REINHARD
KOPKO
KELLER &
MCDONNELL, INC.

OUR MISSION: YOUR SUCCESS

November 30, 2012

To our Clients and Friends,

Each year we write a letter to explain changes in tax law that may affect you. This was a complicated task this year as so much has changed and much more is about to change. Certain provisions of the Patient Protection and Affordable Care Act of 2010 (PPACA) and the Health Care and Education Reconciliation Act of 2010 (HCERA) become effective in 2012 and 2013. In addition, a host of reduced tax rates, credits, deductions and other incentives (collectively called the "Bush-era" tax cuts) are scheduled to expire after December 31, 2012. Finally, to further complicate planning, over 50 tax extenders are up for renewal, either having expired at the end of 2011 or being scheduled to expire after 2012. At the same time, the federal government will be under sequestration, which imposes across-the-board spending cuts after 2012. The combination of expiring tax cuts and automatic federal spending reductions is what is being referred to as the so-called "fiscal cliff". The following is a summary of highlights from the major tax provisions we feel will affect a majority of our clients.

On June 28, 2012, the Supreme Court upheld the constitutionality of the PPACA and the HCERA. The following is a highlight of the major tax provisions of the PPACA and HCERA that become effective in 2012 or 2013:

- Medical deduction threshold: The threshold to claim an itemized deduction for unreimbursed medical expenses increases from 7.5 percent of adjusted gross income (AGI) in 2012 to 10 percent of AGI in 2013.
  - Individuals age 65 and older before the close of the tax year are exempt from the increased threshold; the 7.5 percent threshold continues to apply until after 2016.

- Additional Medicare tax: For 2013, an additional 0.9 percent Medicare tax is imposed on wages and self-employment income of individuals with applicable income in excess of $200,000 ($250,000 for married couples filing a joint return and $125,000 for married couples filing separate returns).

- 3.8% Medicare contribution tax on investment income (surtax): For 2013, the surtax is imposed on the lesser of an individual's net investment income for the tax year or modified adjusted gross income in excess of $200,000 ($250,000 for married couples filing a joint return and $125,000 for married couples filing separate returns). Net investment income includes interest, dividends, annuities, royalties, certain rents, certain other passive business income, as well as certain capital gains.
  - Home sales - A taxable capital gain may arise from the sale of a taxpayer's personal residence. Current tax law allows a taxpayer to exclude up to $250,000 ($500,000 for married couples) of a gain resulting from the sale of one's residence if certain conditions are met. Only a capital gain on a home sale that exceeds these exclusions is includible in net investment income.

- Small employer health insurance tax credit: Employers with 25 full-time equivalent employees (FTEs), average annual wages of its employees for the year of less than $50,000 per FTE and a qualifying arrangement are eligible for a maximum credit of 35 percent of the health insurance premiums paid for tax years 2010 through 2013 (50 percent after 2013) by the small business. Beginning in 2013, employers must participate in an insurance exchange in order to claim the credit.

- Health FSAs offered in cafeteria plans: For 2013, salary reduction contributions to health flexible spending arrangements (health FSAs) are limited to $2,500 and will be adjusted annually for inflation. The 2012 contribution limit was $5,000. The limit does not apply to employer non-elective contributions.

- Individual mandate: The individual mandate is scheduled to be effective beginning in calendar year 2014. As this mandate is not yet effective, business owners and individuals need to be aware of the mandate so they are in compliance come January 1, 2014.

There are various other provisions of the health care acts that have not been listed above because they have not yet been incorporated into current regulations. As 2013 continues and regulations are updated we will issue e-mail alerts and/or client letters to keep you informed. If you have not yet been added to our e-mail list, please contact our office or send an email to cpa@rkkm.com.

With the uncertainty of the outcome of the November elections behind us, we are now faced with the uncertainty of how the President and Congress will come together to develop a tax plan to avoid the "fiscal cliff". Currently, the Bush-era tax cuts are set to expire December 31, 2012 causing increases in income tax rates as well as increases in capital gains rates and dividend rates and decreases in, or the expiration of, popular tax benefits.

