Year-End Tax Strategies

Presented by CohnReznick’s Government Contracting Industry Practice

Ric Nelson, Director and Christine Williamson, Partner
PLEASE READ

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THE ESSENCE OF TAX PLANNING

1. Avoid tax, if you can
2. Defer tax you cannot avoid (but only if it makes sense)
3. Consider all taxes in planning
4. Avoid interest and penalties
5. Never let the tax “tail” wag the economic “dog”
6. Some tax planning is “transaction-based” as opposed to once a year
2013 PLANNING: GOOD NEWS AND BAD NEWS

- **Good**: More short-term tax certainty
- **Bad**: Less short-term business certainty (shutdown effect)
- **Good**: Deferred collections on government contracts (tax deferral)
- **Bad**: Deferred collections on government contracts
AGENDA

• How to go about tax planning
• New for 2013
• Expiring tax breaks
• Planning for businesses
• Planning for individuals
• 3.8% surtax on net investment income
• Wrap-up; Q&A
HOW TO GO ABOUT TAX PLANNING BUSINESSES

• Start with latest year-to-date financial statements
• Estimate activity for remainder of year
• Update numbers and monitor each month
• Last two weeks of the year are often critical to the plan, so plan on staying involved in the process
• Know your method of accounting and that tax planning actions are different depending on accounting method.
HOW TO GO ABOUT TAX PLANNING INDIVIDUALS

• Use last year’s tax return as a guide
• Identify and estimate significant differences from last year
• Identify carryovers (credits, NOLs, capital losses, charitable)
• Using most recent pay stub, estimate taxable wages and withholdings for the year
• Summarize estimated payments made so far, including 2012 overpayment applied
HOW TO GO ABOUT TAX PLANNING
ALL TAXPAYERS

• Determine variables (income that can be deferred, amounts that can be prepaid, possible fixed asset acquisitions, unrealized investment gains/losses, year-end bonuses, etc.)

• Anticipate major differences for 2014

• Project taxable income for 2013 and 2014

• Decide on an overall strategy: defer or accelerate taxable income

• Evaluate actions to take before year-end

• Implement and monitor the plan
NEW FOR 2013

• Higher rates for high net income individuals
  • Regular tax (39.6%)
  • LT capital gains/dividends (20%)
• 3.8% surtax on investment income
• .9% additional Medicare tax on wages/SE income
• Return of personal exemption phase-out (PEP)
• Return of overall limitation on itemized deductions (Pease)
NEW FOR 2013

- In-plan Roth 401(k) conversions
- Health FSA contributions capped at $2,500
- Itemized deduction threshold for medical expenses increased from 7.5% to 10% of AGI (7.5% if age 65)
- Permanent AMT exemption (finally!)
- Repeal of key provision of the Defense of Marriage Act (DOMA)
### Social Security Taxes (FICA) Employee Portion

<table>
<thead>
<tr>
<th>Wages</th>
<th>Social Security Tax</th>
<th>Medicare Tax</th>
<th>Add’tl Medicare Tax *</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to $113,700 ($117,000 in 2014)</td>
<td>6.2%</td>
<td>1.45%</td>
<td>-</td>
<td>7.65%</td>
</tr>
<tr>
<td>$113,700 - $200,000 ($250,000 MFJ)</td>
<td>-</td>
<td>1.45%</td>
<td>-</td>
<td>1.45%</td>
</tr>
<tr>
<td>Above $200,000 ($250,000 MFJ)</td>
<td>-</td>
<td>1.45%</td>
<td>.9%</td>
<td>2.35%</td>
</tr>
</tbody>
</table>

* Employer matches all but the .9% Additional Medicare tax.
# Self-Employment Tax

<table>
<thead>
<tr>
<th>SE Income</th>
<th>Social Security Tax</th>
<th>Medicare Tax</th>
<th>Add’t’l Medicare Tax</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to $113,700 ($117,000 in 2014)</td>
<td>12.4%</td>
<td>2.9%</td>
<td>-</td>
<td>15.3%</td>
</tr>
<tr>
<td>$113,700 - $200,000 ($250,000 MFJ)</td>
<td>-</td>
<td>2.9%</td>
<td>-</td>
<td>2.9%</td>
</tr>
<tr>
<td>Above $200,000 ($250,000 MFJ)</td>
<td>-</td>
<td>2.9%</td>
<td>.9%</td>
<td>3.8%</td>
</tr>
</tbody>
</table>
# Additional .9% Medicare Tax Possible Withholding Shortfall

