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TAX AND BUSINESS ADVISOR

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Tax and Business Alert™

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Head of Household Filing Status

Failure to use head of household (HOH) filing status is a common tax filing mistake. HOH status is preferable to single or married filing separately status because the tax rate brackets are more favorable (except for the 35% single bracket) and the standard deduction is larger.

If you are not eligible to file jointly or as a qualified surviving spouse, HOH filing status may be the best alternative to minimize your federal income tax liability. To qualify as a HOH, each tax year you must—

1. Be unmarried or considered unmarried for this purpose if married on the last day of the tax year;
2. Not be a surviving spouse;
3. Not be a nonresident alien at any time during the tax year;
4. Maintain a household as his home (i.e., provide over half of the costs) that is the principle place of abode for more than half of the tax year of (a) a qualifying child, but not if the child is married and files a joint return or (b) a dependent relative for whom an exemption can be claimed; or
5. Maintain a household that constitutes the principal home of your mother or father if you can claim an exemption for such parent (can be separate from your home).


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The expenses of maintaining the home include property taxes, insurance, mortgage interest payments, rent, utilities, maintenance, and providing food on the premises. Household expenses (i.e., expenses for the mutual benefit of the occupants of the household) do not include expenses for clothing, education, medical care, vacations, life insurance, or transportation.

Example: Qualifying child is married.

Carl is unmarried and his 22-year-old daughter and her husband are living with him. She and her husband are full-time students and do not provide more than half of their support. Carl is providing more than half of the cost of maintaining his household. If Carl's daughter and her husband do not file a joint return, Carl may claim head of household status with his daughter as the qualifying child.

Please contact us if you would like to discuss HOH filing status.

The information contained in this newsletter was not intended or written to be used and cannot be used for the purpose of (1) avoiding tax-related penalties prescribed by the Internal Revenue Code or (2) promoting or marketing any tax-related matter addressed herein.

Capital Gains and Losses

Technically, almost everything you own and use for personal, pleasure, or investment purposes is a capital asset. Capital assets include, but are not limited to, homes, household furnishings, stocks, bonds, and mutual funds. When a capital asset is sold, the difference between the amount you paid (your basis) and the amount you sold it for is generally a capital gain or loss.

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Here are some important facts about capital gains and losses:

- You must report all capital gains on your federal tax return. For most taxpayers, these generally include a primary residence (subject to significant gain exclusions), stocks, bonds, and mutual funds.
- You may deduct capital losses only on investment property (e.g., stocks and mutual funds), not on property held for personal use (e.g., homes and furnishings).
- Capital gains and losses are classified as long-term or short-term, depending on how long you hold the property before you sell it. If you hold it for more than one year, your capital gain or loss is long-term. If you hold it for one year or less, your capital gain or loss is short-term.
- The tax rates that apply to long-term capital gains are generally lower than the tax rates that apply to short-term capital gains and wages.
- If your capital losses exceed your capital gains, the excess can be deducted on your tax return and used to reduce other income, such as wages, up to an annual limit of $3,000, or $1,500 if you are married filing separately.
- If your total net capital loss is more than the annual limit on capital loss deductions, you can carry over the unused part and treat it as if you incurred it in the following year.

The Unearned Income Medicare Contribution

Beginning in 2013, taxpayers with modified adjusted gross income (MAGI) over $200,000 ($250,000 for a joint return or $125,000 for married filing separate) will be subject to a 3.8% surtax called the Unearned Income Medicare Contribution (UIMC) on net investment income. Specifically, the tax equals 3.8% of the lesser of—

1. Net investment income (generally interest, dividends, royalties, rents, and certain capital gains), or
2. The excess of MAGI over $200,000 ($250,000 for a joint return or $125,000 for married filing separate).

To limit exposure to this new 3.8% surtax on unearned income, taxpayers who may be impacted by the UIMC could consider selling, exchanging, or gifting some of their highly-appreciated capital assets prior to 2013.

Avoid Gift Treatment for Large Medical Expenses

The annual exclusion for gifts remains at $13,000 for 2012. This limit applies to the total of all gifts, including birthday and holiday gifts, made to the same individual during the year. However, any payment made *directly* to the medical care provider (e.g., doctor, hospital, etc.) is not subject to the gift tax and, therefore, is not included in the $13,000 limit.

So, when paying large medical bills for parents or persons other than dependent minor children, taxpayers should make the payment directly to the medical service provider. Don't give the funds to the parent or other individual first and have them pay the doctor or hospital. By doing so, you have made a gift to that person, subject to the $13,000 limit.

