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McNEES INSIGHTS
Asset Planning and Federal Taxation

YEAR-END TAX PLANNING *by David M. Watts, Jr.*

Year-end planning is a bigger challenge this year than in past years because, unless Congress acts, tax rates will go up next year, many more individuals will be snared by the alternative minimum tax (AMT), and various deductions and other tax breaks will be unavailable. To be more specific, as a result of expiring Bush-era tax cuts, individuals will face higher tax rates next year on their income, including capital gains and dividends, and estate tax rates will be higher as well. The AMT problem arises because, for 2012, AMT exemptions have dropped and fewer personal credits can be used to offset the AMT. Additionally, a number of tax provisions expired at the end of 2011 or will expire at the end of 2012. Rules that expired at the end of 2011 include, for example, the research credit for businesses, the election to take an itemized deduction for State and local general sales taxes instead of the itemized deduction permitted for State and local income taxes, and the above-the-line deduction for qualified tuition expenses. Rules that will expire at the end of this year include generous bonus depreciation allowances and expensing allowances for business, and expanded tax credits for higher education costs.

These adverse tax consequences are by no means a certainty. Congress could extend the Bush-era tax cuts for some or all taxpayers, retroactively "patch" the AMT for 2012 to increase exemptions and availability of credits, revive some favorable tax rules that have expired, and extend those that are slated to expire at the end of this year. While these uncertainties make year-end tax planning more challenging than in prior years, they should not be an excuse for inaction. Indeed, the prospect of higher taxes next year makes it even more important to engage in year-end planning this year. To that end, we have compiled a checklist of actions that can help you save tax dollars if you act before year-end. Many of these moves may benefit you regardless of what Congress does on the major tax questions of the day. Not all actions will apply in your particular situation, but you will likely benefit from many of them.

- Increase the amount you set aside for next year in your employer's health flexible spending account (FSA) if you set aside too little for this year. Keep in mind that beginning next year, the maximum contribution to a health FSA will be $2,500. And don't forget that you can no longer set aside amounts to get tax-free reimbursements for over-the-counter drugs, such as aspirin and antacids.

- If you become eligible to make health savings account (HSA) contributions late this year, you can make a full year's worth of deductible HSA contributions even if you were not eligible to make HSA contributions for the entire year. This opportunity applies even if you first became eligible in December. In brief, if you qualify for an HSA, contributions to the account are deductible (within IRS-prescribed limits), earnings on the account are tax-deferred, and distributions are tax free if made for qualifying medical expenses.

- Realize losses on stock while substantially preserving your investment position. There are several ways this can be done. For example, you can sell the original holding, then buy back the same securities at least 31 days later.

- If you are thinking of selling assets that are likely to yield large gains, such as inherited, valuable stock, or a vacation home in a desirable resort area, try to make the sale before year-end, with due regard for market conditions. This year, long-term capital gains are taxed at a maximum rate of 15%, but the rate could be higher next year as noted above. And if your adjusted gross income (as specially modified) exceeds certain limits ($250,000 for joint filers or surviving spouses, $125,000 for a married individual filing a separate return, and $200,000 for all others), gains taken next year (along with other types of unearned income, such as dividends and interest) will be exposed to an extra 3.8% tax (the so-called "unearned income Medicare contribution tax").

- If you are in the process of selling your main home, and expect your long-term gain from selling it to substantially exceed the $250,000 home-sale exclusion amount ($500,000 for joint filers), try to close before the end of the year (again, with due regard to market conditions). This can save capital gains taxes if rates go up and can save the 3.8% tax for those exposed to it.

- Consider making contributions to Roth IRAs instead of traditional IRAs. Roth IRA payouts are tax-free and thus immune from the threat of higher tax rates, as long as they are made (1) after a five-year period, and (2) on or attaining age 59-½, after death or disability, or for a first-time home purchase.

