JENNIFER A. JONES, CPA, LTD.

Volume 14, Issue 3 — Client Newsletter — December 2013

2013 Year-End Tax Planning: As we approach year-end, it's again time to focus on last-minute moves you can make to save taxes—both on your 2013 return and in future years. **Click here for the article.**

S Corporation Distributions Are Wages: The president, only employee, and sole shareholder of an S corporation transferred $30,000 to the company in 2007. His fiance contributed an additional $25,000 on his behalf during 2007 and 2008. The S corporation made cash distributions as loan repayments and dividends to the shareholder of not less than $30,844 in 2007 and $31,644 in 2008, but reported no wages paid. After considering a list of factors Courts have established to evaluate transfers to closely held corporations, and the lack of interest, security, or a fixed repayment schedule, the Tax Court found these transfers were capital contributions and not bona fide loans. The payments were recharacterized as taxable wages for employment tax purposes. *Glass Blocks Unlimited* , TC Memo 2013-180 (Tax Ct.). More Info...

Withholding for 0.9% Medicare Tax: Though the additional 0.9% Medicare tax became effective 1/1/13, effects from additional withholding are not felt until an individual's wages for the year pass $200,000. Employers must begin the additional withholding when an individual's compensation for the year exceeds $200,000 without regard to their filing status or compensation from other employers. Depending on filing status, wages, other compensation, and self-employment income, an individual could owe more than the amount withheld. Per the IRS, individuals that anticipate liability for the additional Medicare tax should make estimated tax payments and/or request additional income tax withholding using Form W-4 . Additional FAQs on application of the additional Medicare tax are available on the IRS website (www.irs.gov).

Year-end Gifts and Parties: Just a reminder of how year-end gifts to employees and company parties are taxed:

Noncash gifts: Include the fair-market value (FMV) of taxable noncash gifts in wages subject to FIT, FITW, FICA and FUTA. [Rev. Rul. 57-18, CB 1957-1, 35]

Nontaxable items: Fruit baskets, hams, turkeys, wine, flowers and entertainment tickets to a show, sporting or other event (but not season tickets) generally are *de minimis* (nontaxable) fringes if they are of nominal value and given infrequently

Taxable items: Gift certificates ("cash in kind") are wages subject to FIT, FITW, FICA and FUTA, even for *de minimis* items—e.g., a gift certificate for a turkey is taxable; a turkey is not. Cash gifts of any amount are taxable as wages. [26 CFR 1.132-6(e); TAM 200437030]

Company parties: The cost of company parties is nontaxable to employees and their families as a *de minimis* fringe benefit if infrequent and given to promote employee health, goodwill, contentment or efficiency. The cost of these parties is also 100% (not just 50%) deductible to the business, e.g. Holiday parties, cocktail parties and company picnics. [IRC §132]

Simplified Home Office Deduction: A new, simplified option for claiming a home office deduction reduces paperwork and recordkeeping, but restrictions apply. Learn more by watching this new YouTube video or at Simplified-Option-for-Home-Office-Deduction

2013 Cost-of-Living Limits

IRA Contribution Limit $5,500
IRA 50 & Over Catch-up Contribution $1,000
401(k) Deferral Limit $17,500
401(k) 50 & Over Catch-up Contribution $5,500
SIMPLE Deferral limit $12,000
SIMPLE 50 & Over Catch-up Contribution $2,500
Annual Compensation limit $255,000
Defined Contribution IRC Sec 415 limit $51,000
Compensation limit for SEP eligibility $550
IRC Section 179 $500,000
Estate Tax Exclusion $5,250,000
Gift Tax Annual Exclusion $14,000
Social Security Wage Base $113,700
2014 Wage Base $117,000
2013 & Prior Years' Limits

2013 Standard Mileage Rates:

Business mileage rate **$0.565**
Medical & Moving mileage rate **$0.24**
Charitable mileage rate **$0.14/mile**

TO CONTACT US:

Jennifer A. Jones, CPA, Ltd.
10615 Judicial Drive, Suite 701
Fairfax, Virginia 22030

Phone: 703-352-1587
Fax: 703-352-1927

VISIT OUR WEBSITE AT:
http://www.jajonescpa.com/

TO EMAIL US:
Jennifer A. Jones, Certified Public Accountant
Patricia (PA) Moss, Enrolled Agent
J. Randolph Shull, QuickBooks Certified Professional Advisor

Unsubscribe to Newsletter

Have a Topic or Question?
If you have a subject or question that you would like covered in a newsletter, please email us at: Newsletter Topic

The Importance of Updating Your Beneficiary Designations after Hillman v. Maretta

Pursuant to Virginia Code Â§20-111.1, a beneficiary designation naming a former spouse as beneficiary of a death benefit may be revoked by operation of law upon the entrance of a final decree of annulment or divorce.

