# Tax Alert

# 2014 Tax Planning Guidelines for Individuals & Businesses

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Benjamin Franklin is often quoted as having said that "nothing is certain except death and taxes". Interestingly enough, Franklin wasn't talking about death or taxes. He was writing to a friend about the relatively new American Constitution. Franklin actually wrote "Our new Constitution is now established, and has an appearance that promises permanency, but in this world nothing can be said to be certain, except death and taxes."

The mere appearance of permanency also characterizes the current tax environment. Looming on the horizon are possible comprehensive tax reforms and potential passage of tax extenders.

Now that Republicans have increased their majority in the House and regained control of the Senate, the legislative outlook for comprehensive tax reform has significantly changed. The immediate impact of the mid-term elections will likely be primarily around the package of individual and business "tax extenders" that await retroactive reinstatement to the start of 2014. Under current law, the tax extenders are unavailable for 2014 and subsequent years, unless extended by Congress. This has historically left taxpayers and their advisors without a firm idea of what the tax landscape will look like year to year. For individuals, these tax extenders include the state and local sales tax deduction, special mortgage debt forgiveness provisions, transit benefits parity, higher education tuition deduction, IRA distributions to charities and teachers' classroom expense deduction. While comprehensive tax reform is highly unlikely to occur before the end of 2014, it is possible that a resolution regarding the tax extenders may occur.

This situation presents unique challenges while, at the same time, traditional tax planning techniques are still germane to achieving benefits. We have put together the following guide to address several key issues that will assist you in your personal, business and estate tax planning. Any of the tax professionals at WeiserMazars are ready to meet with you to discuss your specific situation.

Several issues that were important for individuals to plan for in 2013 are still important to address in 2014.

Continuing to take center stage in year-end income tax planning are the return of the 39.6 percent top individual tax rate, an increase in the top capital gains rate from 15 to 20 percent and the introduction of a new 3.8 percent tax on net investment income.

**Individual & Fiduciary Income Tax Rates**
The 2014 federal individual and fiduciary income tax rates and brackets are:

| Rate | Single | Married Filing Jointly | Head of Household | Married Filing Separately | Trust and Estates |
|---|---|---|---|---|---|
| 10% | $0 to $9,075 | $0 to $18,150 | $0 to $12,950 | $0 to $9,075 | N/A |
| 15% | $9,076 to $36,900 | $18,151 to $73,800 | $12,951 to $49,400 | $9,076 to $36,900 | $0 to $2,500 |
| 25% | $36,901 to $89,350 | $73,801 to $148,850 | $48,601 to $127,550 | $36,901 to $74,425 | $2,501 to $5,800 |
| 28% | $89,351 to $186,350 | $148,851 to $226,850 | $127,551 to $206,600 | $74,426 to $113,425 | $5,801 to $8,900 |
| 33% | $186,351 to $405,100 | $226,851 to $405,100 | $206,601 to $405,100 | $113,426 to $202,550 | $8,901 to $12,150 |
| 35% | $405,101 to $406,750 | $405,101 to $457,600 | $405,101 to $432,200 | $202,551 to $228,800 | N/A |
| 39.6% | Over $406,750 | Over $457,600 | Over $432,200 | Over $228,800 | Over $12,150 |

Taking into account the phase-out of itemized deductions and the net investment income tax, the top marginal individual tax bracket could be as high as 44.6%.

Careful consideration of the income and charitable contribution planning ideas outlined below can help minimize the tax bite.

**Capital Gains Tax Rates**
The long term capital gains tax rate is 20% (23.8% if the net investment income tax discussed below applies) if the taxable income exceeds $457,600 for a married couple filing jointly, $228,000 for a married couple filing separately, $432,000 for heads of household and $406,750 for single taxpayers. For taxpayers with taxable income below these thresholds, the capital gains tax rate remains 15% (18.8% including the net investment income tax). Lower rates may apply to individuals at certain income levels. We discuss potential capital gains planning ideas later in this article.

