Year-End Tax Planning for 2013’s Uncertainty
Taking certain steps by December 31 can help you reduce your tax liability. However, the uncertainty surrounding the expiration of the Bush-era tax cuts makes year-end tax planning especially challenging.

Congress has recessed and will not return until after the elections in November, and what, if anything, members will do then likely will depend on the outcome of the elections.

Thus, it is difficult to predict what will happen. Yet the steps you should take before year end depend in part on the deductions that will be available and the rates that will apply in future years, especially the coming year.

Appropriate year-end tax planning steps also depend on your existing and future personal financial situation. Market volatility, for example, may have affected your circumstances and increased uncertainty about what lies ahead.

2012 year-end tax planning will be an exercise in managing long-term uncertainty and capturing near-term opportunities. What follows is a look at the potential tax impact of the November elections followed by an overview of key considerations in four tax planning areas:

1. Income planning
2. Investment portfolio
3. Retirement planning
4. Estate planning
The Potential Tax Impact of the Elections

The end of 2012 is scheduled to bring the expiration of many of President Bush’s tax cuts, several of which are important factors to consider in the context of year-end planning:

• Marginal income tax rates on ordinary income will rise to as high as 39.6%.
• The top rate on long-term capital gains (currently 15%) will increase to 20%.
• Itemized deductions and personal exemptions will again be phased out as adjusted gross income (AGI) increases.
• Dividends will again be taxed at ordinary income rates (which could be as high as 39.6%) rather than enjoying the long-term capital gains treatment that has applied to “qualified” dividends since 2003.

The expiration of these tax cuts coupled with the new Medicare surtaxes will have a significant impact on many individuals. So, too, will the expiration of favorable gift and estate tax rates and exemptions.

While there is still time to resolve many of the tax changes and challenges that are set to occur starting in 2013, a post-election lame duck Congress could result in tax rate increases as we enter the year. These increases could possibly be temporary, and changes could occur during 2013.

President Obama has made it clear that he will not support across-the-board tax law extensions (like the ones in December 2010), and he has advocated targeted tax increases. By comparison, candidate Mitt Romney is looking to reduce tax rates across the board as well as eliminate the alternative minimum tax (AMT) and the estate tax. Whoever is elected, the makeup of the House and Senate will affect whether he can turn his tax proposals into law.

Looking at the Candidates: Marginal Tax Rates

Looking at the Candidates: Other Taxes

<table>
<thead>
<tr>
<th>TYPE OF TAX</th>
<th>CURRENT LAW (2013)</th>
<th>OBAMA PROPOSAL</th>
<th>ROMNEY PROPOSAL</th>
</tr>
</thead>
</table>
| Long-Term Capital Gains | • 10% for lowest marginal tax bracket  
• 20% for others  
• 18% if purchased after 12/31/00 and held for more than five years | • 0% for lowest marginal tax brackets  
• 15% for “middle income” earners  
• 20% for higher income earners | • 0% for married couples filing jointly earning less than $200,000  
• 15% for higher income earners |
| Qualified Dividends | Top rate 39.6% | • 0% for lowest marginal tax brackets  
• 15% for “middle income” earners  
• Ordinary-income tax rates for higher income earners | • 0% for married couples filing jointly earning less than $200,000  
• 15% for higher income earners |
| Estate Tax | Top rate 55%; exemption $1 million | Top rate 45%; exemption $3.5 million | Repeal estate tax |
| AMT | Exemption: $45,000 (married filing jointly) | Three-year AMT patch | Repeal AMT |
| Other Items | Additional 3.8% Medicare surtax on investment income | Limit itemized deductions to 28% for “high income” taxpayers | Repeal AMT |

1 Projected 2013 brackets for married couples filing jointly.
2 Rate would not go into effect until taxable income exceeded $250,000, indexed for inflation.

Sources: Internal Revenue Service, The President’s Budget for Fiscal Year 2013; “Believe in America: Mitt Romney’s Plan for Jobs and Economic Growth”
KEY CONSIDERATION: Income Planning

Year-end tax planning usually calls for deferring income to the next year and accelerating deductions into the current year, because it is generally beneficial to defer tax—unless your marginal rate will be higher next year. With ordinary tax rates scheduled to rise and other tax increases set to go in effect, the timing of income and deductions is an important planning item for this year.

