CHRESTCPA TAX & FINANCIAL PC

1511 YORK ROAD LUTHERVILLE, MD 21093   410-825-5120   FAX 410-321-7483

2014 Outlook: Higher Taxes Are Here

Dear Client,

2013 was a big year for taxes. Earlier in the year, Congress passed legislation averting the so-called "fiscal cliff," and many of the "Obamacare" changes have taken effect, or are about to. While few of us who watched the process would consider it Washington's finest hour, we now have answers to many of the questions that have made proactive planning so difficult over the past few years. And now, as 2014 comes to a close, it's time to pull out the Magic Eight Ball and start to plan.

Here are the highlights:

- First, the **Bush tax cuts** are permanently extended for income up to $400,000 ($450,000 for joint filers). Ordinary income above those thresholds is taxed at 39.6%, while qualified corporate dividends and long-term capital gains above those thresholds are taxed at 20%.

- Next, the **Alternative Minimum Tax** has finally been indexed for inflation. This means Congress will no longer have to "patch" it every year to avoid entangling millions more taxpayers in its web.

- Finally, the **Medicare tax provisions** of the Affordable Care Act, or "Obamacare," have taken effect. This means an extra 0.9% tax on earned income above $250,000 and a 3.8% tax on investment income for taxpayers earning more than $200,000 ($250,000 for joint filers).

President Obama has called for trimming several more tax breaks, possibly including some sacred cows like mortgage interest. However, amid the continuing partisan wrangling over the budget, there appears to be little appetite on Capitol Hill for further changes to the code. So here are some specific strategies for minimizing your tax under the new rules. For more information, call us at 410-825-5120.

Itemized Deductions Going Down

The "fiscal cliff" bill has re-imposed the phaseout of itemized deductions and personal exemptions that went away in 2010. If your income tops $254,200 (singles), $279,650 (heads of household), or $305,050 (joint filers), you'll lose three dollars of itemized deductions for every hundred dollars of income above the threshold. You'll also lose two dollars of personal exemptions for every $2,500 of income above the threshold.

Tax Strategies for Healthcare Costs

Paying for medical care becomes harder every year. The recent healthcare reform act will extend coverage to more of us, but actually makes it harder to deduct unreimbursed expenses. (Formerly, you could deduct medical expenses exceeding 7.5% of your Adjusted Gross Income. Under the new law, that floor is now 10% unless you're over age 65.) It also limits contributions to employer-sponsored flexible spending plans to $2,500/year.

If you're free to select your own coverage, consider choosing a "high-deductible health plan" and opening a Health Savings Account. These arrangements bring down premium costs and use pre-tax dollars for out-of-pocket costs, bypassing the floor on AGI. If you're self-employed, consider establishing a Medical Expense Reimbursement Plan, or MERP. These plans let you pay family medical expenses with pre-tax business dollars. They may even help you avoid self-employment tax.

Audit Odds Still Low

IRS audit odds are increasing, from 1 in 200 returns for 2000 to roughly 1 in 100 for 2012. But your chance of getting audited is still minimal. Don't take low audit rates as an invitation to cheat! But don't let fear of an audit stop you from taking every deduction you're entitled to.

Fund Your SEP Plan

You can contribute up to 25% of pay or $52,000, whichever is greater, into a SEP-IRA. (But beware, you'll also have to cover most employees.) Maximizing your SEP contribution can help assure your retirement security as well as cut this year's tax.

Fund Your Business's 401k Plan

You can defer up to $17,500 of your salary to your 401k this year, plus $5,500 more if you're over age 50. You can also make an employer matching or profit-sharing contribution of up to 25% of your pay or $34,500, whichever is greater. Maximizing your 401k contribution can help assure your retirement security as well as cut this year's tax. Alternatively, if your plan allows it, choosing a "Roth" deferral can provide tax-free income in retirement.

New Roth IRA Conversion Opportunity

New rules now let you convert your traditional IRA to a Roth IRA, regardless of your current income. This is actually one of the bright spots of the of the current tax picture.

Traditional tax planning holds that it makes sense to defer income into retirement accounts now, when you're in your peak earning years (and highest tax bracket) - then withdraw it later during retirement, when your income and tax bracket will presumably be lower. However, tax rates are currently at historic lows, and it's entirely possible they will be higher when you're retired. This suggests the smarter strategy may be to pay tax on retirement funds *now* in order to withdraw them tax-free when rates are higher.

New Tax on Interest Income

The healthcare reform act imposes a new "Unearned Income Medicare Contribution" of 3.8% on interest income. This tax may make municipal bonds and money market funds more attractive relative to fully taxable vehicles. However, the recent economy has jeopardized state and local tax revenues, so there may be credit quality issues to consider. You might also consider deferred annuities and permanent life insurance for fixed-income portions of your portfolio.

Higher Tax on Capital Gains

Tax on long-term capital gains (from sales of property you hold more than 12 months) is now capped at 20% for income exceeding $400,000 ($450,000 for joint filers). The recent healthcare reform act also imposes a new "Unearned Income Medicare Contribution" of 3.8% on capital gains for individuals earning over $200,000 and families earning over $250,000. When you plan to sell appreciated assets, check with us *first*, to discuss if you can use tax-free exchanges, installment sales, charitable trusts, or similar strategies to minimize or even eliminate tax on those sales.

Estate Tax Uncertainty Resolved

The estate tax has veered from zero (in 2010) to 35% on estates exceeding a $5 million "unified credit" (2011-2012). The "fiscal cliff" bill kept the unified credit at $5 million, but indexed it for inflation (so the actual credit is $5.34 million for 2014), and raised the rate to 40% on assets above that threshold. This means that smart estate planning will still be a part of affluent families' financial plans.

Next Steps

We're sure you appreciate this brief outline of the recent tax changes. While smart information is crucial, intelligence alone is useless without the right *action*. If the changes we've discussed so far have you worried about your financial future, you owe it to yourself to take a more comprehensive look at your taxes and finances, so that we can determine exactly which concepts and strategies will work from here. Give us a call!

Sincerely,

Brian F. Chrest, CPA

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