CCH Tax Briefing

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2012 Year-End Tax Planning

October 4, 2012

Special Report

HIGHLIGHTS

- Possible Hikes In Individual Tax Rates
- 3.8% Medicare Surtax On Net Investment Income
- Reduced Dividend Rate In Jeopardy
- Techniques To Reset Basis
- Over 40 Expiring Extenders
- Post-Election Triggers
- Eleven-Hour Strategies

INSIDE

Tax/Budget Uncertainties Impact 2012 Year-End Strategies

Year-end tax planning is always complicated by the uncertainty that the following year may bring and 2012 is no exception. Indeed, year-end tax planning in 2012 is one of the most challenging in recent memory. A combination of events – including possible expiration of some or all of the Bush-era tax cuts after 2012, the imposition of new so-called Medicare taxes on investments and wages, doubts about renewal of many tax extenders, and the threat of massive across-the-board federal spending cuts – have many taxpayers asking how can they prepare for 2013 and beyond … and what to do before then. The short answer is to quickly become familiar with the expiring tax incentives and what may replace them after 2012 … and to plan accordingly. Year-end planning for 2012 requires a combination of multi-layered strategies, taking into account a variety of possible scenarios and outcomes.

This Tax Briefing covers year-end tax planning considerations that are especially unique to 2012. Its focus is on aligning traditional year-end techniques with strategies for dealing with those uncertainties created by Congress's delay in addressing sunsetting tax rates and the extension of other major tax benefits. Year-end strategies in response to the new-for-2013 3.8 percent Medicare contribution tax are also a focal point of this Tax Briefing.

STRATEGY. *Fence-sitting for some year-end strategies may not be possible in December, or earlier, because of the time it takes transactions to be set into motion. Other strategies can be held at the ready with trigger dates, but not executed until more is known about how Washington will act. Chances are good, however, that the tax rates – a major driver of year-end strategies – will not get any lower than they are right now. Effectively, the choice may come down to paying the tax now or later.*

COMMENT. *Democrats and Republicans appear to be taking a wait-and-see approach to deciding the fate of the expiring tax provisions and the spending cuts until after Election Day. Alternatively, the lame-duck Congress could punt the tax provisions to the new Congress that will meet in January 2013. To complicate matters, the Budget Control Act of 2011 imposes across-the-board spending cuts (called "sequestration") after 2012. To avert the spending cuts, lawmakers must make up revenue somewhere else. User fees and other "non-tax" revenues can only go so far. Tax incentives, especially for higher-income individuals and businesses, may be on the chopping block before year-end.*

INDIVIDUAL PLANNING

Year-end tax planning for 2012 is complicated by several unique factors connected to tax rates:

- First, planning must account for the possibility of the expiring Bush-era income tax rates to move in one of four directions: (1) complete sunset for all taxpayers, (2) complete extension for all taxpayers, (3) sunset for higher-income individuals only, or (4) sunset for millionaires only.
- Second, the same four scenarios must be considered in connection with sunsetting Bush-era rates on capital gains and dividends.

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- Third, investors in the higher tax brackets must plan for the 3.8 percent Medicare contribution tax on investment income that starts in 2013.
- Fourth, high-income wage earners must also contend with a 0.9 percent additional Medicare tax that starts in 2013.
- Fifth, the 2012 payroll tax holiday is scheduled to expire after December 31, 2012, raising the employee-share of Old Age, Survivors and Disability Insurance (OASDI) taxes from 4.2 percent to 6.2 percent.

STRATEGY. *As the Presidential election draws closer, there is more talk from both sides about limiting deductions for higher-income taxpayers to offset the cost of other tax cuts, such as an extension of the reduced income tax rates. Governor Romney has discussed a deduction "bucket" of $17,000 that taxpayers could fill with various deductions. President Obama has continued to call for limiting deductions for higher-income taxpayers. It is possible that 2012 could be the last year without significant changes to the rules for deductions.*

INCOME TAX RATES

Nothing adds complexity to year-end 2012 tax planning as much as uncertainty over the fate of the Bush-era reductions to the individual income tax rates. The 2010 Tax Relief Act extended through 2012 the reduced individual income tax rates in place since 2003 under the so-called Bush-era tax cuts. Unless extended, the reduced individual income tax rates will disappear after 2012 to be replaced by higher rates. The current 10, 15, 25, 28, 33, and 35 percent rate structure would be replaced by the higher pre-Bush 15, 28, 31, 36 and 39.6 percent levels.

As proposed by President Obama, the current rate structure would be retained, except for revival of the 36 and 39.6-percent rates. The 36 percent rate, however, would start at a higher-income bracket level of $200,000 for single filers, $250,000 for joint filers, $225,000 for head-of-households and $125,000 for married taxpayers filing separately. If those income levels – which are proposed to start at adjusted gross income rather than taxable income – are also indexed for inflation since 2009, the levels would rise to $213,200 / $266,500 / $239,850 / and $133,250, respectively, for 2013.

COMMENT. *Some lawmakers have discussed higher income thresholds. For example, the 39.6 percent rate would apply only for individuals making more than $1 million.*

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CAPITAL GAINS/DIVIDENDS

Absent Congressional action, the tax rates on qualified capital gains and dividends are scheduled to increase significantly after 2012. The current taxpayer-favorable rates – zero percent for taxpayers in the 10 and 15 percent brackets and 15 percent for all other taxpayers – will be replaced by pre-2003 rates of 10 percent for taxpayers in the 15 percent bracket and a maximum 20 percent rate for all others. Dividends will be subject to the ordinary income tax rates. The maximum rate on five-year property will be 18 percent (8 percent for those in the 15 percent bracket).

COMMENT. *Capital assets yield short-term gains or losses if the holding period is one year or less, and long-term gains or losses if the holding period exceeds one year, so that care must be taken in timing a sale. The excess of net long-term gains over net short-term losses is net capital gain. While short-term capital gains are taxed at ordinary rates, net long term capital gain of noncorporate taxpayers, as adjusted for certain types of long-term gain (adjusted net capital gain), is eligible for lower maximum tax rates than ordinary income.*

STRATEGY. *Depending upon the appreciation or losses now locked into a current portfolio, strategies to be considered include: (1) accelerate long-term capital gain, which has the certainty of being taxed at a 15 percent maximum in 2012 (or zero percent for those in the 10 or 15 percent income tax bracket), or (2) increase carryover losses into potentially higher rates in years after 2012.*

STRATEGY. *For those in control of C corporations, declaring special dividends to be distributed before 2013 may prove particularly fruitful if top rates on dividends rise from 15 percent to 43.4 percent (39.6 percent plus the 3.8 percent Medicare surtax).*

Liquidations. Corporate liquidations are on the uptick as some owners attempt to get taxed on distributions at the Bush-era rates before year end. The general timing rule that applies requires each shareholder of a liquidating corporation to recognize and report gain or loss in accordance with his method of accounting.

STRATEGY. *As 2013 approaches, it may be valuable to consider tax loss harvesting strategies to offset current gains or to accu-*

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mulate losses to offset future gains (which may be taxed at a higher rate). The first consideration is to identify whether an investment qualifies for either short-term or long-term capital gains status, because taxpayers must first balance short-term gains with short-term losses and long-term gains with long-term losses. The "wash sale rule" generally prohibits taxpayers from claiming a tax-deductible loss on a security if they repurchase the same or a substantially identical asset within 30 days of the sale.

Resetting basis. Wash sales are sales of stock or securities in which losses are realized, but not recognized, because the seller acquires substantially identical stock or securities 30 days before or after the sale. Nonrecognition, however, applies only to losses; gains are recognized in full.