The law further provides that, if a former spouse receives a death benefit pursuant to federal law, then the former spouse may be liable for reimbursing the person who would have otherwise received the benefit absent such designation.

Hillman v. Maretta, which was decided on June 5, 2013, challenged Virginia Code Â§20-111.1 as it relates to federal death benefits. In that case, Jacqueline Hillman ("Jacqueline"), the wife of Warren Hillman ("Warren"), sued Judy Maretta ("Judy"), the former wife of Warren, to recover proceeds received by Judy from Warren's Federal Employee's Group Life Insurance policy. Jacqueline claimed that while the Federal Employee's Group Life Insurance Policy Act ("FEGLIA"), 5 U.S.C. Â§8701 et seq., preempted1 state law with regard to the revocation of the designation, FEGLIA did not preempt with regard to the requirement for reimbursement. The United States Supreme Court held that FEGLIA preempts Virginia Code Â§20-111.1, which conflicts with the objective and purpose of FEGLIA, and therefore, the Commonwealth of Virginia cannot hold a former spouse who receives a FEGLI death benefit liable to whoever would have otherwise inherited the benefit.

The effect of Hillman v. Maretta may extend beyond FEGLI benefits and into other federal benefit plans. As a result, it is important that you routinely review your estate plan, which encompasses the distribution of your entire estate and includes designation of beneficiaries.

Recordkeeping Reminder: Sole proprietors and individuals should keep the following records for at least 3 years:

- Bills
- Credit card and other receipts
- Invoices
- Mileage logs
- Canceled, imaged or substitute checks or any other proof of payment
- Any other records to support deductions or credits you claim on your return

Records relating to property should be kept at least 3 years after property is disposed of. Examples include:

- A home purchase or improvement
- Stocks and other investments
- Individual Retirement Account (IRA) transactions
- Rental property records

For more details, see IRS Pub. 552, *Recordkeeping for Individuals*

Back to Top

Beginning in 2014, the mandatory health insurance coverage provisions of the Patient Protection and Affordable Care Act (ACA) go into effect. But the law does not require everyone to have health insurance, nor are all of the coverage requirements applicable to all types of health insurance.

Are you exempt from the health insurance mandate? Most U.S. citizens and legal residents are required to have health insurance beginning in January 2014 or face a penalty tax that can be as high as 1% of taxable household income exceeding the taxpayer's federal income tax filing threshold (increasing to 2% in 2015, and 2.5% in 2016). You can avoid

the penalty tax if you already have health insurance for the entire year, and the coverage is obtained from one of the following:

Medicare
Medicaid or the Children's Health Insurance Program (CHIP)
TRICARE (for service members, their families, and retirees)
The veteran's health program
Employer-provided health coverage
A policy you purchase on your own that's at least at the Bronze level
A plan that is grandfathered (in existence prior to the enactment of the ACA that meets the requirements of grandfathered plans under the law)

However, certain groups are not required to be insured and thus are not subject to the penalty tax. The ACA specifically excludes people who are members of an exempt religious sect or division, members of a health-care sharing ministry, Native Americans, undocumented immigrants, incarcerated individuals, people whose income is so low that they don't have to file federal income taxes, and people eligible for a hardship exemption (when the cost of insurance after employer contributions and federal subsidies exceeds 8% of their income).

What types of insurance are not affected by the health-care reform law?

The health-care reform law does not apply to automobile insurance, homeowners insurance, and umbrella liability coverage, even though they provide some health-related coverage. Also not subject to the law's provisions are life, accident, disability, long-term care, and workers' compensation insurance. Medi-Gap (Medicare supplement) insurance is generally not covered by the ACA if it's sold as a separate plan and not as part of a comprehensive health insurance policy. In addition, retiree-only plans are exempt from the ACA's provisions. These plans are group health insurance plans with fewer than two participants who are current employees.

For more consumer information about enrolling in a health insurance plan, government subsidies, and tax credits, visit the U.S. government's website, www.healthcare.gov.

