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### April 2013

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# Callahan Newsletter

*Keeping you current*

## Estate Tax After the Fiscal Cliff



After threatening to go over the fiscal cliff, the gift tax, estate tax, and generation-skipping transfer (GST) tax have come in for a soft landing. The American Taxpayer Relief Act of 2012 (ATRA 2012),

enacted on January 2, 2013, permanently extended the \$5 million (as indexed) gift tax and estate tax applicable exclusion amount and GST tax exemption. It also permanently extended portability of the gift tax and estate tax applicable exclusion amount between spouses. However, it also increased the top gift, estate, and GST tax rate to 40% starting in 2013. A number of other provisions were also permanently extended.

### Top gift, estate, and GST tax rate

In 2012, there was a 35% top tax rate for gift, estate, and GST taxes. It was scheduled to increase to 55% in 2013. ATRA 2012 provides a permanent 40% top rate, starting in 2013.

### Applicable exclusion amount

You have an applicable exclusion amount that can protect a certain amount of property from the federal gift tax and estate tax. The basic exclusion amount was \$5,120,000 in 2012 (\$5 million as indexed for inflation), but was scheduled to drop to \$1 million in 2013. ATRA 2012 permanently extends the basic exclusion amount at \$5 million as indexed for inflation.

### Portability of exclusion

The estate of a person who died in 2011 or 2012 could transfer the decedent's unused applicable exclusion amount to his or her surviving spouse, who could use the unused exclusion, along with his or her own basic exclusion amount, to shelter property from gift and estate tax (referred to as portability). The provision was scheduled to sunset in 2013. ATRA 2012 has permanently extended the portability provision.

### GST tax exemption

You have a GST tax exemption that can protect a certain amount of property from the GST tax. The GST tax exemption was \$5,120,000 in 2012 (\$5 million as indexed for inflation), but was scheduled to drop to \$1 million (as indexed for inflation) in 2013. ATRA 2012 permanently extends the GST tax exemption at \$5 million as indexed for inflation (it is \$5,250,000 in 2013).

### State death taxes

In 2012, your estate could take an estate tax deduction for death taxes (estate tax or inheritance tax) paid to a state. In 2013, it was scheduled to change back into a credit for state death taxes, as available back in 2001. However, ATRA 2012 permanently extends the deduction for state death taxes.

### Conservation easement exclusion

An estate tax exclusion is available for qualified conservation easements. In 2012, the exclusion was generally available if the property was located anywhere in the United States. In 2013, the exclusion was scheduled to be available, as in 2001, only if the property was located within a limited number of miles from a National Wilderness Preservation System or an Urban National Forest. ATRA 2012 permanently extends the provision that the property can generally be located anywhere in the United States and the mileage requirements do not apply.

### Estate tax deferral for closely held business

Where the value of a closely held business exceeds 35% of the value of the adjusted gross estate, payment of estate tax attributable to the business can be deferred for up to 5 years and then paid in installments over 10 years, all at favorable interest rates. In 2012, a closely held business could have 45 partners or shareholders. In 2013, the permissible number of partners or shareholders was scheduled to drop to 15, as in 2001. ATRA 2012 permanently extends the provision allowing up to 45 partners or shareholders.





**Health-care reform legislation passed in 2010 included a new additional 0.9% Medicare tax on wages, compensation, and self-employment income over certain thresholds. This new tax also took effect on January 1, 2013. The 0.9% tax does not apply to income subject to the NIIT. So while you may be subject to both taxes, the taxes do not apply to the same types of income.**

## Understanding the New Medicare Tax on Unearned Income

Health-care reform legislation enacted in 2010 included a new 3.8% Medicare tax on the unearned income of certain high-income individuals. The new tax, known as the unearned income Medicare contribution tax, or the net investment income tax (NIIT), took effect on January 1, 2013.

### Who must pay the new tax?

The NIIT applies to individuals who have "net investment income," and who have modified adjusted gross income (MAGI) that exceeds certain levels (see the chart below). (Estates and trusts are also subject to the new law, although slightly different rules apply). In general, nonresident aliens are not subject to the new tax.

Filing Status	MAGI over ...
Single/Head of household	\$200,000
Married filing jointly/ Qualifying widow(er)	\$250,000
Married filing separately	\$125,000

### What is MAGI?

For most taxpayers, MAGI is simply adjusted gross income (AGI), increased by the amount of any foreign earned income exclusion.

AGI is your gross income (e.g., wages, salaries, tips, interest, dividends, business income or loss, capital gains or losses, IRA and retirement plan distributions, rental and royalty income, farm income and loss, unemployment compensation, alimony, taxable Social Security benefits), reduced by certain "above-the-line" deductions (see page one of IRS Form 1040 for a complete list of adjustments).

Note that AGI (and therefore MAGI) is determined *before* taking into account any standard or itemized deductions or personal exemptions. Note also that deductible contributions to IRAs and pretax contributions to employer retirement plans will lower your MAGI.

