HERITAGE RETIREMENT ADVISORS

Retirement Transition Specialists

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How to Plan for Your 2014 Taxes and Reduce Your 2013 Income Taxes (Even though it is already 2014)

2014 has already arrived and here we are looking at another tax season.

While 2013 was a year that included last minute tax law changes and suspense, taxpayers in 2014 don't have to worry about a lot of tax surprises. The American Taxpayer Relief Act of 2012 (ATRA) enacted on Jan. 2, 2013, made many existing tax laws permanent and extended other provisions throughout the year. Even in the most stable tax and political environments, though, there is always something to worry about when it comes to taxes. It seems like Congress can never do anything easily. Every year or so, Congress renews some temporary tax provisions. In recent years, however, lawmakers have let the laws expire and then renewed them retroactively, most recently ATRA or the "fiscal cliff" tax bill. Expect a replay in 2014. Fifty-five tax provisions expired on Dec. 31, 2013. This doesn't affect your 2013 tax return, but tax planning for 2014 will be a different story.

Consideration of these so-called "extenders" has been complicated by possible overall tax reform and budget considerations, as well as the political intentions of key Capitol Hill players. Leaders of both parties on the House Ways and Means and Senate Finance tax-writing committees have discussed extending some of the expired tax laws as a package this year. Uncle Sam could raise several billion dollars by letting some or all of the extenders fade away. This would mean that individual taxpayers would lose some of the more popular tax breaks like the itemized deduction for state and local sales taxes and fees, educators' out-of-pocket classroom expenses and the above-the-line deductions for tuition and fees. Lawmakers can look at each now-expired tax provision separately and focus on tax reform first or roll the extenders into a larger tax overhaul bill. The longer they wait to make any decision on renewing these extenders, the harder it will be to plan and implement your 2014 tax strategy. In the meantime, taxpayers are now finishing up the 2013 tax year by filing tax returns. The federal government shut down for 16 days last October, but taxpayers are still paying for it. Thanks to this shutdown, the IRS said it wasn't ready to process individual tax returns until January 31, 2014. While they started encouraging those with electronic returns to start hitting "send" in late January, if you plan on filing a paper return for 2013, the IRS encouraged you to wait until January 31 to mail your return.

While your options for deferring income or accelerating deductions became much more limited after December 31, there are still things that you can do to make the tax-filing season cheaper and easier. Some strategies can help you lower your taxes, while others help you save time and money when preparing your tax return. Avoiding costly penalties and interest on both federal and state taxes is always an important goal.

This special report reviews some of the major recent tax law changes along with a wide range of tax reduction strategies. All examples mentioned in this report are hypothetical and meant for illustrative purposes only.

As you read this report, please note each tax strategy that you think could benefit you. Not all ideas are appropriate for all taxpayers. Consider how one tax strategy may affect another and calculate the income tax consequences (both state and federal). Remember, tax strategies and ideas that have worked in the recent past might not even be available under today's tax laws. Understand all the details before making any decisions—it is always easier to avoid a problem than it is to solve one! Also remember that you have the option to do nothing. As always, please discuss any of your ideas with your tax preparer before taking action.

Please note—your state income tax laws could be different from the federal income tax laws. Visit www.sisterstates.com for a wide range of tax information and links to tax forms for all 50 states.

Contribute to retirement accounts

If you haven't already funded your retirement account for 2013, consider doing so by April 15, 2014. That's the deadline for contributions to a traditional IRA (deductible or not) and a Roth IRA. However, if you have a Keogh or SEP and you get a filing extension to October 15, 2014, you can wait until then to put 2013 contributions into those accounts. To start tax-free compounding as quickly as possible, however, don't dawdle in making contributions.

Making a deductible contribution will help you lower your tax bill this year. Plus, your contributions will compound tax-deferred. Let's examine how that can work. If you put away $5,000 a year for 20 years in an investment with an average annual 8% return, your $100,000 in contributions will grow to $247,000. The same investment in a taxable account would grow to only about $194,000 if you're in the 25% federal tax bracket (and even less if you live in a state with a state income tax to bite into your return).