Back to Top

Doing Business in Another State? It's harder to tell than you may think. Most states don't offer companies clear guidance in this area. With state budgets strained, states are facing greater pressure to crack down as they struggle to close significant budget gaps. States are looking into businesses that have a presence in their state and are subject to state and local income and sales taxes. Companies have been found liable for state corporate tax "when the only connection to that state was that they had an employee telecommuting in that state."

In March 2010, for instance, the Tax Court of New Jersey ruled that a company whose main offices are in Maryland was "doing business" in New Jersey because an employee telecommutes from there. The company, TeleBright Software Corp., is appealing the decision, arguing that having one employee in the state who develops software from home falls short of the statutory definition of "doing business." The company asserted that it doesn't solicit customers or make sales in New Jersey.

Just how much of a tax hit companies face depends on state rules. Some impose income tax based on an out-of-state company's sales in the jurisdiction. Others also take into account the company's payroll and property in the state. However they figure the bill, lots of states seem to be on the same page as New Jersey. In a survey issued in April, 35 states, the District of Columbia and New York City said an employee who telecommutes from a home in the state would create "nexus"—a connection that warrants imposing income tax on an out-of-state employer.

A potential solution has been offered by advisors: Have the telecommuting employee resign, form a C or S corporation and invoice the ex-employer for work. The former employer would have to pay the former employee more to cover new expenses and lost benefits. And, although it would be a challenge, states could still make a case for taxing the former employer.

Back to Top

Updating Taxpayer Addresses: The IRS uses the USPS' National Change of Address (NCOA) database to update taxpayer addresses. When there is a mismatch of information between IRS information and the NCOA database, an address is not automatically updated and the IRS receives returned mail with a USPS yellow sticker displaying the new address. In this program manager technical advice, the IRS looked at whether a taxpayer's address could be changed in its records based on the last known address from a yellow sticker. Since the IRS automatic updating system has strict parameters that sometimes result in mismatches, it was concluded that if the IRS is reasonably confident, after conducting research, that the individual on the yellow sticker is the taxpayer in question, then the address can be updated. PMTA 2012-26.

Validating Suspicious Change of Address: In this program manager technical advice, a request for advice was made as to whether the IRS can communicate directly with the USPS to validate a taxpayer's suspicious change of address. Validation of a suspicious address would require the IRS to provide the USPS with confidential return information (i.e., taxpayer identity), disclosure of which must be authorized under IRC Sec. 6103 . The Code will allow disclosure if necessary to verify the correctness of return information and if "appropriate and helpful in obtaining the information" [Reg. 301.6103(k)(6)-1]. In this case, disclosure would likely be authorized if the IRS reasonably believes that correct address information cannot be acquired without disclosing the taxpayer's identity to the USPS. PMTA 2012-28.

Back to Top

Sub S Corporations' Payroll Tax Avoidance Tactics: Payroll tax collection continues to vex the Internal Revenue Service despite several court cases that have resulted in rulings favorable for the IRS regarding unreasonably low compensation. A recent high profile case was *David E. Watson, P.C. v. United States* on which the Eighth Circuit ruled in 2012. Watson was an indirect partner in a CPA firm, practicing through an S corporation that paid him *$24,000* of salary per year and between $175,000 and $203,000 in profit distributions. The court adjusted his compensation to $93,000.

It isn't hard to see why shareholders of S corporations attempt to justify wage levels below what the IRS considers "reasonable compensation" (assuming the understated compensation is below the FICA wage base). Both the S corporation and employee save the 7.65% FICA and Medicare taxes on the wages not reported.

Another recent case is *Herbert v. Commissioner*. Herbert received between $24,000 and $29,000 of wages for the years 2004 through 2006. In 2007, he received $2,400 of wages. Although the Tax Court noted that the corporation lost money or earned very little income in each of the years, and the corporation closed down in 2009, the Court increased the taxable compensation for 2007. The IRS wanted to reclassify all of the draws from the S corporation for 2007 as additional wages (i.e., an additional $52,600). Ultimately, the judge averaged the petitioner's wages for 2002 through 2006 to arrive at $30,445 as a reasonable wage. (The business was owned by someone else in 2002 and 2003.)

It didn't help matters that Mr. Herbert used the draws to pay corporate expenses personally. He lost, misplaced or never kept receipts for many corporate expenses he paid with cash. The Court accepted Herbert's testimony that he in fact paid significant corporate expenses with cash using funds received from the corporation. Nonetheless, the judge also believed that the wages of $2,400 were too low.

The result? Herbert was found to have under-reported his wages, even though the amount of cash drawn out of the corporation covered corporate expenses. If he had maintained a better set of books, paid all of the corporate expenses with corporate (rather than what became to be personal) funds, he wouldn't have had distributions from the corporation to himself.