### What is investment income?

In general, investment income includes interest, dividends, rental and royalty income, taxable nonqualified annuity income, certain passive business income, and capital gains--for example, gains (to the extent not otherwise offset by losses) from the sale of stocks, bonds, and mutual funds; capital gains distributions from mutual funds; gains from the sale of interests in partnerships and S corporations (to

the extent you were a passive owner), and gains from the sale of investment real estate (including gains from the sale of a second home that's not a primary residence).

Gains from the sale of a primary residence may also be subject to the tax, but only to the extent the gain exceeds the amount you can exclude from gross income for regular income tax purposes. For example, the first \$250,000 (\$500,000 in the case of a married couple) of gain recognized on the sale of a principal residence is generally excluded for regular income tax purposes, and is therefore also excluded from the NIIT.

Investment income does not include wages, unemployment compensation, operating income from a nonpassive business, interest on tax exempt bonds, veterans benefits, or distributions from IRAs and most retirement plans (e.g., 401(k)s, profit-sharing plans, defined benefit plans, ESOPs, 403(b) plans, SIMPLE plans, SEPs, and 457(b) plans).

Net investment income is your investment income reduced by certain expenses properly allocable to the income--for example, investment advisory and brokerage fees, investment interest expenses, expenses related to rental and royalty income, and state and local income taxes.

### How is the tax calculated?

The tax is equal to 3.8% of the lesser of (a) your net investment income, or (b) your MAGI in excess of the statutory dollar amount that applies to you based on your tax filing status. So, effectively, you'll be subject to the additional 3.8% tax only if your MAGI exceeds the dollar thresholds listed in the chart above.

**Example:** Sybil, who is single, has wages of \$180,000 and \$15,000 of dividends and capital gains. Sybil's MAGI is \$195,000, which is less than the \$200,000 statutory threshold. Sybil is not subject to the NIIT.

**Example:** Mary and Matthew have \$180,000 of wages. They also received \$90,000 from a passive partnership interest, which is considered net investment income. Their MAGI is \$270,000, which exceeds the threshold for married taxpayers filing jointly by \$20,000. The NIIT is based on the lesser of \$20,000 (the amount by which their MAGI exceeds the \$250,000 threshold) or \$90,000 (their net investment income). Mary and Matthew owe NIIT of \$760 (\$20,000 x 3.8%).

**Note:** The NIIT is subject to the estimated tax rules. You may need to adjust your income tax withholding or estimated payments to avoid underpayment penalties.

## Financial Tips for Obtaining a Mortgage Loan



**You're entitled to a free copy of your credit report once a year from each of the three major credit reporting agencies. Visit [www.annualcreditreport.com](http://www.annualcreditreport.com) for more information.**

In January 2013, the Consumer Financial Protection Bureau released a new mortgage regulation, which sets forth stricter underwriting requirements for mortgage lenders. The regulation requires lenders to ensure a borrower's ability to repay a loan by taking a variety of underwriting precautions, including verifying income and assets and increasing debt-to-income ratios.

The regulation implements sections of the 2010 Dodd-Frank Act, and is aimed at protecting consumers by providing for a standardization of the mortgage loan underwriting process. However, some mortgage-industry experts fear there's a chance that the regulation may end up making obtaining a mortgage loan more difficult than it has been in the past. And while lenders have until January 2014 for final compliance with the regulation, some have already begun to tighten up their mortgage lending requirements. As a result, you may want to consider the following tips when applying for a mortgage loan.

### **Clean up your credit report**

A borrower's credit history is the cornerstone to any lender's underwriting process. As a result, it's important to make sure that your credit report is in good shape before you apply for a mortgage loan. Your credit report contains information about your past and present credit transactions and is used by mortgage lenders to evaluate your creditworthiness. A positive credit history will not only make it easier to obtain a mortgage loan, but can also result in a lender offering you a lower interest rate.

You should review your credit report and check it for any inaccuracies. If necessary, you may need to take steps to improve your credit history. To establish a good track record with creditors, make sure you always pay your monthly bills on time. In addition, try to avoid having too many credit inquiries on your report, which are made every time you apply for new credit.

### **Improve your debt-to-income ratio**

In the past, lenders looked for borrowers to have a debt-to-income ratio of no greater than 36%. The new mortgage regulation suggests that borrowers have a debt-to-income ratio that is less than or equal to 43%. That means you should be spending no more than 43% of your gross monthly income on longer-term debt payments. If you find that your debt-to-income ratio is too high, there are a couple of steps you can take to lower it.

Your first step should be to look at your long-term debt payments. These include

student loans, credit cards, and car payments--any loans that won't be repaid within a year. Try to make it a priority to pay down your long-term debts as quickly as possible. This may require you to review your budget and make adjustments. If you are having trouble coming up with the extra money, take a look at your discretionary spending. By cutting back on discretionary expenses (e.g., going out to eat or to the movies), you may be surprised at how quickly you can free up money to put towards paying down your debt.