Taxable or Nontaxable Income?

Most of the income we receive is taxable, but certain types of income are only partially taxed or not taxed at all. The following are some of the more common types of income that individuals receive and an indication of how they are treated for federal income tax purposes.

Adoption Expense Reimbursements: Taxpayers adopting a child can exclude from taxable income adoption expenses paid by their employer under the employer's adoption assistance program. The exclusion is limited to a maximum amount, and also by adjusted gross income.

Alimony: Payments properly classified as alimony must generally be included in taxable income by the recipient.

Cash Rebates: Cash rebates from a dealer or manufacturer on an item you purchase are not taxable income. However, the basis of the property must be reduced by the amount of the rebate.

Child Support Payments: Child support payments are generally not taxable to the recipient.

Gambling Winnings: You must include gambling winnings in income. If you itemize your deductions, you can deduct gambling losses you had during the year, but only up to the amount of your winnings.

Life Insurance: Life insurance proceeds you receive as a beneficiary because of an insured person's death generally are not taxable. However, if you surrender a life insurance policy for cash, any proceeds received in excess of the premiums paid for the policy are taxable.

Lotteries and Raffles: Winnings from lotteries and raffles are gambling winnings (see above). In addition to cash winnings, the fair market value of noncash prizes is considered to be taxable income.

Noncash Income: Taxable income may be received in a form other than cash. A good example of this is bartering income where property or services are exchanged.

Property Damage: Payments you received for property damage are not taxable if the payments are not more than your adjusted basis in the property. If the payments are more than your adjusted basis, you will realize a taxable gain.

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Scholarships and Fellowships: Degree candidates can exclude amounts received as scholarships or fellowships from taxable income. However, amounts received for room and board generally do not qualify for exclusion.

Utility Rebates: If you participate in an electric utility's energy conservation program, you may receive a rate reduction or a refundable credit towards the purchase of electricity. The amount of the rate reduction or nonrefundable credit is not includable in taxable income.

Worker's Compensation Benefits: Amounts received by an employee as compensation under state or federal worker's compensation acts for personal injuries or sickness incurred on the job are not generally taxable, unless the amounts received offset previously deducted medical expenses.

These are some common forms of income questions that may arise regarding inclusion or exclusion for federal tax purposes. Please contact us if you have questions regarding income classification or any other tax compliance or planning issue.

Selecting a C Corporation's Tax Year

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b. on whatever date that day of the week falls nearest to the last day of the calendar month (e.g., the Monday closest to the end of July).

Observation: If the first method is used, the tax year can end up to six days before the end of the calendar month the year ends. If the second method is used, the fiscal year can end as many as three days before or after the end of the month.

Selecting a C Corporation's Tax Year

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Businesses that operate as C corporations have substantial flexibility when selecting a tax year. However, businesses that operate as partnerships or S corporations are restricted by law in their choice of a tax year. Once selected, a tax year generally must be maintained until the business is required or elects (with IRS permission, if necessary) to change it.

There are two types of tax years:

a. **Calendar Tax Year.** A calendar tax year is a period of 12 consecutive months beginning January 1st and ending December 31st.

b. **Fiscal Tax Year.** A fiscal tax year is a period of 12 consecutive months ending on the last day of any month other than December, or a 52–53 week period that ends on a specific day of the week occurring either in the last week or nearest the last day of a specific month.

If there is no reason for choosing a specific year-end for financial reporting, eligible businesses should consider a fiscal year if their own natural business suggests it. Many businesses have a cycle, so that certain times of the year are less busy than others. If available, manufacturers, for example, often choose a tax year corresponding to their natural business cycle, which generally ends just after the highest annual sales period for the business. Year-end financial statements that reflect the natural business year will generally present a more liquid position due to lower inventories and the sales peak just experienced.

A business that operates as a C corporation establishes an annual period as its calendar or fiscal tax year by (a) maintaining books and records on the same basis, and (b) filing the initial tax return based on that period. If books and records are not maintained to establish a fiscal year, the corporation will use a calendar tax year. A C corporation must adopt a tax year by the due date (not including extensions) of the return for the corporation's first tax year. The initial return cannot include more than 12 months, but may include fewer, resulting in a short year.

A 52–53 week fiscal tax year is an annual period that varies from 52 to 53 weeks. Any new eligible C corporation that maintains its books and records on a 52–53 week year-end can adopt a 52–53 week year for tax purposes. The tax year always ends on the same day of the week, and always ends—

a. on whatever date that day of the week last occurs in a calendar month (e.g., the last Monday in July), or

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