STRATEGY. *Both a higher potential capital gains rate and the 3.8 percent Medicare surtax (see, below) may be avoided by selling before year-end 2012 and then immediately reinvesting. To buy back the same or substantially similar securities both in kind and amount, of course, requires an upfront cost in finding the cash elsewhere to pay the tax or lowering the amount reinvested.*

To obtain long-term rates, investors must hold the asset (such as stock and most other property) for more than one year. The holding period begins on the day after the asset is acquired and ends on the day the asset is disposed of. Stock is generally treated as sold on the trade date, the date the taxpayer enters into a contract to sell the stock. The trade date should be distinguished from the settlement date, the date that the investor delivers the stock certificate and receives payment. The settlement date may be 3-5 days after the trade date. The trade date also determines (and ends) the holding period for the seller.

EXAMPLE. *A taxpayer bought stock on November 30, 2011 and sold it November 30, 2012. The taxpayer's holding period is exactly one year, and any gain (or loss) is short-term. If the taxpayer instead had sold the stock on December 1, 2012, the taxpayer's holding period is more than one year, and gains (or losses) are long-term.*

EXAMPLE. *A taxpayer bought stock on December 28, 2011 and sold it on December 29, 2012. The settlement date is January 3, 2013. The stock is treated as sold on December 29, 2012; with any gains or losses recognized on the taxpayer's 2012 return.*

CAUTION. *Different rules apply for a short sale, where the taxpayer initially sells shares and then must obtain shares to close out the transaction. If the stock price falls, so that the investor will realize a gain, the gain is realized on the trade date, when the seller directs the broker to purchase shares. If the price rises, so that the investor will realize a loss, the loss is realized when the stock is delivered on the settlement date.*

COMMENT. *In July, the House voted to extend the current capital gains and dividend tax treatment through 2013. The Senate, however, voted to extend the current fa-*

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THREE RATE-CHANGE SCENARIOS FOR 2013

Complete Extension:

The existing rates for 2012 of 10%, 15%, 25%, 28%, 33% and 35% continue unchanged for 2013.

Complete Sunset:

If Congress fails to extend the Bush-era tax rates, the 2013 rates would change under the mandatory sunset provision based on the following schedule:

Existing 2012 rate	Sunset rate
10% and 15%	15%
25%	28%
28%	31%
33%	36%
35%	39.6%

Obama Proposal:

The 2013 rates would change under President Obama's plan released in February 2012 (based on Joint Committee on Taxation projections):

Existing 2012 rate	Obama rate proposal
10% and 15%	10% and 15%
25%	25%
28%	28%
33%	33% up to $200K ($250K joint returns), inflation adjusted
33%	36% (above $200K/$250K joint returns)
35%	39.6%

vorable tax rates only for individuals with incomes below $200,000 (families with incomes below $250,000). For income in excess of $200,000/$250,000 the tax rate on qualified capital gains and dividends would be 20 percent under the Senate bill.

3.8 PERCENT MEDICARE CONTRIBUTION TAX

One of the most important new areas of concern for year-end tax planning in 2012 is the 3.8 percent "unearned income Medicare contribution" tax on higher-income individuals, estates and trusts. Taking effect immediately on January 1, 2013, the Medicare surtax will be imposed on the taxpayer's "net investment income" (NII) and will generally apply to passive income. The Medicare surtax also will apply to capital gains from the disposition of property. The Medicare surtax will not apply to income derived from a trade or business, or from the sale of property used in a trade or business. For individuals, the Medicare surtax will apply to the lesser of the taxpayer's NII or the amount of "modified" adjusted gross income (AGI with foreign income added back) above a specified threshold.

STRATEGY. *Having a tax on NII is a "paradigm shift." Traditionally, taxpayers want income to be passive, so that it is not subject to employment taxes, and want losses to be nonpassive, so they can offset other nonpassive income, such as wages. With the new Medicare surtax on NII, taxpayers with higher incomes may want to demonstrate that income is from an active business, not a passive investment.*

CAUTION. *At the time this briefing was prepared, the IRS had not yet issued guidance on the Medicare surtax. Until guidance is issued, it is not clear whether the government will allow the netting of passive income and losses, which would reduce NII, or whether the tax will apply to the "gross" amount of investment income. The statute, at the same time, refers to "net" investment income overall and to "gross" income from particular items, such as dividends.*

COMMENT. *The application of the tax is still arguably uncertain because of continuing calls for full repeal of the Affordable Care Act. But this is speculative. In the meantime, the Supreme Court's decision in June 2012 upholding the Affordable Care Act guarantees that the tax will take effect on January 1, 2013 and that the tax will not be repealed right away, if at all.*

STRATEGY. *Since the Medicare surtax will not apply until 2013, taxpayers face several important planning decisions while a window of opportunity still exists:*

- Whether to sell off assets and recognize gains in 2012, thus avoiding subjecting them to tax in 2013 (or later);
- How to reduce NII in 2013 and thereafter; and
- How to reduce modified AGI in 2013 and thereafter.

Taxpayers concerned about the Medicare surtax in most cases may want to realign their investments and other income, or possibly sell certain assets, in 2012, before the tax takes effect. While 3.8 percent alone may appear to be only a few basis points above what would be a "nuisance tax," its combination with ordinary income and capital gains rates makes planning worth serious consideration. For example, short-term capital gain tax rates may jump from 35 percent to 43.4 percent (reflecting a combined rate of 39.6 percent and 3.8 percent after 2012).

Guidance pending. Before evaluating alternative year-end strategies, it is necessary to understand how the Medicare surtax works. While some issues are clear from the statute, others will need to be addressed in IRS regulations.

COMMENT. *Some potential issues for IRS guidance include whether to treat as NII carried interests and investor returns from private equity and hedge funds; how the estimated tax payment rules will apply to the Medicare surtax, and application of the Medicare surtax to income from foreign investments. These issues will also impact 2012 year-end planning, forcing some taxpayers to react quickly once regulations are released.*

Specified Thresholds

Individuals. As stated above, the tax applies to an individual on the lesser of the taxpayer's NII or the amount of "modified" adjusted gross income above certain thresholds. Those AGI thresholds are:

- $250,000 for married taxpayers filing jointly or a surviving spouse;
- $125,000 for married taxpayers filing separately; and
- $200,000 for single and head of household taxpayers.

CAUTION. *These threshold amounts are not indexed for inflation.*

EXAMPLES. (1) *A single taxpayer has modified AGI of $230,000, including NII of $40,000. The Medicare surtax applies to the lesser of NII ($40,000) or the excess of AGI over the applicable threshold ($230,000 - $200,000 = $30,000). Thus, the Medicare surtax applies to $30,000.*

(2) *A single taxpayer has modified AGI of $175,000, including $70,000 of NII. Because the taxpayer's income is below the single taxpayer threshold of $200,000, the taxpayer does not owe the Medicare surtax, despite having substantial NII.*

(3) *Married taxpayers have modified AGI of $350,000, including NII of $75,000 and file jointly. The Medicare surtax applies to the lesser of NII ($75,000) or the excess of AGI over the applicable threshold ($350,000 - $250,000 = $100,000). Thus, the Medicare surtax applies to $75,000.*

CAUTION. *Unusual spikes in income may subject individuals to the 3.8 percent surtax. For example, the sale of large assets with years of capital appreciation, such as a residence yielding gains in excess of the principal residence exclusion amount, or a taxable inheritance distribution from*

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an estate, may subject a taxpayer to the 3.8 percent tax. Other common tax planning techniques, such as the conversion of a rollover IRA into a Roth account, may push an individual into 3.8 percent tax territory for everyday stock sales and dividends also realized in the same year (see strategies, below).

Estates and trusts. For an estate or trust, the Medicare surtax applies to the lesser of undistributed net investment income for the year, or the amount of AGI that exceeds the dollar amount at which the highest tax rate bracket begins for estates and trusts (estimated at $11,950 for 2013). Thus, the Medicare surtax applies to a much lower amount for trusts and estates than for individuals.