To qualify for the full annual IRA deduction in 2013, you must either: 1) not be eligible to participate in a company retirement plan, or 2) if you are eligible, you must have adjusted gross income of $59,000 or less for singles, or $95,000 or less for married couples filing jointly.

If you are not eligible for a company plan but your spouse is, your traditional IRA contribution is fully-deductible as long as your combined gross income does not exceed $178,000.

For 2013, the maximum IRA contribution you can make is $5,500 ($6,500 if you are age 50 or older by the end of the year). For self-employed persons, the maximum annual addition to SEPs and Keoghs for 2013 is $51,000.

Although choosing to contribute to a Roth IRA instead of a traditional IRA will not cut your 2013 tax bill (Roth contributions are not deductible), it could be the better choice because all withdrawals from a Roth can be tax-free in retirement. Withdrawals from a traditional IRA are fully taxable in retirement. To contribute the full $5,500 ($6,500 if you are age 50 or older by the end of 2013) to a Roth IRA, you must earn $112,000 or less a year if you are single or $178,000 if you're married and file a joint return.

The amount you save from making a contribution will vary. If you are in the 25% tax bracket and make a deductible IRA contribution of $5,500, you will save $1,375 in taxes the first year. Over time, future contributions will save you thousands, depending on your contribution, income tax bracket, and the number of years you keep the money invested. **If you have any questions on retirement contributions please call us.**

2013 Tax Brackets (for taxes due April 15, 2014)

Tax rate	Single filers	Married filing jointly or qualifying widow/widower	Married filing separately	Head of household
10%	Up to $8,925	Up to $17,850	Up to $8,925	Up to $12,750
15%	$8,926 to $36,250	$17,851 to $72,500	$8,926 to $36,250	$12,751 to $48,600
25%	$36,251 to $87,850	$72,501 to $146,400	$36,251 to $73,200	$48,601 to $125,450
28%	$87,851 to $183,250	$146,401 to $223,050	$73,201 to $111,525	$125,451 to $203,150
33%	$183,251 to $398,350	$223,051 to $398,350	$111,526 to $199,175	$203,151 to $398,350
35%	$398,351 to $400,000	$398,351 to $450,000	$199,176 to $225,000	$398,351 to $425,000
39.6%	$400,001 or more	$450,001 or more	$225,001 or more	$425,001 or more

2014 Tax Brackets (for taxes due April 15, 2015)				
Tax rate	**Single filers**	**Married filing jointly or qualifying widow/widower**	**Married filing separately**	**Head of household**
10%	Up to $9,075	Up to $18,150	Up to $9,075	Up to $12,950
15%	$9,076 to $36,900	$18,151 to $73,800	$9,076 to $36,900	$12,951 to $49,400
25%	$36,901 to $89,350	$73,801 to $148,850	$36,901 to $74,425	$49,401 to $127,550
28%	$89,351 to $186,350	$148,851 to $226,850	$74,426 to $113,425	$127,551 to $206,600
33%	$186,351 to $405,100	$226,851 to $405,100	$113,426 to $202,550	$206,601 to $405,100
35%	$405,101 to $406,750	$405,101 to $457,600	$202,551 to $228,800	$405,101 to $432,200
39.6%	$406,751 or more	$457,601 or more	$228,801 or more	$432,201 or more

Watch for added taxes on your 2013 return

The American Taxpayer Relief Act of 2012 was not kind to those who were already paying the most tax. The new taxes are being calculated for the first time as taxpayers begin the 2013 reporting process and higher wage-earners will find out the extent of their damage when they file their 2013 returns.

2013 & 2014 tax rates and income brackets

Currently there are seven federal income tax brackets. The lowest of the seven tax rates is 10%, while the top tax rate is 39.6%. The income that falls into each is scheduled to be adjusted each year for inflation. For many filers, it makes sense to file jointly. For example, in the 10% through 25% tax brackets, married joint tax return filers' income is double the single taxpayer amount, essentially erasing the marriage tax penalty in these lower brackets. Typically, it is advisable to file jointly if you're married, because married couples who file separate returns tend to face higher taxes. Heads of household get wider income brackets than single filers, meaning their taxes are a bit lower. In addition to paying a top ordinary tax rate of 39.6% if, as a single filer, your taxable income is more than $400,000 ($450,000 for married couples filing jointly), you could face added taxes. The net investment income tax will not only take a bite out of taxpayers' bank accounts, but also cause headaches for high-income earners and their tax professionals working through the tax regulations. For 2013, there is a phase-out of itemized deductions and personal exemptions for taxpayers whose income is greater than $305,050 if married filing jointly, or $254,200 if single.

