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Tax Topics

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It's a waiting game

November 4th and the mid-term elections are just around the corner. Polls suggest that Republicans could gain control of the Senate, and add seats in the House. If that happens, a Republican Congress presumably could pass legislation, but without President Obama's signature, that legislation would not become law – and overcoming a Presidential veto is a high hurdle. Could this electoral scenario therefore prompt compromise or merely continue the existing gridlock? It's anyone's guess.

In the meantime, nearly 60 tax "extenders" still languish. These temporary provisions of the tax law expired at the end of 2013, including the research and development credit, the $250 above-the-line deduction for certain out-of-pocket expenses of teachers, the deduction for state and local sales taxes, and the IRA charitable "rollover" provision (see below). IRS Commissioner John Koskinen recently wrote to Sen. Ron Wyden (D-OR), Chairman of the Senate Finance Committee, urging that Congress "expeditiously" address the extenders, as the continuing uncertainty regarding their fate could delay the start of the 2015 filing season (early filers are typically due a tax refund).

Rep. Dave Camp (R-MI), Chairman of the House Ways and Means Committee (he's retiring at the end of this term), has been pushing to have some of the extenders made permanent, including charitable IRA rollovers, as a prelude to tax reform; such a provision was included in H.R. 4719, the "America Gives More Act," which the House passed in mid-July. Sen. Wyden prefers extending most of the provisions for two years, also as a prelude to tax reform; to this end, the Finance Committee approved the EXPIRE bill (S. 2260) in April, although the bill failed to advance in the Senate.

The extenders therefore remain stalled. The hope is that the post-election lame-duck session of Congress will address them, rather than waiting for the new Congress to be seated in January. Regardless of when Congress addresses these extenders, however, a two-year extension would mean that the provisions still expire at the end of 2015, and have a very short shelf life.

Given the timing, what does this mean for taxpayers who would like to take advantage of **charitable IRA rollovers** in 2014? Recall that this provision lets taxpayers who are at least 70½ give up to $100,000 from their IRA to a public charity such as the taxpayer's favorite museum or alma mater (donor advised funds, supporting organizations or private foundations won't work). The distribution counts towards the taxpayer's "required minimum distribution" (RMD), is not subject to federal income tax, and is not deductible as a charitable contribution (note that the state income tax treatment may differ). The taxpayer can't receive anything in exchange for the contribution (no chicken dinners at the local charity event!), but can use it to satisfy an outstanding pledge. Although the check must be payable directly to the charity, the taxpayer can still deliver it herself.

For these taxpayers, then, it could be "déjà vu all over again."

That is, Congress last renewed charitable IRA rollovers in early 2013 (they had expired at the end of 2011). Nevertheless, a few special rules let taxpayers make 2012 charitable IRA rollovers after the fact: taxpayers who made a charitable IRA rollover in January 2013 could treat it as being made in 2012; and taxpayers who took an IRA distribution in December 2012 could treat it as a 2012 charitable IRA rollover – even though it had first passed through their hands – *if* they gave that same amount of cash to charity before February 1, 2013. Should Congress renew this provision, similar rules may apply for 2014.

Taxpayers who are concerned about when Congress may act could consider the following option: if they haven't yet taken their RMD for 2014, they could direct some or all of it to the charity of their choosing (subject to the conditions outlined above). If Congress renews the provision, these taxpayers are ahead of the game; if Congress doesn't renew the provision, they are no worse off than if they had taken their RMD directly and made a separate gift to charity: they would have been taxable on the RMD dollars anyway and can claim a charitable deduction for their contribution (note that the charitable income tax deduction is *not* a dollar-for-dollar offset). But taxpayers who wish to give more than their RMD to charity (up to $100,000) should proceed with caution: if the charitable IRA rollover provision dies, a gift in excess of their RMD could trigger significant tax on IRA dollars that would otherwise not be currently taxable, as those dollars would still be sitting in the IRA.

Tax reform?

As noted above, tax reform has been receiving bipartisan attention. If reform happens, perhaps in the next year or two (yes, a big "if"!), cherished tax benefits could be on the chopping block – or at least pared down for higher income taxpayers. Two such benefits are deductible contributions to employer-sponsored retirement accounts, such as 401(k)s, and the charitable deduction.

401(k) contributions and other elective deferrals. The 2014 contribution limit for deferred plans such as 401(k)s is $17,500, along with a catch-up contribution of $5,500 for taxpayers who are at least 50. This means that 50 year-old Mom, for example, could elect to contribute up to $23,000 of her 2014 compensation to her 401(k) account (assuming her employer offers one). To the extent she does so, these dollars are not subject to current income tax (and are therefore "pre-tax"), although they *are* subject to Social Security/FICA withholding. The account grows on a tax-deferred basis, and when Mom eventually takes money out in retirement, it is fully subject to income tax.

Mom's 401(k) contribution reduces her "adjusted gross income" (AGI): total income minus so-called "above-the-line" deductions. Because Mom's AGI is smaller, she has less potential exposure to some of the following: "PEP and Pease" (the personal exemption phase-out and limitations on most itemized deductions, including mortgage interest, state and local taxes and charitable contributions), the additional 0.90% (90 basis points) Medicare tax on wage income, plus the 3.8% tax on net investment income, such as dividends and capital gains.

