Solutions for your future
Matheney Stees & Associates
professional corporation
CERTIFIED PUBLIC ACCOUNTANTS AND ADVISORS

Dear Client:

The election is over, so we now have a little bit less hazy view into the tax horizon. Our Christian position on taxes and the election is summed up pretty well in Romans 13:1, 5-7: *Every person is to be in subjection to the governing authorities. For there is no authority except from God, and those which exist are established by God. Therefore it is necessary to be in subjection, not only because of wrath, but also for conscience' sake. For because of this you also pay taxes, for rulers are servants of God, devoting themselves to this very thing. Render to all what is due them: tax to whom tax is due; custom to whom custom; fear to whom fear; honor to whom honor.*

Could our government spend our tax dollars more wisely? We would probably all agree that they could! However, we do have many things in our country that we rely on and should be grateful for—infrastructure, security, etc. Our tax dollars pay for these. We are willing to pay our fair share of taxes to have these benefits.

Here are some things that you may need to consider in making financial decisions before the end of the year.

Overall Assessment

Tax rates are going up. Now that the President has been re-elected, we cannot rule out a rate hike for 2013. If gridlock continues in Washington and no agreement is reached, the Bush tax cuts will be repealed and taxes will be higher ***for almost everyone***. There is a strong probability that some agreement will be reached; singles making over $200,000 and married couples over $250,000 will likely be in a higher bracket, but the continuing poor economy may allow these thresholds to be raised (possibly $400,000 and $500,000, respectively). For those in the higher income brackets, the President wants the top capital gains rate increased to 20% (from 15%).

Normally, the correct tax plan is to defer income into a future year and accelerate deductions into the current year. If your income is above the amounts mentioned above, you should weigh the opposite strategy.

The President's health care reform will be fully implemented over the next several years. This will significantly impact how health insurance is provided, as well as require additional taxes to cover the cost.

Known Tax Changes for 2013

3.8% Medicare tax on unearned income effective 1/1/13. Capital gains, dividends, interest, royalties, rental income and similar income for singles and married couples with adjusted gross income (AGI—essentially, the last line on page 1 of your Form 1040) over $200,000 and $250,000, respectively, will be subject to this tax. ***This is a significant change with a lot of ramifications for those affected by it. We will be sending a more detailed explanation of the effects of this change in December.***

Social security taxes going up next year. All employees and self-employed persons will face 2% higher social security taxes next year due to an expiring tax break. Higher earners may also face increased tax because the Social Security wage base is increasing to $113,700 from $110,100 and a 0.9% higher Medicare tax applies to higher earners.

Higher threshold on medical expense itemized deductions. Through 2012, individuals were allowed to deduct medical expenses that exceeded 7.5% of their adjusted gross income. In 2013, the threshold jumps to 10% of AGI, unless one of the filers is age 65 or older.

Depreciation deductions for businesses. The 50% bonus depreciation deduction expires on December 31, 2012. The higher expensing limits for purchasing machinery or equipment are reduced from $139,000 in 2012 to $25,000 beginning in 2013. There is also an $8,000 bonus depreciation deduction for new vehicles that expires at the end of 2012. Unless Congress changes these, there is a real incentive for businesses to accelerate purchases into 2012, if possible.

Mileage rates. The business mileage deduction will increase from 55½¢ to 56½¢ per mile on 1/1/13. The medical and moving mileage rate also increases from 23¢ to 24¢ per mile, but the charitable rate remains at 14¢ per mile.

Possible Tax Changes for 2013

Limit itemized deductions for higher income earners. In 2009, a limitation lapsed; it limited the deductions for charitable contributions, mortgage interest, taxes and investment expenses by up to 3%. The President is interested in reinstating this. He has also mentioned limiting the tax value of these deductions to 28%.

Work Opportunity Tax Credit. Under current law, this tax credit (ranging from $2,400 to $9,600) for hiring veterans will expire at the end of 2012. There have been indications that Congress will extend this credit in some form.

Estate tax. Unless Congress acts, the estate tax limit and rate will change from $5.12 million and 35% to $1 million and 55%, respectively. There are indications that Congress will pass legislation that keeps the limit and rate at the 2012 amounts and that the portability of exemptions between spouses will also be retained.