STRATEGY. *Trusts and estates should make a point of distributing their net investment income to their beneficiaries rather than having it taxed to the trust or estate. A trust's NII will be taxed at a low threshold (less than $12,000), while the income received by a beneficiary is taxed only if the much higher $200,000/$250,000 thresholds are exceeded. Trustees and beneficiaries should pay particular attention to this issue.*

EXAMPLES (4). *A trust has undistributed NII of $5,000, and AGI of $20,000. The Medicare surtax applies to the lesser of $5,000 or ($20,000 minus the $11,950 threshold, or $8,050). Thus, the Medicare surtax applies to $5,000. If the trust had distributed all of its NII to its beneficiaries, its undistributed NII would have been zero, and the Medicare surtax would not have applied.*

(5) *A trust has undistributed NII of $15,000 and AGI of $25,000. The Medicare surtax applies to the lesser of $15,000 or ($25,000 minus $11,950, or $13,050). Thus, the Medicare surtax applies to $13,050.*

Net Investment Income

NII for purposes of the 3.8 percent Medicare surtax includes:

- 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 (within the meaning of Code Sec. 469);
- Gross income from a trade or business of trading in financial instruments or commodities; and
- Net gain (taken into account in computing taxable income) from the disposition of property, other than property held in an active trade or business.

COMMENT. *The IRS is expected to provide guidance on the categories of NII. Guidance is needed to identify a business of trading in financial instruments or commodities.*

> "One of the most important new areas of concern for year-end tax planning in 2012 is the 3.8 percent 'unearned income Medicare contribution' tax on higher-income individuals, estates and trusts."

Income is NII if the trade or business is a passive activity with respect to the taxpayer. If the individual materially participates in the trade or business, the income is excluded from NII. The Medicare surtax does not apply to other trades or businesses conducted by a sole proprietor, partnership, or S corporation. Income, gain or loss on working capital is not treated as derived from a trade or business.

STRATEGY. *It should also be noted that certain tax-favored income under other provisions of the tax code are provided no special breaks under the 3.8 percent Medicare surtax. For example, long-term capital gains are taxed at the same 3.8 percent rate as short-term capital gains. Gain recognition does undergo a netting process, however, as explained above.*

If property sold was not held in a trade or business, any gain is NII. Further, if property was held in a trade or business, but the individual did not materially participate, the gain is NII.

COMMENT. *The material participation standard also applies to a trade or business held by an estate or trust, but it remains to be seen how the IRS will address material participation for a trust or estate. However, the IRS has taken a tough approach in past litigation and in rulings issued to taxpayers, treating a trustee's management of a business as passive where the trustee hired others to run the business day-to-day.*

If a partnership interest or stock in an S corporation is disposed of, gain or loss is taken into account only to the extent that gain or loss would be taken into account by the partner or shareholder, if the entity had sold all of its properties immediately before the disposition. In effect, only net gain or loss attributable to property that is not used in an active trade or business is taken into account.

NII is the gross income or net gain from these items, reduced by allowable deductions that are "properly allocable" to the gross income or net gain. For rental real property, allocable expenses would probably include depreciation and operating expenses. Treasury guidance is expected to address when items are properly allocable to income and gains.

STRATEGY. *For capital gain property, taxpayers should set up a bookkeeping system now so that in 2013 they can begin to track both amounts that can increase the property's basis and investment expenses that can reduce net gains.*

Exclusions from Tax

The 3.8 percent Medicare surtax does not apply to nonresident aliens, corporations,

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trusts whose interests all are devoted to charitable purposes, charitable trusts under Code Sec. 501, and charitable remainder trusts under Code Sec. 664. Distributions from IRAs, pensions, 401(k) plans, tax-sheltered annuities, and eligible Code Sec. 457 plans are excluded from NII and from the tax.

COMMENT. *Currently there is no exception for distributions from nonqualified deferred compensation plans under Code Secs. 409A or 451. Some practitioners believe this was an oversight by Congress but the IRS has yet to speak on the matter.*

Amounts treated as self-employment income and subject to self-employment tax are not NII. Items that are totally excluded from gross income, such as veteran's benefits, distributions from a Roth IRA, gain excluded on the sale of a principal residence, or interest on tax-exempt bonds, are excluded both from NII and from modified AGI.

STRATEGY. *Taxpayers may want to consider, if possible, selling capital gain property in 2012, before the Medicare surtax applies. This approach may be valuable if the taxpayer is facing large capital gains, such as from the sale of a principal residence above the $250,000/$500,000 exclusion amounts.*

STRATEGY. *The upcoming 3.8 percent Medicare surtax creates an incentive for taxpayers to reevaluate their investment portfolios, individual retirement accounts (IRAs), and other assets. Taxpayers may decide this is a good time to change the source of some of their income. For example, investing in tax-exempt bonds may be more attractive, since the interest income does not enter into AGI or NII. Other types of investments may also generate tax-deferred income that would not be taxed, such as a tax-deferred annuity, or rental real estate. Although the latter is a passive activity, rental real estate often generates a net loss after depreciation, so there would be no NII to tax.*

STRATEGY. *Net investment income for purposes of the 3.8 percent Medicare surtax does not include distributions from qualified plans or IRAs, but those taxable distributions nevertheless do count towards the income threshold amount ($250,000, $200,000, or $125,000).*

STRATEGY. *Newly-retired individuals may consider taking required minimum distributions (RMDs) immediately before year-end 2012. Taxpayers who turn age 70½ in 2012 have the option of deferring their first RMD from their IRAs until 3½ months into the second year. However, the 3.8 percent Medicare surtax may be one more reason not to delay a first-year distribution beyond 2012. While the distribution itself is not subject to tax, it will increase modified adjusted gross income (MAGI), which may subject a greater portion of NII to the Medicare surtax. Bunching two years of RMDs into 2013 may also subject a greater portion of Social Security income to regular income tax and subject the distributions to a higher rate of tax, if the Bush-era tax rates sunset in whole or in part.*

ADDITIONAL 0.9 PERCENT MEDICARE TAX

Effective January 1, 2013, higher income individuals will be subject to an additional 0.9 percent HI (Medicare) tax. This additional Medicare tax should not be confused with the 3.8 percent Medicare surtax, also enacted as part of the Affordable Care Act. 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 a joint return and $125,000 for married couples filing separately) will be subject to a 2.35 percent Medicare tax rate. The additional Medicare tax also attaches to self-employed individuals.

STRATEGY. *Accelerating service-related income into 2012 may serve the dual benefit of avoiding the additional Medicare tax and any increase in the income tax rates as the result of sunsetting Bush-era rates. Consideration should be given to ensuring that annual bonuses are paid out in 2012, as well as to electing to recognize income on stock based contingent compensation. The employee's control of an enterprise requires that a bonus or other form of contingent compensation be included in his income in the year it is authorized unless special facts indicate that payment is not fully possible or authorized in that year.*

STRATEGY. *Planning for the additional Medicare tax is complicated by the fact that it is imposed on the combined wages of the employee and his/her spouse. Married couples who have filed joint returns in past years may want to explore the benefits, if any, of filing separate returns for 2013 and subsequent tax years if their combined incomes make them liable for the additional Medicare tax.*

END OF PAYROLL TAX HOLIDAY?

For the past two years, the employee-share of OASDI taxes has been reduced from 6.2 percent to 4.2 percent (with comparable relief for self-employed individuals). Under current law, that reduction is scheduled to expire after December 31, 2012. On January 1, 2013, the employee-share of OASDI taxes will revert to 6.2 percent; effectively increasing payroll taxes across-the-board.