Although the wages were quite low, the fact of the matter is the business was failing. There wasn't an adequate cash flow to pay wages and expenses. By shuffling funds and taking money personally, Mr. Herbert created a payroll tax liability where such liability shouldn't have existed.

Payroll tax reduction or avoidance is, perhaps, a major reason for the popularity of S corporation status for an operating entity, even though the formation of an LLC under state law provides similar liability protection for the sole proprietor. The IRS projects that 4.6 million Forms 1120-S will be filed for 2012, compared to 3.6 million Forms 1065 (partnership).

As part of its tax reform efforts, Congress is evaluating the continuing treatment of the bottom-line S corporation as not subject to payroll taxes or self-employment tax. The AICPA will be closely monitoring any developments and keeping you up to date through its tax reform page and other communications.

Chris Hesse, CPA, Partner, CliftonLarsonAllen*. Chris is with CliftonLarsonAllen's Federal Tax Resource Group serving all offices of the firm. FTRG is a firm wide group that assists all offices of the firm on federal income tax matters, in addition to drafting CPE material for in-house presentation. Chris is also chairman of the S Corporation Technical Resource Panel for the AICPA.*

Back to Top

2013 Year-end Tax Planning

Back to Top

As we approach year-end, it's again time to focus on last-minute moves you can make to save taxes—both on your 2013 return and in future years.

For most individuals, the ordinary federal income tax rates for 2013 will be the same as last year: 10%, 15%, 25%, 28%, 33%, and 35%. However, the fiscal cliff legislation, passed early this year, increased the maximum rate for higher-income individuals to 39.6% (up from 35%). This change affects taxpayers with taxable income above $400,000 for singles, $450,000 for married joint-filing couples, and $425,000 for heads of households. In addition, the new 0.9% Medicare tax and 3.8% Net Investment Income Tax (NIIT) potentially kick in when modified adjusted gross income (or earned income in the case of the Medicare tax) goes over $200,000 for unmarried, $250,000 for married joint-filing couples, which can result in a higher-than-advertised federal tax rate for 2013.

Despite these tax increases, the current federal income tax environment remains relatively favorable by historical standards. This letter presents a few tax-saving ideas to get you started. As always, you can call on us to help you sort through the options and implement strategies that make sense for you.

Ideas for Your Business

Take Advantage of Tax Breaks for Purchasing Equipment, Software, and Certain Real Property. If you have plans to buy a business computer, office furniture, equipment, vehicle, or other tangible business property or to make certain improvements to real property, you might consider doing so before year-end to capitalize on the following generous, but temporary tax breaks:

- *Bigger Section 179 Deduction.* Your business may be able to take advantage of the temporarily increased Section 179 deduction. Under the Section 179 deduction privilege, an eligible business can often claim first-year depreciation write-offs for the entire cost of new and used equipment and software additions. (However, limits apply to the amount that can be deducted for most vehicles.) For tax years beginning in 2013, the maximum Section 179 deduction is $500,000. For tax years beginning in 2014, however, the maximum deduction is scheduled to drop to $25,000.

- *Section 179 Deduction for Real Estate.* Real property costs are generally ineligible for the Section 179 deduction privilege. However, an exception applies to tax years beginning in 2013. Under the exception, your business can immediately deduct up to $250,000 of qualified costs for restaurant buildings and improvements to interiors of retail and leased nonresidential buildings. The $250,000 Section 179 allowance for these real estate expenditures is part of the overall $500,000 allowance. This temporary real estate break will not be available for tax years beginning after 2013 unless Congress extends it.

  Note: Watch out if your business is already expected to have a tax loss for the year (or be close) before considering any Section 179 deduction, as you cannot claim a Section 179 write-off that would create or increase an overall business tax loss. Please contact us if you think this might be an issue for your operation.

- *50% First-year Bonus Depreciation.* Above and beyond the bumped-up Section 179 deduction, your business can also claim first-year bonus depreciation equal to 50% of the cost of most new (not used) equipment and software placed in service by December 31 of this year. For a new passenger auto or light truck that's used for business and is subject to the luxury auto depreciation limitations, the 50% bonus depreciation break increases the maximum first-year depreciation deduction by $8,000 for vehicles placed in service this year. The 50% bonus depreciation break will expire at year-end unless Congress extends it.