**Net Investment Income Tax**
Since the net investment income tax has only been in existence for one tax year, a refresher is warranted. Taxpayers with qualifying income are liable for the 3.8% net investment income (NII) tax on certain items of unearned income. The tax is levied on the lesser of NII or the amount by which modified AGI exceeds certain threshold amounts. The threshold amounts for the NII tax are:

1. $250,000 for a surviving spouse or married filing jointly (MFJ) taxpayers
2. $125,000 for married filing separately (MFS) taxpayers
3. $200,000 for single taxpayers

Investment income for NII purposes is (1) gross income from interest, dividends, annuities, royalties, and rents (other than from a trade or business); (2) other gross income from a passive activity or a trade or business of trading in financial instruments; and (3) net gain attributable to the disposition of property other than property attributable to an active trade or business. Some items not included in net investment income include distributions from certain qualified retirement plans and individual retirement accounts, amounts subject to self-employment tax and municipal bond interest.

**Additional Medicare Surtax**
In addition to the NII tax, the Patient Protection and Affordable Care Act ("PPACA") instituted an additional .9% Medicare tax effective for the 2013 tax year. The tax is imposed on wages and self-employment income in excess of $250,000 for married filing jointly taxpayers ($200,000 for single taxpayers and $125,000 for married filing separately).

As one plans for 2014, it is important to keep 2015 in mind. Below, we have included charts that compare some of the more common tax rates, exemption amounts and retirement plan contribution limits in 2014 to those that would apply in 2015. The chart highlights that most of these remain the same in 2015 with the exception of the gift, estate and generation-skipping transfer tax exemption. Most of the retirement plan contribution limits will also increase modestly in 2015.

| | 2014 | 2015 |
|---|---|---|
| Maximum income tax rate | 39.6% | 39.6% |
| Maximum capital gains rate | 20% | 20% |
| Maximum qualified dividends rate | 20% | 20% |
| Medicare surtax on NII | 3.8% | 3.8% |
| Maximum Medicare payroll tax rate/wage base | 2.35%*/no limit | 2.35%*/no limit |
| Maximum Old-Age, Survivors, and Disability Insurance (Social Security) – rate/wage base | 6.2%/$117,000 | 6.2%/$118,500 |
| Estate tax exemption | $5,340,000 | $5,430,000 |
| Maximum estate tax rate | 40% | 40% |
| Gift tax exemption | $5,340,000 | $5,430,000 |
| Maximum gift tax rate | 40% | 40% |
| GST tax exemption | $5,340,000 | $5,430,000 |
| Maximum GST rate | 40% | 40% |
| Annual gift tax exclusion | $14,000 per donee | $14,000 per donee |
| Annual exclusion gift to non-citizen spouse | $145,000 | $147,000 |

*This is comprised of the basic Medicare rate of 1.45% plus the additional Medicare tax of 0.9%, discussed above. The maximum employee portion of Medicare is 2.35%, while the maximum employer portion is 1.45%. Employers are responsible for withholding the 0.9% additional Medicare Tax on an individual's wages paid in excess of $200,000 in a calendar year, without regard to filing status.

| 401(k)s, 403(b)s, most 457 plans, and the federal government's Thrift Savings Plan | 2014 | 2015 |
|---|---|---|
| Annual contribution limit | $17,500 | $18,000 |
| Catch-up contribution if age 50 or older | $5,500 | $6,000 |

| SIMPLE 401(k)s and SIMPLE IRAs (often used by smaller companies) | 2014 | 2015 |
|---|---|---|
| Annual contribution limit | $12,000 | $12,500 |
| Catch-up contribution if age 50 or older | $2,500 | $3,000 |

| SEP IRAs and Solo 401(k)s (often used by the self-employed or small business owners) | 2014 | 2015 |
|---|---|---|
| Annual contribution limit | $52,000 | $53,000 |

| IRAs (Traditional or Roth) | 2014 | 2015 |
|---|---|---|
| Annual contribution limit | $5,500 | $5,500 |
| Catch-up contribution if age 50 or older | $1,000 | $1,000 |

**Individual Income Tax Planning**

1. *Capital gains and losses*
    a. *Netting of capital gains and losses:* Taxpayers are allowed to deduct up to $3,000 of net capital losses against ordinary income. Excess capital losses are carried over to future tax years. Review your capital loss carryovers to determine if any appreciated positions could be sold without incurring additional income tax.
    b. *Harvest tax losses:* If you have overall net capital gains, consider selling loss positions. Securities sold at a loss could be repurchased subject to the wash sale rule. This rule prohibits you from recognizing losses if you purchase substantially identical securities within 30 days before or after the sale. Consider purchasing Exchange Traded Funds tied to the original securities industry or sector to avoid waiting the 30 days.
    c. *Qualified small business stock:* Taxpayers who acquire stock that is qualified small business stock and hold the stock for five years may exclude up to 100% of the gain from income upon the sale of the stock. The exclusion is generally 50%, but was increased to 75% for QSBS acquired after February 17, 2009, and before September 28, 2010; and to 100% for QSBS acquired after September 27, 2010, and before January 1, 2014. For QSBS acquired after January 1, 2014, the exclusion returned to 50%. QSBS gain is generally treated as a preference item for AMT purposes, except QSBS gain that qualifies for the 100% exclusion, which is not treated as an AMT preference item.

