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Dear Clients and Friends:

Recent tax law changes—and some that may come after the national elections—are likely to have a significant impact on year-end tax planning in 2014.

First, the Patient Protection and Affordable Care Act of 2010 (the PPACA) added several key tax provisions for individuals and employers, including a new 3.8% surtax affecting many investors. Next, the Tax Relief Act of 2010 (TRA) extended numerous tax breaks, although some were on a temporary basis. Finally, the American Taxpayer Relief Act of 2012 (ATRA) raised tax rates, reduced itemized deductions and personal exemptions for high-income taxpayers, and established permanent parameters for estate- and gift-tax planning, among other changes.

As things stand now, certain favorable tax law provisions that technically expired after 2013 or have been curtailed for 2014 may be reinstated, even retroactive to the beginning of the year, if Congress enacts new legislation. But the uncertainty could affect your year-end tax-planning decisions. It is important to continue to monitor developments.

Keeping all that in mind, we have prepared the following **2014 Year-End Tax-Planning Letter.** For your convenience, the letter has been divided into three sections:

- Individual Tax Planning
- Business Tax Planning
- Financial Tax Planning

Be aware that the tax-planning concepts discussed within this letter are intended only to provide an overview. It is recommended that you review your situation with a tax professional.

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INDIVIDUAL TAX PLANNING

Family Income-splitting

The time-tested technique of family income-splitting may be especially powerful in 2014. Currently, the top ordinary income tax rate is 39.6%, while the rate for taxpayers in the lowest income tax bracket is only 10%. Thus, the tax rate differential between you and a low-taxed family member, such as a child or grandchild, could be as great as 29.6%—not even counting the 3.8% surtax for investors (more on this later).

Tax tip: Shift income-producing property, such as securities, to family members in low tax brackets through direct gifts or trusts. But remember that you are giving up control over those assets—you no longer have legal claim to the property.

Also, be aware of the "kiddie tax." Unearned income above $2,000 received in 2014 by a child younger than age 19, or a child who is a full-time student younger than age 24, is generally taxed at the top marginal tax rate of the child's parents. The kiddie tax could have an impact on family income-splitting strategies at the end of the year.

Charitable Donations

Generally, you can deduct cash or cash-equivalent donations made to qualified charitable organizations, as long as you meet the strict substantiation requirements spelled out in the tax law. Furthermore, if you donate appreciated property held for more than one year, you can generally deduct an amount equal to the property's current fair market value. However, be aware that other limits may apply to charitable deductions.

Tax tip: Assuming you are able to deduct the full amount of your donations, you might step up charitable gift-giving before 2015. For instance, you could make an online donation late in December, charge your credit card and still write off the donation on your 2014 return—even if you do not actually pay the charge until January or later.

Conversely, if you expect to be in a higher tax bracket in 2015 than you are in 2014, you might postpone large gifts to next year when they will provide a greater tax benefit, subject to special rules for itemized deductions.

Alternative Minimum Tax

Despite recent legislation providing relief from the alternative minimum tax (AMT), millions of taxpayers will still be blindsided by this "stealth tax." The calculation for determining liability under the AMT involves inclusion of "tax preference items," various technical adjustments and subtraction of an exemption amount. After comparing the result to your regular tax, you effectively pay the higher of the two.

There are just two AMT rates: (1) 26% on AMT income up to $182,500 (up from $179,500 in 2013) and (2) 28% on AMT income above this threshold. Thus, the top AMT rate is lower than the top regular income tax rate of 39.6%.

Following a series of temporary "patches," the exemption amounts are now indexed annually, among other related changes. The chart below shows the gradual increase in exemption amounts over the last five years.

Filing status	2010	2011	2012	2013	2014
Joint filers	$72,450	$74,450	$78,750	$80,800	$82,100
Single filers	$47,450	$48,450	$50,600	$51,900	$52,800
Married filing separately	$36,225	$37,225	$39,375	$40,400	$41,050

Note that these exemption amounts are reduced for high-income taxpayers. This reduction, now subject to indexing thanks to a recent tax law change, is equal to 25 cents for each dollar of AMT income above $156,500 for joint filers (up from $153,900 for 2013); $117,300 for single filers (up from $115,400 in 2013); and $78,250 for married couples filing separately (up from $76,950 in 2013).

