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Financial Solutions Under One Roof

2013 Year-End Tax Planning Considerations

As the end of the 2013 tax year approaches, set aside some time to evaluate your situation. Here are some things to keep in mind as you consider potential year-end tax moves.

1. The tax landscape has changed for higher-income individuals

This year a new 39.6% federal income tax rate applies if your taxable income exceeds $400,000 ($450,000 if you're married and file a joint return, $225,000 if you're married and file separately). If your income crosses that threshold, you'll also be subject to a new 20% maximum tax rate on long-term capital gains and qualifying dividends (last year, the maximum rate that applied was 15%).

That's not all--you could see a difference even if your income doesn't reach that level. That's because if your adjusted gross income is more than $250,000 ($300,000 if you're married and file a joint return, $150,000 if you're married and file separately), your personal and dependency exemptions may be phased out this year, and your itemized deductions may be limited.

2. New Medicare taxes apply

Two new Medicare taxes apply this year. If your wages exceed $200,000 this year ($250,000 if you're married and file a joint return, $125,000 if you're married and file separately), the hospital insurance (HI) portion of the payroll tax--commonly referred to as the Medicare portion--is increased by 0.9%. Also, a 3.8% Medicare contribution tax generally applies to some or all of your net investment income if your modified adjusted gross income exceeds those dollar thresholds.

3. Don't forget the basics--retirement plan contributions

Make sure that you're taking full advantage of tax-advantaged retirement savings vehicles. Traditional IRAs (assuming that you qualify to make deductible contributions) and employer-sponsored retirement plans such as 401(k) plans allow you to contribute funds pretax, reducing your 2013 income. Contributions that you make to a Roth IRA (assuming you meet the income requirements) or a Roth 401(k) plan are made with after-tax dollars, but qualified Roth distributions are completely free from federal income tax. For 2013, you can contribute up to $17,500 to a 401(k) plan ($23,000 if you're age 50 or older), and up to $5,500 to a traditional or Roth IRA ($6,500 if you're age 50 or older). The window to make 2013 contributions to an employer plan typically closes at the end of the year, while you generally have until the due date of your federal income tax return to make 2013 IRA contributions.

4. Expiring provisions

A number of key provisions are scheduled to expire at the end of 2013, including:

- Increased Internal Revenue Code Section 179 expense limits and "bonus" depreciation provisions end.
- The increased (100%) exclusion of capital gain from the sale or exchange of qualified small business stock (provided certain requirements, including a five-year holding period, are met) will not apply to qualified small business stock issued and acquired after 2013.
- This will be the last year that you'll be able to make qualified charitable distributions (QCDs) of up to $100,000 from an IRA directly to a qualified charity if you're 70½ or older; such distributions may be excluded from income and count toward satisfying any required minimum distributions (RMDs) you would otherwise have to receive from your IRA in 2013.
- The above-the-line deductions for qualified higher education expenses, and for up to $250 of out-of-pocket classroom expenses paid by education professionals, will not be available starting with the 2014 tax year.
- This will also be the last year you'll be able to elect to deduct state and local sales tax in lieu of state and local income tax if you itemize deductions.

Estate Planning and Income Tax Basis

Income tax basis can be important when deciding whether to make gifts now or transfer property at your death. When you make a gift of property, the recipient generally receives your basis in the property. When you transfer property at your death, the recipient generally receives a basis equal to the fair market value of the property. The difference can substantially affect the amount of taxable gain when the recipient sells the property.

Income tax basis can be important when deciding whether to make gifts now or transfer property at your death. This is because the income tax basis of the person receiving the property depends on whether the transfer is by gift or at death. This, in turn, affects the amount of taxable gain subject to income tax when the person sells the property.

What is income tax basis?

Income tax basis is the base figure you use when determining whether you have recognized capital gain or loss on the sale of property for income tax purposes. (Gain or loss on the sale of property equals the difference between your adjusted tax basis and the amount you realize upon the sale of the property.) When you purchase property, your basis is generally equal to the purchase price. However, there may be some adjustments made to basis.

What is the income tax basis for property you receive by gift?

When you receive a gift, you generally take the donor's basis in the property. (This is often referred to as a "carryover" or "transferred" basis.) The carried-over basis is increased--but not above fair market value (FMV)--by any gift tax paid that is attributable to appreciation in value of the gift (appreciation is equal to the excess of FMV over the donor's basis in the gift immediately before the gift). However, for purpose of determining loss on a subsequent sale, the carried-over basis cannot exceed the FMV of the property at the time of the gift.

