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Dear Tax Client:

Wow! Where did the year go? I'm sure Congress feels the same way, as they did not pass much in the way of new tax laws, but they did extend a lot of expiring tax laws at the beginning of the year. Though, as you'll see, a number of them expire again at the end of this year, and there is no indication whether they will be extended again. Below are some of the highlights of the tax legislation taking effect this year and key numbers as adjusted for inflation.

Tax Rates: Congress permanently extended the Bush Era tax rates, but we also have the return of the 39.6% Federal tax bracket starting at \$400k taxable income on Single returns and \$450k on Joint returns as well as the return of the phase-out of personal exemptions and itemized deductions once adjusted gross income exceeds \$250k on Single returns and \$300k on Joint returns. The good news is that the Alternative Minimum Tax exemptions were permanently extended, helping to keep more people from being subject to AMT. The \$1,000 child tax credit was also permanently extended for dependent children under age 17.

Estate & Gift Tax: The estate and gift tax for 2013 is at a marginal rate of 40% for estates and gifts that total more than the \$5,250,000 exemption. The annual non-includible gift limitation increased to \$14,000 per person for 2013 and 2014.

Adoption Credit: For 2013, the adoption credit is \$12,970 but is not refundable. This credit will start phasing out when Adjusted Gross Income (AGI) exceeds \$194,580.

Employer Health Insurance Credit: For 2013, a maximum 35% credit (25% for non-profits) can be taken by small employers who cover at least 50% of their employees' group health insurance premiums. The credit starts to phase out, however, as the average full-time number of employees exceeds 10 and completely phases out with an average of 25 or more employees. The credit also starts to phase out once average annual employee compensation exceeds \$25,000 and completely phases out with an average employee compensation of \$50,000 or more. The exact calculation is very complicated!

Affordable Care Act Provisions: For 2013, deductible medical expenses for those under age 65 first have to exceed 10% of AGI, instead of the old 7.5% of AGI rate, and Flexible Spending Accounts will be limited to \$2,500 for employee contributions. Also for 2013, there is a new 3.8% Medicare tax on investment income (interest, dividends, rents, royalties, capital gains, passive activity income) once AGI exceeds \$200k for Single or \$250k for Joint returns as well as an additional 0.9% Medicare tax withheld on wages that exceed \$200k. Starting in 2014, the health insurance mandate kicks in and penalties will be assessed on individuals who do not have their own qualifying health insurance plan. Starting in 2015, businesses with 50 or more full-time employees that do not provide their full-time employees with qualifying health insurance coverage will also pay a penalty.

IRA and Pensions: In 2013, the maximum deduction for IRA contributions is \$5,500, or \$6,500 for those 50 and older. The salary deferral for pensions is between \$12,000 and \$23,000, depending on age and plan type.

Pension Beneficiaries: Please review the beneficiaries listed for your pension and IRA accounts to make sure the money is distributed according to your wishes. It is especially important to review these after a death in the family, divorce or other event that could result in a change of your desired beneficiaries.

1099-K Income Reporting: For tax years starting in 2012, businesses will **not** be required to separately report cash sales and credit card sales on their tax returns. Instead, the IRS is likely to use the 1099-K generated by merchant card services as an auditing tool to verify income. Businesses should continue to make an effort to record credit card sales separately in their accounting to match the issued 1099-Ks.

Hobby Losses: The IRS is stepping up audits in search of non-deductible hobby losses on individual and S-Corporation returns. To determine if there is a profit motive for a business, the IRS looks at the manner in which the activity is conducted, the expertise of the taxpayer, the time and effort expended by the taxpayer, the taxpayer's financial history and past successes, and whether an element of personal pleasure or recreation is present. Repetitive losses for part-time business activities are hard to justify when the taxpayer has a full-time job elsewhere.

Auto Mileage Rates: For 2013, the per-mile rate for business use is \$0.565. For medical and moving expenses, the per-mile rate is \$0.24, and the rate for charity work remains \$0.14 per mile. For 2014, the business mileage rate drops to \$0.56 and the medical/moving mileage rate drops to \$0.235. Log books are critical for proving vehicle deductions to the IRS.

Home Office Expenses: For 2013 and beyond, the home office deduction can be determined using either actual, substantiated expenses and depreciation or a new safe harbor amount of \$5 per square foot, up to a maximum office size of 300 square feet. If the safe harbor method is used, all mortgage interest and property taxes can then be deducted on Schedule A. However, unused home office deductions from the safe harbor method cannot be carried over.

Capitalizing vs. Expensing: New regulations establish a \$200 de minimis amount under which an item can be expensed rather than capitalized as supplies or equipment. However, a business with a written accounting policy in place at the beginning of the year can make an election to expense items and repairs up to \$500.

Depreciation: The Section 179 expense election on the federal level remains at \$500,000 for 2013, and the California maximum expense election remains at \$25,000. On federal returns for 2013, we also have the 50% bonus depreciation, which allows businesses to immediately deduct a portion of new qualifying personal property. Unless extended by Congress, the current Federal Section 179 limit will revert back to \$25,000 for 2014, and the Federal bonus depreciation will also expire at the end of 2013.

Education: For 2013 through 2017, we still have the American Opportunity Credit for the first 4 years of post-secondary education, which is a maximum credit of \$2,500 per student, based on 100% of the first \$2,000 of tuition, books, supplies and necessary equipment plus 25% of the next \$2,000. As an alternative, the Lifetime Learning Credit remains in effect indefinitely and

provides up to a 20% credit for up to \$10,000 in qualified tuition and fees. All of these credits, however, are subject to income limitations.