2. *Alternative minimum tax (AMT):* AMT is a parallel tax system that was originally intended to cause wealthy taxpayers to pay their fair share of tax. Over the years, more and more individuals (many of whom would not consider themselves wealthy) have become subject to this tax. The AMT system disallows or limits many common income tax deductions including the deduction for state and local income taxes, real estate taxes, interest on home equity loans not used to build or improve your residence, and miscellaneous itemized deductions such as investment advisory fees. AMT brackets and exemptions are indexed annually for inflation. When timing income and deductions, taxpayers must carefully analyze their AMT situation.
    a. If you project that you will be subject to AMT in 2014, you should consider deferring certain deductions such as state income tax payments and real estate taxes until 2015 if you do not expect to be subject to AMT in 2015.
    b. If you project that you will be subject to AMT in 2014, you should consider accelerating ordinary income into 2014. You would pay your tax sooner, but the income may be taxed at 28% (the highest AMT rate) as opposed to 39.6% (the highest ordinary income tax rate)
    c. If you are not projected to be subject to AMT in 2014, you should consider paying your fourth quarter state estimated tax payment prior to December 31, 2014 instead of waiting until its actual due date of January 15, 2015.

d. If you are not projected to be subject to AMT in 2014, also consider exercising Incentive Stock Options (ISOs).

3. *Retirement Planning*
    a. *SEP-IRAs:* Self-employed individuals can take advantage of contributions to retirement plans to improve their tax standing. An individual with a SEP-IRA may be eligible to make a contribution of up to the lower of $52,000 ($53,000 in 2015) or 20% of net self-employment income. This can offset the ordinary income earned during the year, which will eventually lower the overall tax bite. Self-employed individuals can also establish other types of plans such as a Keogh Plan and defined benefit plans.
    b. *ROTH IRA Conversion:* A Roth IRA allows tax-free growth of assets, tax-free distributions and does not require minimum distributions each year upon reaching age 70 1/2. Consider converting a traditional IRA to a Roth IRA. When you convert to a Roth IRA, the converted amount of the traditional IRA will be taxed as ordinary income in the conversion year. The converted amount is also considered part of your modified adjusted gross income when determining if you are subject to the net investment income tax.
    c. *ROTH IRA Re-Characterization*: If you convert to a Roth IRA in 2014, you can re-characterize it back to a traditional IRA until October 15, 2015. This gives you time to monitor market conditions, and make a decision to undo the Roth conversion if the account value decreases significantly from the time of conversion, thereby avoiding the recognition of income tax based on the higher value of the account on the date the conversion was made. This flexibility can be enhanced further by segregating the Roth IRA into separate accounts invested in diversified portfolios of varying asset classes.
    d. *Establishment of Retirement Plan*: Qualified retirement plans need to be established by December 31, 2014, although they can be funded in 2015. IRAs can be established and funded by April 15, 2015.

4. *Passive Activities:* Taxpayers may take deductions for business and rental activities that they do not materially participate in, but nonetheless derive income from (i.e., passive activities). The passive activity rules stipulate that a taxpayer is allowed to deduct losses stemming from passive activities to the extent of one's passive income or if it is the final year of the investment. When passive losses exceed passive income, unused passive losses are carried forward to offset future passive income.
    a. Review your passive activities to determine if some can be grouped together. You may meet the material participation test for a group of activities even though you may not meet the material participation test for each individual activity. Certain tax elections must be made in order to group activities.
    b. Consider the real estate professional rules if you spend a significant amount of time in real estate related activities. A real estate professional is not subject to the passive activity rules.
    c. Converting a passive activity to a non-passive activity, i.e., one in which you materially participate, would reduce your net investment income tax.
    d. Rental Income Exclusion. If you rent out all, or a portion, of your principal residence or second home for less than 15 days, you don't have to report the income. But expenses directly associated with the rental won't be deductible.