File jointly if you're a same-sex married couple

Married same-sex couples now have the same federal tax filing responsibilities as heterosexual couples. Following the Supreme Court invalidation of the Defense of Marriage Act, the IRS instructed same-sex married couples to file jointly or as a married couple filing separately, even if the state where they live does not recognize their marriage. This will simplify same-sex couples' federal filings, but if they must pay state income taxes, depending on their state's law, they could still face filing two state returns as single taxpayers.

2013 Standard deduction amounts

Most taxpayers claim the standard deduction. The amounts for each of the five filing statuses are adjusted annually for inflation. For taxpayers younger than age 65, the standard deduction for married joint filers is double the single amount. Head of household taxpayers get a larger deduction since they are supporting dependents. Older taxpayers and visually impaired filers get bigger standard deduction amounts.

Investment income

The new tax laws permanently raise rates on long-term capital gains and dividends for top-bracket taxpayers. People that have enough income to pay tax at the 39.6% rate will pay 20% in 2013 on the net long-term capital gains and dividends, up from the 15% maximum tax rate in 2012.

One tax strategy is to review your investments that have unrealized long-term capital gains and sell enough of the appreciated investments in order to generate enough long-term capital gains to push you to the top of your 15 % tax bracket. This strategy will be helpful because you do not have to pay any taxes on this gain. Then, if you want, you can buy back your investment the same day, increasing your cost basis in those investments. If you sell them in the future, the increased cost basis will help reduce long-term capital gains. You do not have to wait 30 days before you buy back this investment—the 30-day rule only applies to losses, not gains. Note: this non-taxable capital gain for federal income taxes might not apply to your state.

Remember that marginal tax rates on long-term capital gains and dividends can be higher than expected. The 3.8% surtax raises the effective rate on tax-favored gains and dividends to 18.8% for filers below the 39.6% tax bracket and 23.8% for people in the highest tax bracket.

Calculating capital gains and losses

With all of these different tax rates for different types of gains and losses, it's probably a good idea to familiarize yourself with some of these rules:

- Short-term capital losses must first be used to offset short-term capital gains.
- If there are net short-term losses, they can be used to offset net long-term capital gains.
- Long-term capital losses are similarly first applied against long-term capital gains, with any excess applied against short-term capital gains.
- Net long-term capital losses in any rate category are first applied against the highest tax rate long-term capital gains.
- Capital losses in excess of capital gains can be used to offset up to $3,000 of ordinary income.
- Any remaining unused capital losses can be carried forward and used in the same manner as described above.
- Please remember to look at your 2012 income tax return Schedule D page 2 to see if you have any capital loss carryover for 2013. This is often overlooked, especially if you are changing tax preparers.

Please try to double-check your capital gains or losses. If you sold an asset outside of a qualified account during 2013, you most likely incurred a capital gain or loss. Sales of securities showing the transaction date and sale price are listed on the 1099 generated by the financial institution. However, the 1099 might not show the correct cost basis or realized gain or loss for each sale. You will need to know the full cost basis for each investment sold outside of your qualified accounts, which is usually what you paid for it, but this is not always the case. **Remember: The tax rates on long-term capital gains increased in 2013.**

New 3.8% Medicare investment tax

Starting with 2013 tax returns, the most dreaded new tax is the net investment income tax of 3.8%. It is also known as the Medicare surtax, because the money goes toward that health coverage program for older Americans. If you earn more than $200,000 as a single taxpayer or $250,000 as a married joint return, then this tax applies to either your modified adjusted gross income or net investment income (including interest, dividends, capital gains, rentals, and royalty income), whichever is lower. This new 3.8% tax is in addition to capital gains or any other tax you already pay on investment income.

