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November 18, 2013

Dear Client:

Early in 2013, the 2012 Taxpayer Relief Act was enacted and the "Bush-era" tax cuts, which were scheduled to sunset at the end of 2012, were permanently extended and modified. This legislation is significant because without its enactment, individual tax rates on all income groups would have increased, taxpayer-friendly treatment of capital gains and dividends would have disappeared, and many other popular but temporary incentives would no longer be available.

Because of the many permanent changes, we are able to implement a planning strategy for you that optimizes current tax benefits, yet still allows some certainty when planning for future years.

PERMANENT GENERAL TAX PROVISIONS

Income tax. The lower income tax rates of 10, 15, 25, 28, 33, and 35 percent are made permanent, and a new tax rate of **39.6 percent** is imposed on taxable income over a threshold amount. For 2013, these threshold amounts are:

- $450,000 for married taxpayers filing jointly and surviving spouses
- $225,000 for married taxpayers filing separately
- $425,000 for heads of households
- $400,000 for single taxpayers

Capital gains tax. The favorable rate of zero percent for taxpayers in the 10 and 15 percent brackets remains unchanged. The 15 percent rate for taxpayers is now applicable to those in the 25, 28, 33, and 35 percent brackets, and a new **20 percent rate** applies to higher-income taxpayers that are subject to the 39.6 percent income tax rate.

Also remaining unchanged are the 25 percent rate for unrecaptured Code Sec. 1250 gain, and the 28 percent rate for collectibles and gain on qualified small business stock equal to its partial exclusion. The lower rates for qualified five-year property are no longer applicable.

Tax on dividends. Qualified dividends received from domestic corporations and qualified foreign corporates continue to be taxed at the same rates that apply to capital gains. Certain dividends do not qualify for the reduced rates, including dividends paid by credit unions, mutual insurance companies, and farmers' cooperatives.

Alternative minimum tax. Permanent alternative minimum tax (AMT) exemption amounts, which are annually adjusted for inflation, are provided by the 2012 Taxpayer Relief Act. For 2013, the AMT exemption amounts are:

- $80,800 for married taxpayers filing jointly and surviving spouses;
- $51,900 for unmarried taxpayers and heads of household, other than surviving spouses; and
- $40,400 for married taxpayers filing separately.

You should not ignore the possibility of being subject to the AMT, as doing so may negate certain year-end tax strategies. For example, if income and deductions are manipulated to reduce regular tax liability, AMT for 2013 may increase because of differences in the income and deductions allowed for AMT purposes.

PERMANENTLY REINSTATED PHASEOUTS

Higher income taxpayers are again subject to the personal exemption phase-out and the so-called Pease limitation on itemized deductions beginning in 2013. Both of these provisions were repealed through 2012.

Itemized deduction phase-out. The return of the Pease limitation on itemized deductions (named for the member of Congress who originally sponsored the legislation) reduces itemized deductions for higher-income taxpayers. Beginning in 2013, the itemized deduction phase-out reduces itemized deductions when AGI exceeds the following threshold amounts, which will be adjusted for inflation beginning in 2014:

- $300,000 for married taxpayers filing jointly and surviving spouses;
- $275,000 for heads of households;
- $250,000 for unmarried taxpayers who are not surviving spouses or heads of households; and
- $150,000 for married taxpayers filing separately (equal to one-half of the amount for a joint return or surviving spouse, after any adjustment for inflation).

Personal exemption phase-out. The revival of the personal exemption phase-out rules reduces or eliminates the deduction for personal exemptions for higher income taxpayers. Under the personal exemption phase-out, the total amount of exemptions that may be claimed by a taxpayer is reduced by two percent for each $2,500, or portion thereof (two percent for each $1,250 for married couples filing separate returns) by which the taxpayer's AGI exceeds the applicable threshold. The same threshold limits used in the Pease limitation above apply to the personal exemption phase-out.

