Itemized Deductions: Back to the Future

Reduction scheduled to return in 2013

Absent any new legislation from Congress, a tax law provision that limits the dollar amount of itemized deductions for high-income taxpayers is returning with a vengeance. The so-called "Pease rule" or "Pease amendment"—named for the Congressman who originally introduced it more than 20 years ago—could have a significant impact on your 2013 tax liability.

Background: Under the Pease rule, certain itemized deductions are reduced if your adjusted gross income (AGI) exceeds a specific dollar threshold. This provision was initially included in the Omnibus Budget Reconciliation Act of 1990. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) gradually reduced the impact before the reduction was completely eliminated for 2010. Due to the "sunset" aspects of EGTRRA, it was scheduled to return in 2011, but the 2010 Tax Relief Act extended the repeal through 2012. Now the Pease rule is scheduled to revert to pre-EGTRRA status in 2013.

Note that the Pease rule does not apply to all itemized deductions, although several "big-ticket items" are on the list. This includes charitable donations, mortgage interest, state and local income taxes and property taxes, and miscellaneous expenses. It does not cover medical expense deductions, investment interest deductions, casualty and theft deductions, or gambling loss deductions, but these other deductions already have built-in limits. For instance, medical expense deductions are generally limited to the excess above 10% of your AGI in 2013 (up from 7.5% in 2012).

The dollar threshold for the Pease rule is the same for single filers as it is for joint filers (but it is halved for a married taxpayer filing a separate return). Currently, the reduction is equal to 3% of the excess over the applicable threshold (projected to be $178,150 of AGI for 2013). However, in no case can the reduction be greater than 80% of your total deductions.

Example 1: Suppose that John exceeds the AGI threshold by $200,000 and has $50,000 in annual deductions from charitable gifts, mortgage interest, and state and local taxes. As a result, the reduction is equal to 3% of the $200,000 excess, or $6,000. So his itemized deductions of $50,000 are scaled back to $44,000.

Example 2: Now say that Jane exceeds the AGI threshold by $1 million and has $35,000 in annual deductions from charitable gifts, mortgage interest, and state and local taxes. Normally, the reduction would be equal to 3% of the $1 million excess, or $30,000, cutting back her deductions to only $5,000. But

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this would be a reduction greater than 80%. As a result, the reduction cannot be more than $28,000, so Jane can deduct $7,000.

The Pease rule does not figure in the alternative minimum tax (AMT) calculation for individual taxpayers. But certain itemized deductions—including mortgage interest, and state and local income taxes—are already disallowed under the AMT.

Another comparable tax law rule phases out the tax benefit of personal exemptions for certain high-income taxpayers. Obtain more details from your tax advisers.

Consider the potential impact of the Pease rule in 2013. It may encourage you to postpone charitable gifts to a low-tax year or accelerate deductible expenses into this year if you anticipate being below the AGI threshold. Finally, these rules might change, so stay on top of any new developments.

Compare the Two Types of IRAs

How they stack up against each other

When you hear the word “IRA,” what comes to mind? There are two basic types: the traditional IRA and the Roth IRA. It is important to know the similarities and distinctions.

For starters, the annual limit for contributions to all IRAs for the 2012 tax year, in any combination, is $5,000 (increasing to $5,500 in 2013). Plus, you can add an additional $1,000 if you are age 50 or older. There is no current tax on the contributions earnings in any account. You still have until April 15, 2013, to make contributions for the 2012 tax year, but no extension is permitted. Generally, you can choose from a wide range of investment options for either type of account, but investments in most collectibles are not permitted. Now let’s look at the main differences:

Traditional IRAs: Contributions may be wholly or partially deductible. But deductions are phased out if your modified adjusted gross income (MAGI) exceeds a specified level and you (or your spouse if you are married) are an active participant in an employer-sponsored retirement plan. Therefore, for many individuals, no part of the contribution to a traditional IRA is tax-deductible.