COMMENT. *Congress had initially extended payroll relief only through February 2012, but political pressure resulted in a full-year extension in follow-up February 2012 legislation. Some observers see the same debate taking place for 2013 relief, but with added ammunition given to ending the relief due to budget constraints now imposed against this estimated $110 billion measure.*

STRATEGY. *For calendar year 2012, the payroll tax holiday applied for qualified wages up to the Social Security wage base ($110,100). Accelerating any bonuses and employee recognition payments into 2012 for employees who will be below the $110,100 ceiling at year-end 2012 will potentially allow them to pocket two-per-*

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TRADITIONAL INCOME ACCELERATION/ DEDUCTION DEFERRAL STRATEGIES

Year-end 2012 presents unique challenges due to sunsetting provisions and new taxes on the immediate horizon. Traditional year-end planning techniques nevertheless remain important. Particularly as applied to these special 2012 year-end circumstances, the following income acceleration and reciprocal deduction/credit deferral techniques should be considered:

Income Acceleration:

- Sell outstanding installment contracts
- Receive bonuses before January
- Sell appreciated assets
- Redeem U.S. Savings Bonds
- Declare special dividend
- Complete Roth conversions
- Accelerate debt forgiveness income
- Maximize retirement distributions
- Accelerate billing and collections
- Avoid mandatory like-kind exchange treatment
- Take corporate liquidation distributions in 2012

Deductions/Credit Deferral

- Bunch itemized deductions into 2013/ Standard deduction into 2012
- Postpone bill payments until 2013
- Pay last state estimated tax installment in 2013
- Postpone economic performance
- Watch AGI limitations on deductions/credits
- Watch net investment interest restrictions
- Match passive activity income and losses

cent more. Self-employed individuals in a similar position should try to accelerate self-employment income into 2012.

COMMENT. *Extension of the payroll tax cut could be part of a year-end tax package or it could be left out. If an extension of the payroll tax holiday appears less likely by December, employers might consider warning their employees that take-home pay will be less as a result, starting in January 2013. If expectations are that the 113th Congress will extend the payroll tax holiday retroactively when it convenes in January, the IRS may authorize lower withholding upon assurances by Congressional leaders that relief will be forthcoming.*

ALTERNATIVE MINIMUM TAX

Year-end tax planning has traditionally looked at a taxpayer's potential liability for the alternative minimum tax (AMT) and 2012 is no different. As in past years, taxpayers are waiting to see if Congress will enact an AMT "patch" for 2012. The last patch – which provided for increased exemption amounts and use of the nonrefundable personal credits against AMT liability – expired after 2011.

COMMENT. *AMT rates – of 26 and 28 percent (depending on amount of excess) on the excess of alternative minimum taxable income over the applicable exemption amount – are not scheduled to change in 2013. However, exposure to the AMT may change as the result of the scheduled Bush-era sunsets to the regular tax. Since a determination of AMT liability requires a comparison between regular and AMT computations, having regular taxes higher if the Bush-era rates expire after 2012 may help lower exposure to the AMT by the same amount.*

STRATEGY. *Ignoring the possibility of being subject to the AMT can make certain year-end strategies counterproductive. For example, manipulating certain income and deductions to reduce regular tax liability may in fact increase AMT liability because of differences in the income and deductions allowed for AMT purposes.*

COMMENT. *Tax legislation passed by the House and Senate earlier this year may be a good indicator of the amount of an AMT patch for 2012. In July, the Senate approved the Middle Class Tax Cut Act (Sen. 3412), which would set the AMT exemption amount for individuals at $50,600 and at $78,750 for married couples filing a joint return. The House-passed bill, the Job Protection and Recession Prevention Act of 2012 (HR 8) carries the same AMT exemption amounts for 2012 as the Senate bill. If no patch is passed, the AMT exemption amounts are scheduled to be $33,750 for individuals and $45,000 for married couples filing a joint return for 2012.*

COMMENT. *Even if lawmakers cannot agree on a larger package of tax cut extensions, the AMT patch is likely to be enacted before 2013. Timing is a huge factor. The IRS will need time to reprogram its processing systems for an AMT patch. The longer Congress takes to pass an AMT patch, the greater the likelihood that the start of the 2013 filing season will be delayed.*

STRATEGY. *If an individual's regular tax liability and AMT liability tend to*

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be equal from year to year, tax planning may want to encourage this stability. If deductions are not so evenly spaced, a taxpayer may be able to shift some AMT-triggering items from an AMT year to a non-AMT year. No single factor automatically triggers AMT liability but some common factors are itemized deductions for state and local income taxes; itemized deductions for miscellaneous expenditures, itemized deductions on home equity loan interest (not including interest on a loan to build, buy or improve a residence); and changes in income from installment sales.

STRATEGY. *A valuable distinction between regular tax liability and AMT liability is scheduled to disappear after 2012. Itemized medical expenses will be deductible for regular tax purposes to the extent they exceed 10 percent of the taxpayer's adjusted gross income (AGI), effective for tax years beginning after December 31, 2012, with a carve-out for individuals age 65 and older (see below). The threshold for AMT purposes has been and will continue to be 10 percent.*

PERSONAL EXEMPTION/ ITEMIZED DEDUCTION PHASEOUTS

Effective January 1, 2013, higher income taxpayers may be subject to the return of the personal exemption phaseout (PEP) and the so-called Pease limitation on itemized deductions. Both of these provisions had been repealed through 2012. However, they are scheduled to return after 2012 unless repeal is extended.

STRATEGY. *At this time, there is little likelihood of Congress making any return of PEP and the Pease limitation retroactive to 2012 because the 2010 Tax Relief Act extended repeal of these provisions through 2012. However, PEP and the Pease limitation could return for the 2013 tax year, which would be reflected on returns filed in 2014.*

PEP. Revival of the personal exemption phaseout rules would reduce or eliminate the deduction for personal exemptions for higher income taxpayers starting at "phaseout" amounts that, adjusted for inflation, would start at $267,200 AGI for joint filers and $178,150 for single filers.

Pease limitation. Return of the Pease limitation on itemized deductions (named for the member of Congress who sponsored the legislation) would reduce itemized deductions by the lesser of:

- Three percent of the amount of the taxpayer's AGI in excess of a threshold inflation-adjusted amount projected for 2013 to be $178,150 ($89,075 for a married individual filing separately), or
- 80 percent of the itemized deductions otherwise allowable for the tax year.

COMMENT. *For purposes of the Pease limitation, itemized deductions do not include medical expenses, investment interest expenses, casualty or theft losses, or allowable wagering losses.*

STRATEGY. *Techniques to accelerate itemized deductions ought to be considered for those within range of a revived Pease limitation. Individuals might consider accelerating gifts to charity or state income or property tax payments, for example.*

EDUCATION

Education costs are a key component of year-end planning for many taxpayers, In recent years, a number of education tax incentives have been enhanced, making them even more valuable to qualified taxpayers. Grouped together, education incentives make up a significant portion of the expired or scheduled to expire tax incentives. Some of the education incentives were enhanced by the Bush-era tax cuts; others fall into the tax extender category.

STRATEGY. *Year-end planning for education expenses is complicated by the fact that some of the enhanced incentives are available through the end of 2012 but others expired at the end of 2011. Technically, the expired incentives, such as the higher education tuition deduction, are not available for 2012 but there is a high probability that Congress will extend them through 2012. Congress could extend them before year-end or extend them retroactively after January 1, 2013.*

American Opportunity Tax Credit

In 2009, Congress enhanced the Hope education credit and renamed it the American Opportunity Tax Credit (AOTC). The temporary enhancements, including a maximum credit of $2,500, making the credit available for the first four years of post-secondary education, and partial refundability for qualified taxpayers, are scheduled to expire after 2012. Under current law, less generous amounts will be available with the revived Hope education credit.

