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2012 Year-End Considerations for Business

Last-minute anxiety

The future of gift & estate tax planning

3.8% Surtax on passive income

2013 Update

Sidebar: “Bush-era” tax Cuts

2013 Planning opportunities

Last-minute anxiety

It is the end of a turbulent year during which you have heard about fiscal cliffs and tax-hikes—but should you have done anything about it? To generalize:

1. *C-corps, pay dividends now*. Few of our clients operate as C-corps but you may spread the word to colleagues to strongly consider paying dividends before the end of the year. Even if Congress fixes the hike in dividend rates, the other component of the increase will be the new 3.8% surtax that applies to dividends (more below). Regardless of when the income was generated, a payment in 2013 is subject to the new surtax.

2. *Accelerate what receivables you can*. Taxpayers facing the present uncertainty understandably tend to paralysis, but while we do not know *exactly* what taxes and rates will constitute a change for you and your business in 2013, we do not expect rates to be lower next year. The elementary solution is to reduce taxable income in 2013 by receiving it in 2012. By the same token, businesses that would have used prepayment to reduce net income in 2012 might evaluate whether than deduction would go further in 2013.

3. *Did you start but not complete estate tax and retirement planning*? The historic estate/gift tax opportunities are fading, if we or your own accountants have been asking you about gifting and obtaining gift valuations, then whatever gifts you cannot complete this year will have to be undertaken in a much different form in the future. The deadline for 401(k) contributions is not a feature of any tax law change, but remember that, whereas contributions to your SEP or other IRAs may stretch into 2013, 401(k) contributions for 2012 must be through 2012 payroll (hint: bonuses work for this too).

4. *Get ready for payroll changes and increased estimated quarterly payments*. With the

ease of online processing, using a payroll service makes sense for even the smallest businesses. For example, although it was optional in 2011, employers must report employer-sponsored healthcare coverage on all employee W-2 forms starting in 2012. The reality of sunsetting tax cuts and new surtaxes means that there are big changes to payroll starting January 1, 2013 so be ready to make adjustments. Apart from payroll, business owners should be planning to watch their estimated payments. Because of anticipated tax increases, estimated payments should not risk falling short of the safe-harbor.

The future of gift & estate tax planning

2011 and 2012 represented historic opportunities for estate tax planning. But the country is now facing an abrupt shift in death taxes.

	2011–2012	**2013** if no modification
Highest rate for Estate Tax, Gift Tax, & GST	35%	**55%**
Lifetime Unified Exemption	$5.12M	**$1.0M**
Portability of unused exemption	Full	**None**
Gift Tax Annual Exclusion	$13K	**$13K+ (indexed)**
GST Tax Exemption	$5.12M	**$1.4 million (indexed)**

We have worked with many clients during this period to take advantage of these opportunities. Even though the lifetime gift exclusion will almost certainly decrease and death tax rates will almost certainly increase, the continuing unification of the gift and estate tax exclusion mean you may expect key strategies flowing from past reforms will remain available. Thus we will likely mention gift planning and leveraged transfers from time to time. While we do not know when we will again see rates as favorable as those expiring in 2012, the incoming regime should not be a source of despair.

3.8% Surtax on passive income

We have watched with anxiety as commentators and businesses alike approach 2013 in ignorance of the impact of the surtax on net investment income (NII). Along with the Medicare tax increase of 0.9%, the NII surtax is an integral part of funding the 2010 healthcare overhaul. Many business and employers waited to react until the Supreme Court determined the fate of the Patient Protection and Affordable care Act. The election process then cast further doubt on whether businesses should plan for the taxes so that now, with relatively little warning, the tax is now upon us.

This surtax is imposed on NII to the extent NII pushes the taxpayer over the applicable (un-indexed) threshold: $250,000 for joint returns, $125,000 for separately-filing married taxpayers, and $200,000 in other cases. Thus an unmarried U.S. citizen, with a modified adjusted gross income of $220,000 of which $50,000 is NII would pay 3.8 % tax on $20,000—an extra $760.

New reliance regulations published earlier this month clarify that, despite statutory language indicating the contrary, § 1031 deferred exchange income, installment sale gain, and § 121-excluded gain on the sale of primary residence are not subjected to the NII surtax.

For most individuals, the NII sources to be aware of will be interest earned on bank accounts, the dividends realized on stock investments paid through brokerage accounts, and passive activity income. The category of "passive" investments includes rental income, constructive dividends, royalties, and income from trade and business activities which are passive as to the taxpayer (such as K1 income from partnerships operated by others).

