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Tax Planning in Uncertain Times—2012 and 2013

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Multi-year tax planning has never been more challenging for mid- to high-income taxpayers, high net worth taxpayers and businesses. Expiring "Bush Tax Cuts," expiring "Tax Extenders or Temporary Provisions" and the new Health Care Act that becomes effective January 1, 2013, will mean higher taxes for many. Sadly, as the political debate over tax fairness and who pays heightens, the likelihood that Congress will unite to provide clarity or restore key Bush-era tax cuts on top tax rates, qualified dividend income, and capital gains before the close of 2012, grows slimmer daily.

Adding more complexity to tax planning is the Patient Protection and Affordable Care Act or "the Obama" Health Care Act that becomes effective on January 1, 2013. This Act will impose an additional 0.9 percent Medicare hospital insurance tax that will apply to wages of self-employment income of individuals with earnings exceeding $200,000 (single) or $250,000 (married filing jointly). Additionally, a 3.8 percent "net investment income tax" on unearned income will kick in. This would be in addition to any tax rate increase on dividends, capital gains and ordinary income due to the expiration of the "Bush Tax Cuts." Fortunately, the 3.8 percent does not apply to qualified plan distributions, income from the disposition of "active" LLCs, partnerships and S corporations and certain other types of income. "Active" business income will generally not be subjected to the 3.8 percent, but it will apply to taxable income of trusts with undistributed net income in excess of the dollar amount at which the highest tax bracket for trusts starts ($11,650 in 2012). The following chart summarizes key changes in Federal tax rates of 2012 and 2013 if Congress fails to act.

Income Type	Maximum Marginal Tax Rate 2012	Maximum Marginal Tax Rate 2013	New Medicare Hospital Insurance Tax 2013	New Net Investment Income Tax 2013	Combined Maximum Marginal Tax Rate 2013
Wages and Self Employment income/ $200,000- (single) or $250,000 (married)	35%	39.6%	0.9%**	N/A	40.5%
Long-Term Capital Gain (Max Rate)	15%	20%*	N/A	3.8%	23.8%
Qualified Dividends, Passive Interest, Rents, Royalties, Other	15%	39.6%	N/A	3.8%	43.4 %
Flowthrough Income (Active / Business)	35%	39.6%	N/A	N/A	39.6%
Flowthrough Income (Passive/ Business)	35%	39.6%	N/A	3.8%	43.4%

***This is in addition to the current 1.48% Medicare* ** 6.2% Social Security taxes and zero percent for tax payers in the 10 and 15 percent brackets.*

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According to a recent report by The Joint Committee on Taxation, approximately 38 "Tax Extenders or Temporary Provisions" are expected to expire on December 31, 2012. Also, the itemized deduction "claw back rules" will return. Some of these include the 2010 Tax Relief Act, which provided marriage penalty relief for couples filing jointly, adoption credits, and the American Opportunity Tax Credit (the Hope Education Credit). Still other expiring provisions relate to more stringent rules for employer-provided educational assistance, limits in student loan interest deductions and reductions in the Coverdell Education Savings Account to $500. In addition, elementary and secondary school expenses will no longer be eligible expenses for these accounts.

Significant changes will occur in the Federal Estate and Gift tax areas with the expiration of the 2010 Tax Relief Act, which set the maximum federal estate and gift tax rate at 35 percent for decedents dying in calendar years 2011 and 2012 with a $5 million exemption ($5.12 million adjusted for inflation of 2012). Should Congress fail to act, the maximum estate and gift tax rate in 2013 will jump to 55 percent with a $1 million exemption and a 5 percent surcharge applying to large estates in excess of $10 million. The best suggestion for high net worth taxpayers with concern about the size of their estates and protecting their heirs is to work carefully with their estate and tax advisors to maximize gifting before year end 2012. They should also look closely at Grantor Retained Annuity Trusts (GRATS) and Dynasty Trusts as there are proposals circulating that could reduce the terms and duration of both. This could very well be the last opportunity to save significant amounts on estate and gift taxes!