When you receive distributions from a traditional IRA, you are taxed at ordinary income tax rates on the portion representing deductible contributions and earnings. In addition, you will have to pay a 10% penalty tax on withdrawals made before age 59½, unless one of the special tax law exceptions applies.

Roth IRAs: As opposed to a traditional IRA, contributions to a Roth IRA are never tax-deductible, regardless of your MAGI. But there is a potential payoff on the back-end that you cannot realize with a traditional IRA: qualified distributions from a Roth IRA in existence for at least five years are 100% tax-free. For this purpose, qualified distributions include withdrawals made after age 59½, those made on account of death or disability, or those used to pay qualified first-time homebuyer expenses (up to a lifetime limit of $10,000).

Other distributions are taxed at ordinary income rates under special “ordering rules.” Contributions are treated as coming out first, followed by conversion and rollover amounts and earnings. Thus, even if you do not receive qualified distributions, part or all of the payout may be tax-free.

Due to the lure of tax-free distributions, you might consider converting some or all of the funds in your traditional IRA to a Roth IRA. This may also protect high-income taxpayers in the future from the new 3.8% Medicare surtax on net investment income. (The surtax takes effect in 2013.) But be aware that the conversion itself is taxable at ordinary income rates just like a withdrawal. If you have funds being transferred to pay the resulting tax, it will dilute some of the tax benefit.

Which type of IRA is best for you? It depends on a number of variables and your personal circumstances. Rely on your professional advisers to provide guidance.

Give Us A Call!

Do you have any questions or comments about this newsletter or your individual situation? Please do not hesitate to contact our office. We would be glad to serve you in any way we can.

Ten Job-Hunting Mistakes to Avoid

Don't sabotage employment chances

No one (or hardly anyone) will say that finding a job in the current economic environment is easy. But you might make a bad situation even worse by committing one or more costly blunders. What sort of mistakes are we talking about? Here are 10 job-searching mistakes that might derail your chances when a good employment opportunity presents itself.

1. You ignore the latest advice.

Job-hunting has changed dramatically over the last decade, but you might still be practicing what you learned in the 20th century. Don't follow outdated advice that can hurt your chances now. Ideally, your advice should come from sources who have done a significant amount of hiring themselves—and recently, not a couple of decades ago.

2. You list job responsibilities on your résumé, but not accomplishments.

It is important to focus more on what you *accomplished* than what your duties were. Employers want to know the reason why they should hire you instead of someone else.

3. You list everything you have ever done on your résumé.

Don't go overboard on the details. For instance, it is usually not necessary to list a short-term job you held between graduate school and your first career-related position.

4. You fail to use a cover letter.

A cover letter is a good way to grab attention. It is an opportunity to make a compelling case for being a new-hire without referring to your résumé.

5. You pester the employer for results.

Job-seekers are sometimes advised to check in with employers. But this might backfire if the employer, who is usually inundated with résumés and hard-pressed to spend time interviewing candidates, gets peeved. Try to be patient.

6. You don't prepare for your interviews.

Practice answers to likely questions, and be ready to provide examples why you should be hired. If you are not prepared, you could be passed over for the job, even though you might be a perfect fit.

7. You don't do anything to stand out.

In this competitive labor marketplace, you need to set yourself apart. But that does not mean relying on gimmicks. Show that you are a qualified candidate by pointing out your successes and being responsive, engaging and enthusiastic.

8. You pay little attention to references.

If you are in line for a job, you should not have to scramble to find the boss you worked for years ago or someone else who has retired or moved. Stay in touch with potential references who will be easy to reach if needed.

9. You ignore the "red flags."

Although you may want a job, don't plunge into a nightmare. Watch out for warning signs at interviews such as extremely high turnover rates, a rude or abrasive boss, or an overly negative workplace.

10. You become bitter.

Finding a job is difficult, but don't allow your frustrations to boil over. Your body language and attitude might hinder new employment opportunities. Keep a positive outlook that will encourage an employer to bring you on board.

