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Re: Year-End Tax Planning

Dear Client:

Tax planners and their clients face the prospect of a darker tax climate in 2013 for investment income and gains. Under current law, higher-income taxpayers will face a 3.8% surtax on their investment income and gains. Additionally, if the EGTRRA and JGTRRA sunsets go into effect, all taxpayers will face higher taxes on investment income and gains, and the vast majority of taxpayers also will face higher rates on their ordinary income. This third part of a multi-part year-end planning article explains how the careful handling of capital gains and losses by individuals can save taxes. For the second part, explaining how taxpayers with cash sitting idle in their corporations should consider pulling some of it out before the end of 2012 to avoid higher rates next year. For the first part of this year-end planning article, explaining who has worry about the post-2012 3.8% surtax and what it covers, key sunset rules, and strategies for home sellers.

The case for selling appreciated assets this year. An individual taxpayer who is considering selling some appreciated assets, e.g., because he believes the assets are close to their peak price, or because he needs funds to make other investments that he believes will be even more profitable, should consider the extent to which he should sell all or part of those assets in 2012. While it is often better to defer receipt of income (including capital gains) so as to also defer the payment of tax, for the following reasons it may be better to sell appreciated assets this year.

(1) This year's maximum long-capital gain rate may be lower than next year's maximum rate. For 2012, long-term capital gains are taxed at a maximum rate of 15% (0% to the extent the gain would otherwise be taxed at a rate below 25% if it were ordinary income). By contrast, if the EGTRRA/JGTRRA sunset takes effect, in 2013 long-term capital gain will taxed at a maximum rate of 20% (18% for assets held more than five years). For lower-income taxpayers, the maximum rate will be 10% (8% for assets held for more than five years).

(2) Capital gains of some high-income taxpayers may be subject to a 3.8% surtax in 2013.

(3) Even if the 2012 long-term capital gain rates are extended so that they still apply in 2013, some taxpayers may be in a lower tax-bracket this year than they will be in next year so that all or part of their long-term capital gain may be subject to no tax (or lower tax) if taken into account this year.

(4) Some individuals may be able to make better use of capital losses this year, e.g., be able to offset short-term capital gains with long-term capital losses.

NLG comment: When to sell appreciated assets is not just a tax issue. Most planning involving capital gains and losses requires consideration of investment factors as well. For example, a taxpayer won't want to defer recognizing gain until the following year if there's too much risk that the value of the property will decline before it can be sold. Similarly, a taxpayer won't want to risk increasing a loss on property that he expects will continue to decline in value by deferring the sale of that property until the following year.

Avoiding higher potential rates on long-term capital gains in 2012. Some individuals may have gains on stocks, bonds, mutual fund shares, or other investment assets that they are planning to sell in the next few months to raise funds for other purposes, or because they believe some investments are unlikely to go much higher or may even start declining in value. By selling these assets before the end of the year, these individuals would be sure to benefit from the lower maximum long-term capital gain rate that is in effect in 2012 but which may not be in effect in 2013.

NLG illustration 1: In 2012, Harry and Wanda, a married couple who file a joint return, will have taxable income of $350,000 before taking any capital gains into account. They expect their taxable income next year to be about the same. In the next few months, they are considering selling stock which they have held for three years, and on which they currently have a gain of $200,000. If they sell the stock in 2012 at a gain of $200,000, they will pay a tax of $30,00 on the gain (15% of $200,000). If they wait until 2013 to make the sale, and still have a gain of $200,000, and the EGTRRA/JGTRRA sunset takes effect, they will pay a tax of $40,000 on that gain (20% of $50,000), or $10,000 more than they would pay if the sale had been made in 2012.

NLG recommendation: At this time, it's uncertain whether the EGTRRA/JGTRRA sunset will take effect to increase the maximum tax rate on long-term capital gains, will rise only for higher income taxpayers, or will be deferred once again. Since it's possible that the matter will be resolved before the end of the year by the lame duck Congress, an individual who wants to make a sale this year only if the rate does go up next year should wait—with due regard for the investment factors—to nearer the end of the year to see what happens.