<table>
<thead>
<tr>
<th>Filing status</th>
<th>MFJ</th>
<th>w/h</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wages - Dorothy</td>
<td>$ 200,000</td>
<td>-</td>
</tr>
<tr>
<td>Wages - Dan</td>
<td>200,000</td>
<td>-</td>
</tr>
<tr>
<td>Total wages</td>
<td>400,000</td>
<td></td>
</tr>
<tr>
<td>MFJ threshold</td>
<td>(250,000)</td>
<td></td>
</tr>
<tr>
<td>Amount subject to .9% tax</td>
<td>150,000</td>
<td></td>
</tr>
<tr>
<td>tax rate</td>
<td>0.9%</td>
<td></td>
</tr>
<tr>
<td>Additional Medicare tax</td>
<td>1,350</td>
<td></td>
</tr>
<tr>
<td>Less withholding</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Additional tax due with return</td>
<td>$ 1,350</td>
<td></td>
</tr>
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</table>
### Additional .9% Medicare Tax Possible Withholding Overage

<table>
<thead>
<tr>
<th>Filing status</th>
<th>MFJ</th>
<th>w/h</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wages - Dorothy</td>
<td>$ 400,000</td>
<td>1,800</td>
</tr>
<tr>
<td>Wages - Dan</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Total wages</td>
<td>400,000</td>
<td></td>
</tr>
<tr>
<td>MFJ threshold</td>
<td>(250,000)</td>
<td></td>
</tr>
<tr>
<td>Amount subject to .9% tax</td>
<td>150,000</td>
<td></td>
</tr>
<tr>
<td>Tax rate</td>
<td>0.9%</td>
<td></td>
</tr>
<tr>
<td>Additional Medicare tax</td>
<td>1,350</td>
<td></td>
</tr>
<tr>
<td>Less withholding</td>
<td>(1,800)</td>
<td>1,800</td>
</tr>
<tr>
<td>Withholding in excess of tax</td>
<td>$ (450)</td>
<td></td>
</tr>
<tr>
<td>Threshold</td>
<td>Single</td>
<td>MFJ</td>
</tr>
<tr>
<td>--------------------------------------------------------------------------</td>
<td>------------</td>
<td>------------</td>
</tr>
<tr>
<td>Additional .9% Medicare tax Earned Income</td>
<td>$200K</td>
<td>$250K</td>
</tr>
<tr>
<td>3.8% Net Inv. Income Surtax MAGI</td>
<td>$200K</td>
<td>$250K</td>
</tr>
<tr>
<td>39.6% Individual Tax Bracket Taxable Income</td>
<td>$400K</td>
<td>$450K</td>
</tr>
<tr>
<td>20% LT Capital Gains Rate Taxable Income</td>
<td>$400K</td>
<td>$450K</td>
</tr>
<tr>
<td>Personal Exemption Phase-Out AGI</td>
<td>$250K - $372.5K</td>
<td>$300K - $422.5K</td>
</tr>
<tr>
<td>Itemized Deduction Phase-Out AGI</td>
<td>$250K</td>
<td>$300K</td>
</tr>
</tbody>
</table>
INTERACTION OF 3.8% AND .9% TAXES
PARTNERSHIP V. S CORPORATION

<table>
<thead>
<tr>
<th>Type of Income</th>
<th>Participation Level</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Active</td>
</tr>
<tr>
<td></td>
<td>.9%</td>
</tr>
<tr>
<td>Partnership Guar. Pmt. (salary)</td>
<td>✓</td>
</tr>
<tr>
<td>S Corporation W-2 (salary)</td>
<td>✓</td>
</tr>
<tr>
<td>Gen Partner K-1 (ordinary income)</td>
<td>✓</td>
</tr>
<tr>
<td>Ltd Partner K-1 (ordinary income)</td>
<td></td>
</tr>
<tr>
<td>S Corporation K-1 (ordinary income)</td>
<td></td>
</tr>
<tr>
<td>Interest/Dividends/Capital Gains reported on Partnership/S Corp K-1</td>
<td>✓</td>
</tr>
<tr>
<td>Gain from sale of Partnership interest or S Corporation stock*</td>
<td></td>
</tr>
</tbody>
</table>
REPEAL OF DOMA: FEDERAL TAX IMPACT

• Legally married same-sex couples treated the same for federal tax as heterosexual married couples
• Filing status
  • Married Filing Jointly or Married Filing Separately
• Applies even if couple now resides in a state that does not recognize gay marriage
• Amended returns allowed to claim refunds for 2010, 2011, 2012
REPEAL OF DOMA: STATE TAX IMPACT

• If state recognizes same-sex marriage (DC, MD)
  • Same state tax treatment as for heterosexual married couples
• If state does not recognize same-sex marriage (VA)
  • Must file state return as Single (or Head of Household)
• Practical issues
  • VA starting point is federal AGI
  • Multi-state returns with different filing statuses
EXPIRING TAX BREAKS - BUSINESSES

