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PLANNING NOTES

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# Planning for Largest Tax Increase in U.S. History

**Background:** The 2001 and 2003 Tax Acts created the largest income tax and estate tax cuts in U.S. history. These tax cuts are set to expire at the end of this calendar year, which will trigger the largest tax increase in U.S. history effective as of January 1, 2011. Specifically, the income tax rates in effect in 2000, adjusted for inflation, will return as well as the estate tax regime as it existed prior to 2001.

**What to Expect:** There are three main proposals being considered by the Obama Administration and Congress. The first proposal is to extend the current rates for those taxpayers with incomes of less than $250,000, meaning that the pre-2001 rates will come back only for those taxpayers with incomes of $250,000 or more. The second proposal is to extend the current rates for all taxpayers for an indefinite period of time. The third proposal, which is more of a band-aid approach, would extend the current rates for a year while debating a long term solution. Congressional approval will be required for any of these proposals to become law, and, given the current political climate, that may be difficult to achieve. Accordingly, it is prudent to plan for the expiration of the 2001 and 2003 tax cuts as of December 31 of this year.

**What this Means for you:** With Congress debating whether or not to retain some or all of the 2001 and 2003 tax cuts, taxpayers should analyze their individual and business goals, and plan appropriately for the future. The first step in planning is to become familiar with the current tax environment and to understand how it will be affected by the sunsets.

- *Capital Gains: Trigger gain or Defer?* Historically, tax advisors have encouraged their clients to defer income and gains to the next year and accelerate deductions to the current year. However, in the face of the largest tax increase in U.S. history, advisors are re-thinking that strategy. Since 2010 rates represent, potentially, the lowest tax rates taxpayers will see for some time, this might be the year to accelerate gains and defer deductions. The table below demonstrates the "gross" amount necessary to net $1 after taxes from capital gain income in the current year as well as in the future.

| Capital Gains | Max Capital Gains Rate | Gross | Increase |
|---|---|---|---|
| 2010 | 15% | $1.18 | - |
| 2011-2012 | 20% | $1.25 | $0.07 |
| 2013 and Later | 23.8% | $1.31 | $.013 |

- *Dividends:* Taxpayers whose income is comprised, in large part, of dividends will be hit hard as well. The table below demonstrates the "gross" amount necessary to net $1 after taxes from dividend income in the current year as well as in the future.

| Dividends | Max Dividend Rate | Gross | Increase |
|---|---|---|---|
| 2010 | 15% | $1.18 | - |
| 2011-2012 | 39.6% | $1.66 | $0.48 |
| 2013 and Later | 43.4% | $1.77 | $0.59 |

- *Income Tax Rates:* For those taxpayers paying income tax at the highest marginal rate, which is currently 35%, increases are coming. Those taxpayers, many of whom are individuals reporting income from closely-held businesses on their individual returns, can expect rates to rise to 39.6% in 2011 and 2012. For 2013 and later, these taxpayers will see passive income taxed at a top rate of 43.3% and compensation taxed at a top rate of 40.5%.

- *Condensed Tax Brackets.* While those in the top marginal rate will be hit the hardest, the income tax increases will not be limited to those taxpayers. As seen in the tables below, the 2011 tax rate increase occurs across the board due predominantly to the condensed 2011 rate schedules, which move taxpayers into higher brackets. As calculated using the tables below, in 2010, a married couple with two children, no deductions and $200,000 of adjusted gross income will owe $36,964 in income tax. In 2011, that same couple's federal income tax liability will be $42,465, which is a 15% increase.

| Married Filing Jointly | 2010 |
|---|---|
| $0-$16,750 | 10% of amount over $0 |
| $16,750-$68,000 | $1,675+15% of amount over $16,750 |
| $68,000-$137,300 | $9,362+25% of amount over $68,000 |
| $137,300-$209,250 | $26,687.50+28% of amount over $137,300 |
| $209,250-$373,650 | $46,833.50+33% of amount over $209,250 |
| $373,650 and over | $101,085.50+35% of amount over $373,650 |

| Married Filing Jointly | 2011 |
|---|---|
| $0-$57,650 | 15% of amount over $0 |
| $57,650-$139,350 | $8,647.50+28% of amount over $57,650 |
| $139,350-$212,300 | $31,523.50+31% of amount over $139,350 |
| $212,300-$379,150 | $54,138+36% of amount over $212,300 |
| $379,150 and over | $114,204+39.6% of amount over $379,150 |

- *But It's More than Just a Rate Increase.* Taxpayers in 2011 are set to see more than just rate increases. In addition to the rate increases, more than fifty provisions of the Internal Revenue Code are set to be affected. The effects will include the scaling back of itemized deductions, a lower standard deduction, lower phase-outs for the personal exemption, and a reduction in the individual exemption under the alternative minimum tax ("AMT"). It is worth noting that the increased regular income tax liability will cause AMT liabilities to decrease since taxpayers that would otherwise be subject to the AMT will now be subject to the increased regular income tax.