  Note: First-year bonus depreciation deductions can create or increase a Net Operating Loss (NOL) for your business's 2013 tax year. You can then carry back a 2013 NOL to 2011 and 2012 and collect a refund of taxes paid in those years. Please contact us for details on the interaction between asset additions and NOLs.

Evaluate Inventory for Damaged or Obsolete Items. Inventory is normally valued for tax purposes at cost or the lower of cost or market value. Regardless of which of these methods is used, the end-of-the-year inventory should be reviewed to detect obsolete or damaged items. The carrying cost of any such items may be written down to their probable selling price (net of selling expenses). [This rule does not apply to businesses that use the Last in, First out (LIFO) method because LIFO does not distinguish between goods that have been written down and those that have not].

To claim a deduction for a write-down of obsolete inventory, you are not required to scrap the item. However, in a period ending not later than 30 days after the inventory date, the item must be actually offered for sale at the price to which the inventory is reduced.

Employ Your Child. If you are self-employed, don't miss one last opportunity to employ your child before the end of the year. Doing so has tax benefits in that it shifts income (which is not subject to the Kiddie tax) from you to your child, who normally is in a lower tax bracket or may avoid tax entirely due to the standard deduction. There can also be payroll tax savings since wages paid by sole proprietors to their children age 17 and younger are exempt from both social security and unemployment taxes. Employing your children has the added benefit of providing them with earned income, which enables them to contribute to an IRA. Children with IRAs, particularly Roth IRAs, have a great start on retirement savings since the compounded growth of the funds can be significant.

Remember a couple of things when employing your child. First, the wages paid must be reasonable given the child's age and work skills. Second, if the child is in college, or is entering soon, having too much earned income can have a detrimental impact on the student's need-based financial aid eligibility.

Ideas for Maximizing Non-business Deductions

One way to reduce your 2013 tax liability is to look for additional deductions. Here's a list of suggestions to get you started:

Make Charitable Gifts of Appreciated Stock. If you have appreciated stock that you've held more than a year and you plan to make significant charitable contributions before year-end, keep your cash and donate the stock (or mutual fund shares) instead. You'll avoid paying tax on the appreciation, but will still be able to deduct the donated property's full value. If you want to maintain a position in the donated securities, you can immediately buy back a like number of shares. (This idea works especially well with no load mutual funds because there are no transaction fees involved.)

However, if the stock is now worth less than when you acquired it, sell the stock, take the loss, and then give the cash to the charity. If you give the stock to the charity, your charitable deduction will equal the stock's current depressed value and no capital loss will be available. Also, if you sell the stock at a loss, you can't immediately buy it back as this will trigger the wash sale rules. This means your loss won't be deductible, but instead will be added to the basis in the new shares.

Don't Lose a Charitable Deduction for Lack of Paperwork. Charitable contributions are only deductible if you have proper documentation. For cash contributions of less than $250, this means you must have either a bank record that supports the donation (such as a cancelled check or credit card receipt) or a written statement from the charity that meets tax-law requirements. For cash donations of $250 or more, a bank record is not enough. You must obtain, by the time your tax return is filed, a charity-provided statement that shows the amount of the donation and lists any significant goods or services received in return for the donation (other than intangible religious benefits) or specifically states that you received no goods or services from the charity.

Maximize the Benefit of the Standard Deduction. For 2013, the standard deduction is $12,200 for married taxpayers filing joint returns. For single taxpayers, the amount is $6,100. Currently, it looks like these amounts will be about the same for 2014. If your total itemized deductions are normally close to these amounts, you may be able to leverage the benefit of your deductions by bunching deductions in every other year. This allows you to time your itemized deductions so that they are high in one year and low in the next. You claim actual expenses in the year they are bunched and take the standard deduction in the intervening years.

For instance, you might consider moving charitable donations you normally would make in early 2014 to the end of 2013. If you're temporarily short on cash, charge the contribution to a credit card—it is deductible in the year charged, not when payment is made on the card. You can also accelerate payments of your real estate taxes or state income taxes otherwise due in early 2014. But, watch out for the AMT, as these taxes are not deductible for AMT purposes.

Manage Your Adjusted Gross Income (AGI). Many tax breaks are only available to taxpayers with AGI below certain levels. Some common AGI-based tax breaks include the child tax credit (phase-out begins at $110,000 for married couples and $75,000 for heads-of-households), the $25,000 rental real estate passive loss allowance (phase-out range of $100,000–$150,000 for most taxpayers), and the exclusion of social security benefits ($32,000 threshold for married filers; $25,000 for other filers). In addition, for 2013 taxpayers with AGI over $300,000 for married filers, $250,000 for singles, and $275,000 for heads-of-households begin losing part of their personal exemptions and itemized deductions. Accordingly, strategies that lower your income or increase certain deductions might not only reduce your taxable income, but also help increase some of your other tax deductions and credits.