- Sec. 179 maximum $500K ($25K for 2014)
- 50% bonus depreciation
- 15-yr depreciation for Qualified Leasehold Improvements
- R&D credit
- Work Opportunity Tax Credit
- 5-yr waiting period to avoid S Corp Built-In Gain tax
  - Reverts to 10 years in 2014
EXPIRING TAX BREAKS – INDIVIDUALS

• Charitable contributions from IRA (age 70 ½)
• Deduction for sales tax instead of state income tax
• 10% energy credit
• 100% gain exclusion for Qualified Small Business Stock (Sec. 1202) purchased by 12/31/13 and held 5 years
PLANNING FOR BUSINESSES
OVERALL STRATEGY TO DEFER TAX

- Defer income
  - Defer the right to receive or the receipt of income, depending on method of accounting
- Accelerate deductions
  - Accelerate incurring expenses, or the payment of expenses, depending on method of accounting
PLANNING FOR BUSINESSES
SPECIFIC STRATEGIES – CASH BASIS TAXPAYERS

• Hold off billing clients and, consequently, collecting receivables
• Pay accounts payable, salaries, bonuses, other accrued expenses
• Prepay expenses
  • 1-year rule
  • N/A to inventory
  • Interest only if accrued to Y/E
• Use credit cards for expenses, or debt financing for equipment
PLANNING FOR BUSINESSES
SPECIFIC STRATEGIES – ACCRUAL BASIS TAXPAYERS

• Defer the right to collect unbilled receivables, defer billings

• Hold off completing job or delivering goods/rendering services until next year

• Delay settling dispute involving billings

• Write off wholly-worthless bad debts

• Accrued compensation (salaries, bonuses, vacation)
  • 2 ½ month rule for employees
  • Year-end rule for owners (50% “C” Corp, any % “S” Corp”)
PLANNING FOR BUSINESSES
SPECIFIC STRATEGIES – ALL TAXPAYERS

• Accelerate fixed asset purchases
  • Higher Section 179 expense
  • Bonus depreciation
• Set up retirement plans BEFORE year-end
PASS-THROUGH ENTITIES (S CORPORATIONS, PARTNERSHIPS)

- Watch out for basis limitations
  - Shareholder/partner contribution or loan
  - Re-characterize distributions as loans to shareholders/partners
    - Note receivable with interest at Applicable Federal Rate
  - Increase share of partnership liabilities
  - Take distributions in January of following year
- Watch out for passive activity loss rules
PLANNING FOR INDIVIDUALS
USUAL STRATEGY TO DEFER TAX

Push taxable income to future years by

• Deferring receipt of income

• Accelerating payment of deductions
PLANNING FOR INDIVIDUALS
REASONS NOT TO DEFER TAXABLE INCOME

• Expiring carryovers (NOLs, charitable contributions, credits)
• Bunching strategy (more on this later)
• Higher bracket next year
• AMT this year but not next year
• Detrimental change in filing status next year
PLANNING FOR INDIVIDUALS
SPECIFIC STRATEGIES TO DEFER TAXABLE INCOME

• Defer pass-through income at business level
• Bonus in January instead of December
• Participate in employer’s nonqualified deferred compensation plan
  • Note: does not defer Medicare tax
• Defer taking retirement plan distributions (unless required)
• Sell passive activities to free up suspended losses
PLANNING FOR INDIVIDUALS
SPECIFIC STRATEGIES TO DEFER TAXABLE INCOME

• Maximize 401(k) contribution
• Maximize Flexible Spending Accounts (for next year)
• Set up Health Savings Account if eligible
• Set up self-employed retirement plan before year-end
• Make year-end charitable contributions
  • Credit card charges count as cash payments
  • Non-cash contributions
  • Appreciated stock (especially if held by S corp)
• Prepay state tax, real estate tax
  • But usually NOT if in AMT
TAX STRATEGIES FOR INVESTMENTS
DEFERRING INCOME

• Buy mutual fund shares after the record date
• Sell investments with losses to offset capital gains
  • Generally avoid offsetting LT gains with losses/deductions
  • Be careful of “wash sale” rules
• Installment sale
• Use a like-kind exchange
OTHER STRATEGIES

• Avoid underpayment penalties
  • Consider new 3.8% and .9% Medicare taxes
• Control phase-outs of tax breaks based on AGI using “bunching”
  • Tuition credit, student loan interest, medical, misc itemized
• Make gifts up to $14,000 per donee
• Make Sec. 529 plan contributions
  • Multi-year election
• Evaluate Roth IRA conversion
PLANNING FOR THE ALTERNATIVE MINIMUM TAX

