Year End Tax Planning Newsletter

From Linda K Dahlen, EA

SOME YEAR END IDEAS & CONSIDERATIONS

1. Donate non-cash charitable items, make a list, do photo or video inventory and get the donation made by 12-31-12. Donate money or stock to your church or charity in December. Donations over $250 must have a statement from the recipient organization at the time of the donation. IRS will not accept such statements created at a later date. Donate appreciated stock: you get the fair market value of the stock as a tax deduction, and you do not have to pay tax on the capital gains.
2. If you need more deductions for 2012 as opposed to 2013, pre-pay your real estate taxes before 12-31-12.
3. If you make estimated tax payments, make your 4th quarter tax estimate for STATE, which is due mid-January, NOW or before 12-31-12 so it is a tax deduction for 2012.
4. If you are subject to alternative minimum tax, #2 and #3 above may not help you since they get added back to income for ALT MIN tax purposes.
5. If you do gifting to children or others, the lifetime exclusion is over $5 million for 2012, but drops to $1 million for 2013. Rumor has it that Congress might up that, but those are the numbers for now. 2012 is the year to do gifting with the higher limit allowed.
6. Pay dividends from your corporation or pay bonuses from your business in 2012, in anticipation of the increased tax brackets starting in 2013.
7. Buy business assets in 2012 and place them into SERVICE in 2012. The Section 179 deduction is $139,000 for 2012, but drops to $25,000 for 2013 unless Congress decides to increase it.

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Various Reminders and Alerts

1. **1099 Forms –** Must be issued if you are required to file them. IRS is enforcing this now, with $50 penalty per 1099 if not issued. Generally, a 1099 must be issued for paid outs of $600 or more. Contrary to popular belief, if a person received less than $600, it's NOT tax free income and must still be reported, 1099 or no 1099. This is another IRS audit focus.
2. The **Earned Income Tax Credit** is on the IRS hit list for being rife with fraud. As such, IRS will now require the EIC Form 8867 to be sent with 2012 filed tax returns. If the Form is not sent, the EIC will be denied, and the tax preparer may be levied a $500 penalty. As far back as 1994, the GAO stats indicate that $358 million was erroneously claimed for the EIC, and of that, $183 million was intentional fraud. Current statistics are even more staggering. IRS is looking to tax professionals to watch dog this abuse.
3. **Refund Freezes –** IRS has announced that certain tax returns will have "refund freezes", and that refunds can be held back for up to one year. This includes refunds attributable to the adoption credit. IRS will pay 3% interest on the frozen refund.
4. New legislation **legalizing marijuana** in various states has residents of those states, and non-residents from other states, planning all manner of pot related businesses, from farming to "vapor rooms". The caveat here is that while a State may legalize pot, the Federal Government does not recognize the states' positions on this, medical marijuana or otherwise. IRS Sec. 280E disallows expenses from trafficking in a controlled substance, but the income *IS REPORTABLE*. That said, a recent court case recognized "cost of goods sold" as an expense, but disallowed the use of inventory used for personal purposes (California court case).
5. **Tax and Audit Stats –** For 2011, 133 million tax returns were efiled. 77% of ALL tax returns were efiled. 1.1% of all 1040 Individual Tax returns were audited. 1.5% of C-Corps and .4% of S-Corps were audited. Only 25% of audits were face to face. All others were by mail/phone. IRS intends to step up audits of closely held S-Corps.
6. **WHO DOES YOUR TAXES**? IRS law now says that anyone who prepares a tax return for pay must register with the IRS. It's about time, I say. EA's, CPA's and Attorneys do not have to register since they are already governed by IRS Circular 230. However, the new Registered Tax Return Preparer or RTRP credential, mandatory by the end of 2013, applies to an additional 345,000 non-credentialed tax preparers who must take a competency test with IRS and must now take continuing professional education to stay current with tax laws. Of the 345,000 non credentialed tax preparers, only 32,000 have passed the test (as of Nov. 2012). So, if you see tax preparers disappearing in 2012 and 2013, this might be why. IRS seeks to enhance the professionalism and knowledge of paid tax preparers with this program, in an effort to protect the tax paying public from unqualified or under qualified preparers.