Effect of 3.8% surtax on when to take capital gains into account. For tax years beginning after 2012, a 3.8% surtax applies on the lesser of (i) net investment income or (ii) the amount by which modified adjusted gross income (MAGI) exceeds a threshold amount. The threshold is $250,000 for joint filers or surviving spouses, $125,000 for a married individual filing a separate return, and $200,000 in any other case. MAGI is adjusted gross income increased by the amount excluded from income as foreign earned income under **Code Sec. 911(a)(1)** (net of the deductions

and exclusions disallowed with respect to the foreign earned income). Net investment income generally includes taxable interest, dividends, annuities, royalties, rents, and capital gains.

Individuals who otherwise plan to sell appreciated assets in the next few months, and who would be subject to the surtax, should consider making the sale this year to avoid the surtax. Delaying the sale until next year would result in an increase in taxes even if the EGTRRA/JGTRRA sunset does not go into effect. If the sunset does go into effect, it will result in an even higher increase in the excess of the tax that would have to be paid on their gains in 2013 over what they would have to pay in 2012.

> **NLG illustration 2:** Same facts as in *illustration (1)* except that Harry and Wanda's MAGI for 2013 will be $650,000, and their net investment income will be $30,000, without taking into account gains from their appreciated-in-value stock. If they delay taking their long-term capital gain into account until 2013, in addition to paying a $40,000 tax at 20% rate on their $200,000 long-term capital gains in that year (assuming the EGTRRA/JGTRRA sunset goes into effect), they will pay a surtax of $8,740 on their net investment income (3.8% of $230,000) since the total of their net investment income is less that $400,000 (i.e., the excess of $650,000 in MAGI over the $250,000 threshold for married couples filing a joint return). Of that $8,740 tax on their net investment income, $7,600 is attributable to their long-term capital gains (3.8% of $200,000). Thus, they would pay a total tax of $47,600 on their long-term capital gains in 2013 ($40,000, plus $7,600), or $17,600 more than the $30,000 they would pay if they took their capital gains into account in 2012.
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> **NLG illustration 3:** Same facts as in *illustration (2)* except that the EGTRRA/JGTRRA sunset does not take effect in 2013, and the maximum rate on long-term capital gains remains the same as it was in 2012. Because of the 3.8% surtax, Harry and Wanda will still pay $7,600 more in tax on their long-term capital gains if they take those gains in 2013 instead of in 2012.

Cut taxes on some long-term capital gains by taking them in 2012*, even if EGTRRA/JGTRRA sunset does not come into effect in 2013.* Even if the EGTRRA/JGTRRA sunset does not come into effect in 2013, some comparatively lower-income taxpayers may be able to reduce their taxes on long-term capital gains by taking those capital gains in 2012 instead of 2013, or by splitting gains they plan to take between 2012 and 2013. Taking some of those gains in 2012 may be especially useful for taxpayers who expect to have substantially lower taxable income other than long-term capital gains in 2012 than in 2013, e.g., because they have been out of work for a good part of 2012 but expect to be employed for all or most of 2013.

> **NLG illustration 4:** Andy, a single taxpayer, expects to have taxable income (other than long-term capital gains) of $20,000 in 2012, but expects his taxable income in 2013 to be at least $40,000. We'll assume

the EGTRRA/JGTRRA sunsets won't go into effect in 2013. He will be in the 25% tax bracket for 2012 only if his income is over $35,350, and he is sure to be in a 25% tax bracket in 2013 if his income is at least $40,000. Andy owns some inherited stock on which he has a long-term capital gain of $15,000. If he takes that gain in 2012, he will pay no tax on the gain since his total taxable income including the gain will be only $35,000, or less than the amount at which any of his income would be taxed at a rate of 25% if it were ordinary income. On the other hand, if Andy delays taking the gain until 2013, he will pay a tax of $2,250 on the gain (15% of $15,000) since all of the gain would be taxed at a rate of 25% if it were ordinary income.

NLG illustration 5: Same facts as in illustration (4) except that the EGTRRA/JGTRRA sunset provisions do go into effect in 2013. By delaying taking his gain on his stock until 2013, Andy would pay a tax of $3,000 on the gain (20% of $15,000) unless he had held the stock for more than five years when he sold it, in which case his tax would be $2,700 (18% of $15,000).