5. *Miscellaneous Items:*
    a. Amortizing bond premiums. You can elect to amortize certain bond premiums creating a current year tax deduction. If amortizing is not elected, the premium is considered a basis adjustment that is factored into the gain or loss calculation on disposition.
    b. Consider accelerating or deferring income such as salaries or bonuses to take advantage of income tax brackets.
    c. Medical expenses are deductible only if they exceed 10% of your AGI. The threshold is 7.5% of AGI for any tax year beginning before January 1, 2017 for taxpayers who have attained age 65 before the close of such year. Consider bunching medical expenses into one year in order to reach these floors.
    d. You should review your income tax withholdings and estimated tax payments already made to determine if you have paid enough already to avoid the underpayment of estimated tax penalty. If not, request that your employer take out additional withholdings and/or make a fourth quarter estimated tax payment. Income tax withholdings are considered withheld pro rata throughout the year, so if there is a shortfall during one of the previous quarters, additional withholdings at this time can help avoid or minimize the underpayment of estimated tax penalty. When determining your estimated tax liability for 2014, remember to include the additional .9% Medicare tax as well as the 3.8% net investment income tax.

**Charitable Planning:**
Charitable contributions can provide personal satisfaction along with potentially large income tax deductions. Charitable contribution planning is also completely discretionary and can be timed to best meet your needs.

6. *Charitable contributions:* Contributions of cash to public charities can be deducted up to 50% of your AGI and contributions of appreciated property held for over one year can generally be deducted up to 30% of AGI. Contributions of qualified appreciated stock to a private foundation are subject to a 20% of AGI limitation.
    a. When contributing appreciated securities, consider using the cash you would have used to donate to purchase the identical positions, thereby creating a basis step-up in the positions.
    b. The built-in gain on appreciated securities held for more than one year does not have to be recognized for tax purposes when they are contributed to a charity. Consequently, the capital gains and net investment taxes that would have been realized if the securities were sold are avoided.
    c. Be sure to obtain proper documentation for any gifts in excess of $250.
    d. Pay special attention to the timing of your giving. Checks need to be mailed before year-end and stock is deemed to have been received when recorded by the recipient charity. Credit card contributions can be deducted on the date the charge is made on the card.

7. Individuals over age 70½ previously were permitted to make charitable gifts from an individual retirement account, including required minimum distributions (“RMD”), of up to $100,000 and not report the IRA distributions as taxable income. This provision has been periodically extended by Congress but, as of this writing, has not been extended for the 2014 tax year. Those rules are not expected to change if this provision is extended again. If you are interested in making a charitable gift and are over age 70½, you may wish to delay taking your RMD until it is clear whether or not the provision will be reinstated.

8. *Donor Advised Funds (DAF):* DAFs have become more popular recently. With a DAF, you would contribute assets to a sponsoring organization such as a mutual fund group or investment firm. You relinquish control of the assets, but can still direct the investments and advise the sponsoring organization with respect to what charities receive the assets in the DAF. While donors do not have the legal right to insist that their donated funds be used in a particular manner, most sponsoring organizations oblige the donor's wishes. Donors may take a tax deduction in the year the contribution is made but the DAF may release the funds over time.

9. *Charitable Remainder Trusts:* The charitable remainder trust (CRT) is a popular vehicle for deferred giving, one that offers various structures to match the needs of donors. The transfer is accomplished by creating a trust that pays income to individuals during the trust's existence. After the income term expires, the property remaining in the trust goes to charity. The year the CRT is funded, the donor is entitled to a charitable deduction equal to the present value of the remainder interest given to the charity.

10. *Charitable Lead Trusts*: The charitable lead trust (CLT) is another popular vehicle for charitable giving, especially in today's low interest rate environment. It is similar to a CRT except that the charity receives the income interest and your beneficiaries receive the remainder interest. Depending on how the CLT is structured, you may be entitled to a deduction in the year of the CLT's creation equal to the present value of the income stream.

**Business Planning:**
Businesses seeking to maximize tax benefits through 2014 year-end tax planning may want to consider two general strategies: (1) Use of traditional timing techniques for income and deductions, such as income deferral and deduction acceleration, for cash method taxpayers and (2) Special consideration of significant tax incentives that expired at the end of 2013, but may be extended through 2014. These include the IRS Section 179 deduction (for 2014 and beyond, the limit plummeted to $25,000), research tax credits and bonus depreciation.