Example: *Say your father gives you stock worth $1,000. He purchased the stock for $500. Assume the gift incurs no gift tax. Your basis in the stock, for the purpose of determining gain on the sale of the stock, is $500. If you sold the stock for $1,000, you would have gain of $500 ($1,000 received minus $500 basis).*

Now assume that the stock is only worth $200 at the time of the gift and you sell it for $200. Your basis in the stock, for purpose of determining gain on the sale of the stock, is still $500; but your basis for purpose of determining loss is $200. You do not pay tax on the sale of the stock. You do not recognize a loss either. In this case, your father should have sold the stock (and recognized the loss of $300--his basis of $500 minus $200 received) and then transferred the sales proceeds to you as a gift. (You are not permitted to transfer losses.)

What is the income tax basis for property you inherit?

When you inherit property, you generally receive an initial basis in property equal to the property's FMV. The FMV is established on the date of death or on an alternate valuation date six months after death. This is often referred to as a "stepped-up basis," since basis is typically stepped up to FMV. However, basis can also be "stepped down" to FMV.

Example: *Say your mother leaves you stock worth $1,000 at her death. She purchased the stock for $500. Your basis in the stock is a stepped-up basis of $1,000. If you sold the stock for $1,000, you would have no gain ($1,000 received minus $1,000 basis).*

Now assume that the stock is only worth $200 at the time of your mother's death. Your basis in the stock is a stepped-down basis of $200. If you sold the stock for more than $200, you would have gain.

Make gift now or transfer at death?

As the following example shows, income tax basis can be important when deciding whether to make gifts now or transfer property at your death.

Example: *You purchased land for $25,000. It is now worth $250,000. You give the property to your child (assume the gift incurs no gift tax), who then has a tax basis of $25,000. If your child sells the land for $250,000, your child would have taxable gain of $225,000 ($250,000 sales proceeds minus $25,000 basis).*

If, instead, you kept the land and transferred it to your child at your death when the land is worth $250,000, your child would have a tax basis of $250,000. If your child sells the land for $250,000, your child would have no taxable gain ($250,000 sales proceeds minus $250,000 basis).

In addition to income tax basis, you might consider the following questions:

- Will making gifts reduce your combined gift and estate taxes? For example, future appreciation on gifted property is removed from your gross estate for federal estate tax purposes.
- Does the recipient need a gift now or can it wait? How long would a recipient have to wait until your death?
- What are the marginal income tax rates of you and the recipient?
- Do you have other property or cash that you could give?
- Can you afford to make a gift now?

All in the Family: Transferring a Business to Your Children

With a grantor retained annuity trust (GRAT), you receive a fixed dollar amount that does not change even if the value of the trust property (corpus) increases or decreases. Some other types of trusts are a grantor retained unitrust (GRUT) and a rolling or cascading GRAT. A GRUT allows you to retain the right to receive a fixed percentage of the trust corpus (determined annually), while a rolling or cascading GRAT is a technique that involves creating a series of short-term GRATs (typically two or three years) with each successive GRAT being funded by the annuity payments from the previous ones. This technique can minimize the risk of the grantor dying during the GRAT term, and can also minimize interest rate risk.

You've spent years building a family business that's a source of pride and income for both you and your family, and now you may be thinking of handing over the reins to your children. If so, consider that transferring your business interest to your children may have income, gift, and estate tax consequences. Careful planning can help prevent the need to sell some (or all) of the business assets to pay those taxes.

Some common strategies for minimizing taxes are discussed briefly below. Remember, however, that none of these strategies are without drawbacks. Before you act, consult a tax professional as well as your estate planning attorney.

Gifting or bequeathing your interest outright

If you don't need continued income from the business and you don't want to retain some control, you can simply give the business to your children outright. For example, you can begin a systematic program of making annual gifts to your children in amounts that equal the annual gift tax exclusion ($14,000 per year per recipient in 2013). By transferring your interest in this manner, you may be able to transfer all or a significant portion of the business free from federal gift tax (although these transfers may still be subject to state gift tax). The disadvantage here is the amount of time that may be needed to transfer your entire interest.

If you can wait and transfer your business at your death, Section 6166 of the Internal Revenue Code allows any estate taxes incurred because of the inclusion of your family business in your estate to be deferred for 5 years (with interest-only payments for the first 4 years), and then paid in annual installments of interest and principal over a period of up to 10 years. This will allow your beneficiaries more time to raise sufficient funds to pay the taxes or obtain more favorable interest rates if they need to borrow the money. Be aware that the business must exceed 35% of your gross estate and other requirements must be met.

Selling your interest outright

If you need income from your business, you can sell your business interest (for full fair market value) to your children. This will avoid gift and estate taxes, but you may owe capital gains tax.

