another and defer paying tax on any gain until you sell the replacement property. **Warning:** Restrictions and significant risks apply. ▶

Leveraging tax-saving opportunities and reducing tax risks

When it comes to taxes, owning a business provides both opportunities and risks. For example, you may be able to set up a tax-advantaged retirement plan that allows you to make larger contributions than you could make if you were an employee participating in an employer-sponsored plan. But if you don't carefully plan for your exit from the business, you could lose much of the net worth you built up in the business to taxes.

Retirement saving

If most of your money is tied up in your business, retirement can be a challenge. So if you haven't already set up a tax-advantaged retirement plan, consider setting one up this year. If you might be subject to the new 3.8% Medicare tax on net investment income (see "What's new!" on page 9), this may be particularly beneficial because retirement plan contributions can reduce your MAGI and thus help you reduce or avoid the 3.8% tax.

Keep in mind that, if you have employees, they generally must be allowed to participate in the plan (provided they work enough hours). Here are a few options that may enable you to make large contributions:

Profit-sharing plan. This is a defined contribution plan that allows discretionary employer contributions and flexibility in plan design. You can make deductible 2013 contributions (see Chart 3 for limits) as late as the due date of your 2013 income tax return, including extensions — provided your plan exists on Dec. 31, 2013.

SEP. A Simplified Employee Pension is a defined contribution plan that provides benefits similar to those of a profit-sharing plan. But you can establish a SEP in 2014 and still make deductible 2013 contributions (see Chart 3) as late as the due date of your 2013 income tax return, including extensions. Another benefit is

that a SEP is easier to administer than a profit-sharing plan.

Defined benefit plan. This plan sets a future pension benefit and then actuarially calculates the contributions needed to attain that benefit. The maximum annual benefit for 2013 is generally \$205,000 or 100% of average earned income for the highest three consecutive years, if less. Because it's actuarially driven, the 2013 contribution needed to attain the projected future annual benefit may exceed the maximum contributions allowed by other plans, depending on your age and the desired benefit.

You can make deductible 2013 defined benefit plan contributions until the due date of your return, provided

your plan exists on Dec. 31, 2013.

Warning: Employer contributions generally are required and must be paid quarterly if there was a shortfall in funding for the prior year.

Exit planning

An exit strategy is a plan for passing on responsibility for running the company, transferring ownership and extracting your money from the business. This requires planning well in advance of the transition. Here are the most common exit options:

Buy-sell agreements. When a business has more than one owner, a buy-sell agreement can be a powerful tool. The agreement controls what happens to

CHART 3 Profit-sharing plan vs. SEP:
How much can you contribute?

Profit-sharing plan	SEP
2013 maximum contribution: \$51,000 or \$56,500.	2013 maximum contribution: \$51,000.
Eligibility: You can't contribute more than 25% of your compensation generally, but you can contribute 100% up to the 401(k) limits (see Chart 5 on page 20) if the plan includes a 401(k) arrangement. To qualify for the \$56,500 limit, your plan must include a 401(k) arrangement and you must be eligible to make catch-up contributions (that is, be age 50 or older).	Eligibility: You can't contribute more than 25% of your eligible compensation (net of the deduction for the contribution if you're self-employed). So to make the maximum contribution, your eligible compensation must be at least \$204,000 (\$255,000 if you're self-employed).
Note: Other factors may further limit your maximum contribution.	



the business when a specified event occurs, such as an owner's retirement, disability or death. Among other benefits, a well-drafted agreement:

- Provides a ready market for the departing owner's shares,
- Sets a price for the shares, and
- Allows business continuity by preventing disagreements caused by new, unwanted owners.

A key issue with any buy-sell agreement is providing the buyer(s) with a means of funding the purchase. Life or disability insurance often helps fulfill this need and can give rise to several tax issues and opportunities.

One of the biggest advantages of life insurance as a funding method is that proceeds generally are excluded from the beneficiary's taxable income. There are exceptions, however, so be sure to consult your tax advisor.

Succession within the family. You can pass your business on to family members by giving them interests, selling them interests or doing some of each. Be sure to consider your income needs, how family members will feel about your choice, and the gift and estate tax consequences.

