# 10 Tax Planning Tips for 2012

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## When it comes to taxes, most people are busy pulling records together and making appointments with their tax advisor or the latest edition of TurboTax in preparation for filing 2011 taxes. But financial advisors are already focused on 2012 and beyond.

The actions you take between now and the end of the year will affect the outcome of your 2012 tax return, and it's not too early even to think about 2013 and beyond. The Bush-era tax cuts are set to expire at the end of this year. If they are not renewed, you may face higher taxes in the form of a higher income tax rate, increased taxes on long-term capital gains and qualified dividends, a lower estate tax limit, and a decrease in the child tax credit. The time to prepare for possibly higher tax rates is now.

Here are 10 tax issues to be aware of this year.

1. **Payroll tax cut extension.** After a week-long battle, Congress and President Obama settled on a two-month extension that retained a discounted Social Security tax rate of 4.2% until Feb. 29, 2012. By the time you read this, a deal may have been struck to extend the payroll tax holiday through the end of the year. If not, you can expect less take-home pay starting in March. For business owners, a year-long extension would be good news, because it would keep more cash in consumers' pockets and in their own employees' paychecks.

2. **Estate tax limit may decrease.** Perhaps no other provision in the Bush tax cuts is provoking as much potential angst among the wealthy and their financial advisors, attorneys, and accountants as the estate tax. As it currently stands, federal law exempts the first $5.12 million in an individual's estate and the first $10.24 million in a couple's estate from federal estate taxes. Many state laws follow federal law, so if the exemption decreases, state taxes for many high-net-worth individuals will also be affected.

   Michael Fitzgerald, CPA, principal of Fitzgerald Financial Partners in Houston, Texas, believes that Congress will allow the tax cuts to expire, which makes it imperative that high-net-worth individuals and their advisors plan carefully around estate tax and other expiring tax provisions. The biggest issue in regard to changes in estate taxes is to ensure that any



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estate plans are up to date and reviewed with the potential changes in mind, Nadeau says.

"We're taking this potential change as an opportunity to revisit estate planning and estate-planning documents," she says. "We've got some clients we work with whose documents were drafted many years ago where the language needs to be corrected and assets titled correctly."

3. **Gift tax limit may decrease.** The lifetime exemption for the gift tax—the amount that individuals and couples can give away tax-free over their lifetimes—would decrease from $5.12 million to $1 million for individuals and from $10.24 million to $2 million for couples. "Four million is a big difference. We definitely have clients who are considering gifting that much money this year to get those funds out of their estates and take advantage of the larger amount while it lasts," says Nadeau. "It's a gift from the IRS, so advisors should discuss options with their clients."

   On an annual basis, the exclusion for gifts is $13,000 per individual or $26,000 for couples, according to the IRS.

4. **Capital gains taxes may rise.** Since 2001, investors have enjoyed extremely low rates on capital gains. Since this year may be the last year for such favorable rates, harvesting capital gains on securities in taxable accounts makes sense. Should rates increase, they will rise to 20% from the current rate of 15%. So, it may make sense to harvest capital gains this year to take advantage of tax rates that may not be this low in the foreseeable future, says Andrew Schrange, founder and editor in chief of Moneycrashers.com, a financial planning website.

5. **Dividend tax rates could revert to ordinary income rates.** Should the Bush tax cuts not be extended, investors in dividend stocks and dividend-oriented mutual funds in non-qualified accounts will be in for a big shock, as rates will increase dramatically. This is especially true for high-net-worth individuals, who if taxed at the highest marginal rates will see an increase of more than 150% in the tax rate they pay on dividends, to 39.6% from 15%.

   The implications? It won't make nearly as much sense to hold dividend-oriented investments in non-qualified accounts should the tax cuts expire. "Investors may want to reduce non-qualified portfolio emphasis on a dividend stock investing strategy due to the significant potential increase in dividend tax rates," says Schrage.

6. **Prepare for FACTA reporting requirements.** Two years ago, Congress enacted the Foreign Account Tax Compliance Act, which requires U.S. citizens holding $50,000 or more in financial assets outside the U.S. to file extensive information about those holdings. While the specific filing requirements haven't yet been issued, investors should be aware of all foreign investment holdings and be prepared to report on them in depth, says Nadeau.

   "With FACTA, the IRS is looking to find offshore accounts that aren't being reported," she says. "For instance, many hedge funds and private equity funds are operated offshore because in the past, there were more deductions available. But now, investors in hedge funds, private equity funds, and other investments, including real estate, will have to report to the IRS."

