# 15 Strategies for 2013 Year-End Tax Planning

*by Robert S. Keebler*

The time has come again to start thinking about year-end tax planning. Tax changes that went into effect at the beginning of 2013 added new complexity, but also created new planning opportunities. The American Taxpayer Relief Act of 2012 (ATRA) increased the top tax rate on dividends and long-term capital gains from 15% to 20%, and the top tax rate on ordinary income and short-term capital gains from 35% to 39.6%. When the new net investment income tax (NIIT) is factored in, the top rates could be as high as 23.8% and 43.4%, respectively. This heightens the importance of managing tax brackets from year to year and brings income smoothing strategies to the forefront.

Before exploring strategies that can be used to avoid the new high tax brackets and reduce or avoid the NIIT, it is important to understand the powerful effect that different tax rates can have on the amount of wealth that can be accumulated over a period of time, as well as how the new NIIT works.

### Effect of Different Tax Rates on Wealth Accumulation

The following examples illustrate the importance of bracket management and income smoothing.

**Example 1 (Capital gains).** Bill can invest $10,000/year in capital gain assets. The following chart shows the amount of wealth Bill can accumulate after 10, 25, or 40 years given a 10% pre-tax rate of return and various long-term capital gain rates.

| Tax Rate | 10 Years | 25 Years | 40 Years |
|---|---|---|---|
| 0% | $159,374 | $983,471 | $4,425,926 |
| 15% | $148,351 | $766,680 | $2,956,825 |
| 20% | $144,865 | $731,059 | $2,590,565 |
| 23.8% | $142,277 | $691,709 | $2,344,846 |

**Example 2 (Ordinary Income).** Assume the same facts as in example 1, except that Bill invests in assets that produce ordinary income (for example, corporate bonds).

| Tax Rate | 10 Years | 25 Years | 40 Years |
|---|---|---|---|
| 33% | $136,222 | $605,901 | $1,848,316 |
| 35% | $134,944 | $588,877 | $1,756,319 |
| 39.6% | $132,056 | $551,746 | $1,563.265 |
| 43.4% | $129,722 | $523,081 | $1,421,436 |

### NIIT

For individuals, the NIIT is a 3.8% surtax that applies to the lesser of (1) net investment income (NII) or (2) the excess of a taxpayer's modified adjusted gross income (MAGI) over an applicable threshold amount (ATA). NII generally includes interest, dividends, annuities, royalties, rents, income from a business that is a passive activity with respect to the taxpayer, and net capital gain on the sale of non-business assets, reduced by any deductions properly allocable to such income. It does not include salaries, wages, bonuses, distributions from IRAs or qualified plans, or self-employment income.

For most taxpayers, MAGI is the amount reported on the last line of Form 1040, page 1. The ATAs are $250,000 for married taxpayers filing jointly, $125,000 for married taxpayers filing separately, and $200,000 for single filers.

**Strategies for Staying Out of Higher Tax Brackets and Avoiding NIIT**
Fortunately, there are many effective strategies that can be used to keep taxpayers out of higher tax brackets and reduce or eliminate NIIT. Here are 15:

1. **Harvesting Capital Losses**. The taxpayer sells assets at a loss and uses these losses to offset capital gains realized on other assets. This strategy might be particularly useful if capital gains realized for the tax year would otherwise push the taxpayer into a higher tax bracket or cause the NIIT to apply.
2. **Harvesting Capital Gains**. If the taxpayer has a lower capital gains bracket now than he expects to have in the future, the taxpayer may wish to recognize gain now instead of later. Note, however, that selling early introduces a trade-off between paying less tax and losing tax deferral. Thus, a quantitative analysis should be performed to see if gain harvesting is advisable. Note also that if the taxpayer is currently in the 10% or 15% ordinary income tax bracket, the loss of tax deferral is not a factor. Long-term capital gains for these taxpayers are taxed at 0%, so there is no trade-off for the lower rate.
3. **Roth IRA Conversions**. There have always been important advantages to Roth IRA conversions, but now they can also be used to smooth income. Traditional IRA distributions are not NII, but they are included in MAGI and this could increase exposure to the NIIT. To illustrate, suppose that Tina is a single taxpayer with $150,000 of salary income and $50,000 of interest income. Although Tina has $50,000 of NII, she is not subject to the NIIT because her income does not exceed her ATA of $200,000. If she receives a $60,000 distribution from a traditional IRA, her MAGI increases to $260,000. The full $50,000 of NII becomes subject to tax and Tina pays NIIT of $1,900 (.038 x $50,000).