Tax tip: Assess your personal situation. Depending on the results, you may want to shift tax preference items to 2015 to avoid or reduce AMT liability for 2014. Alternatively, you might accelerate income into this year if you expect to pay a top regular income tax rate in 2015 that is higher than your 2014 AMT rate. In any event, do not wait until it is too late.

Pease and PEP Rules

Two recent tax law changes may reduce the tax benefits available to high-income taxpayers, but timely year-end action can minimize the consequences.

1. **Pease rule:** Under this rule, named for the congressman who initially introduced the legislation, most itemized deductions—including those claimed for charitable donations, state and local taxes, and mortgage interest—are reduced for 2014 by 3% of the excess above $254,200 of adjusted gross income (AGI) for single filers and $305,050 for joint filers (but not by more than 80% overall).

2. **PEP rule:** The personal exemption phaseout (PEP) rule requires you to reduce personal exemptions by 2% for every $2,500 of AGI (or fraction thereof) above the same thresholds used for the Pease rule.

Tax tip: Analyze your exposure to the Pease and PEP rules. In some cases, you may be able to lower your AGI or shift deductions to your tax advantage. For example, you might postpone large charitable gifts to next year if you expect that itemized deductions would be reduced by the Pease rule in 2014, but not in 2015.

Note that certain itemized deductions—typically, those with built-in floors—are not affected by the Pease rule. However, all personal exemptions, including those claimed for dependents, are subject to the PEP rule.

Medical and Dental Expenses

For 2014, you generally may deduct only unreimbursed medical and dental expenses in excess of 10% of your AGI. Prior to 2013, the limit was 7.5% of AGI, but this threshold remains through 2016 only for taxpayers who are age 65 or older.

Usually, you have no control over when medical or dental expenses occur. At other times, however, you may be able to schedule elective expenses, like physical examinations or dental cleanings, to your tax advantage.

Tax tip: Move nonemergency expenses into the optimal tax year for claiming deductions. For instance, if you are near or have already surpassed the AGI threshold this year, you could accelerate elective expenses into 2014. Otherwise, you might as well delay expenses to 2015, when you at least have a chance at a deduction.

For this purpose, include the unreimbursed medical and dental expenses you pay for your immediate family as well as other tax dependents such as an elderly parent or in-law. Paying these expenses may help you qualify for a deduction or boost an existing deduction.

Miscellaneous

- Keep an eye on tax benefits for higher education expenses. Although the tuition deduction expired after 2013, Congress may renew this tax break. Currently, a taxpayer may be eligible to claim one of two higher education credits, subject to phaseouts and other special rules. Historically, you could not claim both an education credit and the tuition deduction in the same tax year.

- When it makes sense, prepay state and local taxes due on January 1 of next year to increase your deduction for this year. However, if you expect to be in a higher tax bracket in 2015 than you are in 2014, you might bypass this common tax strategy.

- In some cases, you may consolidate outstanding personal debts into a home equity debt. Interest on personal debts is not tax-deductible, but you can deduct mortgage interest paid on the first $100,000 of home equity debt in most states, no matter how the proceeds are used. Caveat: The debt must be secured by your home.

- Miscellaneous expenses are deductible only in excess of 2% of your AGI. As with medical and dental expenses, you might arrange to pay qualified expenses (e.g., tax assistance fees) before 2015 to increase your deduction for 2014.

- You may be liable for an “estimated tax penalty” if you fail to pay enough tax through any combination of withholding or quarterly installments. But you can avoid the penalty by paying enough to satisfy a “safe harbor” of 90% of current tax liability or 100% of the previous year’s tax liability (110% if your AGI was above $150,000).

- Continue to monitor tax developments in Congress. If history repeats itself, tax breaks for education expenses (see above), energy-saving expenditures and state sales taxes (in lieu of deducting state income taxes) may be reinstated retroactively.

Section 179 Deductions

Under Section 179 of the tax code, a business may currently deduct, or "expense" in tax parlance, the cost of qualified property placed in service during the year, up to a maximum allowance. The maximum deduction is phased out on a dollar-for-dollar basis for amounts above an annual threshold.