Another way to improve your debt-to-income ratio is to increase your income. Perhaps you can earn extra income by taking a second job or performing part-time consulting work in your chosen profession or field of expertise. If you are married and either you or your spouse is currently not working, you or your spouse may want to consider the possibility of reentering the workforce.

### **Increase the size of your down payment**

While it is possible to obtain a mortgage with a minimal down payment--for example, Federal Housing Administration (FHA) mortgages require down payments of as little as 3.5% of the home's purchase price--a larger down payment will usually assure you a more attractive mortgage loan. In addition to requiring private mortgage insurance (PMI), lenders generally offer lower loan limits and higher interest rates to borrowers who have a down payment of less than 20% of a home's purchase price.

If you find that you don't have enough for a down payment, you may want to consider holding off on purchasing a home to give you time to increase your down payment fund. In the meantime, you can invest your down payment in a low-risk, interest-bearing account such as a money market deposit account.

Or, consider looking into alternative ways to fund your down payment, such as:

- Converting/liquidating assets to cash.
- Using gifts.
- Borrowing from a cash value life insurance policy or employer-sponsored retirement plan. (Keep in mind, however, that if you take a loan against your cash value, the death benefit available to your survivors will be reduced by the amount of the loan. In addition, policy loans may reduce available cash value and can cause your policy to lapse. Finally, you could face tax consequences if you surrender the policy with an outstanding loan against it.)

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Securities and advisory services offered through LPL Financial member FIRNA/SIPC, a Registered Investment Advisor.



### I don't think I'll be able to file my tax return by April 15. Is there any way to file my return at a later date?

If you don't file your federal income tax return on time, you could be subject to a failure-to-file penalty.

Fortunately, you can file for and obtain an automatic six-month extension by using [IRS Form 4868](#).

You must file for an extension by the original due date for your return. Individuals whose due date for filing a return is April 15 would then have until October 15 to file their return.

It is important to note, however, that in most cases this six-month extension is an extension to file your tax return and not an extension to pay any federal income tax that is due.

You should estimate and pay any federal income tax that is due by the original due date of the return without regard to the extension. Any taxes that are not paid by the regular due date will be subject to interest, and possibly penalties.

There are a couple of instances, however, where the IRS allows both an extension to file a tax return and an extension to pay any federal income tax due:

- If you are a U.S. citizen or resident and, on the due date of your federal income tax return, you either: (1) live outside the U.S. or Puerto Rico (with your main place of business or post of duty outside the U.S. or Puerto Rico as well), or (2) are in the military or naval service outside the U.S. or Puerto Rico, you may be allowed an automatic two-month extension of time to both file your federal income tax return and pay any federal income tax due. Interest will be assessed on any unpaid taxes due as of the regular due date.
- If you serve in a combat zone (or qualified hazardous duty area), your due date for both filing a federal income tax return and paying federal income tax is automatically extended by at least 180 days from the last day you are in a combat zone or the last day of qualified hospitalization for injury related to service in a combat zone. No penalties or interest will be assessed for failing to file a return or to pay federal income tax during this extension period.



### After filing my tax return, I found out that I'll be getting a large refund this year. What should I do with it?

It's easy to get excited at tax time when you find out you'll be getting a refund from the IRS--especially if it's a large

sum of money. The prospect of taking your family on a dream vacation, purchasing that 60-inch LCD television you've had your eye on, or going on a shopping spree at the mall all seem like great ways to spend the money. But what about doing something a bit more practical with your refund, such as putting it towards improving your overall financial picture?

While it may not seem as exciting as a vacation to a tropical island, consider putting your refund in a tax savings vehicle such as a retirement or education savings plan. To make it even easier for you, the IRS allows direct deposit of refunds into a variety of accounts, including IRAs and Coverdell education savings accounts.

Another option is to pay down any existing debt you may have, especially if it is in the form of credit card balances that carry high interest rates. Paying off any outstanding balances will reduce the interest you pay each month in addition to the total interest you'd pay over the

long term--freeing up money to work for you in more beneficial ways, such as saving and investing.

You may also consider putting your refund towards increasing your cash reserve. It's a good idea to have at least three to six months' worth of living expenses in your cash reserve. Without adequate savings, a period of unemployment or an unexpected illness could be financially devastating.

Keep in mind that a refund is essentially an interest-free loan from you to the IRS. If you find that you always end up receiving an income tax refund, it may be time to adjust your withholding. When determining the correct withholding amount, your objective should be to have just enough withheld to prevent you from incurring penalties when your tax return is due.

Finally, to avoid any surprises at tax time (either in the form of a refund or tax bill due), it's a good idea to periodically check your withholding, especially when your lifestyle or employment circumstances change. Visit [www.irs.gov](http://www.irs.gov) for more information.