NLG illustration 6: Beatrice, a widow, living on social security and a small pension, expects to have taxable income of $25,000 in both 2012 and 2013. She owns some non-dividend-paying stock on which she has long-term capital gain of $20,000. She would like to sell the stock and invest the proceeds in bonds that would provide her with some interest income. Assume the EGTRRA/JGTRRA sunset does not go into effect in 2013. If she sells all the stock in 2012, she will have to pay a $1,448 tax on her gain (15% of $9,650, the amount by which her total income of $45,000 (including the capital gain) exceeds $35,350, the amount at which all her income would be taxed at a rate under 25% if it were all ordinary income.

On the other hand, if she sells half the stock in 2012 and half in 2013 to split the gain, then she will not pay any tax on the gain in either year since her total taxable income in each year, including the gain, will be less than the amount on which her income would be taxed at a rate of 15% if it all were ordinary income).

Using available losses. Long-term capital losses are used to offset long-term capital gains before they are used to offset short-term capital gains. Similarly, short-term capital losses must be used to offset short-term capital gains before they are used to offset long-term capital gains. Noncorporate taxpayers may use up to $3,000 of total capital losses in excess of total capital gains as a deduction against ordinary income in computing AGI.

For 2012, a noncorporate taxpayer is subject to tax at a rate as high as 35% on short-term capital gains and ordinary income. If the EGTRRA/JGTRRA sunsets take effect, for 2013, a noncorporate taxpayer will be subject to tax at a rate as high as 39.6% on short-term capital gains and ordinary income. As noted above, in 2012, most long-term capital gains are taxed at a maximum rate of 15%, but will be taxed

at a maximum rate of 20% in 2013 if the EGTRRA/JGTRRA sunsets take effect (18% for assets held more than five years).

> **NLG recommendation:** A taxpayer should try to avoid having long-term capital losses offset long-term capital gains since those losses will be more valuable if they are used to offset short-term capital gains or ordinary income. Thus, to the extent that taking long-term capital losses in a different year than long-term capital gains is consistent with good investment planning, the taxpayer should take steps to prevent those losses from offsetting those gains.
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> **NLG illustration 7:** Toward the end of 2012, Jack, a single taxpayer whose ordinary income puts him in the 35% tax bracket, has unrealized long-term capital losses of $50,000, unrealized short-term capital gain of $50,000, and unrealized long-term gains of $50,000. Jack believes that the total amount of his capital gains and losses will not change much between the end of 2012 and the beginning of 2013. If Jack realizes all of his gains and losses in 2012, his long-term capital losses will offset all of his long-term capital gains, and he will pay a tax of $17,500 on his short-term capital gains in 2012 (35% of $50,000).
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> On the other hand, if Jack realizes his long-term capital gain of $50,000 in 2012, and defers realizing his long-term capital loss and his short-term capital gain until 2013, he will pay a tax of $7,500 on the long-term capital gain in 2012 (15% of $50,000). In 2013, he will pay no tax on the short-term capital gain of $50,000 since it will be offset in full by the $50,000 of long-term capital loss carried over to, and realized in, that year. This will be so regardless of whether the EGTRRA/JGTRRA sunsets take effect in 2013. The 3.8% surtax won't apply to the transactions because the loss will fully offset the gain.
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> **NLG observation:** In *illustration (7),* if all of the gains and losses had been realized in 2013, Jack would still have paid a tax at ordinary income rates on the short-term capital gain in 2013, and if the EGTRRA/JGTRRA sunsets do take effect in that year, his tax would be $19,800 (39.6% of $50,000), and not $17,500. In addition, depending on what Jack's MAGI is in 2013, the gains may be subject to the 3.8% surtax, resulting in an additional tax of $1,900 (3.8% of $50,000).

How to preserve investment position after recognizing gain or loss on stock. For the reasons outlined above, paper losses or gains on stocks may be worth realizing in 2012 to recognize losses and use them to offset other gains, or to avoid potentially higher taxes if appreciated stocks are sold in 2013 or a later year. But suppose the taxpayer owns stock that is an attractive investment worth holding onto for the long term. There is no way to precisely preserve a stock investment position while at the same time gaining the benefit of the tax loss, because the so-called "wash sale" rule precludes recognition of loss where substantially identical securities are bought and sold within a 61-day period (30 days before or 30 days after the date of sale). Thus, a taxpayer can't sell the stock to establish the tax loss and simply buy it back the next

day. However, he can substantially preserve an investment position while realizing a tax loss by using one of these techniques:

1. Double up. Buy more of the same stocks or bonds, then sell the original holding at least 31 days later. The risk here is of further downward price movement.
2. Sell the original holding and then buy the same securities at least 31 days later. The risk here is that the taxpayer may have to pay more to buy the same stocks or bonds back if the price goes up before the repurchase.
3. Sell the original holding and buy similar securities in different companies in the same line of business. This approach trades on the prospects of the industry as a whole, rather than the particular stock held.
4. In the case of mutual fund shares, sell the original holding and buy shares in another mutual fund that uses a similar investment strategy.
   NLG caution: If the other mutual fund tracks too closely the investments in the fund that was sold, there is a danger that IRS will treat it as substantially identical to the fund that was sold. This would be especially true for index funds, e.g., mutual funds that invest in stocks that track the S&P 500 index.

NLG observation: The basis of repurchased shares is adjusted to reflect losses barred under the wash sale rule.

NLG observation: The wash sale rules apply only when securities are sold at a loss. As a result, a taxpayer may recognize a paper gain on stock in 2012 for year-end planning purposes and then buy it back at any time without having to worry about the wash sale rules.

NLG observation: Even if a taxpayer has substantial long-term capital gains in a stock that he expects to appreciate even more over the next few years, there can be advantages to selling all or part of it in 2012 even if there are no offsetting losses available to reduce the amount of capital gain that will be recognized this year. By selling this year, the taxpayer's gain will be taxed at no more than 15%. If he sells in 2013, and the EGTRRA/JGTRRA sunsets take effect, the gain will be taxed at a rate of 20%. Since the wash sale rules don't apply to stock sold at a gain, the taxpayer can buy the same number of shares he sells at the same time as the sale is made. While he will have to pay a tax on the gain, he will get a stepped-up basis for the shares he buys. Thus, if the stock continues to appreciate, and he sells all or part of it in 2013 or a later year, the gain recognized in the later year will be reduced by the amount of the increase in his basis. Thus, there will be less gain to be taxed at a 20% rate if the EGTRRA/JGTRRA sunsets take effect in 2013, and also less gain that might be subject to the 3.8% surtax.

NLG illustration 8: Kelly, a single taxpayer who is in the 35% tax bracket, owns 2,000 shares of stock of X Corp for which she paid $200,000, and on which she has a substantial unrealized long-term

capital gain. Kelly believes that X stock will continue to appreciate substantially over the next year but is concerned with the possibility that the EGTRRA/JGTRRA sunsets will go into effect for 2013, and she will have to pay a higher tax if she sells her shares that year. In addition, she's been told that she will be subject to a 3.8% tax on her net investment income in 2013. Following the advice of her investment and tax advisors, Kelly sells her X stock in Oct. 8, 2012, for $700,000 and recognizes a gain of $500,000 on the sale ($700,000 less $200,000), on which she will pay a tax of $75,000 (15% of $500,000). She immediately purchases 2,000 shares of X stock for $700,000, the same price at which she sold her original shares.

In 2013, Kelly's MAGI, before taking net investment income into account, will be more than $200,000, the threshold at which the 3.8% surtax comes into effect. This means that her entire net investment income will be subject to the 3.8% surtax since her net investment income will always be less than the excess of her MAGI (including net investment income) over $200,000. X stock continues to appreciate in value, and on Oct. 10, 2013, she sells all her shares for $1.1 million, and recognizes a long-term capital gain of $400,000 on the sale ($1.1 million less $700,000). Thus, Kelly will pay a surtax of $15,200 on her gain (3.8% of $400,000). In addition, if the EGTRRA/JGTRRA sunsets take effect in 2013, she will pay a long-term capital gains tax of $80,000 (20% of $400,000) on her gain.

However, if she had not made her sale and repurchase of X stock in 2012, she would pay a surtax of $34,200 (3.8% of $900,000), and a long-term capital gains tax of $180,000 (20% of $900,000). Thus, she would pay total taxes of $214,200 in 2013 ($34,200 surtax plus long-term capital gains tax of $180,000). That's $44,000 more than the total taxes of $170,200 she will pay by taking her $500,000 gain in 2012 and reducing her gain in 2013 to $400,000 ($15,200 surtax for 2013, plus $75,000 long-term capitals gain tax for 2012, plus $80,000 long-term capital gains tax for 2013).

As always, we hope the guidance above will be helpful for both your personal and business endeavors.

Very truly yours,

Vincent J. Nardone

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