PERMANENT CHILD-DRIVEN TAX BENEFITS

Child and dependent care (CDC) credit. The increased credit amounts and higher expense limits for the CDC are permanently extended. For 2013, the maximum amount of qualifying expenses to which the credit may be applied is $3,000 for individuals with one qualifying child or dependent (for a maximum credit of $1,050), or $6,000 for individuals with two or more qualifying children or dependents (for a maximum credit of $2,100). For taxpayers with AGI between $15,000 and $43,000, the 35 percent credit rate is reduced by one percentage point for each $2,000 of AGI until the credit percentage is 20 percent for taxpayers with AGI of $43,000.

Child tax credit (CTC). The increased amount of $1,000 for the CTC and the ability to offset CTC against both regular income tax and AMT are permanent. However, the reduced earned income threshold amount of $3,000 for purposes of the refundable component of the credit is extended only through December 31, 2017.

PERMANENT EDUCATION BENEFITS

Coverdell Education Savings Accounts (ESAs). The increased maximum contribution amount of $2,000 is made permanent, along with corresponding rules and provisions. Taxpayers who have not contributed the maximum amount to a Coverdell ESA should do so before year end.

Educational assistance programs. Employees are allowed to exclude from gross income and wages up to $5,250 in annual educational assistance provided under an employer's nondiscriminatory "educational assistance plan." Employer-provided educational benefits may also be excludable as working condition fringe benefits.

Scholarship programs. Any amount received as a qualified scholarship and used for qualified tuition and related expenses is excludable from income. The exclusion does not apply to any portion of the amount received which represents payment for teaching, research, or other services by the student required as a condition for receiving the qualified scholarship.

However, scholarship recipients with obligatory service requirements under the NHSC or Armed Forces Scholarship Program can exclude from income qualified tuition and related expenses, as well as amounts that represent payment for services.

Student loan interest deduction. The increased phase-out thresholds for the student loan interest deduction were made permanent, and continue to be adjusted each year for inflation. In addition, the 60-month limitation on the deduction and the restriction that makes voluntary payments of interest nondeductible are permanently repealed.

EXTENDED TAX BENEFITS

Although some tax benefits were extended through 2017, others were extended only through the 2013 tax year. If any of the tax relief applicable to your situation is set to expire after 2013, you should try to take advantage of it in the current year.

American Opportunity Tax Credit (AOTC). The AOTC is extended to apply to tax years beginning before 2018, including the $2,500 maximum credit per eligible student, the higher income phase-out ranges of $80,000 to $90,000 for single filers ($160,000 to $180,000 for joint filers), the eligibility extension to the first four years of post-secondary education, the inclusion of text books and course materials as eligible expenses, and the 40 percent refundable credit component.

Higher education tuition deduction. The above-the-line deduction for qualified tuition and related expenses is extended through 2013. Since the deduction is an adjustment to gross income, it can be taken even if the taxpayer does not itemize deductions, and it is not subject to the two-percent-of-AGI floor or the overall limitation on itemized deductions. However, an individual who can be claimed as a dependent by another taxpayer cannot take a deduction for qualified tuition and related expenses.

NEW TAX PROVISIONS FOR 2013

There are also new provisions that you must become familiar with, as they may affect your overall tax strategy:

Same-Sex Marriage Ruling

The same-sex marriage ruling states that same-sex couples who are legally married in a state that recognizes their marriage are considered married for federal tax purposes, regardless of whether their state recognizes same-sex marriage. Although this ruling was effective September 16, 2013, it is applied retroactively for 2013. As a result, in 2013 and all future years, legally married same-sex couples must file their federal income tax returns as married filing jointly (MFJ) or married filing separately (MFS).

The ruling opens the door for same-sex married couples to enjoy all of the federal tax-related benefits previously available only to opposite-sex married couples. Any same-sex marriage legally entered into in one of the 50 states, the District of Columbia, a U.S. territory or a foreign country is covered by the ruling. These benefits include (but are not limited to):

- Income tax benefits such as marriage penalty relief
- Estate and gift tax benefits
- MFJ or MFS filing status and standard deduction
- Claiming personal and dependency exemptions
- Claiming child-driven credits
- Taxpayer-friendly employee benefits
- Spousal IRAs

Health Care Reform

Since the U.S. Supreme Court upheld the constitutionality of the health care reform provisions, individuals must comply with those requirements already in effect, and others that are applicable in 2013 or later. Beginning in 2014, some of the most far reaching provisions of this legislation will become effective: the individual mandate to carry minimum essential health coverage for taxpayers and their dependents; the ability to obtain coverage through an insurance exchange; and a special tax credit to help offset the cost of insurance.