Barring Congressional action, individuals should expect the following changes for 2013:

- <u>Income tax rates</u>: Individuals may find themselves in higher tax brackets than they have been in the past. Unless extended, the 2012 lower rates of 10, 15, 28, 33 and 35 percent will be replaced by the higher pre-Bush rates of 15, 28, 31, 36 and 39.6 percent in 2013.
- <u>Capital gains rates</u>: The 2012 rates of zero percent for taxpayers in the 10 and 15 percent brackets and 15 percent for all other taxpayers will be replaced by the higher pre-2003 rates of 10 percent for taxpayers in the 15 percent bracket and a maximum 20 percent rage for all others for 2013.
- <u>Dividend rates</u>: The lower dividend rates will be eliminated causing dividends to be taxed at a taxpayer's ordinary income tax rate for 2013.
- <u>Additional 0.9% Medicare tax</u>: For 2013, wages and self-employment income in excess of $200,000 ($250,000 for married couples filing a joint return and $125,000 for married couples filing separate returns) will be subject to an additional 0.9 percent Medicare tax for a total Medicare tax rate of 2.35 percent. This should not be confused with the 3.8 percent Medicare surtax described earlier.
- <u>End of the payroll tax holiday</u>: For 2011 and 2012, employees benefited from a reduced employee-share OASDI rate of 4.2 percent from the previous 6.2 percent rate showing an increase in take-home pay. For 2013, the employee-share of OASDI taxes will revert back to 6.2 percent.
- <u>Personal exemption/itemized deduction phase-outs</u>: Higher income taxpayers may be subject to the return of personal exemption phase-out and the so-called Pease limitation on itemized deductions for 2013.
- <u>Education credits</u>: The enhanced American Opportunity Tax Credit (AOTC) allowing a credit of up to $2,500 for the first four years of post-secondary education will be eliminated in 2013 and will revert back to the less generous Hope Scholarship Credit which allows a credit of up to $1,500.
  - Eligible taxpayers may want to consider paying 2013 education expenses during 2012 to take advantage of the AOTC as the credit applies to amounts paid during a tax year, not amounts billed.
- <u>Coverdell Education Savings Accounts (ESA)</u>: For 2012, the maximum annual contribution to a Coverdell ESA is $2,000. This amount is scheduled to decrease to $500 for 2013.
- <u>Student loan interest deduction</u>: For 2012, the maximum deduction for taxpayers with modified adjusted gross income (MAGI) below $75,000 ($150,000 for married couples filing a joint return) is $2,500. For 2013, the income threshold is scheduled to be $55,000 ($75,000 for married couples filing a joint return). Also for 2013, qualified interest must be paid during the first 60 months that interest payments are required in order to be deductible.
- <u>Child Tax Credit</u>: For 2012, the child tax credit is $1,000 per eligible child. The credit will be reduced to $500 per eligible child for 2013.
- <u>Exclusion of discharge of indebtedness income</u>: Discharge of indebtedness income is excluded from gross income if the discharged debt is qualified principal residence indebtedness that is discharged any time during the 2007, 2008, 2009, 2010, 2011 and 2012 tax years.

While a divided Congress may act to prevent some or all of the following, individual taxpayers should note the long-running benefits that expired December 31, 2011 that could impact your 2012 income tax returns:

- <u>Alternative Minimum Tax (AMT)</u>: For 2012, more taxpayers will find themselves subject to the Alternative Minimum Tax (AMT) rules that the Bush-era tax cuts were keeping many taxpayers from being subject to. AMT rates of 26 and 28 percent on the excess of alternative minimum taxable income over the applicable exemption amount will be in effect. For 2012, the applicable exemption amount is scheduled to be $33,750 ($45,000 for married couples filing a joint return).

- Teacher's classroom expense deduction: For 2012 and beyond, the $250 above-the-line deduction for qualified unreimbursed educator expenses is not available.
- State and local sales tax deduction: For 2012 and beyond, the option to deduct state and local general sales taxes in lieu of deducting state and local income taxes is not available.
- Charitable distributions from IRAs: For 2012 and beyond, the incentive for individuals age 70½ and older to exclude from gross income up to $100,000 of qualified charitable distributions from individual retirement accounts (IRAs) is not available. A taxpayer may still make a gift from their IRA to a charity in 2012 and beyond, however, the distribution will not be excluded from income. The taxpayer would then claim an itemized deduction for the charitable contribution.
- Mortgage insurance premiums: For 2012 and beyond, the ability to treat premiums paid for qualified mortgage insurance as qualified residence interest and deduct as an itemized deduction is not available.
- Residential energy property credit: For 2012 and beyond, the residential energy property credit available for certain improvements including qualified windows, skylights, doors, building insulation systems, certain roofing materials, central air conditioning systems and certain waters heaters is not available.
  - Residential energy efficient property credit - The credit available for qualified solar electric property, solar water heating property, fuel cell property, small wind energy property and qualified geothermal heat pump property installed at the taxpayer's principal residence continues to be available through 2016.

Year-end planning for businesses is also complicated by the number of expired or soon-to-expire tax incentives. Barring Congressional action, businesses should expect the following changes for 2012 and 2013:

- Bonus depreciation: For 2012, a special 50 percent first year bonus depreciation allowance is provided for qualified new property with recovery periods of 20 years or less. The allowance is not available for 2013.
- Code section 179 expensing: For 2012, the dollar limitation for section 179 expensing is $139,000 with a $560,000 investment ceiling. The limitation is scheduled to drop to $25,000 for 2013 with a $200,000 investment ceiling.
- Work Opportunity Tax Credit (WOTC): 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.
- Research tax credit: For 2012, the research tax credit is not available.