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7. **MINNESOTA and Other States Audit Targets –** As states scurry to make ends meet with budget deficits, so audit focus items have been stepped up. Sales Tax audits are one, but it is the USE TAX that is of greater interest. Any business that buys consumables or assets on the internet is subject to USE TAX if tax was not charged on their purchase. Another focus is SNOWBIRDS and Residency Tests. Beware if you are claiming residency in a state that has no income tax filing, because Minnesota and other states are looking to prove you are a Minnesota resident. Other Minnesota audit focus items are employee business expenses on Form 2106, and finally, are the "Economic Reality" audits. Federal and States are looking at loss position tax returns that have disproportionate itemized deductions and spending with the question "How do you live on so little income?" They will look at everything from bank statements, to ebay and paypal records, to barter and determining possible cash income not reported.
8. **"Squealer Program" -** That is, the IRS offers rewards for tips that result in audits that result in tax capture. Example: A former UBS (United Bank of Switzerland) banker tipped off the IRS that UBS customers who were US Citizens had foreign bank accounts and were not paying tax on that foreign income. His IRS reward was $104 MILLION! On the down side, he served some jail time for his part in things. Long story short, the secret informant polices of the IRS allows taxpayers to anonymously report tax cheats, and get cash reward for it.
9. **Sobering Retirement Stats -** It is estimated that 40% of the baby boom generation has nothing but social security benefits planned for their retirement. Conspicuous Consumption has replaced saving for many Boomers. Right now, 1 out of 6 Americans receive social security benefits. More than 2/3 of retirees rely on Social Security for at least half their income. Almost 80% of Americans pay more SS tax than any other tax. A young taxpayer can expect to pay out about a $500,000 in their lifetime before they retire. Social Security issues have now become a tax audit HOT ISSUE.
10. **Debt Forgiveness for Home Foreclosure –** For a principal residence (main home), Debt Forgiveness is NOT TAX FREE starting in 2013 just because it's your main home. The only way your main home debt forgiveness is tax free starting is 2013, is insolvency. Insolvency is when what you owe in total before the home debt forgiveness is more than your total assets and then only the amount of debt exceeding total assets, is tax free.
11. **Taxmaageddon –** aka, The Cliff. What is it anyway? In a nutshell, there are many Bush administration provisions that expire for 2012 and 2013. We won't list all of them here, but here is part their impact if Congress finishes up on Dec. 20, 2012 and there are no changes:
    a. Expiring tax breaks will increase overall taxes $500 billion nationwide.
    b. The average household would see an increase of $3800 in taxes
    c. This could be the largest tax hike in history
    d. Tax rates: 10% bracket eliminated; 25% bracket goes to 28%; 33% bracket goes to36%; 35% bracket goes to 39.6%; Capital Gains rates to 10/20% from 0/15%.
    e. Qualified Dividends go to regular tax rates; Per child tax credit goes from $1000 down to $500; Dependent care tax benefits are cut back; EIC is cut back; AMT patch and credits are gone; Education Credits are reduced; Education savings accounts are reduced; Student Loan Interest deduction is shaved.

Those most impacted will be (a) High Income taxpayers, (b) Investors with capital gain property, (c) Lower income taxpayers with small children, (d) Businesses and Farms buying equipment, (e) Taxpayers facing foreclosure on a home, (f) Parents with small children and with children in college.

Tax Planning for 2012 with losses

1. Convert traditional deductible IRAs to Roth IRAs. The conversion is not subject to penalties, although it does create taxable income. If the taxpayer is sitting on a $30,000 loss, then at least $30,000 of conversions may take place without tax cost. The true tax adviser shines here because we have utilized deductible IRAs in good years, converted them at minimal tax cost in bad years, and made them tax-free upon withdrawal. There aren't many things that allow a deduction ***and*** tax-free income on withdrawal. Watch the trap, however, the conversion must be done by year end, so for 2012, it must be completed by December 31, 2012.
2. Current year asset purchases in loss years should be conservatively depreciated. During 2012 this means several things. First, use the longer ADS depreciation life on current year purchases. Second, capitalize smaller tools and implements, as well as major repairs that you would normally deduct through farm supplies so as to save deductions for future years. Third, elect not to take bonus depreciation on any current year purchases.
3. The sale of any assets taxed using the installment method should be avoided in loss years. The taxpayer may elect out of the installment treatment simply by reporting the full amount as a taxable sale. Future payments would then merely be taxable interest income and free principal payments. Watch out though, this election may only be made during the year of sale, not in future years.
4. Unused gain assets should be sold by year end to reduce the loss at minimal tax cost.
5. Minimize NOL's to save deductions for next year, particularly if self-employed, since NOL's do not apply against self-employment income. Consider whether to attach the NOL carryback waiver to the 2012 return to automatically carry losses to 2013.
6. Cash in US Savings Bonds that have been sitting around.

Tax Planning for 2012 Profit Years

1. Maximize Section 179 *after* taking full bonus depreciation-yes they can both be taken in the same year. Place new needed equipment in service by 12/31/2012.
2. Fully fund SEP or other retirement accounts for taxpayers, or IRAs, or both if income limits are met.
3. Make current year income deferral elections wherever possible for involuntary conversions and cost sharing payments.
4. Consider whether you would rather pay this year's tax rate or next year's rate in light of surtaxes, fiscal cliffs, phased-out deductions and AMT.
5. Carefully consider installment sale options and the effect on future surtaxes and tax rates

Long Term Tax Planning

1. Hire minor children and fund their Roth or traditional IRAs to utilize the money for future college costs, 1st home purchases, etc.
2. Hire spouse and establish medical reimbursement plan for spouse.
3. Establish HSA account in conjunction with tailored medical reimbursement plan.
4. Utilize cost segregation or similar analysis in asset purchases to allocate a portion of the purchase price to equipment, buildings, fences, wells and similar depreciable improvements.
5. Utilize separate entities for real estate and maximize tax benefits through this 4-part guideline:

a. Have the real estate separately, legally titled in a different entity which files its own tax return;

b. Utilize an attorney-drawn written lease;

c. Utilize commercial "triple-net" lease features which retain all expenses in the operating business and minimal expenses in the real estate entity to minimize Social Security tax and 2013 surtaxes;

d. Maximize rental rates by justifying fair market value amounts using an independent third party. Try www.loopnet.com , for example.

If you are getting this newsletter and you are NOT my tax client, please be sure to check with a tax professional before applying any of the advice in this newsletter. If you ARE my tax client and have questions, please contact me well before December 31st in order to have strategies count for this year. EVERY taxpayer has different circumstances and not all tax advice fits every taxpayer. Advice for your particular situation should be analyzed and prudently weighed for YOUR unique circumstances before taking any action that cannot be reversed. As always, please feel free to contact me if you have questions.

Feel free to share this tax newsletter with friends. Thank you.

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