Kiddie Tax: For 2013, dependent children under age 19 or under the age of 24 if a full-time student with more than \$2,000 in taxable investment income will pay tax on the excess at their parent's rates.

Capital Gains and Dividends: For 2013 and beyond, there is a 0% rate (yes, zero) for capital gains and qualified dividends included in taxable income that would otherwise fall in the 15% tax bracket, and a 15% rate for capital gains and qualified dividends in taxable income that would normally be subject to the 25% to 35% marginal rates. We also have a new 20% rate for capital gains and dividends when taxable income is subject to the new 39.6% marginal rate, which starts at \$400k for Single filers and \$450k for Joint filers. However, AMT could increase the overall effective rates.

Residential Energy Credits: The credit for energy-efficient property improvements to existing primary residences, which expires at the end of 2013, is a maximum \$500 lifetime credit for installing energy efficient exterior doors, roofing material, windows, insulation, gas water heaters and furnaces, and high-efficiency air-conditioners. Through 2016, there is also a 30% credit on the purchase of solar hot water heaters, solar electrical equipment, geothermal heat pumps, or wind turbines for first or second homes or newly constructed homes.

Plug-in Electric Drive Vehicle Credit: For 2013 and 2014, a credit for buying qualified plug-in hybrid electric vehicles will start at \$2,500 and cap at \$7,500, based on the vehicle's battery capacity and gross weight. Only the first 200,000 of these vehicles sold by each manufacturer will receive the full credit before it starts to phase out. A qualifying vehicle must be newly purchased and derive its propulsion from a rechargeable battery with a 4 kilowatt-hour capacity, or 2.5 kilowatt-hour capacity for 2 or 3-wheeled vehicles. Golf carts do not qualify, however.

Charitable Contributions: For charitable contributions, last year's rules remain in effect: used clothing or household items must be in "good" condition to have charitable value, all items worth \$5,000 or more require an appraisal, deductions for cash donations require a written receipt or a canceled check, but all cash donations of \$250 or more require a contemporaneous written receipt indicating that no goods or services were provided in exchange for the donation.

Foreign Bank and Financial Accounts: Anyone with a financial interest or signature authority over one or more accounts in a foreign country with an aggregate of more than \$10,000 in value at any time during the calendar year must electronically file the new FinCEN Form 114 by the following June 30th, and any person or entity with more than \$50,000 in value (\$100,000 if married filing joint) must also file Form 8938 with their individual, corporate, partnership or fiduciary tax returns.

Foreign Property Trusts and Corporations: The IRS is stepping up compliance in this area as well, requiring anyone owning an interest in or making a transfer of property to a foreign trust or corporation to file Forms 3520, 3520-A, 5471 and/or 926 each year. However, a recent IRS Private Letter Ruling indicated the requirement does not include trust commonly used to establish ownership of foreign property, such as a Fideicomiso. The penalties for failure to file any of these foreign reporting forms are substantial, starting at \$10,000 or 10% of total value,

depending on the form. Our firm will not be filing Forms 3520, 3520-A, 5471 or 926 as they are not supported by our tax software and do not fall within our area of expertise.

Expiring Provisions: There are a number of tax provisions that expire at the end of 2013 that may or may not be renewed. The expiring provisions include the \$250 teacher deduction, the sales tax deduction, the college tuition deduction, the allowable IRA contributions to charities, the 15-year leasehold improvement depreciation, the expanded Section 179 and Bonus depreciation amounts, the mortgage insurance premium deduction, the R&D credit and many others.

CA Head-of-Household Credit: California now has a credit for qualifying taxpayers who are seniors filing as head-of-household or parents filing as single but who have joint custody of one or more children.

California Estimates: Tax estimates paid to CA will be uneven for 2014 and in the foreseeable future, following the 30%, 40%, 0% and 30% pattern we've had for the last couple years. However, if any estimate or extension payment is greater than \$20,000, or if an individual or corporation reports a total tax on their CA return greater than \$80,000, then they are required to remit the funds electronically from that point forward. There is a 1% penalty on the amount paid if it is not electronically transmitted when required.

California Jobs Credit: For 2013, California still offers a credit for employers with 20 or fewer employees of up to \$3,000 for each additional full-time employee hired, such that there is an increase in total employees over the prior year.

California Use Tax: California requires in a situation where goods are purchased out of state, via mail order or internet, and no CA sales tax is collected but the goods are used or consumed in CA, that the responsible party must pay the equivalent sales tax as a use tax. This use tax can be paid on an individual return, and California now offers a "safe harbor" table based on income level if a taxpayer has difficulty finding a year's worth of receipts for out-of-state purchases, as long as no single item is purchased for \$1,000 or more.

California Worker Misclassification: Starting in 2012, California will be able to collect substantial penalties as well as civil penalties and initiate enforcement action by the Contractors' State License Board against an employer and even their advisers for the willful misclassification of workers as independent contractors instead of employees. Our firm recommends that employers seek legal counsel experienced in employment issues to determine the appropriate classification of workers.

Keep in mind that we have only presented you with highlights of the changes and not the full text of the tax laws, and as such, your own tax situation can be different from anyone else's. We would be happy to consult with you on how these changes might affect you specifically.

Best wishes for a Happy New Year!



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