The maximum allowance gradually increased to a high-water mark of $500,000, with a $2 million phaseout threshold, for the last four tax years. But it has been scaled back to just $25,000, with a $200,000 threshold, for 2014 (see chart below). Barring any late Congressional action, this relatively low limit may affect year-end planning.

Tax year	Deduction limit	Phaseout threshold
2007	$125,000	$500,000
2008–2009	$250,000	$800,000
2010–2013	$500,000	$2 million
2014	$25,000	$200,000

Tax tip: Buy property for your business that is needed, but hold off on other large purchases. Wait to see if Congress acts in time to provide benefits for property placed in service late in 2014.

Note that the Section 179 deduction is available for used, as well as new, business equipment. However, the deduction cannot exceed your taxable income from business activities. Keep this rule in mind when you make year-end purchases.

In a similar fashion, the tax law allowed a 50% bonus depreciation deduction for qualified property placed in service in 2013. For bonus depreciation purposes, "qualified property" included property with a cost-recovery period of 20 years or less and certain software, leasehold improvements and water utility property. Unlike Section 179, bonus depreciation was available only for property that has not been used. This tax break may be reinstated for 2014, along with a higher Section 179 allowance.

Depreciation Deductions

Absent the Section 179 deduction, you may recoup part of the cost of business property through regular depreciation deductions. Generally, deductions are computed under the Modified Accelerated Cost Recovery System (MACRS).

How it works: Your business may deduct the equivalent of a half-year's worth of depreciation for business property placed in service before the end of the year—no matter how late in the year it actually occurs. This tax break is called the "half-year convention." For instance, using the IRS tables for the half-year convention, you can deduct 20% of the cost of new computers placed in service in late December.

However, if the cost of business property (other than real estate) placed in service during the last quarter of the year—October 1 through December 31—exceeds 40% of the cost of assets placed in service during the entire year, depreciation deductions are calculated under the "midquarter convention," which is generally less favorable for business entities.

Tax tip: Figure out the maximum deduction available through Section 179 and MACRS. When warranted, postpone purchases to 2015 if you will trigger the last-quarter tax trap.

Repairs vs. Improvements

While expenses spent on making repairs are currently deductible, the cost of improvements to business property must be capitalized. The IRS issued new capitalization regulations in 2013 clarifying the distinctions between repairs and improvements.

As a rule of thumb, a repair keeps property in efficient operating condition while an improvement prolongs the life of the property, enhances its value or adapts it to a different use. For example, fixing a broken window is a repair, but the addition of a new wing to a business building is treated as an improvement.

Tax tip: When appropriate, schedule minor repairs to be made before the end of the year. The deductions can offset taxable income of your business in 2014.

Note that the capitalization regulations allow a qualified business to make a safe harbor election with regard to certain improvements. In effect, this may enable you to take a current deduction for amounts above the maximum Section 179 deduction. Contact your professional tax adviser for more details.

Business Bad Debts

If your business is having difficulty obtaining payments for goods or services it provides, you may be able to salvage some tax relief on your 2014 return.

Tax tip: Step up your collection activities at year-end. For instance, you may issue a series of dunning letters to debtors asking for payment. If you are still unable to collect the unpaid amount, you can generally write off the debt as a business bad debt.

Generally, business bad debts are deducted from taxable income in the year they become worthless. To qualify as a business bad debt, a loan or advance must have been created or acquired in connection with your business operation and result in a loss to the business entity if it cannot be repaid.

Finally, keep detailed records of all your collection activities—including letters, telephone calls, e-mails and efforts of collection agencies—in your files. This documentation can help support your position claiming worthlessness of the debt if the IRS ever challenges the bad debt deduction claimed on your 2014 return.

Small Employer Health Insurance Credit

Under the PPACA, a qualified small business is eligible for a credit if it pays for health insurance coverage for its employees. To qualify, the business must have fewer than 25 full-time employees (FTEs) with average annual wages of less than $50,800 in 2014. The credit is reduced if either of these two limits is exceeded.

Previously, the maximum credit was equal to 35% of the nonelective contributions made on behalf of employees. Beginning in 2014, it increases to 50% of the contributions.