- If you believe a Roth IRA is better than a traditional IRA, consider converting traditional IRAs to Roth IRAs this year to avoid a possible hike in tax rates next year. Also, although a 2013 conversion won't be hit by the 3.8% tax on unearned income, it could trigger that tax on your non-IRA gains, interest,

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and dividends. Reason: the taxable conversion may bring your modified adjusted gross income (AGI) above the relevant dollar threshold (e.g., $250,000 for joint filers). But conversions should be approached with caution because they will increase your AGI for 2012. And if you made a traditional IRA to Roth IRA conversion in 2010, and you chose to pay half the tax on the conversion in 2011 and the other half in 2012, making another conversion this year could expose you to a much higher tax bracket.

- Take required minimum distributions (RMDs) from your IRA or 401(k) plan (or other employer-sponsored retired plan) if you have reached age 70-½. Failure to take a required withdrawal can result in a penalty equal to 50% of the amount of the RMD not withdrawn. If you turn age 70-½ this year, you can delay the first required distribution to 2013, but if you do, you will have to take a double distribution in 2013—the amount required for 2012 plus the amount required for 2013. Think twice before delaying 2012 distributions to 2013—bunching income into 2013 might push you into a higher tax bracket or bring you above the modified AGI level that will trigger a 3.8% extra tax on unearned income such as dividends, interest, and capital gains. However, it could be beneficial to take both distributions in 2013 if you will be in a substantially lower bracket in 2013, for example, because you plan to retire late this year or early the next.

- This year, unreimbursed medical expenses are deductible to the extent they exceed 7.5% of your AGI, but in 2013, for individuals under age 65, these expenses will be deductible only to the extent they exceed 10% of AGI. If you have a shot at exceeding the 7.5% floor this year, accelerate into this year "discretionary" medical expenses you were planning on making next year. Examples: prescription sunglasses, and elective procedures not covered by insurance.

- Consider using a credit card to prepay expenses that can generate deductions for this year.

- Increase your withholding if you are facing a penalty for underpayment of federal estimated tax. Doing so may reduce or eliminate the penalty.

- If you expect to owe state and local income taxes when you file your return next year, consider asking your employer to increase withholding of state and local taxes (or make estimated tax payments of state and local taxes) before year-end to pull the deduction of those taxes into 2012 if doing so won't create an alternative minimum tax (AMT) problem.

- Take an eligible rollover distribution from a qualified retirement plan before the end of 2012 if you are facing a penalty for underpayment of estimated tax and the increased withholding option is unavailable or won't sufficiently address the problem. Income tax will be withheld from the distribution and will be applied toward the taxes owed for 2012. You can then timely roll over the gross amount of the distribution, as increased by the amount of withheld tax, to a traditional IRA. No part of the distribution will be includible in income for 2012, but the withheld tax will be applied pro rata over the full 2012 tax year to reduce previous underpayments of estimated tax.

- Make gifts sheltered by the annual gift tax exclusion before the end of the year and thereby save gift and estate taxes. You can give $13,000 in 2012 to each of an unlimited number of individuals but you can't carry over unused exclusions from one year to the next. The transfers also may save family income taxes where income-earning property is given to family members in lower income tax brackets who are not subject to the kiddie tax. Savings for next year could be even greater if rates go up and/or the income from the transfer would have been subject to the 3.8% tax in the hands of the donor.

These are just some of the year-end steps that can be taken to save taxes. Again, by contacting us, we can tailor a particular plan that will work best for you. ■

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PLANNING AND PAYING FOR LONG-TERM CARE (PART 5 IN A SERIES: MEDICAID/ MEDICAL ASSISTANCE) *by Scott Alan Mitchell*

In Part 4, I explained that some assets are counted for Medical Assistance eligibility – and other assets are "exempt" or not counted. Recall that exempt assets include one's principal residence, one motor vehicle, household furnishings, and a spouse's retirement accounts. Countable assets include bank accounts, CD's, most types of investments (stocks, bonds, mutual funds, etc.), most types of annuities, and cash value in life insurance policies.