STRATEGY. *Eligible taxpayers may want to front-load paying 2013 education expenses before year-end 2012 to take advantage of the AOTC. Some post-secondary schools require payment for the spring 2013 semester in late 2012.*

STRATEGY. *Eligible taxpayers in their third or fourth year of post-secondary education, should evaluate the value of claiming the AOTC because the revived HOPE credit may only be claimed for the first two years of post-secondary education after 2013.*

STRATEGY. *Eligible taxpayers may want to upgrade their laptops or other devices before year-end. An expenditure for a computer may qualify for the AOTC if the computer is needed as a condition of enrollment or attendance at the educational institution.*

COMMENT. *The value of the AOTC is reduced for certain taxpayers because of income thresholds. Generally, a taxpayer whose MAGI is $80,000 or less ($160,000 or less for married couples filing a joint return) may claim the AOTC for the qualified expenses of an eligible student. The AOTC is reduced if*

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a taxpayer's MAGI exceeds these threshold amounts. A taxpayer whose MAGI is greater than $90,000 ($180,000 for married couples filing a joint return) cannot claim the AOTC.

Coverdell Education Savings Accounts

Similar to IRAs, Coverdell Education Savings Accounts (Coverdell ESAs) are accounts established to pay for qualified education expenses. Under current law, the maximum annual contribution to a Coverdell ESA is $2,000, and qualified education expenses include elementary and secondary school expenses. Unless extended, the maximum annual contribution for a Coverdell ESA is scheduled to decrease to $500 after 2012.

STRATEGY. *Under current law, taxpayers may take a Coverdell ESA distribution for qualified education expenses and claim the AOTC/Lifetime Learning credits, if eligible. This treatment, however, is scheduled to expire at the end of 2012.*

STRATEGY. *Taxpayers who have not contributed the maximum amount to a Coverdell ESA should before year-end. Although Congress may extend the $2,000 maximum threshold for another year, the $2,000 amount is certain for 2012. There is no limit on the number of Coverdell accounts that can be established for a beneficiary. However, the total contribution to all accounts on behalf of a beneficiary cannot exceed $2,000 for 2012.*

Employer-Provided Education Assistance

Employer-provided education assistance is scheduled to undergo some significant changes after 2012, unless the current enhancements are extended. Under current law, qualified employer-provided educational assistance of up to $5,250 may be excluded from income and employment taxes. The 2010 Tax Relief Act extended the exclusion through 2012 only.

LIFE CYCLE CHANGES IMPORTANT TO YEAR-END STRATEGIES

While tax considerations are important, sometimes life gets in the way. Year-end tax strategies should also consider personal circumstances that changed during 2012 as well as what may change in 2013. These "life cycle" changes include:

- Change in filing status: marriage, divorce, death or head of household changes
- Birth of a child
- Child no longer young enough for child credit
- Child who has outgrown the "kiddie" tax
- Casualty losses
- Changes in medical expenses
- Moving/ relocation
- College and other tuition expenses
- Employment changes
- Retirement
- Personal bankruptcy
- Large inheritance
- Business successes or failures

STRATEGY. *If the current law treatment is not extended, employee income and wages for tax years beginning after 2012 will include all employer-provided education assistance that pays for graduate education expenses or does not qualify as a working condition fringe benefit. Employers should investigate converting an existing tuition reimbursement policy to a working condition fringe benefit in time to cover tuition that may be due in January.*

Student Loan Interest Deduction

Individual taxpayers with MAGI below $75,000 ($150,000 for married couples filing a joint return) may be eligible to deduct interest paid on qualified education loans up to a maximum deduction of $2,500, subject to income phase out rules. There is also no limitation as to the number of months during which interest paid on a student loan is deductible. The enhanced treatment for the student loan interest deduction is scheduled to expire after 2012.

STRATEGY. *Many taxpayers now deducting student loan interest may no longer be able to do so after 2012 if the extension of existing enhancements is not forthcoming. The income thresholds are scheduled to be $55,000 for individual taxpayers and $75,000 for married couples filing a joint return after 2012. Moreover, qualified interest will be deductible only if paid during the first 60 months that interest payments are required. If a borrower is in arrears on payments, making them by year-end 2012 may preserve a final interest deduction for 2012, should Congress not extend this popular provision.*

Higher Education Tuition Deduction

The above-the-line higher education tuition deduction expired after 2011. The maximum $4,000 deduction was available for qualified tuition and fees at post-secondary institutions of learning, including colleges, universities, and vocational schools, subject to income phaseouts.

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STRATEGY. *If the higher education tuition deduction is revived for 2012, taxpayers will need to weigh its value against the AOTC and Lifetime Learning credit. Taxpayers cannot claim the higher education tuition deduction in the same tax year that they claim the AOTC or the Lifetime Learning credit. A taxpayer also cannot claim the higher education tuition deduction if anyone else claims the AOTC or the Lifetime Learning credit for the student in the same tax year.*

Teacher's Classroom Expense Deduction

Before 2012, professional educators could claim a maximum $250 above-the-line annual deduction for qualified unreimbursed expenses. These expenses include books, supplies, computers and software. The professional educator must work at least 900 hours during a school year and be a K-12 teacher, instructor, counselor, principal or aide. Under current law, the deduction is not available for 2012, unless extended.

COMMENT. *The deduction has been routinely extended in past years and is a good candidate for extension through 2012 (and possibly 2013).*

OTHER TAX EXTENDERS FOR INDIVIDUALS

Child Tax Credit

Taxpayers who claim the child tax credit need to plan for its scheduled reduction after 2012. Absent Congressional action, the child tax credit, at $1,000 per eligible child for 2012, will be $500 per eligible child, effective January 1, 2013.

STRATEGY. *Whether the child tax credit remains at $1,000 or drops to $500 in 2013, year-end planning that manipulates income and deductions in general should factor in the adjusted gross income phaseout levels for the child tax credit, which would remain the same. For married individuals filing a joint return, the phaseout of the child tax credit starts at $110,000 of modified AGI. For unmarried taxpayers, the phaseout starts at $75,000. The phaseout starts at $55,000 for married couples filing separate returns.*

STRATEGY. *While the likelihood of extension of this very popular tax break is high, couples might consider the possible reduction of this credit in any custody agreements that might be drafted under pending separation or divorce proceedings.*

State and Local Sales Tax Deduction

Before 2012, qualified taxpayers could deduct state and local general sales taxes in lieu of deducting state and local income taxes. The 2010 Tax Relief Act last extended the optional itemized deduction for state and local general sales taxes, which had been available since 2004, to tax years 2010 and 2011. Unless extended, the deduction for state and local general sales taxes will not be available for tax year 2012 and beyond.

STRATEGY. *The deduction for state and local general sales taxes is a popular provision which enjoys bipartisan support in Congress. Its prospects for extension through 2012 (or possibly even through 2013) are therefore good. Taxpayers contemplating big ticket purchases may want to make them before the end of 2012 in the event the deduction for state and local sales taxes is extended through 2012 only.*

Transit Benefits Parity

Qualified transportation fringe benefits may be excluded from an employee's gross income for income tax and payroll tax purposes. More generous exclusion amounts under the 2010 Tax Relief Act which provided for transit benefits parity among transit passes and van pool benefits, and qualified parking, expired after 2011. Under current law, for 2012, the excludible amount for qualified transportation fringes is limited to an inflation-adjusted $125 per month total for transit passes or van pooling; and an inflation-adjusted $240 per month for qualified parking.

STRATEGY. *If Congress extends transit benefits parity in late 2012, it is unclear if the extension would be retroactive to January 1, 2012, as such an extension would create significant logistical challenges for employers. A prospective extension through 2013 would be more manageable. Employers should thus consider opting out of retroactively offering an arrangement for 2012 that includes transit passes and van pooling at the higher $240 level even if Congress should approve an extension for 2012.*

Charitable Distributions from IRAs

Before 2012, individuals age 70 ½ and older could exclude from gross income qualified charitable distributions from individual retirement accounts (IRAs). The exclusion could not exceed $100,000 per taxpayer each tax year. The last extension of the incentive expired after 2011 and, under current law, is not available for 2012 and beyond.