The following revenue-raising health care reform provisions become effective in 2013:

Net Investment Income Tax (NIIT). Taking effect on January 1, 2013, a Medicare surtax of **3.8 percent** is imposed on the lesser of net investment income (NII) or modified adjusted gross income (MAGI) above a specified threshold. However, the Medicare surtax is not imposed on income derived from a trade or business, nor from the sale of property used in a trade or business.

NII includes the following investment income reduced by certain investment-related expenses, such as investment interest expense, investment brokerage fees, royalty-related expenses, and state and local taxes allocable to items included in net investment income:

- Gross income from interest, dividends, annuities, royalties, and rents, provided this income is not derived in the ordinary course of an active trade or business;
- Gross income from a trade or business that is a passive activity;
- Gross income from a trade or business of trading in financial instruments or commodities; and
- Gain from the disposition of property, other than property held in an active trade or business.

Individuals are subject to the 3.8 percent NIIT if their MAGI exceeds the following thresholds (which are not adjusted for inflation):

- $250,000 for married taxpayers filing jointly or a qualifying widower with a dependent child;
- $125,000 for married taxpayers filing separately; and
- $200,000 for single and head of household taxpayers.

Additional HI (Medicare) Tax. Beginning in 2013, higher income individuals are subject to an additional 0.9 percent HI (Medicare) tax, not to be confused with the 3.8 percent Medicare surtax on NII. The additional Medicare tax means that the portion of wages received in connection with employment in excess of $200,000 ($250,000 for married couples filing jointly and $125,000 for married couples filing separately) is subject to a 2.35 percent Medicare tax rate. The additional Medicare also applies to self-employed individuals. To avoid an underpayment penalty related to this tax or the NIIT, you can instruct your employer to withhold an additional amount of federal income tax from your wages before year end.

Increased medical expense threshold. In 2013, the threshold for the itemized deduction for unreimbursed medical expenses increases from 7.5 percent of AGI to 10 percent of AGI for regular income tax purposes. For AMT purposes, medical expenses remain deductible only to the extent they exceed 10 percent of AGI. However, taxpayers (or their spouses) who are age 65 and older before the close of the tax year are exempt from the increased threshold of 10 percent for the 2013 through 2016 tax years. These taxpayers can continue to deduct qualified medical expenses that exceed 7.5 percent of AGI.

Traditional Tax Planning

Traditional year-end planning techniques nevertheless remain important for 2013. As always, tax planning requires a combination of multi-layered strategies, taking into account a variety of possible scenarios and outcomes. The income deferral and deduction/credit acceleration techniques may be used to reduce an individual taxpayer's income tax liability:

Income Deferral:

- Defer billings and collections
- Receive bonuses earned for 2013 in 2014
- Sell appreciated assets in 2014
- Offset tax losses against current gains (loss harvesting)
- Postpone the redemption of U.S. Savings Bonds
- Declare any special dividends in 2014
- Delay Roth conversions to 2014
- Defer debt forgiveness income if possible
- Minimize retirement distributions
- Execute like-kind exchange transactions
- Take corporate liquidation distributions in 2014

Deductions/Credit Acceleration:

- Bunch itemized deductions into 2013/Standard deduction into 2014
- Accelerate bill payments into 2013
- Pay last state estimated tax installment in 2013 instead of 2014
- Minimize the effect of AGI limitations on deductions/credits
- Maximize net investment interest deductions
- Match passive activity income and losses

Every tax situation is different and requires a careful and comprehensive plan. We can assist you in aligning traditional year-end techniques with strategies for dealing with any unconventional issues that you may have. Please call or email our office for an appointment.

Sincerely,

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