• Calculate your AMT “spread”
  • Difference between regular tax and tentative minimum tax (TMT)
• R&D credit available only against regular tax in excess of TMT
• Incentive Stock Options
  • Taxable for AMT when exercised
  • Different gain for regular tax and AMT when sold
• If in AMT this year but not next year
  • Accelerate income to be taxed at lower AMT rate
  • Defer deductions to get benefit at higher rate
• If in AMT every year
  • Spread out AMT adjustments to minimize phase-out of exemption
3.8% SURTAX ON NET INVESTMENT INCOME

- 3.8% tax on lesser of “net investment income” or modified AGI above threshold
  - $200,000 Single
  - $250,000 Married Filing Jointly
- Added to regular tax or AMT
INVESTMENT INCOME

Includes:
- Interest
- Dividends
- Most capital gains
- Annuities
- Rents
- Royalties
- Income from passive activities

Does NOT include:
- Wages
- Self-employment income
- Retirement plan distributions
- Income from active interest in Pship/S Corp
- Gain on sale of active interest in Pship/S Corp
- Tax-exempt income
DEDUCTIONS ALLOWED AGAINST INVESTMENT INCOME

• Allowed
  • Rental expenses
  • Investment interest expense
  • State income tax on investment income
  • Investment fees (to extent deductible after limits)
  • Capital losses, including carryovers
  • Passive losses, including carryovers
• NOT allowed
  • Net operating loss carryover
### Example A (Andy): 3.8% Surtax

<table>
<thead>
<tr>
<th>Filing status</th>
<th>Single</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wages</td>
<td>$175,000</td>
</tr>
<tr>
<td>Interest</td>
<td>5,000</td>
</tr>
<tr>
<td>Capital gain</td>
<td>25,000</td>
</tr>
<tr>
<td>AGI</td>
<td>$205,000</td>
</tr>
</tbody>
</table>

- Surtax applies to $5,000, which is the lesser of:
  - Net investment income ($30,000) or
  - AGI above threshold ($205,000 – 200,000 = $5,000)
- Surtax = 3.8% x $5,000 = $190
**EXAMPLE B (BARBARA): 3.8% SURTAX**

<table>
<thead>
<tr>
<th>Filing status</th>
<th>Single</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wages</td>
<td>$220,000</td>
</tr>
<tr>
<td>Interest</td>
<td>5,000</td>
</tr>
<tr>
<td>Capital gain</td>
<td>25,000</td>
</tr>
<tr>
<td>AGI</td>
<td>$250,000</td>
</tr>
</tbody>
</table>

- Surtax applies to $30,000, which is the lesser of:
  - Net investment income ($30,000) or
  - AGI above threshold ($250,000 – 200,000 = $50,000)
- Surtax = 3.8% x $30,000 = $1,140
**Example C (The Carters): 3.8% Surtax**

<table>
<thead>
<tr>
<th>Filing status</th>
<th>MFJ</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wages - Cameron</td>
<td>$120,000</td>
</tr>
<tr>
<td>Wages - Cathy</td>
<td>100,000</td>
</tr>
<tr>
<td>Interest</td>
<td>5,000</td>
</tr>
<tr>
<td>Capital gain</td>
<td>25,000</td>
</tr>
<tr>
<td>AGI</td>
<td>$250,000</td>
</tr>
</tbody>
</table>

- Surtax does not apply, since AGI does not exceed threshold ($250,000).
PLANNING FOR THE 3.8% SURTAX

- First calculate AGI and net investment income
- Overall strategy if above AGI threshold
  - Reduce AGI or
  - Reduce net investment income
- Coordinate with regular tax and AMT planning
- Look ahead to next year
  - Try to smooth out income if close to threshold
PLANNING FOR THE 3.8% SURTAX
REDUCE NET INVESTMENT INCOME

• Short term
  - Offset capital gains with capital losses
  - Sell passive investments to trigger suspended losses
  - State income tax may reduce NII even if in AMT
  - Use installment method

• Long term
  - Invest in tax-exempt securities
  - Maximize contributions to retirement accounts
    • Retirement income not subject to surtax
PLANNING FOR THE 3.8% SURTAX
REDUCE AGI BELOW THRESHOLD

• Short term
  – Defer year-end income
  – Make deductible retirement contributions
  – Trigger suspended losses (active or passive)

• Long term
  – Consider Roth 401(k) participation
  – Consider Roth IRA/Roth 401(k) conversion
  • Current income for amount converted, but future distributions not taxable
WRAP-UP

- “Disclaimer”: general knowledge, not specific to your situation (“only your accountant knows for sure”)
- What’s YOUR situation? (not your neighbor’s…)
- Good to go into meetings and process “armed” with ideas and knowledge, but also open-minded to suggestions
- Tax is NEVER the MAIN REASON to do or not do something that makes/doesn’t make economic sense.
RESOURCES

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