Now may be a particularly good time to transfer ownership interests through gifting. If your business has lost value, you'll be able to transfer a greater number of shares without exceeding your \$14,000 gift tax annual exclusion amount. Valuation discounts may further reduce the taxable value. And, with the lifetime gift tax exemption at a record-high \$5.25 million for 2013, this may be a great year to give away more than just your annual exclusion amounts. (See page 22 for more on gift and estate planning.)

Management buyout. If family members aren't interested in or capable of taking over your business, one option is a management buyout. This can provide for a smooth transition because there may be little learning curve for the new owners. Plus, you avoid the time and expense of finding an outside buyer.



ESOP. If you want rank and file employees to become owners as well, an employee stock ownership plan (ESOP) may be the ticket. An ESOP is a qualified retirement plan created primarily to purchase your company's stock. Whether you're planning for liquidity, looking for a tax-favored loan or wanting to supplement an employee benefit program, an ESOP can offer many advantages.

Selling to an outsider. If you can find the right buyer, you may be able to sell the business at a premium. Putting your business into a sale-ready state can help you get the best price. This generally means transparent operations, assets in good working condition and no undue reliance on key people.

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 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 page 8.) 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 could also help you stay under the thresholds for triggering the 3.8% Medicare contribution tax on net investment income and 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. ▶

Your donations may be more powerful in 2013

Deductions are more valuable when tax rates are higher, and higher-income taxpayers face higher rates in 2013. So you may reap greater savings from your donations this year. Donations to qualified charities are generally fully deductible for both regular tax and AMT purposes. By carefully choosing what you donate and how you donate it, you may be able to enjoy additional benefits. But it's important to pay attention to the myriad rules and limits that apply — such as the itemized deduction reduction. (See “What’s new!” on page 5.) If you don’t, your benefit could be smaller than expected.

Cash donations

Outright gifts of cash (which include donations made via check, credit card and payroll deduction) are the easiest. The key is to substantiate them. To be deductible, cash donations must be:

- Supported by a canceled check, credit card receipt or written communication from the charity if they're under \$250, or
- Substantiated by the charity if they're \$250 or more.

Deductions for cash gifts to public charities can't exceed 50% of your AGI. The AGI limit is 30% for cash donations to nonoperating private foundations. Contributions exceeding the applicable AGI limit can be carried forward for up to five years.

AMT ALERT! Charitable contribution deductions are allowed for AMT purposes, but your tax savings may be less if you're subject to the AMT. For example, if you're in the 35% tax bracket for regular income tax purposes but the 28% tax bracket for AMT purposes, your deduction may be worth only 28% instead of 35%.

Stock donations

Publicly traded stock and other securities you've held more than one year are long-term capital gains property, which

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. This will be especially beneficial to taxpayers facing the new 3.8% Medicare tax on net investment income or the return of the top 20% long-term capital gains rate this year.

Donations of long-term capital gains property are subject to tighter deduction limits, however — 30% of AGI for gifts to public charities, 20% for gifts to nonoperating private foundations.

Don't donate stock that's worth less than your basis. Instead, sell the stock so you can deduct the loss and then donate the cash proceeds to charity.

Making gifts over time

If you don't know which charities you want to benefit but you'd like to start making large contributions now, consider a private foundation. It offers you significant control over how your donations ultimately will be used.

You must comply with complex rules, however, which can make foundations expensive to run. Also, the AGI limits for deductibility of contributions to nonoperating foundations are lower.

If you'd like to influence how your donations are spent but avoid a

foundation's downsides, consider a donor-advised fund (DAF). Many larger public charities and investment firms offer them. **Warning:** To deduct your DAF contribution, you must obtain a written acknowledgment from the sponsoring organization that it has exclusive legal control over the assets contributed.

Charitable remainder trusts

To benefit a charity while helping ensure your own financial future, consider a CRT:

- For a given term, the CRT 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 for the present value of the amount that will go to charity.
- The property is removed from your estate.

A CRT can also help diversify your portfolio if you own non-income-producing assets that would generate a large capital gain if sold. Because a CRT is tax-exempt, it can sell the property without paying tax on the gain and then invest the proceeds in a variety of stocks and bonds.