STRATEGY. *Under current law, a taxpayer can make a gift from his or her IRA to a charity in 2012 but the amount will not be excluded from income. Instead, the gift may qualify as an itemized tax deduction, provided it is made to a qualified charitable organization and substantiation requirements, as well as percentage-of-income limits, are satisfied.*

Mortgage Deductions/Exclusions

The existing tax code carves out a number of tax breaks directly targeted at personal residences. One of those tax breaks – the deductibility of mortgage insurance premiums – expired at the end of 2011; another – the exclusion of forgiven mortgage debt as discharge of indebtedness income – is set to expire at the end of 2012.

Mortgage insurance premiums. For the period 2007 through 2011, premiums paid for qualified mortgage insurance could be treated as qualified residence interest and deducted as an itemized deduction, subject

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to certain restrictions. Renewal of this tax break into 2012 is uncertain at this time.

STRATEGY. *Amounts prepaid for qualified mortgage insurance, except for mortgage insurance provided by the VA or the RHA, were required to be allocable to periods beyond the year in which they are paid up to 84 months and are charged to a capital account and treated as paid in the allocable year. Therefore, although this tax break may not be renewed for 2012, prior premiums that had been prepaid may be allocable to 2012.*

Exclusion of discharge of indebtedness income. When a debt is forgiven, it is generally considered imputed income to the debtor at the time of forgiveness. However, under a relief provision precipitated by the home mortgage crisis, discharge of indebtedness income is excluded from gross income if the indebtedness discharged is "qualified principal residence indebtedness" that is discharged any time after December 31, 2006, and before January 1, 2013.

"Qualified principal residence indebtedness" is defined as "acquisition indebtedness" of $2 million or less. "Acquisition indebtedness" is any indebtedness incurred for the acquisition, construction, or substantial improvement of the principal residence and is secured by the residence. This is an expiring provision that likely may be renewed, given that many homeowners are still underwater on their mortgages.

STRATEGY. *Determining precisely the tax year in which debt forgiveness occurs may enter into year-end planning, both for purposes of claiming the exclusion in 2012 under current law and for purposes of accelerating or postponing discharge of indebtedness income in those instances where the exclusion does not apply. Discharge of indebtedness income, regardless of the applicability of the exclusion, generally will not be recognized before any sale or foreclosure takes place. Discharge of indebtedness income may also not take place until well after a sale if the lender pursues the borrower under the personal liability created by the mortgage note, even though it may later abandon its claim. This is more likely in the case of vacation homes, which are not covered by the exclusion, in which the lender assumes that the borrower has other assets.*

Residential Energy Incentives

Two incentives, the Code Sec. 25C residential energy property credit, and the Code Sec. 25D residential energy efficient property credit, are designed to reward taxpayers who, on the consumer level, make qualified energy improvements. The Code Sec. 25C credit expired after 2011. The Code Sec. 25D credit is scheduled to expire after 2016.

Code Sec. 25C Credit. The Code Sec. 25C credit was available for certain improvements, including qualified windows, skylights and doors, building insulation systems, certain roofing materials, central air conditioning systems, and certain water heaters.

Code Sec. 25D Credit. The Code Sec. 25D credit is available for qualified solar electric property, solar water heating property, fuel cell property, small wind energy property, qualified geothermal heat pump property. The taxpayer's residence must be his or her principal residence and be located in the U.S. Purchasers of new homes may qualify for the credit.

STRATEGY. *Prospects for extending Code Sec. 25C are uncertain. Several bills to extend the credit through 2012 or 2013 have been introduced in Congress but have either languished in committee or have been rejected. Installation of the energy-saving equipment must take place in the year for which the credit is claimed, as a mere sales contract dated in the year of the credit is insufficient.*

The Code Sec. 25D credit, however, remains available through 2016, and is not subject to any cap.

COMMENT. *In 2011, the Treasury Inspector General for Tax Administration (TIGTA) uncovered significant abuse of the Code Sec. 25C credit because there was no requirement that individuals provide third-party documentation supporting the purchase of qualifying products and/or costs associated with making energy efficient improvements, nor if these qualified purchases and/or improvements were in fact made to their residence. If the Code Sec. 25C credit is revived, Congress could impose documentation requirements similar to those imposed to prevent abuse of the first-time homebuyer credit.*

ESTATE/GIFT TAX

Estate tax planning in recent years has been complicated by significant uncertainty over long-term federal estate and gift tax rates. Indeed, few federal tax provisions have undergone as many changes as the federal estate tax rules in recent years. The current estate and gift tax effective through 2012 is set at a maximum rate of 35 percent with a $5.12 million exemption amount. Unless extended, the maximum estate tax rate will revert to 55 percent after 2012 with a $1 million exemption amount.

COMMENT. *The maximum estate tax rate is expected to increase after 2012, but likely not to 55 percent. A top rate of 45 percent with a $3.5 million exemption amount has reportedly been discussed among Congressional Democrats but there is also significant support for keeping the maximum rate at 35 percent with an inflation-adjusted $5 million exemption amount. A separate $1 million exemption from gift tax has also been proposed.*

STRATEGY. *Gift-giving, ideally on an annual basis that includes 2012, should continue to form part of one's overall estate plan. The annual gift tax exclusion per donee on which no gift tax is due is $13,000 for 2012 (and is projected to be $14,000 in 2013), with $26,000 allowed to each donee by married couples filing a split-gift election ($28,000 in 2013). Making a gift at year-end 2012 to take advantage of this annual, per-donee exclusion should be considered by anyone with even modest wealth.*

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STRATEGY. *Combining the gift tax exclusion with the zero percent capital gains rates available through 2012 for donees in the 10 or 15 percent income tax bracket might also prove advantageous, especially if appreciated property is gifted to older children who are beyond the reach of the "kiddie tax," which taxes at the parent's marginal rate certain unearned income of a child.*

Time for large year-end gifts? The combination of a high unified gift and estate tax exclusion of $5.12 million that will sunset at the end of 2012 and the relatively low valuation of many businesses as the result of the economic downturn may enhance the incentive for making large year-end gifts. Some taxpayers may also be willing to transfer more than $5.12 million at this time, when the unified gift and estate tax rate is at a relatively low 35 percent and poised to rise to as much as a maximum 55 percent starting in 2013.

BUSINESS PLANNING

Year-end planning for business, like year-end planning for individuals, is complicated by the number of expired or soon-to-expire tax incentives. Many of these incentives have routinely been extended in past years. However, their fate in a budget-conscious Congress is uncertain.

BONUS DEPRECIATION

In recent years, Congress has used bonus depreciation to encourage economic growth. Currently, a special 50-percent first year bonus depreciation allowance is provided for qualified property. This allowance is scheduled to expire after 2012 (2013 in the case of certain longer production period property and certain transportation property).

COMMENT. *For a temporary period, taxpayers could take advantage of 100 percent bonus depreciation. However, 100 percent bonus depreciation expired at the end of 2011 (2012 in the case of certain longer production period property and certain transportation property).*

To be eligible for bonus depreciation, qualified property must be depreciable under the Modified Accelerated Cost Recovery System (MACRS) and have a recovery period of 20 years or less. These requirements encompass a wide-variety of assets. The property must be new and placed in service before January 1, 2013 (January 1, 2014 for certain longer production period property and certain transportation property).

EXAMPLE. *Qualifying assets with a five-year life for depreciation purposes are purchased for $500,000 and placed into service in January, 2012. The taxpayer may claim $250,000 bonus depreciation and $50,000 first year depreciation.*

COMMENT. *The rules for determining the acquisition date of an asset changed when 100 percent bonus depreciation dropped to 50 percent. Special rules also apply to self-constructed property.*

STRATEGY. *The equipment eligible for bonus depreciation must be placed in service, and not merely purchased, by year-end to be eligible in 2012. Placed in service generally requires installation and ready-for-use in the business. Title must also pass. Payment under an installment agreement beyond 2012, however, will not impact on claiming bonus depreciation for 2012.*

STRATEGY. *Bonus depreciation is not mandatory. Certain taxpayers should consider electing out of bonus depreciation to spread depreciation deductions more evenly over future years.*

Code Sec. 280F dollar limitations. Bonus depreciation also relates to the vehicle depreciation dollar limits under Code Sec. 280F. This provision imposes dollar limitations on the depreciation deduction for the year in which a taxpayer places a passenger automobile in service within a business, and for each succeeding year. Unless bonus depreciation is extended, 2012 will be the final year in which substantial first-year writeoffs for the purchase of a business automobile may be available.