   By contrast, if the distribution was from a Roth IRA, Tina's MAGI would stay at $200,000 and there would be no NIIT payable. Tina could eliminate all future NIIT on IRA distributions by converting the traditional IRA to a Roth IRA, assuming a conversion otherwise made sense. This strategy would also have an income smoothing effect if the taxpayer expected to be in a higher tax bracket when distributions were received than when the conversion (or series of conversions) was done.
4. **Substantial Sale Charitable Remainder Trust (Charitable Remainder Annuity Trust or Charitable Remainder Unitrust)**. This strategy is very favorable for a taxpayer who expects to recognize a large capital gain during the tax year that would push him into a higher tax bracket or cause the NIIT to apply. The taxpayer transfers the appreciated asset to the charitable remainder trust (CRT) and the CRT sells it. Because the CRT is a tax-exempt entity, no gain is recognized. Gain on the annuity or unitrust payments are subject to tax only as annual distributions are received by the donor, spreading the income out over a period of time.
5. **Charitable Lead Annuity Trust (CLAT)**. Direct charitable contributions do not reduce MAGI because they are taken below the line. When a CLAT makes its annual annuity or unitrust payments to charity, however, the charitable deduction reduces the trust's MAGI, possibly also reducing the NIIT payable and leaving more in the CLAT to pass to the donor's heirs at the end of the trust term.
6. **Oil & Gas Investments**. These investments can create a large deduction in a tax year. Therefore, they can be used in a high income year to keep a taxpayer out of higher brackets or to avoid the NIIT.

7. **Two-Year Installment Sales**. Installment sales from parents to children or a children's trust can spread out gain over a period of time, thereby smoothing income. The children or the trust must wait more than two years to resell the assets to avoid having the sale proceeds included in the parents' income at the time of the second sale under IRC Section 453(e).
8. **Retirement CRT**. A net income with make-up charitable remainder unitrust (NIMCRUT) can be used as a supplement to a qualified retirement plan. The NIMCRUT minimizes trust distributions during a taxpayer's high earning work years, while investing for tax-deferred growth. After the taxpayer retires and has lower annual income, the appreciated assets are invested to generate the maximum amount of income possible, producing an income smoothing effect.
9. **Income shifting CRT**. This is a CRT in which the donor's children receive the lead annuity or unitrust payments. By transferring income producing assets to the trust, the parents can reduce or eliminate their exposure to high tax brackets and/or the NIIT during high earning years.
10. **Deferred Annuities**. During higher tax bracket years, the taxpayer invests income-producing assets in deferred annuities to reduce taxable income. Annuity payments begin when the taxpayer is in a lower tax bracket, thereby smoothing income.
11. **Borrowing From Permanent Life Insurance Policies**. The taxpayer pays into a permanent life insurance policy in high income years, reducing taxable income. If the taxpayer needs additional income in later years, she can borrow from the policy on a tax-free basis instead of selling assets and perhaps pushing income into a higher tax bracket or creating NIIT exposure.
12. **Incomplete Gift, Non-Grantor Trusts**. Taxpayers in high tax states may be able to reduce or eliminate state tax by creating a trust in a state that does not tax income. Over time, such a trust could produce impressive state tax savings. At present, Nevada appears to be the most favorable state for creating such trusts.
13. **Grouping Business Activities to Create Material Participation**. A taxpayer may want to group business activities to create material participation so that the income from those activities is not considered passive and, as a result, is not subject to the NIIT.
14. **Choice of Filing Status**. For married couples, the amount of NIIT payable may vary depending on whether they file jointly or file single returns. Such taxpayers should run the numbers to see which filing status would be preferable.
15. **Tax-Efficient Investing**. Tax-aware investing can substantially reduce taxable income and increase after-tax returns, perhaps keeping a taxpayer in a lower tax bracket. Tax-aware investing includes the following components: (1) increasing investments in tax-favored assets; (2) deferring gain recognition; (3) changing portfolio construction; (4) after-tax asset allocation; (5) tax-sensitive asset location; (6) managing income, gains, losses, and tax brackets from year-to-year; and (7) managing capital asset holding periods.

With the end of 2013 fast approaching, now is the time to find out if one or more of the strategies summarized here might help you save on your income tax this year.

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**About the Author**

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**AICPA's PFP website**: Access the Planning After ATRA and the Net Investment Income Tax Toolkit for all of Robert Keebler's charts to assist with year-end planning, including year-end planning strategies and the bracket management chart. Other resources available on this page include a new tax calculator, webcasts and podcasts recordings and related materials, sample client letters and videos to illustrate the importance of your clients meeting with you this year. You can also find the 4-volume The CPA's Guide to Financial & Estate Planning, updated for ATRA and NIIT in this toolkit.

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