Tax tip: Stay within the limits for claiming the credit. Note that sole proprietors, partners in a partnership, 2%-or-more owners of S corporations and 5%-or-more business owners, as well as their family members, do not count as FTEs for this purpose.

For 2014 and thereafter, an employer must obtain health insurance through the Small Business Health Options Program (SHOP) to qualify for the credit.

Miscellaneous

- Purchase routine business supplies before the end of the year. Your company can generally deduct the costs in 2014 even if the supplies are not used until 2015.
- Losses claimed by S corporation shareholders are limited to the basis in the stock plus outstanding debt. Thus, you might make a capital contribution or loan money to the corporation before year-end to increase your basis for loss deduction purposes.
- A company may deduct 100% of business travel costs and 50% of entertainment and meal expenses. To increase your current deduction, accelerate trips planned for 2015 into 2014. Note that a company can deduct 100% of the cost of a holiday party as long as the entire workforce is invited.
- If you buy a heavy-duty SUV or van for business driving, you may be able to claim a first-year deduction of up to $25,000. The usual "luxury car limits" don't apply to certain heavy-duty vehicles.
- When you qualify for home office deductions, you may deduct certain expenses incurred in connection with the business use. The IRS recently approved use of a simplified home office deduction, capped at $1,500.
- If you are starting a new business, open it before 2015. You are allowed to take a current deduction in 2014 for up to $5,000 for qualified start-up costs, instead of amortizing them over the usual 180-month period.
- When it makes sense, defer compensation, such as year-end bonuses, to 2015. An accrual-basis company may deduct year-end bonuses paid within 2½ months of the close of the tax year (but not for bonuses paid to certain business owners).

Capital Gains and Losses

Basic tax law rules require capital gains and losses to be netted and to offset each other. Any excess loss may offset up to $3,000 of ordinary income before it is carried over to the next year. A net long-term capital gain is generally taxed at a maximum rate of 15%, but it is 20% for those in the top ordinary income tax bracket. Short-term capital gains are taxed at ordinary income rates.

A traditional approach is to "harvest" capital losses from securities sales before the end of the year to offset prior gains. Conversely, if you are showing a net capital loss, you might realize capital gains that will be absorbed by prior losses.

Tax tip: In recent years, there has been more focus on harvesting capital gains. Significantly, a 0% capital gains tax rate applies to taxpayers in the lowest two regular income tax brackets of 10% and 15%. Even if your capital gains push you into a higher tax bracket, you still benefit from the 0% rate on the portion of the gains up to the top income threshold for the 15% tax bracket.

Be aware that other special rules may apply to capital gains and losses. For example, losses from passive investment activities may be limited.

3.8% Net Investment Income Surtax

For 2013 and thereafter, the 3% Medicare surtax applies to the lesser of your "net investment income" (NII) or the amount by which your modified adjusted gross income (MAGI) exceeds $200,000 for single filers and $250,000 for joint filers. The definition of NII includes interest, dividends, capital gains and income from passive activities, but not other items such as Social Security benefits, tax-exempt interest and distributions from qualified retirement plans and individual retirement accounts (IRAs).

Tax tip: Take steps to reduce exposure to the 3.8% surtax. For instance, depending on your situation, you might use one or more of the following techniques:

Add municipal bonds ("munis") to your portfolio. Interest income from munis does not count as NII, nor is it included in the MAGI calculation.

Establish a charitable remainder trust (CRT). With a CRT, you qualify for a current tax deduction while the income is sheltered from the surtax.

Become active in a passive activity. For example, if you own a business and meet the tax law requirements for "material participation," the business income may be exempted from the surtax.

Consider an investment in a tax-deferred annuity that "leapfrogs" your highest-earning years when the 3.8% surtax is likely to apply.

Of course, these decisions should not be made in a vacuum. Coordinate tax-saving strategies with other aspects of your financial plan.

Roth IRA Conversions

There are two main types of IRAs: (1) Traditional IRAs and (2) Roth IRAs.

Although contributions to traditional IRAs may be tax-deductible, deductions are phased out for "active participants" in employer-sponsored retirement plans. Future distributions are taxed at ordinary income rates. Conversely, Roth IRA contributions are never tax deductible, but qualified distributions from a Roth in existence at least five years are 100% tax-free. Taxation of other distributions is based on special "ordering rules."