You'll owe capital gains tax when you receive CRT payments, but because the payments are spread over time, much of the liability will be deferred. Plus, only a portion of each payment will be attributable to capital gains; some will be considered tax-free return of principal. This may help you reduce or avoid exposure to the new 3.8% Medicare contribution tax and the 20% top long-term capital gains rate.

You can name someone other than yourself as income beneficiary or fund the CRT at your death, but the tax consequences will be different.

Charitable lead trusts

To benefit charity while transferring assets to loved ones at a reduced tax cost, consider a CLT:

- For a given term, the CLT pays an amount to one or more charities.
- At the term's end, the CLT's remaining assets pass to one or more loved ones you name as remainder beneficiaries.
- When you fund the CLT, you make a taxable gift equal to the present value of the amount that will go to the remainder beneficiaries.
- The property is removed from your estate.

For gift tax purposes, the remainder interest is determined assuming that the trust assets will grow at the Section 7520 rate. The lower

CHART 4 What's your donation deduction?

Cash. This includes not just actual cash but gifts made by check, credit card or payroll deduction. You may deduct 100%.

Ordinary-income property. Examples include stocks and bonds held one year or less, inventory, and property subject to depreciation recapture. You generally may deduct only the lesser of fair market value or your tax basis.

Tangible personal property. Your deduction depends on the situation:

- If the property *isn't* related to the charity's tax-exempt function (such as an antique donated for a charity auction), your deduction is limited to your basis.
- If the property *is* related to the charity's tax-exempt function (such as an antique donated to a museum for its collection), you can deduct the fair market value.

Use of property. Examples include use of a vacation home and a loan of artwork. Generally, you receive no deduction because it isn't considered a completed gift. There may, however, be ways to structure the gift to enable you to get a deduction.

Long-term capital gains property. This might be stocks or bonds held more than one year. You may deduct the current fair market value.

Services. You may deduct only your out-of-pocket expenses, not the fair market value of your services. You can deduct 14 cents per charitable mile driven.

IRA funds. If you're age 70½ or older, in 2013 you can distribute up to \$100,000 from your IRA directly to charity. No charitable deduction is allowed for any amount that would otherwise have been taxable, but you save the tax you would otherwise have owed. Such a donation can help satisfy your RMD. (See "Required minimum distributions" on page 21.) However, as of this writing, this break is scheduled to expire Dec. 31, 2013. Contact your tax advisor for the latest information.

Vehicle. Unless it's being used by the charity, you generally may deduct only the amount the charity receives when it sells the vehicle.

Note: *Your annual charitable donation deductions may be reduced if they exceed certain limits based on your AGI, the type of donation and the type of charity receiving the donation. If you receive some benefit from the charity in connection with your donation, such as services or products, your deduction must be reduced by the value of the benefit you receive. Various substantiation requirements also apply. Consult your tax advisor for additional details.*

the Sec. 7520 rate, the smaller the remainder interest and the lower the possible gift tax — or the less of your lifetime gift tax exemption you'll have to use up. If the trust's earnings outperform the Sec. 7520 rate, the excess earnings will be transferred to the remainder beneficiaries gift- and estate-tax-free.

Because the Sec. 7520 rate currently is low, now may be a good time to take

the chance that your actual return will outperform it. Plus, with the currently high gift tax exemption, you may be able to make a larger transfer to the trust this year without incurring gift tax liability. (For more on the gift tax, see page 22.)

You can name yourself as the remainder beneficiary or fund the CLT at your death, but the tax consequences will be different. ▶

How to start children off on the right financial track



Whether you're a parent or a grandparent, you likely want to do what you can to start the children in your life off on the right financial track. By helping them take advantage of tax-deferred and tax-free savings opportunities, you can do just that. Or you may be able to benefit from opportunities that save tax while you provide for your children's or grandchildren's education expenses, which will also help put them on firm financial footing as they enter adulthood.

IRAs for teens

One of the best ways to get children on the right financial track is to set up IRAs for them. Their retirement may seem too far off to warrant saving now, but IRAs can be perfect for teenagers precisely 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. A teen's 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 Roth IRAs, see page 20.)

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 22.)

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.

529 plans

Section 529 plans provide another valuable tax-advantaged savings opportunity. You can choose a prepaid tuition plan 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.
- 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.