Possible Tax Changes for 2012 Returns

Expired tax deductions for individuals. A number of these expired at the end of 2011, including the state and local sales tax deductions (for taxpayers in states with no income tax, such as Tennessee), classroom expense deduction for teachers, the mortgage insurance premium deduction, and the tuition and related fees deduction for higher education expenses. There is some indication that these deductions may be allowed in 2012, but legislation will need to be enacted.

Millions may be hit by alternative minimum tax (AMT). The AMT is designed to ensure that taxpayers don't take advantage of too many tax breaks—deductions, credits, exclusions, etc.—to pay too little tax. For 2012, perhaps 28 million more taxpayers may face AMT because AMT exemption amounts have dropped significantly and fewer credits may be used to offset AMT. The "patch" to fix this expired in 2011. Currently, the IRS has left its processing systems with the "patch" in place, so they are expecting a fix from Congress. Congress may step in as it has in the past to rectify this problem but it is hard to accurately predict if and when that may happen—and time is running out.

2012 Year-End Tax Planning Considerations

The following considerations apply primarily to higher income individuals affected by the increasing tax rates.

- *Selling assets in 2012 may be beneficial.* For those in the higher income brackets, the President wants the top capital gains rate increased to 20% (from 15%). Selling qualifying stock or real estate at a gain now would lock in the 15% rate (even if you immediately repurchase the same investment).
- *Use Roth IRA's instead of traditional IRA's.* The 3.8% surtax makes Roth IRA's a more attractive alternative since the qualified distributions are tax-free and won't be included in AGI.
- *Roth IRA conversions may be attractive.* If you fall in the high income ranges mentioned at the beginning of this letter or have a lot of unearned income, you may want to look at doing a conversion in 2012 to shield the unearned income from the 3.8% surtax, as well as minimize the effect of potentially higher tax brackets in future years. You need to approach the conversion with care because it will increase your AGI for 2012, possibly exposing you to a higher tax bracket in 2012. An added benefit of a Roth conversion is that it can be reconverted ("undone") until October 15, 2013, so if adverse tax law changes don't materialize, you can reinstate your former position.
- *Required minimum distributions from IRA's and employer plans.* If you turn 70½ in 2012, you are allowed to postpone your initial distribution until April 1, 2013, but must also take your second distribution in 2013; depending on your income level, you may want to take the first distribution in 2012 to avoid the higher tax rates and exposure to the 3.8% surtax.
- *Bonuses and stock options.* Employees who have a choice on these may want to receive their bonuses this year and also consider exercising stock options that are set to expire.
- *Deductible expenses.* Delay any possible deductions until next year, even if Congress revives the 3% cutback in itemized deductions. Instead of paying your property taxes in 2012, wait until 2013; don't make your first 2013 mortgage payment early or pay 2012 state or local income taxes before 2013; and make any charitable contributions from year-end bonuses after 2012.

- *Gift planning.* Taxpayers have until 12/31/12 to take advantage of the very beneficial gift tax rates. Through this date, a person may be able to gift a total of $5.12 million to individuals without having to pay any federal gift tax (a gift tax return is required to be filed, however). Most states, including Tennessee and Georgia, have no gift tax filing requirements, so no state gift taxes will be owed on these gifts, either. The maximum federal gift limit may be limited to $1 million beginning in 2013, but there are indications that the higher exemption may be extended. In 2012, if you give more than $13,000 to any individual, you will generally be required to file a federal gift tax return, but probably won't have any gift tax consequences. This amount increases to $14,000 annually in 2013.
- *Mutual funds.* If a fund pays a dividend late in the year, be careful about when you purchase the fund. If it pays the dividend after you purchase it, you owe tax on the dividend, but the fund's share price will fall by the amount of the dividend, so, in effect, you are prepaying your tax to the IRS. To avoid this trap, buy the shares after the dividend's record date.

Should you like more detail regarding any of these items or have **any** tax questions, please feel free to contact the tax professionals in our office for assistance. We look forward to hearing from you.

Very truly yours,

Matheney Stees & Associates, PC