Income and expense items whose timing you may be able to control include:

- bonuses
- self-employment income
- retirement plan distributions
- state and local income tax payments
- real estate tax payments
- charitable contributions

Additional Considerations

More taxes on earned income. Beginning in 2013, taxpayers with earned income over $200,000 per year ($250,000 for joint filers and $125,000 for married filing separately) will pay an extra 0.9% (from 1.45% to 2.35%) in Medicare taxes on this excess income. This may be another reason to accelerate earned income into 2012 to the extent possible.

Keep in mind that your employer will begin withholding the additional amount once your pay for the year exceeds the applicable threshold. It may be worthwhile to review the amount of withholdings you have on your paycheck. However, if you are married, your employer will not consider your spouse's earned income, so your additional liability for the year could exceed the amount withheld.

For more information, see our Financial Planning Update, “Tax Planning in the Aftermath of the Supreme Court's Healthcare Law Ruling” (www.williamblair.com/pwm-resources), or contact us for a copy.

Return of income-based phaseouts. Until 2010, itemized deductions and personal exemptions for taxpayers had been reduced based on income level. The limitation on itemized deductions—known as Pease after the congressman who introduced it—cut itemized deductions by 3% of AGI above specified thresholds, but not by more than 80%. The personal exemption phaseout (PEP) reduced the value of each personal exemption from its full value by 2% for each $2,500 (or part thereof) above specified income thresholds that depend on filing status. Personal exemptions were thus fully phased out over a $122,500 range.

Both phaseouts were eliminated in 2010, but they are scheduled to return in 2013. While the 2013 phaseout ranges have not been released yet, projections suggest that the thresholds will start at $261,650 for married couples filing jointly and $174,450 for single filers.

You may want to take advantage of the current window of opportunity by maximizing your deductions this year, particularly if you have higher-than-normal income (such as from a Roth IRA conversion). On the other hand, even with the phaseout your deductions might be more valuable next year because of higher income tax rates.

Higher medical and dental expense deduction threshold. Beginning in 2013, the threshold for the itemized deduction for unreimbursed medical expenses rises from 7.5% of AGI to 10%. (The 10% threshold already applies for AMT purposes.) The increase is waived, however, for individuals age 65 or older for tax years 2013 through 2016.

If you are under 65, think about “bunching” nonurgent medical expenses into 2012 to take advantage of the lower 7.5% threshold. Keep in mind that these expenses include items such as reading or prescription glasses, contact lenses, and hearing aids. Accelerating when these items are purchased may reduce your taxes.

Charitable deductions. One deduction you may be able to more easily time to your tax advantage is your charitable contributions deduction, because you have complete control over when and how much you give. For more information on charitable giving, see our September 2011 Financial Planning Advisory, “Charitable Giving: Strategies and Opportunities” (www.williamblair.com/pwm-resources), or contact us for a copy.

Alternative minimum tax (AMT). AMT income is determined by a separate calculation, which treats some income items differently and does not allow certain deductions. You must pay AMT if your AMT liability exceeds your regular tax liability. The top AMT rate is only 28%, but it typically applies to a larger income base and can result in a higher tax bill. Actions intended to defer tax could instead trigger or increase AMT liability this year or next, so it is important to consider the potential for AMT.

A significant exemption applies, but it phases out for taxpayers with higher incomes. The exemption and the top of the phaseout ranges have dropped significantly for 2012. This means you may be more likely to be subject to the AMT this year, which should be considered in your income and deduction timing decisions this year. Fortunately, an AMT credit is available in certain situations.
Legislation to Watch For

- 2012 income tax rates could be extended for everyone or for only certain individuals—or rates could be reduced across the board.
- The phaseouts for personal exemptions and deductions could be eliminated.
- The election to deduct state and local sales taxes instead of state income taxes may return.
- AMT exemptions could be increased for 2012 and 2013 or the AMT could be eliminated.

