Overview of tax saving moves for the rest of 2013

This memo generally is oriented towards the time-honored approach of deferring income and accelerating deductions to minimize 2013 taxes. For individuals, deferring income also may help minimize or avoid AGI-based phase-outs of various tax breaks. As always, however, year-end tax planning doesn't occur in a vacuum. It must take account of each taxpayer's particular situation and planning goals, with the aim of minimizing taxes to the greatest extent possible. For example, higher income individuals must consider the effect of the 39.6% tax bracket that is in effect for tax years beginning in 2013 and later years, the 20% tax rate (instead of 15%) on long-term capital gains and qualified dividends for taxpayer taxed at a rate of 39.6% on ordinary income, the phase-out of itemized deductions and personal exemptions when income is over specified thresholds, and the 3.8% surtax (Medicare contribution tax) on net investment income for taxpayers whose income is over specified thresholds (which are lower than the thresholds at which the phase-out of itemized deductions and personal exemptions begins. Thus, while many taxpayers will come out ahead by following the traditional approach, others, including those with special circumstances (see below), should consider accelerating income and deferring deductions. Most traditional techniques for deferring income and accelerating expenses can be reversed to achieve the opposite effect. For instance, a cash method professional who wants to accelerate income can do so by speeding up the billing and collection process instead of deferring income by slowing it down. Or, a cash-method taxpayer who sells property in 2013 and realizes a large long-term capital gain can accelerate income by electing out of the installment method.

If you have any questions on the strategies listed below please contact Ben Haberman at 509-535-3503 ext 8.

Inflation adjustments to rate brackets, exemption amounts, etc. In 2014, some individuals will benefit from inflation adjustments in the thresholds for applying the income tax rates, higher standard deduction amounts, and higher personal exemption amounts.

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Capital gains. For 2013 and later years, long-term capital gains are taxed at a rate of (a) 20% if they would be taxed at a rate of 39.6% if they were taxed as ordinary income, (b) 15% if they would be taxed at above 15% but below 39.6% if they were taxed as ordinary income, and (c) 0% if they would be taxed at a rate of 10% or 15% if they were taxed as ordinary income. Strategies for matching capital gains and capital losses to make the most of these rules are explained. The 3.8% surtax on net investment income also may apply.

Low-taxed dividend income. Qualified dividend income is taxed at the same favorable tax rates that apply to long-term capital gains. Converting investment income taxable at regular rates into qualified dividend income can achieve tax savings and result in higher after-tax income.

Electing to claim sales and use taxes as an itemized deduction instead of state income taxes. For 2013 (but not 2014, unless Congress extends this popular option), individual taxpayers have the choice of claiming an itemized deduction for state and local sales and use taxes instead of state income taxes. For a discussion of this election.

Traditional IRA and Roth IRA year-end moves. These include converting traditional IRAs to Roth IRAs, re-characterizing such conversions, and possibly reconverting amounts from traditional IRAs to Roth IRAs.

Expensing deduction. For tax years beginning in 2013, the expensing limit is $500,000 and the investment ceiling limit is $2,000,000. And a limited amount of expensing may be claimed for qualified real property. However, unless Congress changes the rules, for tax years beginning in 2014, the dollar limitation will drop to $25,000, and the beginning-of-phase-out amount will drop to $200,000 (Code Sec. 179(b)), and expensing won't be available for qualified real property (Code Sec. 179(f)(1)). The generous dollar ceilings that apply in 2013 mean that many small and medium sized businesses that make timely purchases will be able to currently deduct most if not all their outlays for machinery and equipment. What's more the expensing deduction is not prorated for the time that the asset is in service during the year. This opens up significant year-end planning opportunities.

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Bonus first-year depreciation deduction. Most new machinery and equipment (as well as software) bought and placed in service in 2013 qualifies for a 50% bonus first year depreciation deduction. Unless Congress extends this tax break, property bought and placed in service in 2014 (other than certain specialized property) will not qualify for the 50% bonus first year depreciation deduction. Thus, enterprises planning to purchase new depreciable property should try to do so in 2013 if doing so otherwise makes sound business sense.

Deduction for qualified production activities income. Taxpayers can claim a deduction, subject to limits, for 9% of the lesser of (1) the taxpayer's "qualified production activities income" for the tax year (i.e., net income from U.S. manufacturing, production or extraction activities, U.S. film production, U.S. construction activities, and U.S. engineering and architectural services), or (2) the taxpayer's taxable income for that tax year before taking this deduction into account. This deduction generally has the effect of a reduction in the taxpayer's marginal rate and, thus, should be taken into account when making decisions regarding income shifting strategies.

Changes in individual's tax status may call for acceleration of income. Changes in an individual's tax status due, say, to divorce, marriage, or loss of head of household status must be considered.
Alternative minimum tax (AMT). Watch out for the AMT, which applies to both individuals and many corporations. A decision to accelerate an expense or to defer an item of income to reduce taxable income for regular tax purposes may not always save taxes because it may subject the taxpayer to the AMT,

Time value of money. Any decision to save taxes by accelerating income must take into account the fact that this means paying taxes early and losing the use of money that could have been otherwise invested.

Estimated tax. When taxes on deferred or accelerated taxable income must actually be paid depends to a great extent on how the estimated tax rules apply. The estimated tax rules can be affected by how much taxable income is shifted.

Obstacles to deferring taxable income. The Code contains a number of rules that hinder the shifting of income and expenses. These include the passive activity loss rules, requirements that certain taxpayers use the accrual method, and limitations on the deduction of investment interest.

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Charitable contributions., The timing of charitable contributions can have an important impact on year-end tax planning. Note that for 2013 (but not for 2014, unless Congress extends this tax break), individual taxpayers who are at least 70 1/2 years old may contribute to charities directly from their IRAs without having the amount of their contribution included in their gross income. By making this move, some taxpayers may be able to reduce their tax liability even more than they would have if they had received the distribution from their IRA and then contributed the amount distributed to charity.

Net operating losses and debt cancellation income. A business with a loss this year may be able to use that loss to generate cash in the form of a quick net operating loss carryback refund. This type of refund may be of particular value to a financially troubled business that needs a fast cash transfusion to keep going. There also are a number of different kinds of debt cancellation or debt reduction transactions that may generate taxable income in 2013 if not deferred until 2014.

Energy tax incentives. Tax credits are available for nonbusiness energy property placed in service in 2013 (but not in 2014 unless Congress acts to extend this credit) and for residential energy efficient property placed in service before 2017.

Special situations mentioned above

... Taxpayer expects to be in a higher tax bracket next year.

...Head-of-household or surviving spouse status ends after this year

...Taxpayer plans to get married next year

... Taxpayer expects to be eligible for one or more credits next year (e.g., the child tax credit), but not this year, that are subject to phaseout when AGI reaches specified limits.

... Taxpayer expects to start receiving Social Security benefits next year.

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