2013 Year-End Tax Planning

Not So Black and White

BMO PRIVATE BANK www.bmoprivatebank.com

By Dave Bensema, CPA, CFP®, BMO Private Bank

As 2013 year-end tax planning begins, we noticeably are dealing with an increasingly complex tax code. As such, what once may have been considered clear-cut, strategically sound advice appears far less black and white than in previous years.

A common question at this time of year is "How can I reduce my income taxes?" There is one definite answer — "Make less money." However, since most people do not prefer this alternative, it is important to consider current year perspective and potential long-term (3–5 year) consequences—perhaps now more than ever before.

Current Tax Code Complexities

One set of rules for general income taxes, often referred to as "ordinary income."

A different set of rules for capital gains and qualified dividends.

Another set of rules for the Alternative Minimum Tax (AMT).

And new for 2013:

Net Investment Income Tax (NIIT) of 3.8% on investment earnings, based on Adjusted Gross Income (AGI).

Additional Medicare Tax of 0.9% on earned income—wages or self employment—if wage income exceeds $200,000 single or $250,000 for a joint filer.

Interwoven through these tax laws are several "phase-outs"—limitations on tax deductions or benefits based on where income falls. These phase-outs are contingent on one of the following: Adjusted Gross Income (AGI), Modified Adjusted Gross Income (MAGI), or Alternative Minimum Taxable Income (AMTI).

The purpose of this article is to help sift through the current tax code clutter and to encourage a comprehensive review with your wealth and tax advisors to determine a viable year-end strategy.

Net Investment Income Tax—New for 2013

The Net Investment Income Tax (NIIT) adds a 3.8% tax on investment income if your Adjusted Gross Income (AGI) exceeds $200,000 for a single taxpayer or $250,000 for a couple filing jointly. One way to determine if you might be subject to this tax is to look at last year's income tax return and have a general idea if this year's income would be significantly different. The AGI is found at the bottom of the first page of your tax return—line 37. If this line is above $200,000/$250,000, then this new tax could affect you. The tax is on NET investment income. The income subject to this tax would include interest and dividends (lines 8 and 9), distributions from non-qualified annuities, income from rental real estate, S-Corporations or partnerships (line 17, unless an active business interest), and net capital gain from the sale of investments (lines 13 and 14).

Deductions that could reduce or help eliminate Net Investment Income Tax include investment interest (Schedule A, line 14), state income taxes on investment income, and investment management fees (Schedule A, line 23). In addition, business owners might use a home equity loan to help fund a business investment. This could be classified as either home equity interest or investment

> "A common question at this time of year is 'How can I reduce my income taxes?'"

interest. The investment interest classification has two main advantages. First, it reduces the amount subject to the Net Investment Income Tax, and second, the investment interest deduction is not subject to a phase-out of itemized deductions. ***Note:** Investment interest is only deductible to the extent of investment income.*

One misconception regarding Net Investment Income Tax is that all home sales would be subject to this new tax. For a primary residence, a taxpayer can exclude $250,000 of gain from the sale of a home ($500,000 on a joint return) if the home was used as a primary residence for 2 of the last 5 years. Only the gain in excess of this exclusion would be subject to the new 3.8% tax.

Return of Deduction Phase-Outs

Returning for 2013 is a reduction of itemized deductions and personal exemptions if income exceeds certain levels — $250,000 for single taxpayers and $300,000 for couples filing jointly. If income exceeds these levels, deductions are reduced by 3% of the amount by which AGI exceeds threshold. Now, before you run to pay off your mortgage in the belief that your deduction will no longer have meaning, look at the following example of a couple filing jointly with combined income of $350,000.

Phase-Out Example

Where AGI = $350,000 • Threshold = $300,000 • Excess = $50,000

Itemized Deductions	No Mortgage	With Mortgage
State Income Taxes	$17,500	$17,500
Property Taxes	20,000	20,000
Charity	10,000	10,000
Mortgage		20,000
Total Deduction	**$47,500**	**$67,500**
Reduction (3% of Excess)	(1,500)	(1,500)
Net Deductions	**$46,000**	**$66,000**

Note that the full benefit of the deduction still reduces taxable income in this example.

Accelerate or Defer Income

With ever-changing tax laws, it is increasingly important to consider opportunities for acceleration or deferral of income. As always, much depends not only on this year's income — but where income may be in future years. If one expects to always be in the top income tax bracket, deferring income to defer tax liability may make sense.

Income deferral opportunities are very limited. Following are the most common:

- *Full funding of Employer Retirement Accounts (401k, SEP IRA, SIMPLE IRAs, 403b)*
- *Additional funding of IRAs. Income from investment of funds is deferred and not subject to the Net Investment Income Tax. (Roth IRAs may be an option and provide tax flexibility in retirement.)*
- *Slowed collection of business receivables around year-end (for cash basis taxpayers).*

Income acceleration can also make sense in several instances. For example, if you have a highly variable income due to business cycles, accelerating income during lower tax years can be extremely beneficial. Also, if you are not currently subject to the Net Investment Income Tax but may be in future years, acceleration can lower overall taxes. Finally, retirees, particularly between the start of their retirement and age 70½ when required distributions begin, should look at their changing taxable income to determine if acceleration (or deferral) is warranted.