Making the Most of Year-end Securities Transactions

For most individuals, the 2013 federal tax rates on long-term capital gains from sales of investments held over a year are the same as last year: either 0% or 15%. However, the maximum rate for higher-income individuals is now 20% (up from 15% last year). This change affects taxpayers with taxable income above $400,000 for singles, $450,000 for married joint-filing couples, $425,000 for heads-of-households, and $225,000 for married individuals who file separate returns. Higher-income individuals can also get hit by the new 3.8% NIIT on net investment income, which can result in a maximum 23.8% federal income tax rate on 2013 long-term gains.

As you evaluate investments held in your taxable brokerage firm accounts, consider the tax impact of selling appreciated securities (currently worth more than you paid for them). For most taxpayers, the federal tax rate on long-term capital gains is still much lower than the rate on short-term gains. Therefore, it often makes sense to hold appreciated securities for at least a year and a day before selling to qualify for the lower long-term gain tax rate.

Biting the bullet and selling some loser securities (currently worth less than you paid for them) before year-end can also be a tax-smart idea. The resulting capital losses will offset capital gains from other sales this year, including high-taxed short-term gains from securities owned for one year or less. For 2013, the maximum rate on short-term gains is 39.6%, and the 3.8% NIIT may apply too, which can result in an effective rate of up to 43.4%. However, you don't need to worry about paying a high rate on short-term gains that can be sheltered with capital losses (you will pay 0% on gains that can be sheltered).

If capital losses for this year exceed capital gains, you will have a net capital loss for 2013. You can use that net capital loss to shelter up to $3,000 of this year's high-taxed ordinary income ($1,500 if you're married and file separately). Any excess net capital loss is carried forward to next year.

Selling enough loser securities to create a bigger net capital loss that exceeds what you can use this year might also make sense. You can carry forward the excess capital loss to 2014 and beyond and use it to shelter both short-term gains and long-term gains recognized in those years.

Identify the Securities You Sell. When selling stock or mutual fund shares, the general rule is that the shares you acquired first are the ones you sell first. However, if you choose, you can specifically identify the shares you're selling when you sell less than your entire holding of a stock or mutual fund. By notifying your broker of the shares you want sold at the time of the sale, your gain or loss from the sale is based on the identified shares. This sales strategy gives you better control over the amount of your gain or loss and whether it's long-term or short-term.

Secure a Deduction for Nearly Worthless Securities. If you own any securities that are all but worthless with little hope of recovery, you might consider selling them before the end of the year so you can capitalize on the loss this year. You can deduct a loss on worthless securities only if you can prove the investment is completely worthless. Thus, a deduction is not available, as long as you own the security and it has any value at all. Total worthlessness can be very difficult to

establish with any certainty. To avoid the issue, it may be easier just to sell the security if it has any marketable value. As long as the sale is not to a family member, this allows you to claim a loss for the difference between your tax basis and the proceeds (subject to the normal rules for capital losses and the wash sale rules restricting the recognition of loss if the security is repurchased within 30 days before or after the sale).

Ideas for Seniors Age 70½ Plus

Make Charitable Donations from Your IRA. IRA owners and beneficiaries who have reached age 70½ are permitted to make cash donations totaling up to $100,000 to IRS-approved public charities directly out of their IRAs. These so-called *Qualified Charitable Distributions,* or QCDs, are federal-income-tax-free to you, but you get no itemized charitable write-off on your Form 1040. That's okay because the tax-free treatment of QCDs equates to an immediate 100% federal income tax deduction without having to worry about restrictions that can delay itemized charitable write-offs. QCDs have other tax advantages, too. Contact us if you want to hear about them.

Be careful—to qualify for this special tax break, the funds must be *transferred directly* from your IRA to the charity. Also, this favorable provision will expire at the end of this year unless Congress extends it. So, this could be your last chance.

Take Your Required Retirement Distributions. The tax laws generally require individuals with retirement accounts to take withdrawals based on the size of their account and their age every year after they reach age 70½. Failure to take a required withdrawal can result in a penalty of 50% of the amount not withdrawn. There's good news for 2013 though—QCDs discussed above count as payouts for purposes of the required distribution rules. This means, you can donate all or part of your 2013 required distribution amount (up to the $100,000 limit on QCDs) and convert taxable required distributions into tax-free QCDs.

