Tax Tips for End of 2013 ... And Some Years Beyond

With the end of 2013 fast approaching, now is a good time to explore some of the tax planning ideas that can lower a client's tax bill. Traditional year-end tax planning ideas still work and, in fact, gain even greater significance for high income earners than in prior years – namely due to the reinstatement of the 39.6% top tax rate, a new 3.8% net investment income tax (also called the Medicare surtax), and the increased 0.9% Medicare tax on employees and self-employed persons with high incomes.

1. Higher income tax rates for high income earners beginning in 2013. For high income taxpayers, the top income tax rate in 2012 was 35%. But in 2013, the top rate is 39.6% for ordinary income of individuals with taxable incomes over $400,000 (single) and $450,000 (married filing jointly). In addition, the increased 0.9% Medicare tax is levied on income above $200,000 (single) and $250,000 (married filing jointly).

   a. *Timing: acceleration or deferral*? Taking the above factors into consideration, it appears that estimating annual income will be important in deciding whether to accelerate income into the current tax year ***or*** defer earned income into the following tax year. With the top tax rate now set at 39.6%, clients might need to see a tax advisor to do income forecasting to anticipate which years they'll have more income and which ones they'll have less income (e.g., due to the completion of a project or a contract in a certain year).

   b. *Deferred compensation plans*. Due to § 409A, it generally is too late to elect to defer 2013 income, but for tax years beyond 2013, it may be worth considering whether to reduce income by installing a deferred compensation plan.

2. Pay deductible expenses early. Pay deductible expenses in 2013 to get a deduction on your 2013 tax return. For example, pay your real estate tax bill in December 2013 – don't wait until January 2014. Likewise for those who make estimated tax payments; pay your 4th quarter estimated state income tax payment in December 2014. Although that payment is ordinarily due in 2014, *state* income taxes are deductible federally in the year paid. So if you want to claim a deduction in 2013, don't wait until 2014 to make the payment. *Caution*: Consider to what extent the alternative minimum tax (AMT) might eliminate the benefits of these deductions. This is an excellent reason to talk with a tax advisor.

3. Offset capital gains with losses. Capital gains in 2013 are now subject to the 3.8% Medicare surtax on "net investment income" (defined below). This means that high income taxpayers could be taxed at a 23.8% tax rate (20% capital gains tax rate *plus* the 3.8% Medicare surtax). Consequently, offsetting capital gains against capital losses may be more necessary than ever before. To the extent losses exceed gains, up to $3,000 can be deducted from ordinary

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income. But be careful: if you intend to repurchase the same investments, watch out for the "wash sale" rule, which denies a loss when the investment is purchased within 30 days of the sale.

4. Contribute to an IRA or 401(k). Contribute the maximum to a Roth IRA, traditional IRA, or 401(k). As the chart below shows, some of these contributions can be made as late as April 15 of next year.

	Contribution Limit	Catch-Up Contribution (age 50 or over)	Contribution Due Date
401(k)	$17,500	$5,500	December 31, 2013
Traditional IRA	$5,500	$1,000	April 15, 2014
Roth IRA	$5,500	$1,000	April 15, 2014

Deductible contributions to 401(k)s and traditional IRAs reduce taxable income today (contributions to Roths aren't deductible). After the contributions are made, the growth of all of these arrangements is not taxable, so while in deferral they won't generate any income that can trigger the 3.8% net investment income tax, and even taxable distributions from these accounts are specifically excluded from this net investment income tax (although they admittedly increase modified adjusted gross income, so make the imposition of that tax on *other* income more likely).

5. Planning for the new 3.8% Medicare surtax on "net investment income." As mentioned above, this year there is a new surtax that applies to investment income. It is imposed on the *lesser* of (1) net investment income, *or* (2) the amount that the individual's modified adjusted gross income (MAGI) exceeds $200,000 (single) or $250,000 (married filing jointly). For purposes of this tax, "investment income" includes interest, dividends, capital gains, rents, royalties, annuities, income from businesses that are passive activities to the taxpayer, and income from businesses involved in trading of financial instruments or commodities.

Because two things are needed to trigger the tax – MAGI above the threshold and net investment income – those with a MAGI below the threshold amount need not worry about the NII tax. For those well above the threshold, the only way to reduce the tax is to reduce net investment income. But for those with MAGI near the threshold amount, consider the following techniques that will both reduce net investment income or MAGI, and oftentimes both:

- Deferring compensation
- Triggering capital losses
- Contributing to a tax deductible retirement plan or IRA
- Establishing employer-sponsored long-term care plan (premiums won't be taxed)
- Avoiding dividend paying stocks
- Buying tax free bonds
- Delaying receipt of Social Security
- Initiating Roth IRA conversions (to reduce MAGI in years after the conversion)
- Establishing charitable remainder trusts

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- Establishing non-grantor charitable lead trusts
- Setting up installment sales to spread out gain
- Owning assets that grow tax-deferred, such as annuities and life insurance
- Taking non-annuitized distributions from life insurance

6. Estimated tax payments. With the 39.6% top tax rate now in effect, particular attention should be paid when a high income taxpayer unexpectedly receives a large sum. These clients should contact their tax advisors as soon as possible so that their remaining estimated tax payments for the year can be increased to avoid penalties.

7. Annual exclusion gifts. For estate planning and transfer tax purposes, the tried and true strategy of making maximum annual exclusion gifts still constitutes good tax planning ($14,000 per person, or $28,000 for a married couple splitting gifts). Clients might also want to consider giving income producing assets to children in a lower income tax bracket.

8. Charitable donations. Whereas charitable donations might have been a last minute thought in prior years, with the new higher tax rates, annual charitable donations could become part of the high income earners' standard year-end tax reduction program. Donations of highly appreciated property to charity will become even more attractive because the donor can then avoid capital gains – which are now up to 23.8% when adding in the new Medicare surtax.

Conclusion

Higher tax rates seem here to stay. From now on, good income tax planning would seem to require that high income taxpayers consult with their tax advisors more than just once a year, and that they work together diligently to monitor current and anticipated income.

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