2012 Marginal Tax Rates

<table>
<thead>
<tr>
<th></th>
<th>SINGLE</th>
<th>MARRIED JOINTLY</th>
<th>TAX RATE</th>
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<tr>
<td>$ 0 – $ 8,700</td>
<td>$ 0 – $ 17,400</td>
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<tr>
<td>$ 8,700 – $ 35,350</td>
<td>$ 17,400 – $ 70,700</td>
<td>15%</td>
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<tr>
<td>$ 35,350 – $ 85,650</td>
<td>$ 70,700 – $ 142,700</td>
<td>25%</td>
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<td>$ 85,650 – $ 178,650</td>
<td>$142,700 – $ 217,450</td>
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<td>$178,650 – $ 388,350</td>
<td>$217,450 – $ 388,350</td>
<td>33%</td>
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<tr>
<td>Over $388,350</td>
<td>Over $388,350</td>
<td>35%</td>
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2012 AMT Exemptions

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<td>Amount</td>
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<td>$45,000</td>
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<td>Phaseout(^1)</td>
<td>$112,500 – $247,500</td>
<td>$150,000 – $230,000</td>
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</tbody>
</table>

\(^1\) The alternative minimum tax (AMT) income ranges over which the exemption phases out and only a partial exemption is available. The exemption is completely phased out if AMT income exceeds the top of the applicable range.

Source: Internal Revenue Service

KEY CONSIDERATION:
Investment Portfolio

Tax consequences should not be the main driver of investment decisions, but in a rising-tax-rate environment, taxes should be an important consideration. Most long-term capital gains will likely be subject to higher rates next year. So, in certain circumstances, it may make sense to sell highly appreciated investments before the end of the year to lock in the historically low current rates. The 15% long-term capital gains tax rate applies through 2012. You may want to consider whether you should sell appreciated assets to take advantage of the lower rate while it is still available.

For 2012, the long-term capital gains rate is 0% for lower bracket taxpayers. If you have adult children in one of these brackets, consider transferring appreciated assets to them so they can sell the assets before the end of the year and enjoy the 0% rate. If the child is under age 24, however, first make sure he or she will not be subject to the “kiddie tax.” Also, consider any gift tax consequences. (See page 7 for more on the kiddie tax and gift taxes.)

Investments you have held less than one year are subject to short-term gains rates (equal to your ordinary-income tax rate). The higher 2013 long-term gains rate will likely be lower than your 2012 ordinary-income rate. So you may want to discuss with your advisor the risks and trade-offs of holding on to investments until you can enjoy long-term capital gains treatment.

Dividend-producing investments will see an even larger tax rate increase in 2013 if scheduled changes go into effect. Qualified dividends, which are currently taxed at 15% (0% for lower bracket taxpayers), are scheduled to be taxed as ordinary income beginning in 2013 absent any changes in the law. This switch would result in an increase of more than 250% over current rates for those in the top tax bracket.

Further, as mentioned earlier, the limitation on personal exemptions and itemized deductions is also scheduled to return next year, which would affect the tax paid on dividends. The impact of the personal exemption phaseout would be based upon the number of exemptions claimed, but the Pease limitation on itemized deductions would increase the marginal tax rates of affected taxpayers by approximately 1.2%.

These tax increases on dividend income may merit a review of your portfolio’s overall asset allocation and strategies for generating income from your investments.

Additional Considerations

**New Medicare surtax on investment income.** The 2010 Health Care Act also created a new 3.8% tax on certain types of investment income—such as interest, dividends, rents, royalties, and certain capital gains. The tax will be applied to net investment income to the extent modified adjusted gross income (MAGI) exceeds $200,000 for single taxpayers ($250,000 married couples filing jointly). For more information, see our Financial Planning Update, “Tax Planning in the Aftermath of the Supreme Court’s Healthcare Law Ruling” (www.williamblair.com/pwm-resources).

The potential for long-term capital gains rates to increase from 15% to possibly 25% should be a significant factor in selling appreciated assets during 2012.
Losses. Recent market volatility may mean you can take advantage of tax-loss harvesting. Losses are not losses for tax purposes until they are recognized—that is, until you sell the investment for less than what you paid for it. Then you can use the loss to offset recognized gains or perhaps even ordinary income. Alternatively, the loss might be carried forward to offset gains in future years.

By working with your William Blair financial advisor now to determine your year-to-date gains and losses, you can coordinate sales of other investments before year end to achieve your tax and investment planning goals. The tax benefit of recognizing a loss will depend in part on the netting rules that relate to short-term versus long-term gains and losses.