Code Sec. 168(k)(2)(F)(i) increases the first-year depreciation allowed for vehicles subject to the Code Sec. 280F luxury-vehicle limits, unless the taxpayer elects out, by $8,000, to which the additional first-year depreciation deduction applies. The maximum depreciation limits under Code Sec. 280F for passenger automobiles first placed in service by the taxpayer during the 2012 calendar year are: $11,160 for the first tax year ($3,160 if bonus depreciation is not taken); $5,100 for the second tax year; $3,050 for the third tax year; and $1,875 for each tax year thereafter. The maximum depreciation limits under Code Sec. 280F for trucks and vans first placed in service during the 2012 calendar year are $11,360 for the first tax year ($3,360 if bonus depreciation is not taken); $5,300 for the second tax year; $3,150 for the third tax year; and $1,875 for each tax year thereafter.

STRATEGY. *Under Code Sec. 179(b)(5), not more than $25,000 of the cost of a heavy SUV can be written off under Code Sec. 179. Nevertheless, heavy SUVs (sport utility vehicles and pickup trucks with a gross vehicle weight rating in excess of 6,000 pounds) are exempt from the luxury vehicle depreciation caps. Therefore, combining Code Sec. 179 expensing with full 50 percent bonus depreciation can result in a substantial first year write-off of a heavy SUV's purchase price if done before 2013.*

Half and quarter year conventions. The half-year convention treats all property placed in service during any tax year (or disposed of during any tax year) as placed in service (or disposed of) at the midpoint of that tax year. The amount of allowable depreciation in a tax year in which the half-year convention applies is one half the amount that would be allowed by applying the applicable depreciation method for a full tax year. The mid-quarter convention must be used instead of the half-year convention if, during any tax year, the aggregate bases of all property (other than re-

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alty) that is placed in service during the last three months of that year exceed 40 percent of the aggregate bases of all property placed in service during the tax year. The mid-quarter convention treats all property placed in service during any quarter of a tax year (or disposed of during any quarter of a tax year) as having been placed in service (or disposed of) at the midpoint of that quarter.

STRATEGY. *Bonus depreciation is not subject to half or quarter year conventions; a qualifying asset purchased on the last day of the tax year qualifies for as much bonus depreciation as an asset purchased on January 1st of the same year. However, the remainder of regular depreciation for year-end purchases is subject to those conventions.*

CODE SEC. 179 EXPENSING

Many taxpayers have grown accustomed to enhanced Code Sec. 179 expensing. However, the generous dollar limitation and investment limitations are scheduled to plunge after 2012.

Code Sec. 179 gives businesses the option of claiming a deduction for the cost of qualified property all in its first year of use rather than claiming depreciation over a period of years. Under current law, the dollar limitation for 2012 is $139,000 with a $560,000 investment ceiling placed on the purchase of all otherwise qualifying property. The Code Sec. 179 dollar limit is scheduled to drop to $25,000 for 2013 with a $200,000 investment ceiling.

COMMENT. *A precipitous drop has already taken place from $500,000 with a $2 million investment ceiling applicable to 2010 and 2011.*

STRATEGY. *Businesses may want to accelerate purchases into 2012 to take advantage of the still generous Code Sec. 179 expensing dollar and investment amounts. Qualified property must be tangible personal property, actively used in the business, and for which a depreciation deduction would be allowed. Qualified property must be newly purchased new or used property, rather than property you previously owned but recently converted to business use. Examples of types of property that would qualify for Code Sec. 179 expensing are office equipment or equipment used in the manufacturing process.*

STRATEGY. *Year-end may be the time to invest in off-the-shelf computer software. Code Sec. 179 expensing is allowed for off-the-shelf computer software placed in service in tax years beginning before 2013.*

CAUTION. *Real property generally is excluded from Code Sec. 179 expensing. The 2010 Tax Relief Act provided that qualified leasehold property, qualified restaurant property and qualified retail improvement property placed in service in 2010 or 2011 were eligible for special expensing rules. However, starting in 2012, no such expansion of Code Sec. 179 expensing has been available.*

STRATEGY. *If qualified equipment purchases for the year exceed the expensing dollar limit (but not the overall investment ceiling), the taxpayer may decide to split the expensing election among the new assets any way it chooses. It may be more valuable to expense assets with the longest depreciation recovery periods. As long as the taxpayer starts using the newly purchased business equipment before the end of the tax year, the taxpayer gets the entire expensing deduction for that year. The amount that can be expensed depends upon the date the qualified property is placed in service; not when the qualified property is purchased or paid for.*

COMMENT. *While a decision on what to expense need not be made until 2012 returns are filed, proactive management of qualifying purchases before year end can lead to higher tax savings.*

STRATEGY. *The limitations are per-year and not cumulative. The optimal balance between 2012 and 2013 in purchasing equipment, therefore, would be to engage in 2012 purchases that maximize the $139,000 expensing limit, then defer in 2013 to maximize the $25,000 limit (or higher, should Congress decide to be more generous).*

The Code Sec. 179 deduction is also limited to a taxpayer's trade or business taxable income. Any excess beyond taxable income may be carried forward (unlike bonus depreciation, which may generate a net operating loss that may be carried back or carried forward). The taxable income limit, however, is applied to all trades or businesses owned by the taxpayer. In another twist, wages are considered when computing the taxable income limit, therefore enabling some employees with side businesses at home to expense the full value of equipment purchases.

Interplay with bonus depreciation. The purchased property may qualify for both Code Section 179 expensing and bonus depreciation. Code Sec 179 expensing should be taken first, followed by bonus depreciation and then regular first-year depreciation. For example, a 2012 purchase of $400,000 in assets that qualify as five-year property for depreciation purposes would be entitled to a $139,000 Code Sec. 179 deduction, a $130,500 bonus depreciation and a $26,100 regular depreciation deduction assuming a half-year convention.

De minimis expensing alternative. New de minimis expensing rules allow a taxpayer to deduct certain amounts paid or incurred to acquire or produce a unit of tangible property if the taxpayer has an Applicable Financial Statement (AFS), written accounting procedures for expensing amounts paid or incurred for such property under certain dollar amounts, and treats such amounts as expenses on its AFS in accordance with its written accounting procedures. An overall ceiling limits the total expenses that a taxpayer may deduct under the de minimis rule.

STRATEGY. *The de minimis expensing rule is especially useful to businesses that may exceed the $560,000 investment ceiling or $139,000 dollar limit imposed in 2012 for use of Code Sec. 179 expensing. The de minimis expensing rule*

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applies to amounts paid or incurred (to acquire or produce property) in tax years beginning on or after January 1, 2012.

QUALIFIED LEASEHOLD/ RETAIL IMPROVEMENTS, RESTAURANT PROPERTY

Before 2012, qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property were eligible for a 15-year recovery period. The qualified property had to be placed in service before January 1, 2012. Under current law, this incentive is not available for qualified property placed in service after December 31, 2011. However, Congress could extend the incentives retroactively to January 1, 2012.

STRATEGY. *Taxpayers that did not take advantage of the incentive before 2012 may benefit from an extension for property placed in service before January 1, 2013. Of course, this is speculative but taxpayers should evaluate the benefits of any retroactive extension.*

WORK OPPORTUNITY TAX CREDIT

The Work Opportunity Tax Credit (WOTC) rewards employers that hire individuals from targeted groups with a tax credit. Under current law, the WOTC is not available for 2012 except for the target group applicable to qualified veterans. The Vow to Hire Heroes Act of 2011 (Heroes Act) extended the WOTC for unemployed veterans and unemployed veterans with service connected disabilities through 2012. The Heroes Act did not extend the non-veteran WOTC provisions.