You may have evaluated your active participation status in the past and you now have an additional reason to seek to become active. You should be aware of that the IRS expects reevaluations in 2013 and is making concessions. The IRS reliance regulations announced that taxpayers will be allowed a fresh start in their Section 469 grouping. As we may have discussed with you, the IRS resists regrouping passive activities, but they have now announced that, in light of the new rate and the stricter rules, taxpayers may adjust to take advantage of a special regrouping opportunity in 2013.

2013 Update

Code Sec. 179 expensing. Code Sec. 179 gives businesses the option of claiming a deduction for the entire cost of qualified property in its first year of use rather than claiming depreciation over a period of years. For 2010 and 2011, the Code Sec. 179 dollar limitation was $500,000 with a $2 million investment ceiling. The dollar limitation for 2012 is $139,000 with a $560,000 investment ceiling. Under current law, the Code Sec. 179 dollar limit is scheduled to drop to $25,000 for 2013 with a $200,000 investment ceiling.

Businesses should consider accelerating purchases into 2012 to take advantage of the still generous Code Sec. 179 expensing. Qualified property must be tangible personal property, which you actively use in your business, and for which a depreciation deduction would be allowed. Qualified property must be newly purchased new or used property, rather than property you previously owned but recently converted to business use. Examples of types of property that would qualify for

Code Sec. 179 expensing are office equipment or equipment used in the manufacturing process. Additionally, Code Sec. 179 expensing is allowed for off-the-shelf computer software placed in service in tax years beginning before 2013.

If your equipment purchases for the year exceed the expensing dollar limit, you can decide to split your expensing election among the new assets any way you choose. If you have a choice, it may be more valuable to expense assets with the longest depreciation periods. As long as you start using your newly purchased business equipment before the end of the tax year, you get the entire expensing deduction for that year. The amount that can be expensed depends upon the date the qualified property is placed in service; not when the qualified property is purchased or paid for.

Congress could raise the Code Sec. 179 dollar limit and investment ceiling for 2013. In July 2012, the Senate voted to increase the Code Sec. 179 dollar amount to $250,000 with an $800,000 investment limitation for tax years beginning after December 31, 2012. The House voted to increase the Code Sec. 179 dollar amount to $100,000 with a $400,000 investment limitation for tax years beginning after December 31, 2012.

Bonus depreciation. The first-year 50 percent bonus depreciation deduction is scheduled to expire after 2012 (2013 in the case of certain longer-production period property and certain transportation property). Unlike the Section 179 expense deduction, the bonus depreciation deduction is not limited to smaller companies or capped at a certain dollar level. To be eligible for bonus depreciation, qualified property must be depreciable under Modified Accelerated Cost Recovery System (MACRS) and have a recovery period of 20 years or less. The property must be new and placed in service before January 1, 2013 (January 1, 2014 for certain longer-production period property and certain transportation property).

Businesses also need to keep in mind the relationship of bonus depreciation and the vehicle depreciation dollar limits. Code Sec. 280F(a) imposes dollar limitations on the depreciation deduction for the year a taxpayer places a passenger automobile in service within a business, and for each succeeding year. Code Sec.

168(k)(2)(F)(i) increases the first-year depreciation allowed for vehicles subject to the Code Sec. 280F luxury-vehicle limits, unless the taxpayer elects out, by $8,000, to which the additional first-year depreciation deduction applies. The maximum depreciation limits under Code Sec. 280F for passenger automobiles first placed in service by the taxpayer during the 2012 calendar year are: $11,160 for the first tax year ($3,160 if bonus depreciation is not taken); $5,100 for the second tax year; $3,050 for the third tax year; and $1,875 for each tax year thereafter. The maximum depreciation limits under Code Sec. 280F for trucks and vans first placed in service during the 2012 calendar year are $11,360 for the first tax year ($3,360 if bonus depreciation is not taken); $5,300 for the second tax year; $3,150 for the third tax year; and $1,875 for each tax year thereafter. Sport utility vehicles and pickup trucks with a gross vehicle weight rating in excess of 6,000 pounds are exempt from the luxury vehicle depreciation caps.