Sadly, at this time there's little you can do to reduce this tax for 2013, but you can try to reduce its impact in 2014. A helpful strategy is to pay attention to timing, especially if your income fluctuates from year to year or is close to the $200,000 or $250,000 amount. Consider realizing capital gains in years when you are under these limits. The inclusion limits penalize married couples, so realizing investment gains before you tie the knot may help in some circumstances. This tax makes the use of depreciation, installment sales, and other tax deferment strategies suddenly more attractive.

New Medicare health insurance tax on wages

If you earn more than $200,000 in wages, compensation, and self-employment income ($250,000 if filing jointly, or $125,000 if married and filing separately), the Affordable Care Act also levies a special 0.9% tax on your wages and other earned income. You'll pay this all year as your employer withholds the additional Medicare Tax from your paycheck. If you're self-employed, be sure to plan for this tax when you calculate your estimated taxes.

If you're employed, there's little you can do to reduce the bite of this tax. Requesting non-cash benefits in lieu of wages won't help—they're included in the taxable amount. If you're self-employed, you may want to take special care in timing income and expenses (especially depreciation) to avoid the limit.

New simplified option for home office deduction

In the past, taking a deduction for a home office has often seemed more trouble than it is worth, as you prorated utilities and other expenses to the portion of your home you used for business. For 2013 returns filed in 2014, the IRS is now offering a simplified home office deduction. The new optional deduction is $5 for each square foot of home office space, up to a maximum of 300 square feet. That comes to a maximum $1,500 annual home office deduction. The IRS estimates that this option will save home-office filers an estimated 1.6 million hours of paperwork and record keeping collectively. Instead of filling out Form 8829, you'll use a worksheet in the Schedule C instruction book and enter your simplified home-office deduction amount on Schedule C. While the new deduction option will be welcomed by many, note that the requirements to qualify as a home office still apply. For instance, the office space must be used regularly and exclusively for business.

Even better, when you use this simplified option, you can still deduct mortgage interest and real-estate taxes in full. When you sell your home, you won't have to worry about calculating depreciation on your home or recapturing depreciation. If you qualify for the home office deduction, there's no better time to take it. It's worth even designating a room of your house to your business, assuming you meet the qualifications.

Medical expenses

Another recent tax change is the floor for deducting medical expenses. In the past, you could deduct medical expenses once they passed 7.5% of your adjusted gross income (AGI). Starting in 2013, you can only deduct them to the extent they exceed a whopping 10% of your AGI. If you or your spouse is over age 65, the old 7.5% floor still stands until 2017.

This higher floor makes the bunching of medical expenses even more necessary. If you have big medical expenses, try to pay them in a year when you can take advantage of the deduction. Medical expenses are deductible in the year you pay them, not necessarily when you incur them. For example, if your children need braces on their teeth and you are making payments over time to the orthodontist, you may never get a deduction for the expense. However, if you pay it all in one year, you might pass the 10% floor and get some consolation in the form of a tax deduction.

Energy credits

You can still get an energy efficiency tax credit for qualifying energy-efficient products such as solar hot water heaters, solar electric equipment and wind turbines. The credit is 30% of the cost of these products you installed in or on your home.

There is no limit to the amount of credit you can take, and you can carry forward any unused credit to future tax years. This credit has been extended to 2016.

Charitable gifts and donations

When preparing your list of charitable gifts, remember to review your checkbook register so you don't leave any out. Everyone remembers to count the monetary gifts they make to their favorite charities, but you should count noncash donations as well. Make it a priority to always get a receipt for every gift. Remember that you'll have to itemize to claim this deduction, but when filing, the expenses incurred while doing charitable work often is not included on tax returns.

You can't deduct the value of your time spent volunteering, but if you buy supplies for a group, the cost of that material is deductible as an itemized charitable donation. Similarly, if you wear a uniform in doing your good deeds (for example, as a hospital volunteer or youth group leader), you can also count the costs of that apparel and any cleaning bills as charitable donations.

You can also claim a charitable deduction for the use of your vehicle for charitable purposes, such as delivering meals to the homebound in your community or taking your child's Scout troop on an outing. For 2013, the IRS will let you deduct that travel at 14 cents per mile.