For a single individual, "countable" assets must be below $8,000. However, if the individual's gross monthly income is over $2,094, assets must be below $2,400. For married couples, the spouse in the nursing home must have assets below the aforementioned limits, and the "community spouse" may retain one-half of the couple's "countable" assets (with a minimum of $22,728 and a maximum of $113,640).

Repeating the illustration in Part 4, assume that a married couple owns a house, car, and household furnishings. Additionally, the couple has $250,000 in investments, bank accounts, CD's, etc., and the nursing home spouse has an individual retirement account with a balance of $100,000. The couple's countable assets would be $350,000 (excluding the house, car, and household furnishings). Assume that the nursing home spouse can retain $2,400 in assets. Additionally, the community spouse can retain one-half of the countable assets – subject to the maximum of $113,640. Thus, the couple can protect $116,040 (in addition to the house, car, and household furnishings), and the remaining "excess" assets total $233,960 – meaning that the couple cannot become eligible for MA unless and until the excess is either exhausted on nursing care or protected in some other fashion.

In this Part 5, I now discuss how excess assets are addressed (or "spent down") before applying for Medical Assistance - and the various options that the law allows couples to protect some or all of the excess assets. As a starting point, in the above example, the couple certainly could use the excess $233,960 to pay the nursing home each month for 24-28 months until the excess money is exhausted (and the community spouse has remaining assets of $113,640), and then apply for Medical Assistance.

However, in addition to the community spouse being able to retain no more than $113,640 in assets, it should be noted that after Medical Assistance benefits are approved, some or all of the nursing home spouse's income must be paid to the nursing home each month after Medical Assistance benefits are approved. This often results in a tight monthly budget for the community spouse for the rest of his or her life. Additionally, if larger expenses arise, such as the need to replace a vehicle, pay a home equity loan, replace a roof or furnace, pay for the nursing home spouse's funeral, etc., the remaining asset cushion of $113,640 can be quickly depleted.

Thus, as an alternative to simply spending down the excess assets by pay the nursing home each month until the excess $233,960 is spent, consider the below options to protect some or all of the excess assets for the benefit of the community spouse.

1. **Pre-paid funerals** – So long as pre-paid funerals are "irrevocable" and below a certain amount established by each county (usually below $11,000 or $12,000, each), a pre-paid funeral for each of the spouses is not countable as an asset for Medical Assistance purposes. Thus, after a spouse is admitted to a nursing facility, it is usually advisable for the couple to purchase two pre-paid funerals.
2. **Pay off debt** – If a couple has a home equity loan, car loan, credit card debt, etc., such debts can be paid off with the excess assets as part of the spend-down, thus sparing the community spouse from a monthly debt payment. It should be noted that paying off debt is not a "gift" that otherwise might make one ineligible for Medical Assistance benefits.
3. **House repairs** – When a spouse enters a nursing facility, the community spouse should take inventory of home repairs (roof, HVAC system, etc.) that might be needed over the coming years. If a roof is twenty years old, the community spouse might consider replacing the roof and paying for it out of the $233,960 in excess assets, rather than paying for a new roof out of the $113,640 in assets that the community spouse can protect. Because one's house is an exempt asset, repairs to the house likewise become exempt.
4. **Household furnishings and personal effects** – Because these items are exempt assets, a community spouse might desire to purchase new furniture or new appliances or new clothing.
5. **New car** – If a community spouse expects to be driving for years to come, and if the existing car is 10 or 15 years old, for example, the community spouse should consider purchasing a new car.
6. **Spousal annuity** – As mentioned above, when a spouse goes on Medical Assistance, some or all of the spouse's income generally must be paid to the nursing home. Although some of the income can be transferred to the community spouse, it is important to note that when the nursing home spouse dies, the community spouse receives the higher of the two spouses' Social Security payments, and the second Social Security payment ends. Additionally, some pension payments end upon the death of the "working" spouse. Thus, to ensure that the community spouse has adequate income for the balance of his or her life, and does not realize a pay decrease upon the death of the nursing home spouse, a community spouse should consider investing in a spousal annuity whereby the community spouse could invest $100,000 or $200,000, for example, in an annuity to receive a monthly annuity/income payment for life. There are certain criteria that such annuities must meet, but so long as those criteria are met, the money invested in the annuity is not considered an available asset for Medical Assistance purposes, and it can be a valuable tool to ensure that the community spouse has sufficient monthly income to meet his or her monthly expenses for the balance of the community spouse's life.
7. **Purchase of income-producing property** – Income-producing property, or property essential to self-support, generally is exempt as an asset. Therefore, a community spouse could use excess assets