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. 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.

CASE STUDY III**A 529 plan can be a powerful estate planning tool for grandparents**

Jim and Judy have built up a large net worth and are concerned about estate taxes. They have six grandchildren and are looking for tax-advantaged ways to transfer assets to them. But they're concerned about giving up control of the assets.

Their tax advisor suggests that they set up a Section 529 college savings plan for each grandchild. They can retain control of the accounts, even after their grandchildren reach the age of majority. Because contributions to 529 plans are eligible for the \$14,000 per beneficiary annual gift tax exclusion, and annual exclusion gifts are also excluded from the generation-skipping transfer (GST) tax, they can also avoid any GST tax liability that may otherwise be incurred when transferring wealth to a grandchild — without using up any of their combined \$10.5 million GST tax exemption.

Plus, they can take advantage of the special break for 529 plans that allows up to five years' worth of annual exclusion gifts (\$70,000 per beneficiary) to be front-loaded into one year, doubling to \$140,000 for married couples splitting gifts.

So Jim and Judy can transfer as much as \$840,000 this year and not use any of their lifetime gift tax exemptions or GST tax exemptions. But if either of them dies before 2018, that spouse's estate will include a portion of the gift made in 2013. That amount will also use up part of the spouse's GST tax exemption or be subject to GST tax, because it no longer will be considered an annual exclusion gift.

- 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.

Whether a prepaid tuition plan or a savings plan is better depends on your situation and goals.

Prepaid tuition vs. savings plan

With a *prepaid tuition plan*, if your contract is for four years of tuition, tuition is guaranteed regardless of its cost at the time the beneficiary actually attends the school. The downside is that there's uncertainty in how benefits will be applied if the beneficiary attends a different school.

A 529 *college savings plan*, on the other hand, can be used to pay a student's expenses at most postsecondary educational institutions. 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 biggest downside may be that you don't have direct control over investment decisions; you're limited to the options the plan offers. Additionally, for funds already in the plan, you can make changes to your investment options only once during the year or when you change beneficiaries. For these reasons, some taxpayers prefer Coverdell ESAs. (See "What's new!" at left.)

But each time you make a *new* contribution to a 529 savings plan, you can select a different option for that contribution, regardless of how many times you contribute throughout the year. And you can make a tax-free rollover to a different 529 plan for the same child every 12 months.

Jumpstarting a 529 plan

To avoid gift taxes on 529 plan contributions, you must either limit them to \$14,000 annual exclusion gifts or use part of your lifetime gift tax exemption. A special break for 529 plans allows you to front-load five years' worth of annual exclusions and make a \$70,000

contribution (or \$140,000 if you split the gift with your spouse). That's *per beneficiary*.

If you're a grandparent, this can be a powerful estate planning strategy. (See Case Study III at left.)

American Opportunity credit

When your child enters college, you may not qualify for the American Opportunity credit because your income is too high, but your child might. The maximum credit, per student, is \$2,500 per year for the first four years of postsecondary education. And both the credit and a tax-free ESA or 529 plan distribution can be taken as long as expenses paid with the distribution aren't used to claim the credit.

If your dependent child claims the credit, you must, however, forgo your dependency exemption for him or her (and the child can't take the exemption). But because of the return of the exemption phaseout (see "What's new!" on page 5), you might lose the benefit of your exemption anyway. So this may be an easy decision.

The "kiddie tax"

If you're considering making financial gifts to children beyond what they can use to fund an IRA or what you put into a tax-advantaged education plan, keep in mind that there could be tax consequences you may not expect: The income shifting that once — when the "kiddie tax" applied only to those under age 14 — provided families with significant tax savings now offers much more limited benefits. Today, 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 kiddie 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. ▶

Tax law changes mean retirement plans may provide more benefits — but could trigger more taxes

Tax-deferred (or tax-free, in the case of Roth accounts) compounding can have an exponential effect on your investment returns, and the increase in the top tax rate to 39.6% this year means that the tax deferral (or tax savings) can be even greater. Maximizing your contributions to a traditional plan could also keep you from becoming subject to the 39.6% rate or the new 3.8% Medicare contribution tax on net investment income. But when it comes to distributions, traditional plans could have the opposite effect — pushing you into the 39.6% bracket or triggering the 3.8% tax. So careful planning is critical.