Also, if you turned age 70½ in 2013, you can delay your 2013 required distribution to 2014, if you choose. However, waiting until 2014 will result in two distributions in 2014—the amount required for 2013 plus the amount required for 2014. While deferring income is normally a sound tax strategy, here it results in bunching income into 2014. Thus, think twice before delaying your 2013 distribution to 2014—bunching income into 2014 might throw you into a higher tax bracket or have a detrimental impact on your other tax deductions in 2014.

Ideas for the Office

Maximize Contributions to 401(k) Plans. If you have a 401(k) plan at work, it's just about time to tell your company how much you want to set aside on a tax-free basis for next year. Contribute as much as you can stand, especially if your employer makes matching contributions. You give up "free money" when you fail to participate to the max for the match.

Take Advantage of Flexible Spending Accounts (FSAs). If your company has a healthcare and/or dependent care FSA, before year-end you must specify how much of your 2014 salary to convert into tax-free contributions to the plan. You can then take tax-free withdrawals next year to reimburse yourself for out-of-pocket medical and dental expenses and qualifying dependent care costs. Watch out, though, FSAs are "use-it-or-lose-it" accounts—you don't want to set aside more than what you'll likely have in qualifying expenses for the year.

Married couples who both have access to FSAs will also need to decide whose FSA to use. If one spouse's salary is likely to be higher than what's known as the FICA wage limit (which is $113,700 for this year and will likely be somewhat higher next year) and the other spouse's will be less, the one with the smaller salary should fund as much of the couple's FSA needs as possible. The reason is the 6.2% social security tax levy for 2014 is set to stop at the FICA wage limit (and doesn't apply at all to money put into an FSA). Thus, for example, if one spouse earns $120,000 and the other $40,000 and they want to collectively set aside $5,000 in their FSAs, they can save $310 (6.2% of $5,000) by having the full amount taken from the lower-paid spouse's salary versus having 100% taken from the other one's wages. Of course, either way, the couple will also save approximately $1,400 in income and Medicare taxes because of the FSAs.

If you currently have a healthcare FSA, make sure you drain it by incurring eligible expenses before the deadline for this year. Otherwise, you'll lose the remaining balance. It's not that hard to drum some things up: new glasses or contacts, dental work you've been putting off, or prescriptions that can be filled early.

Adjust Your Federal Income Tax Withholding. As stated at the beginning of this letter, higher-income individuals will likely see their taxes go up this year. This makes it more important than ever to do the calculations to see where you stand before the end of the year. If it looks like you are going to owe income taxes for 2013, consider bumping up the federal income taxes withheld from your paychecks now through the end of the year. When you file your return, you will still have to pay any taxes due less the amount paid in. However, as long as your total tax payments (estimated payments plus withholdings) equal at least 90% of your 2013 liability or, if smaller, 100% of your 2012 liability (110% if your 2012 adjusted gross income exceeded $150,000; $75,000 for married individuals who filed separate returns), penalties will be minimized, if not eliminated.

Watch Out for Alternative Minimum Tax

Recent legislation slightly reduced the odds that you'll owe the alternative minimum tax (AMT). Even so, it's still critical to evaluate all tax planning strategies in light of the AMT rules before actually making any moves. Because the AMT rules are complicated, you may want our assistance.

Don't Overlook Estate Planning

For 2013, the unified federal gift and estate tax exemption is a historically generous $5.25 million, and the federal estate tax rate is a historically reasonable 40%. Even if you already have an estate plan, it may need updating to reflect the current estate and gift tax rules. Also, you may need to make some changes for reasons that have nothing to do with taxes.

Year-end Depreciation Planning

If more than 40% of the total depreciable bases of MACRS property is placed in service during the last three months of the tax year, the mid-quarter convention must be used for all MACRS personal property placed in service that year. Normally, a business wants to avoid the mid-quarter convention since property acquired after the midpoint of the tax year is entitled to less depreciation in the first year than under the half-year convention. One way the business can do this is by timing asset purchases so that 40% or less of the assets purchased during the year are placed in service during the last three months of the year. For a calendar-year business, that would be in October, November, and December. Or, the business can claim the Section 179 deduction for property placed in service in the last three months, since that property is excluded from the 40% test.