Dividends. Under current law, tax-favorable dividends tax rates are scheduled to expire after 2012. Qualified dividends currently are eligible for a maximum 15 percent tax rate for taxpayers in the 25 percent and higher brackets; zero percent for taxpayers in the 10 and 15 percent brackets. In July, the House voted to extend the current dividend tax

Sidebar: "Bush-era" tax Cuts

Apart from the abrupt estate tax changes, you will have heard of radical income tax changes due to the expiration of the "Bush-era" tax cuts—the collective term for the tax measures enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA). EGTRRA and JGTRRA made over 30 major changes to the Tax Code which are scheduled to sunset at the end of 2012. The major changes for business and investment in negotiated in the coming weeks as these expire are:

- Reduced maximum capital gains rate expires
- Lower capital gain tax rates for qualified five-year gain will be revived
- Exclusion of gain on sale of small business stock treated as AMT preference item will increase
- Taxation of qualified dividends at capital gain rates will no longer apply
- Credit for employer-provided child care facilities and services expire
- Accumulated earnings tax rate increases to 39.6 percent
- Personal holding company tax rate increases to 39.6 percent
- Repeal of collapsible corporation rules expires

treatment through 2013. The Senate, however, voted to extend the current tax favorable rates only for individuals with incomes below $200,000 (families with incomes below $250,000). For income in excess of $200,000/$250,000 the tax rate on qualified dividends would be 20 percent.

If Congress takes no action, qualified dividends will be taxed at the ordinary income tax rates after 2012 (with the highest rate scheduled to be 39.6 percent not taking into account the 3.8 percent Medicare contribution tax for higher income individuals). Qualified corporations may want to explore declaring a special dividend to shareholders before January 1, 2013

Expiring business tax incentives. Many temporary business tax incentives expired at the end of 2011. In past years, Congress has routinely extended these incentives, often retroactively, but this year may be different. Confronted with the federal budget deficit and across-the-board spending cuts scheduled to take effect in 2013, lawmakers allow some of the business tax extenders to expire permanently. Certain extenders, however, have bipartisan support, and are likely to be extended. They include the Code Sec. 41 research tax credit, the Work Opportunity Tax Credit (WOTC), and 15-year recovery period for leasehold, restaurant and retail improvement property.

Small employer health insurance credit. A potentially valuable tax incentive has often been overlooked by small businesses, according to reports. Employers with 10 or fewer full-time employees (FTEs) paying average annual wages of not more than $25,000 may be eligible for a maximum tax credit of 35 percent on health insurance premiums paid for tax years beginning in 2010 through 2013. Tax-exempt employers may be eligible for a maximum tax credit of 25 percent for tax years beginning in 2010 through 2013.

The Code Sec. 45R credit is subject to phase-out rules. The credit is reduced by 6.667 percent for each FTE in excess of 10 employees. The credit is also reduced by four percent for each $1,000 that average annual compensation paid to the employees exceeds $25,000. This means that the credit completely phases out if an employer has 25 or more FTEs and pays $50,000 or more in average annual wages.

Let's look at an example. A for-profit employer has 10 FTEs and pays average annual wages of $25,000 in tax year 2012. The employer's qualified employee health care costs for tax year 2012 are $70,000. The employer's Code Sec. 45R credit is $24,500 ($70,000 x 35 percent).

The credit is scheduled to climb to 50 percent of qualified premium costs paid by for-profit employers (35 percent for tax-exempt employers) for tax years beginning in 2014 and 2015. However, an employer may claim the tax credit after 2013 only if it offers one or more qualified health plans through a state insurance exchange.

2013 Planning opportunities

Looking beyond your compliance headaches with taxes phasing in and credits phasing out, what can you be doing to thrive in the era of uncertainty?

1. *Run the numbers*. Have our CPAs or your own advisors review your projections and your financial statements after the first months of the year. By the time Congress concludes its modifications of the tax code, you may be able to make projections that in turn allow us to identify opportunities to shift income and maximize valuable deductions. The more abrupt the regulatory changes, the more one's field of view tends to contract. While you need to be responsive to short term risks, this should be tempered by your longer term projections to prevent a costly overreaction.
2. *Lay structural foundations*. In your mental business plan, you have some idea of a succession plan or end game but it may not be clear and you may not be ready to implement it in full. Laying at least the foundation—by forming holding companies and executing the trusts—creates opportunities to maximize investments and minimize exposure. Estate taxes

are the classic example of how the system rewards forethought as a mature gifting plan and transfers leveraged over many years create the most robust and most advantageous plans. There is a less-apparent corollary in the asset protection realm. As business-owners meet the risk of frivolous regulation and malicious litigation, an asset protection plan thrown together ad hoc is often much more costly while being significantly less effective. In this way, structures installed in advance are like insurance policies that deliver their promised benefits when secured at the right time.

We will be reaching out during the year and please contact us when you are ready to review your planning.