Using a buy-sell agreement

If you want to sell your business interest to your children but retain control over the business for a period of time, consider using a buy-sell agreement. This is a legal contract that states that the sale will happen when a specific event occurs, such as your retirement, disability, divorce, or death. When the triggering event occurs, the children will be obligated to buy your interest from you or your estate. The price and sale terms will have been predetermined by the contract. Remember, however, that you will be bound under a buy-sell agreement: you won't be able to sell or give your business to anyone except the buyers named in the agreement (unless they consent).

Using a grantor retained annuity trust (GRAT)

A GRAT is a trust into which you transfer your business interest, and from which you receive income for a period of time. The value of the gift is determined using the IRS's current interest rate (published monthly by the IRS). The trust must terminate at a specified time (e.g., 10 years). You receive annuity payments during the term of the trust, and at the end, your children will receive the business. If the business has appreciated beyond the IRS's interest rate, the excess can pass tax free. Be aware, however, that if you die during the GRAT term, your entire business interest will be included in your gross estate for federal estate tax purposes. You will have failed to transfer your business interest and lost the tax advantages of the GRAT. Plus, you will have incurred the costs of creating and maintaining the GRAT for nothing. For these reasons, be sure to structure your GRAT carefully.

Creating a family limited partnership (FLP)

An FLP is a type of business entity. First, you establish a partnership with both general and limited partnership interests. Then, you transfer the business to this partnership. You retain the general partnership interest for yourself, allowing you to maintain control over the day-to-day operation of the business. Over time, you gift the limited partnership interests to your children, leveraging your lifetime gift tax exemption and the annual gift tax exclusion. You also save taxes because the value of the gifts may be eligible for valuation discounts, such as the minority interest and lack of marketability discounts.

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Is it true that my child can receive Social Security benefits based on my earnings record?

Your child--whether he or she is your biological child, adopted child, or stepchild--may be able to receive Social Security monthly benefits based on your earnings record if you're receiving disability or retirement benefits from Social Security, or in the event of your death. These often overlooked benefits can provide steady income for your family when it's needed the most.

How much will your child receive from Social Security? When you start receiving retirement or disability benefits, your child may be eligible to receive up to 50% of your benefit. When you die, your child may be eligible to receive up to 75% of your basic benefit (the benefit that the Social Security Administration calculates you would have received if you had reached full retirement age at the time of your death). Various factors will affect the amount of your child's benefit, including whether other family members are also receiving benefits on your earnings record.

To receive Social Security benefits based on your record, your child must generally be a dependent under age 18 (or age 19 if a full-time student in grade 12 or lower) and unmarried. However, if your unmarried child is disabled and was disabled before age 22, he or she can qualify for benefits based on your record at any age; benefits for a disabled child may end, though, if your child marries or is no longer considered disabled.

You can find out more about family benefits based on your earnings record by checking your Social Security Statement. To access your statement, sign up for a *my* SocialSecurity account at the Social Security Administration's website, www.socialsecurity.gov. Your statement will give you important information about Social Security that you can use to plan for your family's financial future. This includes how you and your family members qualify for benefits, estimates of your future retirement and disability benefits, and what survivors benefits your child and other family members might receive if you die.

Do I need to make any changes to my Medicare coverage for next year?

If you're currently enrolled in Medicare, you've probably begun receiving information about your coverage. That's because the annual enrollment period for Medicare runs from October 15 through December 7. During this period, you can make changes to your Medicare coverage that will be effective on January 1, 2014. If you're satisfied with your current coverage you don't need to make changes, but you should review your options before you decide to stay with your current plan.

Your Medicare plan sends you two important documents every year that you should review. The first, called the Evidence of Coverage, gives you information about what your plan covers, and its cost. The second, called the Annual Notice of Change, lists changes to your plan for the upcoming year (these will take effect in January). You can use these documents to evaluate your current plan and decide if you need different coverage. If you haven't already gotten one, you should soon receive a copy of Medicare & You 2013, the official government Medicare handbook. It contains detailed information about Medicare that should help you decide if your current plan is right for you.

As you review your coverage, here are a few points to consider:

- Will your current plan cover all the services you need and the health-care providers you need to see next year?
- Does your current plan cost more or less than other options? Consider premiums, deductibles, and other out-of-pocket costs you pay such as co-payments or coinsurance costs; are any of these costs changing?
- Do you need to join a Medicare drug plan? When comparing plans, consider the cost of drugs under each plan, and make sure the drugs you take will still be covered next year.
- Does your Medigap plan (if you have one) still meet your needs?

If you have questions about Medicare, you can call 1-800-MEDICARE (1-800-633-4227 or TTY 1-877-486-2048) or visit the Medicare website at www.medicare.gov.

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