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SHOULD YOU BE CONSIDERING YEAR-END GIFTS? *by Vance E. Antonacci*

A variety of favorable tax laws are set to expire at the end of 2012. A notable example of an expiring tax law is the $5,120,000 per person exemption amount for lifetime gifts.

To provide some background, the current tax laws provide each person with the ability to transfer up to $5,120,000 either during the person's lifetime without incurring a gift tax liability or at death without incurring an estate tax liability. Therefore, a married couple may make a lifetime transfer of up to $10,240,000 of assets by year end (assuming no prior gifts that utilized the exemption amount). This ability to make large gifts can be advantageous for transferring family business interests, real estate, or other valuable assets within a family.

Each person should evaluate whether a substantial gift before the end of the year is appropriate even if the full exemption amount will not be used. The exemption amount for estate tax and gift will be $1,000,000 per person next year. Although the tax laws may be amended to increase the total exemption amount above $1,000,000, historically the law has not provided for an exemption amount for gifts of more than $1,000,000 per person. Therefore, a significant planning opportunity could be lost at the end of this year.

A substantial gift could also be advantageous for the following reasons:

- Shifting income producing assets to other family members who are not subject to the 3.8% and 0.9% taxes on net investment income.
- Dividend producing stocks can be gifted to family members in lower income tax brackets since in 2013 dividends will again be taxed at ordinary income tax rates.
- Gifting strategies which are more beneficial in a low interest rate environment, such as a grantor retained annuity trust or an intentionally defective grantor trust, have appeal given the low interest rate environment that currently exists.

Each person's situation and circumstances are unique, but consideration should be given to whether a gift should be made prior to December 31, 2012. ■

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to purchase a rental property, for example, which not only protects the excess assets but provides the community spouse with an income stream.

8. **Limited gifts** – Although gifts will be covered in more detail in Part 6, the law provides that an individual can gift a total of $500 per month without any penalty in Medical Assistance eligibility. Gifts of more than $500 per month made within 5 years of applying for Medical Assistance generally result in a period of ineligibility for Medical Assistance.

To illustrate how the above options might apply in a given case, if a couple has excess resources of $233,960, they could purchase two pre-paid funerals for $20,000; a new roof for $15,000; a new furnace for $8,000; a new car for $30,000; and a spousal annuity for $161,000. These expenditures would fully exhaust the excess resources, spare the community spouse some large future expenditures, preserve the community spouse's protected share of $113,640, and allow the nursing home spouse to become eligible for Medical Assistance benefits.

In conclusion, some couples prefer to use their excess assets to pay for nursing care until the excess is "spent down" on the nursing home spouse's care – and then apply for Medical Assistance after the assets are decreased to $113,640. However, as noted above, doing so can jeopardize the financial security of the community spouse in meeting his or her own lifetime living expenses. Thus, as the above examples demonstrate, couples should give careful consideration to options available to protect excess assets during the spend-down process and before assets are decreased to $113,640.

In Part 6, I will address the intricate and often misunderstood issue of how gifting of assets impacts one's eligibility for Medical Assistance. ■

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