Deduct state taxes

If you itemize your deductions, you can choose between deducting state and local sales tax or state income tax. The sales tax option, which had expired at the end of 2011, was retroactively restored by the ATRA through 2013—a real benefit for taxpayers who live in states without an income tax.

Most folks who file federal income taxes also have to file a state tax return around the same time. Residents of nine states do not have to pay state tax on wage income. Seven of the states—Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming—have no state-level taxation of any earnings. Tennessee and New Hampshire tax only interest and dividend income. Of course, these states still need money, so residents typically pay plenty in sales and property taxes. If you live in the other 41 states or the District of Columbia, remember to file your annual state tax return.

Child and dependent care credit

Millions of parents claim the child and dependent care credit each year to help cover the costs of after-school day care while Mom and Dad work. Some parents overlook claiming the tax credit for child care costs during the summer. This tax break also applies to summer day camp costs. The key is that for deduction purposes, the camp can only be a day camp, not an overnight camp.

Remember the dual nature of the credit's name: child and dependent. If you have an adult dependent that needs care so that you can work, those expenses can possibly be claimed under this tax credit.

Required Minimum Distributions (RMD)

If you turned age 70½ during 2013, you still have until April 1, 2014, to take out your first RMD. This is a one-time opportunity in case you forgot the first time. The deadline for taking out your RMD in the future will be December 31st of each year. If you do not pay out your RMD by this deadline, you will be faced with a 50% penalty on the amount you should have taken.

Note: you usually do not have to take out an RMD from your current employer's retirement account as long as you work there and don't own more than 5% of the company. See your plan administrator if you have any questions.

Roth IRA conversions

A Roth IRA conversion is when you convert part or all of your traditional IRA into a Roth IRA. This is a taxable event. The amount you converted is subject to ordinary income tax. It might also cause your income to increase, thereby subjecting you to the Medicare surtax. Roth IRAs grow tax-free and withdrawals are tax-free in the future, a time when tax rates might be higher.

Whether to convert part or all of your traditional IRA to a Roth IRA depends on your particular situation. It is best to prepare a tax projection and calculate the appropriate amount to convert. Remember—you do not have to convert all of your IRA to a Roth. Roth IRA conversions are not subject to the pre-59½ 10% penalty.

Another benefit of a Roth IRA conversion is that it allows you the flexibility to recharacterize your conversion by October 15th of the following tax year. This gives you the benefit of hindsight. If you do a conversion and the value of the Roth IRA goes down, you can change your mind and re-characterize it back to the traditional IRA without any tax consequence.

Consider using multiple Roth IRA accounts. If you decide to recharacterize, you must use all of the assets of a particular Roth IRA. You have the ability to choose which Roth IRA to recharacterize, but you do not have the right to recharacterize some of the investments within a Roth IRA. For example, if you use multiple Roth IRA accounts and one of the accounts drops in value while the others increase, you can switch the underperforming account back to a traditional IRA tax and penalty free while still keeping the other Roth IRAs. Roth 401(k)s, first available in 2006, continue to evolve. ATRA allows plan participants to convert the pre-tax money in their 401(k) plan to a Roth 401(k) plan without leaving the job or reaching age 59½. There are a number of pros and cons to making this change. Perhaps the biggest downside to an in-plan conversion is that there is no way to recharacterize the conversion. Your converted amount stays inside of the 401(k). Please call us to see if this makes sense for you.

Inherited IRAs

Be careful if you inherit a retirement account. In many cases, the decedent's largest asset is a retirement account. If you inherit a retirement account, such as an IRA or other qualified plan, the money is usually taxable upon receipt. There is no step-up in basis on investments within retirement accounts and therefore most distributions are 100% taxable.

Non-spouse beneficiaries usually cannot roll over an inherited IRA to their own IRA, but the solution to this problem is easy: establish an Inherited IRA, also known as a "stretch" IRA. Non-spouse beneficiaries of any age are allowed to start their RMDs the year following the year the owner died and stretch them out over their own life expectancy. This will reduce your income taxes significantly compared to having all of the IRA taxed in one year.

These tax laws are very complicated and you must implement the requirements carefully to avoid any unnecessary income taxes and penalties. Please contact us before receiving any distributions from a retirement account you inherit. Remember—it is easier to avoid a problem than it is to solve one!