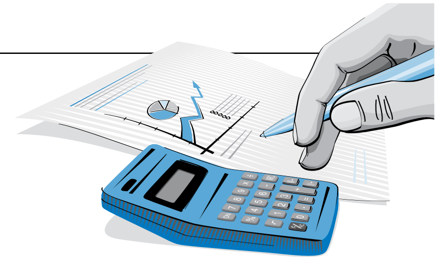
Of course, there are no guarantees, but avoiding these 10 common mistakes can only help. The rest is up to you.

Beware the Ides of March

For those of you who are not familiar with Shakespeare's *Julius Caesar*, the "Ides of March" is March 15. That is also the deadline for emptying out a flexible spending account (FSA) from the prior year if your company permits a "grace period" of 2½ months after the close of the year.

Any amount for 2012 that you don't use by March 15, 2013, is gone … forever.

Note: Beginning in 2013, contributions to a health care FSA are capped at $2,500. Previously, there was no limit.



Putting Work Into the Business Budget

Practical tips for financial improvement

Do you sit down regularly, perhaps monthly, to develop a budget reflecting your personal income and expenses? The same basic principles that apply to a household budget may be extended to your small business. In fact, it can be argued that business budgeting is now more important than ever. Here are several practical suggestions:

♦ **Be conservative.** It is far better to err on the side of understating income and overstating expenses than to do things the other way. That will help eliminate unpleasant surprises at the end of the year. If things work out better than anticipated, count the surplus as a bonus.

♦ **Remain flexible.** Essentially, a corporate budget is a projection of the income and expenses of your enterprise. In other words, it should be based on calculated estimates at the beginning of the year, but that doesn't mean it should be rigid. Use your recent history as a guideline, but leave some room for flexibility.

♦ **Divide up expenses.** Certain costs, such as the monthly rent bill, are usually fixed throughout the year. But dollars spent on other items—for example, supplies and equipment—may fluctuate throughout the year. Identify the unpredictable expenses and separate them. Not only will this provide clarity for your business but it may lead to strategies for minimizing costs.

♦ **Monitor the results.** When your business pays its bills each month, see how the numbers match up against your projections. You may have to adjust your budget to reflect actual income and expenses. Remember that your budget is a "work in progress," not a finished product

♦ **Discipline yourself.** Putting a plan in writing can help you curtail unnecessary expenses. For instance, without a budget you might drive down to the local computer store to buy the latest gadget as soon as you receive a big check from a client. With budgetary restraints, you can earmark the funds for necessary expenses.

♦ **Plan for the future.** Once you become adept at pinpointing business patterns through your budget, it will become easier to plan long-term growth and development. Again, use a healthy dose of caution: It's better to be conservative than to make projections your company simply won't attain.

♦ **Get started now.** Although it takes time to develop a detailed budget, roughing out a rudimentary version is generally better than no budget at all. If you wait until another year rolls around to take this approach, it may be too late.

Final words: If you are having difficulty balancing all the various factors, you don't have to go it alone. With assistance from your professional advisers, you should be able to create a monthly budget that meets the needs of your particular business.

Facts and Figures

Timely points of particular interest

➡ **Compare and Contrast**—Making a written comparison of your business with that of your main competitor enables you to pinpoint both of your respective strengths and weaknesses. It also makes an argument for others to choose your business. Prospects can read the comparisons and make an informed decision about your business. This could be a good way to promote a business within a specific industry. **Caveat:** Such an undertaking requires research and writing skills.

➡ **Disaster Relief**—Normally, you must claim a casualty loss on the tax return for the year in which the catastrophic event occurred. But you can obtain faster tax relief for losses in a federal disaster area by claiming the losses on the tax return for the prior year. For instance, victims of Hurricane Sandy may benefit by amending their 2011 returns. Similarly, if you suffer a disaster in 2013, you can claim a loss on your 2012 return.