Options for accelerating income include:

Harvesting Long Term Capital Gains. Capital gains taxes can vary as follows:

- *No capital gains tax in the 10% or 15% tax bracket*
- *15% capital gains tax for someone with taxable income below $400,000 ($450,000 for a joint filer);*
- *20% capital gains tax if taxable income exceeds $400,000/$450,000*
- *In addition, gains could be subject to the 3.8% net investment income tax.*

In other words, total taxable income (excluding the lowest tax brackets) could mean the difference between capital gains taxes of 15% and 23.8% — a significant variance.

> "As always, much depends not only on this year's income—but where income may be in future years. If one expects to always be in the top income tax bracket, deferring income to defer tax liability may make sense."

Exercising Non-Qualified Stock Options. Non-Qualified stock options are reported as wages. Acceleration may make sense if your income is below $200,000 and could be higher in future years.

Accelerating Bonuses. Payment of a bonus prior to December 31 instead of early 2014 may be useful if income is expected to be higher the following year.

Converting to Roth IRA. Move funds from a traditional IRA to a Roth IRA in low income years to avoid taxes in the future when income may be higher. As an example, for some between the age of 60 and 70, with the right plan in place there is potential to convert funds from IRAs to Roth IRAs annually with almost no taxes due to itemized deductions.

Please note: *If next year you find your income estimates were off and pushed your taxable income too high, you can undo the conversion until you file your income tax return—potentially until October 15th with extensions.*

Regarding acceleration of income, it is important to note that taxable income above the $200,000/$250,000 threshold could trigger the additional 3.8% Net Investment Income Tax or 0.9% Medicare tax.

Accelerate or Defer Deductions

Another year-end tax planning option is the acceleration or deferral of tax deductions. It is important to note that charitable contributions, state income taxes and mortgage payments are the most common tax deductions to be scrutinized for timing implications. As with income movement, recommended timing of deductions for tax purposes is based largely on current versus projected future income.

Charitable Contributions. In most instances, contributions are deductible in the year paid to the charity. Payments made in December vs. January can impact your income tax bill. Scenarios to consider:

- *You have a large taxable income in 2013 and want to lessen the tax burden. Further, you are in the habit of making charitable contributions of $10,000 per year. In this example, you could place $100,000 into a Donor Advised Fund which acts similar to a charitable foundation. You would obtain the income tax deduction for the current year and be in control of future grants and timing thereof from the Donor Advised Fund to your charities of choice.*

> For more information about opening a Donor Advised Fund under the BMO Charitable Fund Program, please visit www.bmo.com/charitablefund.

- *Taxpayers over age 70 can elect to distribute up to $100,000 from an IRA directly to a charity. This distribution has many benefits. It can count towards the required minimum distribution and would not be included in income or shown as a deduction. By not showing the income, this lowers the reported AGI, thereby reducing phased out deduction amounts as well as exposure to the Net Investment Income Tax.* ***Note:*** *This provision expires on 12/31/2013 and may or may not be extended to 2014.*

State Income Taxes. Consider paying your January installment of state income taxes prior to December 31st. However, if you are subject to the AMT (see line 45 of your income tax return), this will negate any benefit of accelerating the income tax payment.

Mortgage Payments. Paying your January mortgage payment prior to December 31 will shift the interest deduction between tax years—but will leave less of a deduction for next year.

Conclusion

The growing complexity of our tax system makes generalized recommendations difficult. Effective year-end tax planning in 2013 requires a thorough understanding of current tax law and a detailed review of present and future income and tax realities and expectations. Weighing the short- and long-term consequences of any decision is paramount, so please consult with your tax advisor and other professionals to develop a plan that is right for you.

Feel Confident About Your Future

BMO Private Bank — its professionals, its disciplined approach, its comprehensive and innovative advisory platform — can provide financial peace of mind.

For greater confidence in your future, call your BMO Private Bank Advisor today.

www.bmoprivatebank.com

Dave Bensema is a Senior Financial Planner with BMO Private Bank. He specializes in providing customized financial planning solutions to individuals and families as part of an overall wealth management strategy. He joined BMO in 1991 and has over 20 years of experience in the financial services industry.

Dave earned a bachelor's degree in Accountancy from Northern Illinois University and an MBA in Finance from Kellstadt Graduate School of Business at DePaul University. He is a Certified Public Accountant (CPA) and a CERTIFIED FINANCIAL PLANNER™ professional.

United States Department of Treasury Regulation Circular 230 requires that we notify you that this information is not intended to be tax or legal advice. This information cannot be used by any taxpayer for the purpose of avoiding tax penalties that may be imposed on the taxpayer. This information is being used to support the promotion or marketing of the planning strategies discussed herein. BMO Harris Bank and its affiliates do not provide legal or tax advice to clients. You should review your particular circumstances with your independent legal and tax advisors.

BMO Private Bank is a brand name used in the United States by BMO Harris Bank N.A. Member FDIC. Not all products and services are available in every state and/or location.
Certified Financial Planner Board of Standards Inc. owns the certification marks CFP®, CERTIFIED FINANCIAL PLANNER™ and CFP® in the U.S.