Year-end Section 179 Deduction Trap

The current $500,000 Section 179 deduction limit applies to tax years beginning in 2013. Under current law, the limit will be a much lower $25,000 for tax years beginning in 2014. This presents a potential tax trap for fiscal year pass-through entities (e.g., partnerships and S corporations) with calendar year owners. Assets acquired and placed in service during the year beginning in 2013 and ending in 2014 will qualify for the larger limit, but the amount passed through to the owners will be reported on their 2014 tax return, when the much lower limit applies. In this scenario the excess amount will be wasted—it cannot be deducted nor can it be carried over. Although Congress may increase the Section 179 deduction limit for tax years beginning in 2014, there's no guarantee that it will come close to or equal the current $500,000 deduction limit.

Year-end Related Party Planning

Expenses paid by an accrual method business to a cash method owner cannot be deducted by the business under IRC Sec. 267(a)(2) until they are includable in the owner's income. This rule applies to expenses paid to a

person who owns directly or indirectly more than 50% of a C corporation's stock, any capital or profits interest in a partnership (or an LLC taxed as a partnership), or any stock in an S corporation. For example, assume that Essco is an accrual method S corporation with a 10/31 fiscal year-end. On 10/31/13, it owes $1,500 equipment rent to Joe, a 5% shareholder. If it pays the rent on 11/1/13, it will deduct the rent on its 10/31/14 tax return, but Joe will recognize the income in 2013. If it pays the rent on 10/31/13, it can deduct the rent for the year ending 10/31/13, and Joe will recognize the income in 2013. If it pays the rent during the period 12/1/14–10/31/14, it will deduct the rent for the year ending 10/31/14 and Joe will recognize the income in 2014.

Back to Top

Practitioner's Reference Sheet for 2013 Year-end Planning Letter

Section 179 Deduction and Section 179 Deduction for Real Estate: IRC Sec. 179.

50% Bonus Depreciation: IRC Sec. 168(k) and Rev. Proc. 2011-26.

Caution: Not all states allow the increased Section 179 deduction or bonus depreciation.

Evaluate Inventory for Damaged or Obsolete Items: Reg. 1.471-2(c); Ltr. Rul. 9729001; *Thor Power Tool Co.*, 43 AFTR 2d 79-362, 99 S. Ct. 773 (1979).

Employ Your Child: IRC Secs. 408, 408A, 3101(a) and (b), 3121(b)(3)(A), 3301, and 3306(c)(5); Regs. 31.3121(b)(3)-1 and 31.3306(c)(5)-1.

Make Charitable Gifts of Appreciated Stock: IRC Sec. 170(e)(1).

Don't Lose a Charitable Deduction for Lack of Paperwork: IRC Sec. 170(f)(17).

Maximize the Benefit of the Standard Deduction: IRC Sec. 63(c).

Manage Your AGI: IRC Secs. 24, 68, 86(c), 151(d), and 469(i). Other AGI-sensitive items include Coverdell education savings account contributions (IRC Sec. 530), education loan interest deductions (IRC Sec. 221), deductible IRA contributions (IRC Sec. 219), and Roth IRA contributions (IRC Sec. 408A).

Making the Most of Year-end Securities Transactions: IRC Secs. 1(h), 1091, 1211(b), and 1222.

Identify the Securities You Sell: Reg. 1.1012-1(c).

Secure a Deduction for Nearly Worthless Securities: IRC Secs. 165(g)(1), and 267.

Make Charitable Donations From Your IRA: IRC Sec. 408(d)(8). See also TAM-1584[1] (1/22/13).

Take Your Required Retirement Distributions: IRC Secs. 401(a)(9) and 4974; Reg. 1.401(a)(9)-9.

Maximize Contributions to 401(k) Plans: IRC Sec. 401(k).

Take Advantage of Flexible Spending Accounts (FSAs): IRC Sec. 125.

Adjust Your Federal Income Tax Withholding: IRC Sec. 6654.

Watch Out for AMT: IRC Secs. 55–59.

Don't Overlook Estate Planning: IRC Secs. 2001, 2010, 2502, 2503, and 2505.

Back to Top

[1] ~~Copyright © 2013 Thomson Reuters~~/Practitioners Publishing Company. All Rights Reserved. Practitioners Tax Action Bulletins®, Five-Minute Tax Briefing®, Tax Action Memo®, and National Tax Advisory® are registered trademarks used herein under license. For subscription information, call (800) 431-9025. This publication is designed to provide accurate information on the subject matter covered. The publisher is not engaged in rendering professional advice or service. If such expert assistance is required, the services of a competent professional should be sought.