Businesses will also see the impact in 2013, with fewer stimulus opportunities such as curtailment of Code Sec. 179 dollar and investment limits ($139,000 and $560,000 limits down to $25,000 and $200,000) and reduction in bonus depreciation rates for qualified investments and property. Thus, taxpayers owning businesses may want to consider pushing deductions into a higher tax year after 2012. A few possibilities include deferral of pension/retirement plan fund allocations that are flexible between years and/or employee and owner bonuses. Timing of asset purchases and election of Code Sec. 179 "expensing" and the election of "bonus" depreciation should be reviewed carefully as the deductions may prove more beneficial in 2013 when rates are higher. Furthermore, because of the looming 3.8 percent net investment income tax, taxpayers should check to make sure that the characterization of activities – "active" or "passive" – is clearly defined and optimized for minimizing taxes on regular income, the 3.8 percent tax and payroll taxes. Because qualified dividends will be subject to higher ordinary income rates (from 15 percent up to 43.4 percent), C corporations and S corporations with excess earnings and profits and ample cash should review whether to make dividend payments before the end of 2012. S Corporations short of cash can make a cashless "deemed dividend" by year end under Sec. 1368(e)(3) and Reg. Sec 1.1368-1(f)(3). Likewise, C Corporations can make a "consent dividend" under Sec. 565.

Now is also the time for individual taxpayers anticipating being subjected to higher income tax rates in 2013 to carefully review their tax posturing. Should capital gains from the sale of stock, bonds, real estate and other assets held more than a year be taken in 2012 rather than 2013 or beyond? Should investors reposition portfolios to create less interest or dividend income? Investors should review investments in trade accounts with respect to their goals and objectives. Taking capital gains in 2012 to avoid additional taxes and reinvesting in growth stocks with little to no dividend income may or may not be the best strategy given that dividend paying stocks have generally outperformed others over the longer term.

Without an Alternative Minimum Tax (AMT) patch at or slightly above the 2011 level, it is estimated that more than 20 million mid- to high-income taxpayers will be subjected to the AMT in 2012. Without a patch, the AMT exemption for 2013 will reduce from $48,450 (single) to $33,750 or from $74,000 (married filing jointly) to $45,000. Because of uncertainty of Congressional action or at what the AMT exemption might be, planning becomes trickier here. Generally, once a taxpayer becomes subject to AMT, then the strategy is to accelerate taxable income into the AMT year and defer tax deductions into a non-AMT year when the marginal rates are higher.

Other strategies to be considered by taxpayers expecting to be taxed at the higher rates next year are exercising stock options and taking bonuses in 2012, rather than deferring them to 2013. Likewise, taxpayers may not find installment sales appealing and may want to forgo Sec. 1031 (like-kind exchanges) and/or Section 1033 (involuntary conversion) elections as well.

Of course, the other choice for taxpayers is to do “nothing” and to assume that because of slowing economic conditions, Congress will ultimately vote to extend the Bush Tax cuts as they exist and at least most of the expiring temporary provisions for another year. That way, tax planning could focus exclusively on the impact of the new Health Care Act. However, this strategy could prove to be risky and costly to the taxpayer given the current standoff in Congress. The House and Senate passed competing tax cut extension bills in July. Although both bills extend many of the expiring incentives for one more year, extend the current individual tax rates established in 2003 (10, 15, 25, 28, 33, and 35 percent) through the end of 2013, and extend the current $1000 child care credit and the AMT patch for 2012 (exemption of $50,600 for singles and $78,750 for married filing jointly), the major sticking point is that the Senate version would only extend the capital gains and dividend treatment for those with incomes below $200,000 (single) or $250,000 (married filing jointly). For those making more than these thresholds, the capital gains rate under the Senate Bill would be increased from 15 percent to 20 percent. Although the major common point in both the House and the Senate bills, the willingness to extend the Bush-era tax cuts for one year could be the starting vehicle for deliberations. As Congress now returns from its summer recess, many political observers believe that politicians on both sides of the aisle will remain steadfast because of the upcoming elections and therefore, less likely to compromise. Others speculate that, even after Election Day, the likelihood of passage by a lame duck Congress remains questionable and there are others who do not expect resolution and clarity from Congress until sometime after January 2013, if at all.

Delays by Congress can be costly to taxpayers in terms of time needed for implementing tax savings strategies. Congressional delays also increase the likelihood of incorrect estimated payments and can hinder the filing of tax returns and receipt of any refunds. The last time this happened was in 2010 when legislation concerning expiring tax provisions and incentives was not passed until mid-December. This meant that tax returns could not be filed until February for many due to the lack of government forms. Another concerning issue with delays is the potential shift of power in Congress from the upcoming election. A new Congress may very well determine not only whether the Bush Tax Cuts will be gone forever, but our long term tax policy as well. Therefore, the most prudent strategy is to review your current tax position carefully with your tax advisor and financial consultants NOW. Know where you stand, and plan ahead so that any last minute adjustments can be made before December 31, 2012!