Retirement plan contributions

Contributing the maximum you're allowed (see Chart 5) to an employer-sponsored defined contribution plan is likely a smart move:

- Contributions are typically pretax, reducing your modified adjusted gross income (MAGI), which can help you reduce or avoid exposure to the 3.8% Medicare tax.
- 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.

If you participate in a 401(k), 403(b) or 457 plan, it may allow you to designate some or all of your contributions as Roth contributions. While Roth contributions don't reduce your current MAGI,

qualified distributions will be tax-free.

Roth contributions may be especially beneficial for higher-income earners, who are ineligible to contribute to a Roth IRA. In addition, under ATRA, 401(k), 403(b) and 457 plans can now more broadly permit employees to convert some or all of their existing traditional plan to a Roth plan.

Roth IRA 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. It also can provide estate planning advantages: 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.

There's no income-based limit on who can convert to a Roth IRA. 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 3.8% Medicare tax, 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.

If you *don't* have a traditional IRA, consider a "back door" Roth IRA: You set up a traditional account and make a nondeductible contribution to it. You 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.

Early withdrawals

With a few exceptions, retirement plan distributions before age 59½ are subject to a 10% penalty on top of any income tax that ordinarily would be due. This means that, if you're in the top tax bracket of 39.6%, you can lose almost half of your withdrawal to federal taxes and penalties — and more than half if you're subject to state income taxes and/or penalties. Additionally, you'll lose

CHART 5 Retirement plan contribution limits for 2013

	Regular contribution	Catch-up contribution ¹
401(k)s, 403(b)s, 457s and SARSEPs ²	\$17,500	\$5,500
SIMPLEs	\$12,000	\$2,500

¹ For taxpayers age 50 or older by the end of the tax year.

² Includes Roth versions where applicable.

Note: Other factors may further limit your maximum contribution. But if 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. See page 14.



CASE STUDY IV Making the most of catch-up contributions

Marisa is 49 and for many years has been making the maximum 401(k) plan contribution because she wants to leverage all of the tax-advantaged savings opportunities available to her. 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 5.)

How much of a difference can it make to take full advantage of catch-up contributions? Let's say Marisa 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. The boost to her retirement savings will depend on her investment return. But even at a relatively low return rate, 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	
4% return	\$114,500
6% return	\$135,500
8% return	\$161,500

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

the potential tax-deferred future growth on the withdrawn amount.

If you have a Roth account, you can withdraw up to your contribution amount without incurring taxes or penalties. But you'll be losing the potential tax-free growth on the withdrawn amount.

So if you're in need of cash, consider tapping your taxable investment accounts rather than dipping into your retirement plan. (See page 8 for information on the tax treatment of investments.)

Leaving a job

When you change jobs or retire, avoid taking a lump-sum distribution from your employer's retirement plan because it generally will be taxable, plus potentially subject to the 10%

early-withdrawal penalty. Here are options that will help you avoid current income tax and penalties:

Staying put. You may be able to leave your money in your old plan. But if you'll be participating in a new employer's plan or you already have an IRA, this may not be the best option. Why? Because keeping track of multiple plans can make managing your retirement assets more difficult. Also consider how well the old plan's investment options meet your needs.

A rollover to your new employer's plan. This may be a good solution if you're changing jobs, because it may leave you with only one retirement plan to keep track of. But also evaluate the new plan's investment options.

A rollover to an IRA. If you participate in a new employer's plan, this will require keeping track of two plans. But it may be the best alternative because IRAs offer nearly unlimited investment choices.

If you choose a rollover, 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 tax, they are included in your MAGI and thus could trigger or increase the 3.8% tax on your net investment income.

If you've inherited a retirement plan, consult your tax advisor regarding the distribution rules that apply to you. ▶

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 6.) 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 6.)

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 6 Transfer tax exemptions and highest rates				
Year	Estate tax exemption ¹	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%

¹ 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 16.)

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 7 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 ¹		\$ 115,400 – \$ 323,000	\$ 115,400 – \$ 323,000	\$ 153,900 – \$ 477,100	\$ 76,950 – \$ 238,550

¹ 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 8 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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