If you are trying to achieve a tax loss with minimal change in your portfolio’s asset allocation, keep in mind the wash-sale rule. It prevents you from using a loss on a security if you buy the same or a substantially identical security within 30 days before or after you sell the security that created the loss.

Year-end investment decisions. Without action on the part of Congress and the president, taxes will increase significantly in 2013. While it is difficult to predict what will happen for 2013, taxpayers should carefully consider accelerating taxable income into 2012.

When making investment decisions, tax consequences, however, are only one of many factors to consider. The capital market environment as well as your risk tolerance, financial goals, and personal situation also should be taken into account. In other words, it is important to be tax aware, but tax considerations should not be the primary driver of your investment or other financial planning decisions; a combination of factors should be considered. In the current economic environment, nontax factors could change at any time. Therefore, being flexible and speaking with your William Blair advisor regularly about your portfolio and your overall financial situation are key to achieving your goals.

Legislation to Watch For

- Lower long-term capital gains tax rates could be extended to 2013 for everyone or for certain individuals based on income levels.
- The treatment of qualified dividends as long-term capital gains could be extended to 2013 for everyone or for certain individuals based on income levels.
- The additional 3.8% surtax on investment income for individuals at certain income levels that is scheduled to go into effect in 2013 could be repealed.

Potential Increase in Taxes on Investment Income

KEY CONSIDERATION: Retirement Planning

Generally, in an environment of rising tax rates, converting part or all of a traditional IRA to a Roth IRA is a good idea. If you have a traditional IRA, 2012 may be a particularly good year to consider a conversion. It can allow you to turn tax-deferred growth into tax-free growth, which may be especially beneficial if tax rates rise in 2013 as scheduled. The converted amount is generally taxable in the year of the conversion, so you may save tax by converting this year, before tax rates rise.

A conversion this year might also help you avoid or reduce the new Medicare tax on net investment income that is scheduled to go into effect in 2013. (See page 5.) IRA distributions are not subject to the tax, but they increase your MAGI, which could trigger the Medicare tax on your net investment income.

A conversion can provide estate planning advantages as well: Roth IRAs do not require you to take required minimum distributions (RMDs), so you can let the entire balance grow tax-free for the benefit of your heirs. Similarly, distributions from a Roth IRA are income tax free. Whether a conversion makes sense for you depends on a variety of factors that you should discuss with your advisors.

Additional Considerations

Maximizing contributions. Consider contributing the maximum allowed to an employer-sponsored retirement plan, such as a 401(k). Contributions are typically pretax, so they can reduce your taxable income. Plan assets can grow tax-deferred until you take distributions. Your employer may even match some or all of your contributions—also on a pretax basis. If you are a business owner or self-employed, you may be able to set up a plan that allows much larger contributions. To make the most of your contribution opportunities, be aware of the limits and deadlines.
• The ability for taxpayers over age 70 1/2 to avoid taxes on traditional IRA distributions by making a direct contribution to charity of up to $100,000, which expired December 31, 2011, may be extended.

**2012 Retirement Plan Contribution Limits**

<table>
<thead>
<tr>
<th>TYPE OF PLAN</th>
<th>UNDER 50</th>
<th>50 OR OLDER</th>
<th>CONTRIBUTION DEADLINE</th>
</tr>
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<tbody>
<tr>
<td>401(k)</td>
<td>$17,000</td>
<td>$22,500</td>
<td>Dec. 31, 2012</td>
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<tr>
<td>SIMPLE</td>
<td>$11,500</td>
<td>$14,000</td>
<td>Dec. 31, 2012</td>
</tr>
<tr>
<td>IRA</td>
<td>$5,000</td>
<td>$6,000</td>
<td>April 15, 2013</td>
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*Plans for Business Owners and the Self-Employed*

- Profit-Sharing Plan: $50,000 ($55,500 if age 50 or older) by Oct. 15, 2013
- SEP: $50,000 ($50,000 if age 50 or older) by Oct. 15, 2013

1 Other factors may reduce your limit.
2 If tax return extension is filed.

Source: Internal Revenue Service

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**RMDs.** RMDs apply to most traditional retirement plan owners age 70 1/2 or older and generally to those who have inherited a retirement plan, regardless of age or plan type. It is critical to take any RMDs by year end because the penalty for noncompliance is 50% of the amount you should have withdrawn but did not. Because RMDs from traditional plans are generally fully taxable at ordinary-income tax rates, they can generate substantial tax liability. This liability may be even larger in 2013, because of higher ordinary-income rates. It may be beneficial to take a distribution in excess of your RMD for 2012 to “lock in” your current tax rate. The larger distribution will lower future years’ RMDs, which could be taxed at a higher rate. However, you must consider the impact of the loss of future tax-deferred growth on the amount you withdraw.