STRATEGY. *Under current law, the window for hiring a qualified veteran to claim the WOTC is short. The qualified veteran must begin work for the employer before January 1, 2013. For-profit and non-profit employers can benefit from the WOTC if they hire a qualified veteran before January 1, 2013. The WOTC for qualified veterans can be as high as $9,600.*

RESEARCH TAX CREDIT

The Code Sec. 41 research tax credit expired after 2011. However, the research credit enjoys significant bipartisan support and is a strong candidate for extension through 2012 (and possibly through 2013). The question is when Congress will extend the research credit: either before year-end 2012 or in early 2013 and make an extension retroactive to January 1, 2012.

COMMENT. *The alternative simplified credit method also expired after 2011. Under the alternative simplified credit method, a taxpayer's research credit is equal to 14 percent of the amount by which the qualified research expenses for the tax year exceed 50 percent of the average qualified research expenses for the three preceding tax years. The rate is reduced to six percent if the taxpayer has no qualified research expenses in any one of the three preceding tax years.*

NEW MARKETS TAX CREDIT

The new markets tax credit (NMTC) is designed to encourage investments, loans, or financial counseling for businesses and real estate projects in low-income communities. Under Code Sec. 45D, taxpayers may claim the credit by making an equity investment in a community development entity (CDE), which in turn will invest the funds in the low-income community. Both individuals and corporations can invest in a CDE. The investment must be acquired at its original issue, either directly or through an underwriter.

The Treasury Department allocates credits to the CDEs. Taxpayers may claim a total credit of 39 percent of the original amount invested. The credit is claimed over seven years: five percent in the first three years, six percent over the succeeding four years. Because the majority of investments have involved real estate, Treasury and the IRS have recently issued regulations to encourage investments, primarily as working capital and equipment loans, in businesses that are not involved in real estate.

STRATEGY. *The program expired at the end of 2011 but may be extended by Congress retroactively in 2012 or into 2013. Treasury allocated $3.6 billion in investment authority to CDEs in 2011, which in the meantime is positioned to generate approximately $1.4 billion in NMTCs. Taxpayers interested in claiming NMTCs (yields currently are very competitive) should be on the lookout for investment opportunities and be aware of participation deadlines sensitive to year-end opportunities to claim the credit.*

More Business Tax Extenders

A number of other business tax extenders expired after 2011. They include (not an exhaustive list):

- 100 percent exclusion for gain on sale of qualified small business stock
- Enhanced deduction for charitable contributions of food inventory
- Enhanced deduction for corporate charitable contributions of book inventory
- Enhanced deduction for corporate charitable contributions of computers
- Expensing of brownfields remediation costs
- Employer wage credit for activated military reservists
- Subpart F exceptions for active financing income
- Look through rule for related controlled foreign corporation payments
- Railroad track maintenance credit
- Seven year recovery period for motorsports entertainment complexes
- Mine rescue team training credit
- Indian employment credit
- Accelerated depreciation for business property on Indian reservations
- Special expensing rules for qualified film and television productions
- Election to expense advanced mine safety equipment
- Tax incentives for the District of Columbia
- Tax incentives for empowerment zones

COMMENT. *In August 2012, the Senate Finance Committee approved the Family and Business Tax Cut Certainty Act of 2012. The bill would extend many of the*

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individual and business tax extenders, but not brownfields remediation expensing, certain tax incentives for the District of Columbia, and the enhanced deduction limits for charitable contributions of computer equipment and book inventory. At this point, however, it is unclear if the full Senate will take up the bill as written after the November elections.

HEALTH CARE

Year-end planning also should take into account the various tax provisions affecting health care costs. The Patient Protection and Affordable Care Act and its companion bill, the Health Care and Education Reconciliation Act (collectively known as the Affordable Care Act), enacted a host of tax-related provisions impacting individuals and business. Some of the tax provisions were effective immediately, others in 2011 and 2012, and more in 2013 and beyond. In addition to the 3.8 percent Medicare contributions tax and the 0.9 percent Medicare tax already discussed, several other provisions in the Affordable Care Act impact year-end 2012 tax planning.

COMMENT. *Tax planning for health care is complicated by uncertainty over the fate of the Affordable Care Act until after the November elections. Governor Mitt Romney, the Republican Party candidate for President, has said he will repeal the Affordable Care Act if elected, but has indicated his support for continuing some of the provisions. If re-elected, President Obama has promised to move forward with implementation of the Affordable Care Act, including the so-called individual mandate, which was upheld by the U.S. Supreme Court, and the employer-shared responsibility payment provision. These two provisions are scheduled to take effect after 2013.*

Itemized Deduction for Medical Expenses

The itemized deduction for medical expenses is scheduled to undergo a significant change effective 2013. Under current law, taxpayers who itemize deductions may claim an itemized deduction for qualified unreimbursed medical expenses to the extent the expenses exceed 7.5 percent of adjusted gross income (AGI). Effective for tax years beginning after December 31, 2012, the 7.5 percent threshold increases to 10 percent.

STRATEGY. *Although medical expenses are often unforeseen, taxpayers who anticipate incurring qualified medical expenses for purposes of the itemized deduction, such as for elective surgery, may wish to accelerate those expenses into 2012. If the expenses can be accelerated, it may be more advantageous to claim them in 2012 with the threshold at 7.5 percent rather than in subsequent years with a 10 percent threshold.*

STRATEGY. *The Affordable Care Act carved out an important but temporary exception to the 10 percent threshold for individuals age 65 and older. Taxpayers (or their spouses) who are age 65 or older before the close of the tax year (for tax years beginning after December 31, 2012 and ending before January 1, 2017), may continue to apply the 7.5 percent threshold.*

COMMENT. *The Affordable Care Act only increased the threshold from 7.5 percent to 10 percent for regular income tax purposes. The AMT treatment of the itemized deduction remains unchanged at 10 percent. There is no age 65 exception for the 10 percent threshold for AMT purposes.*

Health Flexible Spending Arrangements

Health flexible spending arrangements (health FSAs) are a popular savings vehicle for qualified health care expenses. After 2012, however, the maximum salary reduction contribution to a health flexible spending arrangement (health FSA) will be capped at $2,500. Any salary reductions in excess of $2,500 will subject the employee to tax on distributions from the health FSA after 2012.

STRATEGY. *Before the Affordable Care Act, many employers imposed a $5,000 maximum salary reduction contribution cap to a health FSA. Individuals with contribution limits above $2,500 for 2012 should make decisions about the priority of certain health care decisions before the end of 2012, especially where expenses that can be avoided in 2013 can be accelerated to 2012.*

STRATEGY. *Unlike past years, health FSA dollars cannot be used in 2012 to pay for over-the-counter medications (except insulin). Effective January 1, 2011, distributions from health FSAs are allowed to reimburse the cost of over-the-counter medicines only if they are purchased with a prescription. Items that are not medicines continue to qualify, including bandages, and diagnostic devices, such as blood sugar test kits.*

COMMENT. *The $2,500 amount is indexed for inflation, but only for tax years beginning after December 31, 2013.*

Medical Loss Ratio Rebates

The Affordable Care Act requires health insurance issuers to submit data on the proportion of premium dollars spent on clinical services and quality improvement. If the percentage does not meet minimum standards, issuers must provide rebates to enrollees.

The first round of medical loss ratio (MLR) rebates under the Affordable Care Act took place in 2012.

STRATEGY. *Whether an MLR rebate is taxable depends on a number of variables. If a tax benefit was previously gained on the premiums now being rebated, the rebate is taxable; otherwise, the rebated premiums are generally tax free to the recipient. Taxpayers taking inventory of income and deductions for purposes of year-end 2012 tax planning should keep this additional income source in mind.*