Five helpful tax time strategies

- ✓ Write down all receipts you think are even possibly tax-deductible. Many taxpayers assume that various expenses are not deductible and do not even mention them to their tax preparer. Don't assume anything—give your tax preparer the chance to tell you whether something is or is not deductible.

- ✓ Be careful not to overpay Social Security taxes. If you received a paycheck from two or more employers, and earned more than $113,700 in 2013, you may be able to file a claim on your return for the excess Social Security tax withholding.

- ✓ Don't forget deductions carried over from prior years because you exceeded annual limits, such as capital losses, passive losses, charitable contributions and alternative minimum tax credits.

- ✓ Check your 2012 tax return to see if there was a refund from 2012 applied to 2013 estimated taxes. Remember that this amount represents a payment for 2013 taxes and also is tax deductible as state income taxes as mentioned above.

- ✓ Calculate your estimated tax payments for 2014 very carefully. Most computer tax programs will automatically assume that your income tax liability for the current year is the same as the prior year. This is done in order to avoid paying penalties for underpayment of estimated income taxes. However, in many cases this is not a correct assumption, especially if 2013 was an unusual income tax year due to the sale of a business, unusual capital gains, exercise of stock options, or even winning the lottery!

The health insurance mandate

The Patient Protection and Affordable Care Act requires that you must carry a minimum level of health insurance for yourself, your spouse, and your dependents starting in 2014. If you fail to do so, you could possibly pay a fine. This fine in 2014 could be up to 1% of your yearly income or $95 per person for the year, whichever is higher. The penalties go up for 2015 and again for 2016.

Although you won't see this item on your 2013 tax return, this is something to be aware of because the mandate begins in 2014.

Conclusion

The IRS has certainly lived up to the old adage, "The only thing that is constant is change!" Each year brings us a new opportunity to adjust to different rules and tax laws, along with the opportunity to revisit our tax strategy and hopefully in turn reduce our taxes.

Many financial experts believe that higher taxes are inevitable in the near future in order to tame rising budget deficits. This could change the way Americans save and invest their money in the long run. In addition, the new tax laws may change your personal strategy. As always, you don't have to make decisions right away, but it is never too early to begin thinking about strategies for coping in a higher-tax world.

We hope that all these tax laws and changes do not confuse you. We believe that taking a proactive approach is better than a reactive approach—especially regarding income tax strategies!

Remember—if you ever have any questions regarding your finances, please be sure to call us first before making any decisions. We pride ourselves in our ability to help clients make decisions! Many times there is a simple solution to your question or concern. Don't worry about things that you don't need to worry about!

P.S. If you enjoy Girl Scout cookies, you might be able to turn that into a tax deduction. The only downside is that you can't eat them. The Girl Scouts of the USA is an Internal Revenue Service registered 501(c)(3) group, so donations you make to the group are tax deductible. However, when you're buying cookies for your own personal consumption from your neighborhood Girl Scouts, you are not making a donation. Technically, you are purchasing a product at a fair market value, so no part of your purchase price is tax deductible. Strategically, if you buy the cookies and then give them right back to the Girl Scouts who sold them, you can deduct the purchase price as a charitable contribution. Another strategy is to donate the cookies you purchased from a Girl Scout to another organization, which may qualify as a donation to the organization receiving the cookies and may therefore be tax-deductible. Of course, that strategy requires you to have the discipline of not sampling those tempting treats. For many of us, it might be better to write the Girl Scouts a clearly tax-deductible check, which also can serve as documentation of the gift, separate from cookie purchases.

Complimentary Financial Check-Up!

If you are not currently a client of Heritage Retirement Advisors, we would like to offer you a complimentary, one-hour, private consultation with one of our professionals at absolutely no cost or obligation to you. To schedule your financial check-up, please call **Raylene at Heritage Retirement Advisors, Inc. at (858) 487-1111.**

Sources: www.irs.gov; Kiplinger Tax Letter (1/2014); Fox Business (1/2014); abcnews.com (12/2013); Bankrate.com (1/2104); turbotax.intuit.com (1/2014) Fact Checked by Keebler & Associates.