   The additional compliance requirements have the potential to create a time-consuming hassle for investors, whether they merely own a condo in the Turks and Caicos or have substantial investments in several offshore hedge funds or other partnerships. "These reporting requirements can impact your return on investment," Nadeau notes. "Penalties for violating the requirements are harsh—$10,000 every 30 days until compliance with the rules, up to $50,000 per asset."

7. **Child tax credit may decrease.** Under the Bush-era tax cuts, the child tax credit was

increased from $500 per qualifying child to $1,000. The credit applies to children under the age of 17 that meet IRS criteria including residence, relationship, and support tests. If the Bush-era tax cuts aren't renewed, this credit will revert to the $500 level.

8. **Alternative minimum tax adjustment in limbo.** Since the alternative minimum tax hasn't been permanently adjusted for inflation, Congress typically enacts year-by-year legislation adjusting it for inflation so it doesn't impact lower-income taxpayers. This adjustment was not enacted at the end of 2011, but it is expected to be brought up in Congress in 2012. While many lawmakers from both parties support extending the AMT patch for another year, it does involve a good deal of revenue, which may set it up as a target for budget-deficit hawks. As a result, its status is uncertain at this time.

9. **Veteran hiring tax credit.** Employers that are interested in hiring unemployed veterans will qualify for a tax credit from $2,400 to $9,600, according to Fitzgerald. The longer the veteran has been unemployed, the larger the tax credit will be. Employers that hire veterans who have been unemployed at least four weeks will get a $2,400 tax credit; those who hire a veteran who has been unemployed for six months will receive a $5,600 tax credit; and the largest credit, that of $9,600, will apply for employers that hire unemployed veterans with certain disabilities.

10. **Medicare tax looming in 2013.** A new tax set to debut on Jan. 1, 2013, will tax high-net-worth individuals' investment income to the tune of an additional 3.8% Medicare tax on investment income, according to Nadeau. This additional tax on investment income gives even more incentive to pull capital gains forward into 2012, she says.

The tax will affect individuals with gross incomes exceeding $200,000 for individuals and $250,000 for couples. The tax will be applied to unearned income, which includes capital gains, interest, dividends, annuity income, royalties, and rents. Tax-exempt investment income isn't included.

These are just some of the issues to discuss with your advisors. While taxes shouldn't be driving portfolios, it is an extremely hot topic right now and it's important to be positioned for whatever Congress decides. As always, check with a tax professional before making any final decisions.

## 7 questions to ask your tax advisor at tax time

Before wrapping up your 2011 tax return, take a few minutes to ask your tax advisor the following questions designed to help you prepare for 2012.

1. **Will I be subject to the alternative minimum tax in 2012?** If Congress hasn't passed an AMT patch for 2012, your tax advisor may not even be able to answer this question. But it helps to have an idea because it will determine your marginal tax rate for 2012.

2. **What will my tax bracket be in 2012?** Again this question cannot be answered with complete certainty, because you don't know yet what your taxable income will be for the year. But the brackets are fairly broad, so your CPA may be able to help you determine whether you'll be in the 15%, 25%, 28%, 33%, or 35% bracket.

3. **Can you help me estimate my income for 2012?** If "income" were simply a matter of wages, no one is in a better position than you to answer this question. But there are many forms of income, including gross income, adjusted gross income, modifications to adjusted gross income, and taxable income. Knowing these forms of income may help you determine if you can do certain things, such as contribute to a Roth IRA for 2012.

4. **Do I have any remaining loss carryforwards going into 2012?** This will help determine investment strategy during 2012. If you have losses from previous years that you were not able to offset with gains or other income, you can essentially take tax-free gains in 2012, depending on the amount.

5. **If I were to do a Roth conversion in 2012, what would my tax liability be?** When you convert a traditional IRA to a Roth IRA, you pay the taxes up front in exchange for having all future investment gains be tax free. This makes sense for many investors, but you do need to prepare for the big tax bill due in April after the conversion.

6. **Do you have any recommendations for reducing my 2012 taxes?** What about 2013 and beyond? This is the perfect time to get advice from your tax advisor about how to reduce taxes for 2012 and 2013 and beyond.

7. **Is there anything my financial advisor can do to help my tax situation?** This open-ended question could result in some good instructions that you can take back to your financial advisor for investment strategy, retirement plan contributions, and more.

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*Amy E. Buttell and Elaine Floyd are writers for Horsesmouth, an independent organization providing unique, unbiased insight into the critical issues facing financial advisors and their clients. Horsesmouth was founded in 1996 and is located in New York City.*