**What to do now:** Taxpayers should consider their options as soon as possible given the fact that year-end is fast approaching, and current income tax rates are likely to be the lowest to be seen for many years to come.

- *S Corporations.* S corporations that were formerly C corporations may have historic C corporation earnings and profits. While distributions from S corporations generally are not taxable to the shareholder, if the distribution is deemed to come from the historic earnings and profits of the C corporation, these distributions are taxed as dividends. Since dividend rates are set to increase, S corporation management should consider whether it would be wise to make a shareholder distribution and elect to have this distribution come from these historic C corporation earnings and profits.

The effect of this election, in 2010, would be a taxable dividend to the shareholders at current dividend rates of 15%.

- *C Corporations.* C corporations should consider the merits of paying abnormally large dividends before the end of this calendar year. Those corporations owning assets that are not critical to its business should consider selling those assets, recognizing gains at the current rates, and distributing the gains to its shareholders.

- *Roth IRA Conversions.* Contributions to Roth IRAs are taxed currently while future distributions of principal and appreciation occur free of income tax. If a taxpayer has been considering converting to this type of account, with increased rates on the horizon, now might be the time.

- *Investment Assets.* Taxpayers should take a close look at the investment assets they are holding, particularly marketable securities. Taxpayers holding investments with built-in gains should consider selling those investments, recognizing the gain in 2010, and reinvesting the after-tax proceeds in a similar class of investments. However, taxpayers may want to defer selling investment assets with built-in losses until 2011 or future years. Since tax rates are set to increase, those losses will be worth more in the future. Taxpayers with capital loss and net operating loss carryovers should take a close look at whether the greatest tax benefit will be derived from recognizing gains at lower rates in 2010 and having those gains offset by loss carryovers or whether they should defer their gains in order to take advantage of their loss carryovers in future years.

- *Avoid like-kind exchanges.* Taxpayers who have an opportunity to sell property and have the need to reinvest the sales proceeds in similar property routinely structure the transaction as a "like-kind exchange" to defer gain recognition until the eventual sale of the replacement property. Instead of deferring gain on asset sale/replacement transactions occurring in 2010, taxpayers may want to structure the transactions to avoid the like-kind exchange rule in order to benefit from the higher tax basis for the replacement property that results from reporting gain on the transaction.

- *Elect out of Installment Sale Reporting.* Taxpayers planning to sell assets in 2010 with part of the consideration payable in a later year may want to elect out of installment sale treatment whereby taxpayers recognize gain on a transaction over the life of the payment period. By electing out of installment sale treatment, taxpayers will recognize all gain currently at, potentially, much lower rates.

- *Consider a Sale-Leaseback.* Taxpayers might also want to consider a sale-leaseback as an option to borrowing against an asset. By structuring a sale-leaseback, a taxpayer could recognize gain currently at a low rate and take lease payment deductions in future years when rates have increased.

- *Capitalize.* Tax advisors have, in the past, advised taxpayers to attempt to expense as opposed to capitalize the cost of equipment under the old adage, "A deduction delayed is a deduction denied." This year, advisors are suggesting that taxpayers consider doing just the opposite: capitalize. By capitalizing the cost of new equipment purchases, the taxpayer will be able to benefit from higher depreciation expenses in future years when rates are set to increase. In addition to capitalizing the cost of new equipment purchases, taxpayers should consider foregoing the use of accelerated depreciation in 2010, since rates are lower, and stretching the depreciation into future years, when rates will likely be higher. Therefore, before taking advantage of the Small Business Jobs Act, which includes increased Section 179 expensing and bonus depreciation, taxpayers should consider whether deferring those deductions into future years through the use of capitalization and a slower depreciation method will a better financial option.

- *Compensation Payment.* Consider delaying the payment of bonuses beyond two and a half months after year-end so that those payments can be deducted in 2011 and later. Also, consider delaying contributions for qualified retirement plans until after the extended due date so that those payments can be deducted in 2011 and later.

**Going Forward:** In these uncertain times, and with tax increases likely to occur in 2011, income tax planning is crucial. Taxpayers should plan now and then reevaluate their plans in light of any new tax developments occurring during the lame duck session after the November elections. Lastly, in early 2011, taxpayers should evaluate any tax elections they might be considering and the impact those elections may have prior to filing their tax returns. It is important to remember that there is no one-size-fits-all income tax plan for the upcoming year, and with January 1, 2011, nearing, there is no time to waste.

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