

Vaughn Tribble, CPA

Daniel Ayala, CPA

Douglas Tribble, CPA

**Tribble & Ayala**  
**Certified Public Accountants, Inc.**

571 Stanislaus Ave, Ste A  
P.O. Box 400  
Angels Camp, CA 95222  
(209) 736-4631  
Fax (209) 736-0207

2686 McKenzie Ave  
P.O. Box 1020  
Arnold, CA 95223  
(209) 795-2311  
Fax (209) 795-4730

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Dear Tax Client:

It's that time of year again...time to look at how your tax returns could be affected by new tax laws. Unfortunately, with Congress in bipartisan gridlock for most of the year as well as spending time on the elections, we have little in the way of new helpful tax laws, but we have lots of tax deductions and credits that expired at the end of 2011 and were not renewed for 2012. If Congress acts soon, there is a chance that some of the provisions that expired could be given new life, but don't hold out too much hope because the biggest concerns right now in Congress are the Bush Era tax rates, deductions and credits that sunset at the end of this year if they are not extended again, which makes it hard for us to do any tax or estate planning with you. With all the finger-pointing going on, though, one wonders if the politicians really care about getting the job done as much as keeping up appearances and playing golf. Below are some of the highlights of the new tax legislation and key numbers as adjusted for inflation.

Estate & Gift Tax: The estate and gift tax for 2012 is at a marginal rate of 35% for estates and gifts that total more than the \$5,120,000 exemption. The annual non-includible gift limitation remains at \$13,000 per person for 2012, but will increase to \$14,000 per person for 2013.

Adoption Credit: For 2012, the adoption credit is \$12,650 and is no longer refundable. This credit will start phasing out when Adjusted Gross Income (AGI) exceeds \$189,710.

Employer Health Insurance Credit: Starting in 2010 and expiring at the end of 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: Starting in 2010, children under the age of 27 can now be covered under their parents' health plan and the premiums deducted by the employer or by the self-employed. There is also a new 10% tax on indoor tanning services. Starting in 2011, non-prescription medications (excluding insulin) will no longer be considered eligible expenses for health savings or flexible spending accounts. Starting in 2013, deductible medical expenses 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 in 2013, there will be a new 3.8% Medicare tax on investment income (interest, dividends, rents, royalties, capital gains) once AGI exceeds \$200k for single or \$250k for joint returns as well as an additional 0.9% Medicare tax on wages when AGI exceeds those amounts. 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 and on businesses with 50 or more full-time employees that do not provide them with qualifying health insurance coverage.

IRA and Pensions: In 2012, the maximum deduction for IRA contributions is \$5,000, or \$6,000 for those 50 and older. The salary deferral for pensions is between \$11,500 and \$22,500, depending on age and plan type.

IRA to Roth Conversions: For 2012, taxpayers that converted traditional IRA funds to a Roth IRA in 2010 and elected to pay the tax over two years will be paying the final installment of that deferred tax liability.

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-B Stock Sale Reporting: Starting for 2011, brokerage firms will be required to report cost basis information for stock sales where the stock had originally been purchased on or after January 1, 2011. Mutual fund basis reporting will apply to purchases and reinvestments occurring on or after January 1, 2012, and basis reporting on options will start with purchases occurring on or after January 1, 2013.

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 2012, the per-mile rate for business use is \$0.555. For medical and moving expenses, the per-mile rate is \$0.23, and the rate for charity work remains \$0.14 per mile.

Depreciation: The Section 179 expense election on the federal level has decreased to \$139,000 for 2012, and the California maximum expense election remains at \$25,000. On federal returns for 2012, we have the return of the 50% bonus depreciation, which allows businesses to immediately deduct a portion of new qualifying personal property.

Education: For 2012, 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. This credit is set to expire at the end of 2012, to be replaced by the smaller Hope Credit. 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 2012, dependent children under age 19 or under the age of 24 if a full-time student with more than \$1,900 in taxable investment income will pay tax on the excess at their parent's rates.

Capital Gains and Dividends: For 2012, 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 dividends in taxable income normally subject to the 25% or higher marginal rates. However, AMT could increase the overall effective rates. For 2013, these rates could increase by 5-10% for all of us, some of us, or none of us, pending action (or inaction) by Congress.

Residential Energy Credits: The credit for non-business energy-efficient property improvements expired at the end of 2011. A 30% credit still exists on the purchase of solar hot water heaters or electrical equipment, geothermal heat pumps, or wind turbines for first or second homes or newly constructed homes.

Plug-in Electric Drive Vehicle Credit: For 2012 to 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: This law has been around awhile, but lately the IRS seems more determined to get full compliance. 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 file Form TDF 90-22.1 by the following June 30<sup>th</sup>, 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, including those commonly used to establish ownership of foreign property, such as a Fideicomiso, to file Forms 3520, 3520-A, 5471 and/or 926 each year. 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 other tax provisions that expired at the end of 2011 that may or may not be renewed. The expired provisions include the \$250 teacher deduction, the sales tax deduction, the college tuition deduction, the allowable IRA contributions to charities, the higher AMT exemptions, 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.

California Updates: With the passage of Proposition 30, we have an income tax increase for those with taxable income over \$250k filing single or over \$500k filing joint retroactive to January 1, 2012, as well as a quarter-percent increase in sales tax starting in 2013.

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 2012 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: 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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