Tax tip: Consider a Roth conversion for part or all of your traditional IRA funds. The transfer is currently taxable, but can provide future tax-free benefits. This is especially important if you expect to be in a higher tax bracket in the next few years.

Note that a Roth IRA conversion increases your MAGI for purposes of the 3.8% NII surtax. Therefore, to reduce your overall tax liability, you might initiate a series of Roth IRA conversions over several years instead of converting all the funds this year.

Required Minimum Distributions

As a general rule, you must receive "required minimum distributions" (RMDs) from qualified retirement plans and IRAs after attaining age 70½. The amount of the distribution is based on life expectancy tables.

Tax tip: Arrange to take RMDs well before the end of the year to avoid any potential problems. The penalty for a failure is severe: It is equal to 50% of the required amount (less any amount you have received).

However, be aware of this special exception. If you are still working and not a 5%-or-more owner of the business you are employed by, you can postpone RMDs from the employer's qualified plan until retirement. This rule does not apply to RMDs from IRAs.

Note that RMDs are not treated as NII for purposes of the 3.8% NII surtax. Nevertheless, an RMD may still increase your MAGI in the surtax calculation.

Estate and Gift Taxes

Beginning in 2001, legislation gradually increased the estate-tax exemption and reduced the top estate-tax rate, prior to a one-year repeal of the estate tax in 2010. Then the TRA reinstated the estate tax with a top rate of 35% and an exemption of $5 million (subject to inflation indexing). Other related tax breaks, including portability of estate-tax exemptions between spouses, were included in this law.

Subsequently, ATRA established a permanent top tax rate of 40% and estate-tax exemption of $5 million (indexed to $5.34 million in 2014), among other changes in this area. See the following chart for reference.

Tax year	Top estate-tax rate	Maximum estate-tax exemption
2002	50%	$1 million
2003	49%	$1 million
2004	48%	$1.5 million
2005	47%	$1.5 million
2006	46%	$2 million
2007–2008	45%	$2 million
2009	45%	$3.5 million
2010	Repealed	Not applicable
2011	35%	$5 million
2012	35%	$5.12 million
2013	40%	$5.25 million
2014	40%	$5.34 million

Tax tip: Update your estate plan to reflect current law. For instance, ATRA permanently retained the portability provision for married couples, so wills and trusts may be revised to take this into account. Seek guidance from your professional advisers.

Finally, be aware that you still may reduce the size of your taxable estate through lifetime gifts to family members. Under the annual gift-tax exclusion, you can give each recipient up to $14,000 ($28,000 for joint gifts by a married couple) in 2014.

Miscellaneous

- Under the "wash sale rule," you cannot deduct a loss on securities sales if you acquire substantially identical securities within 30 days. The simplest way to avoid this result is to wait at least 31 days before you repurchase the same or similar securities.
- It is often beneficial tax-wise to sell mutual fund shares before the fund declares dividends (the "ex-dividend date") and buy shares after the date the fund declares dividends.
- Increase deferrals to your 401(k) account to boost retirement savings. The maximum deferral for 2014 is $17,500 ($23,000 if age 50 or older). For instance, you might defer more to your account after clearing the 2014 Social Security wage base of $117,000. This will not reduce your take-home pay if only the payroll tax savings are allocated to extra 401(k) deferrals.
- Consider investments in dividend-paying stocks. As with net long-term capital gains, the maximum tax rate on qualified dividends received in 2014 is generally 15%, increasing to 20% for high-income taxpayers, while lower-income taxpayers may benefit from a 0% rate.
- When appropriate, invest in Passive Income Generators (PIGs) that provide income absorbed by passive activity losses (PALs). Generally, PALs for 2014 are limited to the amount of your income this year from passive activities.

CONCLUSION

This year-end tax-planning letter is based on the prevailing federal tax laws, rules and regulations. Of course, it is subject to change, especially if major tax reform provisions are enacted before the end of the year.

Finally, remember that the letter is intended only as a general guideline. Your personal circumstances will likely require greater examination. We will be glad to schedule a meeting with you to provide assistance with all your tax-planning needs.

Very truly yours,

LCS&Z, LLP