**Roth IRA recharacterizations and reconversions.** While Roth IRA conversions can be beneficial in many situations, with recent market volatility, you may end up owing tax on value that has been lost since the conversion, or the tax may simply become less affordable. You have the option to “undo” the conversion in a recharacterization. You avoid tax on the conversion-date balance, including the lost value.

If a conversion is otherwise desirable, you can reconvert, subject to applicable timing requirements. The tax you will owe will be based on the account’s potentially lower value on the date of the reconversion. However, remember that the tax rate might be higher in future years. There are many important considerations you should discuss with your advisors before implementing a recharacterization or reconversion.

**Legislation to Watch For**

**2012 Retirement Plan Contribution Limits**

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<td>April 15, 2013</td>
</tr>
</tbody>
</table>

First, consider annual exclusion gifts. They can be made to any individual but must be made by year end or the $13,000 per recipient exclusion for the year will be lost. If you are married, you and your spouse can together give $26,000, but you may need to file a gift tax return. Multiply $26,000 by the number of children and grandchildren you have, and you may be able to remove a significant amount of wealth from your estate without reducing the estate tax exemption that will be available at your death.

Second, consider making gifts that take advantage of the $5.12 million gift tax exemption while it is available. Both the gift and estate tax exemptions are scheduled to drop to $1 million in 2013.

For individuals and families that may not be comfortable parting with significant wealth, there are strategies that “lock in” the transfer tax exemptions (thus keeping the assets out of your estate) while still providing you with a sense of financial security. For example, trusts can be established for the gift of a personal residence while still allowing the current owner to remain in the residence. For married couples, gifts can be made between spouses which, when properly structured, are excluded as assets for estate tax purposes while providing the spouse access to the assets or the income generated by the assets during his or her lifetime.

Lastly, gifts can allow you to shift income to family members in lower tax brackets, perhaps saving tax overall for the family. For example, if you have children or grandchildren in the 10% or 15% regular income tax brackets who qualify for the 0% long-term capital-gains rate, you can give them highly appreciated assets that they potentially could sell at a 0% tax cost, if they do so before January 1, 2013, when the 0% rate is scheduled to rise to 10%.

**Additional Considerations**

“**Kiddie**” tax. For children subject to this tax, any unearned income beyond $1,900 (for 2012) is taxed at their parents’, likely higher, rate, reducing the benefits of income shifting. Keep this in mind before transferring assets to children—or to young...
Uncertainty Calls for Reviewing Your Situation

In this environment of uncertainty, the importance of reviewing your situation cannot be overemphasized. It also is critical to involve your William Blair advisors and tax professionals in the review process. They can help you determine the best steps for achieving your overall financial goals.

Financial Talk Webinar
Year-End Tax Planning for 2013’s Uncertainty

William Blair & Company’s Julie Alcala and Michael Lee hosted an interactive webinar recently. They discussed tax strategies that can be implemented before the end of 2012 to capitalize on the current tax and interest rate environment and examined the tax policies being proposed by Republicans and Democrats and the potential implications of November’s elections.

To listen to a replay of this webinar, visit www.williamblair.com/pwm-resources and select the link for Financial Talk Webinars.

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Rising Gift, Estate, and GST taxes

<table>
<thead>
<tr>
<th>TAX TYPE</th>
<th>2012 RATE</th>
<th>2012 EXEMPTION</th>
<th>2013 RATE</th>
<th>2013 EXEMPTION</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gift</td>
<td>35%</td>
<td>$5.12 million</td>
<td>55%</td>
<td>$1 million</td>
</tr>
<tr>
<td>Estate</td>
<td>35%</td>
<td>$5.12 million</td>
<td>55%</td>
<td>$1 million</td>
</tr>
<tr>
<td>GST</td>
<td>35%</td>
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<td>55%</td>
<td>$1 million</td>
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Source: Internal Revenue Service

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