11. For tax years after 2013, bonus depreciation has officially expired (except for certain non-commercial aircraft and longer production period property which may be eligible for 50% bonus depreciation through 2014). Although the possibility of retroactive reinstatement of the bonus depreciation election should be factored into a year-end strategy, a final decision on making it is not required until a return is filed. Further, bonus depreciation is not mandatory. Consider electing out to spread depreciation deductions more evenly over future periods.

12. The research tax credit may be retroactively revived by Congress. The research credit may be claimed for increases in business-related qualified research expenditures and for increases in payments to universities and other qualified organizations for basic research.

13. IRC Section 199 allows taxpayers to deduct an amount equal to the lesser of a phased-in percentage of taxable income (AGI for individuals) or qualified production activities income. Historically, this has been underutilized. Taxpayers should look to take advantage of the deduction as their particular tax situation applies.

14. Final regulations for treating costs related to tangible property may provide for significant tax planning opportunities. Acquisitions of certain items of property under $5,000 can be deducted under a de minimis safe-harbor provision, if the taxpayer issues audited financial statements. If not, the limit is $500. Taxpayers must have a written policy in place to qualify.

**Estate and Gift Tax Planning**

There is, at last, some semblance of permanency with respect to transfer taxes. The estate, gift and generation skipping transfer tax rates are now set at 40%. The applicable exemptions are now fixed, although annually indexed for inflation. However, keep in mind, this area is a sensitive political one and can change at any time. Consider the following options as we close out the year.

15. *Maximize annual exclusion gifts*: Each person may make total annual gifts that are free of gift tax of up to $14,000 ($28,000 for a married couple) to an unlimited number of donees. To qualify for the "annual exclusion," the gift must be a present interest – meaning that the donee must have immediate right and access to the gifted property. An annual exclusion gift also does not reduce one's lifetime exemption. This could make for a very nice holiday gift.
    a. Special attention should be made if annual exclusion gifts are made to life insurance trusts in order to pay for premiums. Such gifts should be documented and trustees should ensure that the trust beneficiaries receive notice of withdrawal rights, also known as Crummy letters.

16. *Utilization of lifetime exemption:* Each person can gift a total amount up to their lifetime exemption ($5,340,000 in 2014) without incurring gift tax. You may want to utilize a portion or all of your gift tax exemption to make substantial lifetime gifts. Gifts that utilize the gift tax exemption can remove the value of the gifted asset, plus any future appreciation from your taxable estate.

17. *Front loading Section 529 plans:* A section 529 plan is a plan established to put aside funds for college. A transfer to a section 529 plan is considered a gift and qualifies for the annual exclusion discussed above. Five years' worth of gifts can be made at one time, thereby allowing a married couple to gift up to $140,000 to a 529 plan without generating any tax or using any exemption amounts. If this is done, the gift is treated as being made over five years. For instance, if you gave $70,000 to a section 529 plan before the end of 2014, you would be deemed to have given a $14,000 annual exclusion gift this year and the next four years.

18. *Grantor retained annuity trusts (GRATs)*: GRATs can be used to transfer future appreciation of an asset to beneficiaries. These trusts generally work best with assets that are likely to appreciate quickly and during a time (such as now) when interest rates are low. There have been various proposals that would potentially limit the benefit of GRATs, so if you are considering a GRAT, it would be prudent to implement it before any changes are enacted.

19. *Portability:* Portability allows the surviving spouse to use the deceased spouse's unused lifetime gift and estate tax exemption ("DSUE") amount during the surviving spouse's lifetime or have the amount applied upon death. Therefore, if one spouse dies with an estate tax exemption amount remaining, the surviving spouse's remaining exemption will be increased by the deceased spouse's unused amount. Portability gives individuals another opportunity to maximize the use of both spouses' exemption amounts, especially if a lifetime plan has not been put in place or fully implemented. Portability does not apply to the GST tax exemption. Portability must be elected. If the election was missed, the Internal Revenue Service has granted an extension until December 31, 2014 to make the election in certain situations.

20. Other estate planning tools exist and can be discussed with your advisors, such as the use of Sales to Intentionally Defective Grantor Trusts, Qualified Personal Residence Trusts and the use of Family Limited Partnerships.

Careful and well executed tax planning requires special attention across a wide range of areas. Your planning should be analyzed in light of the current legislative environment and keeping your individual goals in mind.

To refine your approach, learn more about any of the strategies mentioned, or to discuss your individual circumstances, please contact your WeiserMazars tax professional for more information.

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