In 2014, PEP and Pease start to affect taxpayers whose AGI exceeds $254,200 (single taxpayers), $305,050 (married filing jointly) or $152,525 (married filing separately); the 0.90% additional Medicare tax affects taxpayers whose wage income exceeds $200,000 (single taxpayers), $250,000 (married filing jointly) or $125,000 (married filing separately). The 3.8% net investment income tax can affect taxpayers whose AGI (plus otherwise excluded foreign income) exceeds the same $200,000/$250,000/$125,000 thresholds for the additional Medicare tax (thresholds that are *not* indexed for inflation).

Mom's AGI therefore has a ripple effect on her overall tax picture – and the lower her AGI, the less tax she may pay.

Could tax reform affect Mom's ability to fund her 401(k) with pre-tax dollars? Yes. Mom might find that at least part of her contribution must be made with "after-tax" dollars (this likely would give her "basis" in the account and make part of her eventual retirement distributions tax-free).

Or Mom might discover that pre-tax retirement accounts have disappeared altogether, in favor of what amounts to after-tax Roth retirement accounts for all (with Roth accounts, account earnings are generally income-tax free). Although such an approach could offer Mom long-term advantages, it is a more expensive proposition for her in the short-term.

To illustrate, suppose that in 2014, Mom will fully fund her 401(k) with $23,000. Factoring in Social Security/FICA withholding (for simplicity's sake, let's call it 9%), Mom has to earn $1.10 for every dollar she puts in the account, or about $25,275. How much would Mom need to earn if she could only use after-tax dollars for that $23,000 contribution? For simplicity's sake, let's assume that Mom's paycheck gets a 50% haircut, or that she takes home 50 cents on every dollar that she earns, factoring in withholding for federal, state and local income taxes, FICA, health and dental insurance premiums, contributions to her flexible spending and dependent care accounts, disability insurance, etc. Under this scenario, Mom would need to earn $46,000 to put $23,000 into her 401(k) – a big difference that could hamper her ability to save for retirement.

The bottom line is that to the extent taxpayers can afford to fully fund their retirement accounts, it makes sense to do so – particularly when the funding can be done with pre-tax dollars.

Charitable gifts of "capital gain property." Just as tax reform could affect retirement accounts, it could also affect itemized deductions, including those for charitable contributions. A number of proposals would further limit the amount high income taxpayers could deduct; another one, which was in Chairman Camp's Discussion Draft for tax reform (released in February of this year), would generally bar taxpayers from taking a fair market value deduction for charitable gifts of "capital gain property," unless the property fell into one of several exceptions, including that it was publicly traded stock. In other words, for example, the proposal would limit a donor's deduction for a charitable gift of closely held stock to the donor's "adjusted basis" in the stock.

Under current law, "capital gain property" typically refers to property that would be eligible for long-term capital gains tax treatment if it were sold – in other words, this is property the donor has owned for more than a year (appreciated property that doesn't met this holding period would be subject to ordinary income treatment if it were sold).

It is worth reviewing how powerful gifts of appreciated stock can be, for both the donor and the charity. The following example illustrates this:

Dad would like to give his alma mater $100,000, but doesn't want to deplete his cash reserves. Dad therefore gives Alma Mater $100,000 worth of XYZ stock, which has a zero basis, and a built-in capital gain of $100,000. Must Dad recognize this gain? After all, if he had first sold the stock and used the net proceeds for his gift to Alma Mater, he would probably be facing total tax of about 30%-35%, given the top 20% capital gains tax, state and local taxes, and the 3.8% net investment tax. Answer: No, Dad doesn't recognize the gain, and it doesn't matter to Alma Mater, which is tax-exempt and can sell the stock without tax friction. Furthermore, Dad's deduction is based on XYZ's fair market value; if he can't fully use the deduction this year (it can't exceed 30% of his adjusted gross income), he has five years going forward to use it.

This is a true win-win: Dad is able to make a charitable gift without depleting his cash, and charity arguably ends up with a larger gift. Philanthropically minded individuals can therefore reduce some of their low-basis holdings without incurring tax.

To sum up. If Congress manages to hammer out tax reform, cherished tax benefits may take a hit. Before that happens, however, taxpayers who are in a position to take advantage of these benefits may want to consider doing so.

Social Security increase

On October 22nd, the Social Security Administration announced that there would be a 1.7% increase in Social Security benefits for 2015. The 6.2% payroll tax – the OASDI (old age, survivors, and disability insurance) portion of FICA – will apply to an employee's first $118,500 of earnings (up from $117,000 in 2014). The 1.45% Medicare hospital insurance portion of FICA applies to an unlimited amount of wages (as mentioned above, the Medicare tax is increased by another 0.90% for wage income that exceeds $200,000 (single taxpayers), $250,000 (married filing jointly) and $125,000 (married filing separately) – bringing the total Medicare tax for wage income above those amounts to 2.35%).

November 7520 rate

The November 7520 rate remains at 2.2%, where it was in October. The November mid-term rates are: 1.90% (annual), 1.89% (semiannual and quarterly), and 1.88% (monthly). The October mid-term rates were: 1.85% (annual), 1.84% (semiannual and quarterly), and 1.83% (monthly).

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