Typical tax planning strategies shift income into a future year and maximize deductions in the current year. With income tax rates set to increase in 2013, taxpayers may want to recognize income in 2012, when lower tax rates are available, or push deductions into 2013, when the higher rates will be in effect.

Here's a look at some rules determining when you can deduct certain items:

- Employer retirement plan deadlines: Generally, employer plans (including Keoghs) established by December 31 get a deduction for that year. For self-employed plans, you have until the due date for filing your return plus any extension. Thus, self-employed individuals who miss the Keogh setup deadline have more time to open SEP-IRAs. Contributions for 2012 are due April 15, 2013 (October 15, 2013 for extended returns).
- Keoghs and SEP limits: The same pay-in cap of 20% of net self-employment earnings (the net profit shown on your Schedule C, less one-half of your SECA tax liability) applies for 2012.
- Individual retirement accounts: Regular IRAs must be established by April 15, 2013 for 2012 deductions with pay-ins being due by then as well. A filing extension will not buy you additional time. The same applies to Roth IRAs and Coverdell education savings accounts.
- Gift tax rules: If you are making a gift by check, be sure the donee deposits it in 2012 if you want the money to count as a 2012 gift for gift tax purposes. Alternatively, deliver a certified check to the recipient this year. That will count as a 2012 gift, even if the donee does not deposit the check into his or her account until next year. If you are giving securities, endorse them over to the donee and deliver them by year-end if you want the gift to count for 2012. On a gift made late in the year, companies may not be able to re-title the certificates in the donee's name by December 31. The annual exclusion for gifts increases to $14,000 for 2013, up from $13,000 in 2012.

- Charitable contributions: Mailing checks for deductible items before year-end constitutes a 2012 write-off. If you plan to defer deductions, make sure you wait until after the first of the year to mail your checks because you claim the deduction in the year a check is mailed, even if it does not clear your bank until January. For charges that you make with a credit card, you claim the deduction for the item only in the tax year in which you pay the credit card bill. For transactions made with a bank debit card, you take the deduction in the tax year the goods are purchased using the debit card.

In addition, a few items which affect our clients for the 2013 tax year are:

- The optional mileage allowance for owned or leased autos will be 56.5 cents per mile for business travel in 2013 (up from 55.5 cents per mile in 2012).
- The wage base for federal unemployment remains at $7,000 and the wage base for Ohio unemployment remains at $9,000
- The maximum salary or wage deferral in a 401(k) plan increases $17,500 for calendar year 2013 (up from $17,000 in 2012) plus a $5,500 catch up contribution for those ages 50 or older.
- For a SIMPLE IRA, the maximum deferral for 2013 increases to $12,000 (up from $11,500 in 2012) plus a $2,500 catch up contribution for those ages 50 or older.
- The maximum contribution limit for Individual Retirement Accounts, including ROTH accounts increase to $5,500 for 2013 (up from $5,000 in 2012) plus a $1,000 catch up contribution for those over the age of 50.
- Social Security earners who turn age 66 in 2013 (full retirement age for those born 1943-1954) can earn up to $40,080 in 2013 prior to turning age 66 without losing any benefits. Social Security recipients who have not reached age 66 by the end of 2013 can earn up to $15,120 before they will lose any benefits. Once an individual turns 66, there is no earnings limit.
- As of the date of this letter, the following 2013 amounts were not yet available:
    - Personal and dependent exemption amounts
    - Standard deduction amounts
    - Maximum earned income tax credit (EITC)
    - Modified adjusted gross income threshold at which the lifetime learning credit begins to phase out

  As the above information is released by the IRS, we will issue email alerts and post the information to our website in an effort to keep you informed. Our website can be found at www.rkkm.com.

As we cannot predict what provisions Congress will uphold, eliminate or extend, we have prepared this letter to discuss the law as it currently stands. We have discussed some of the most important recent changes in tax law & hope this information is helpful. With so many recent/potential changes it is not possible to put everything into one letter. Today's uncertainty makes doing nothing or adopting a wait and see attitude very tempting. Multi-year tax planning, which takes into account a variety of possible scenarios and outcomes, can provide a win-win combination irrespective of what happens. If you would like more details about these provisions, please contact our office for more details on how we can customize a tax strategy for you in uncertain times.

Very truly yours,

Reinhard, Kopko, Keller & McDonnell

Reinhard·Kopko·Keller & McDonnell, Inc.