



# Planning for Individual Taxpayers in Anticipation of a Higher Tax Rate Environment

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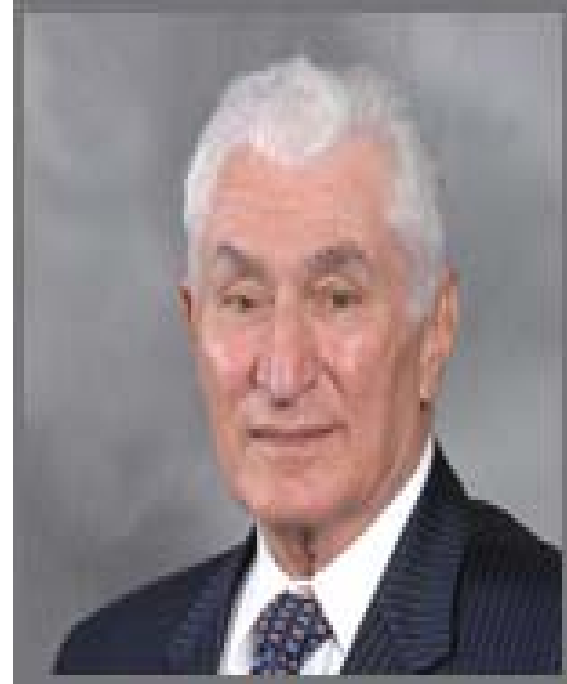
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# Background and Overview

- Where Are We Now
- Expiration of Bush Administration Tax Cuts and Higher Rate Environment for 2011
- Other Proposals Including Obama Administration Proposal and House Surtax on Wealthy
- Planning Possibilities for Higher Rate Environment



# Where are We Now

- Ordinary Income Tax Rates for 2009 and 2010 (under existing law)
- Tax Brackets for 2009 and Estimates\* for 2010 (minimal increases due to low inflation)

Tax Rate	Married Filing Joint		Most Single Filers	
	2010 Taxable Income	2009 Taxable Income	2010 Taxable Income	2009 Taxable Income
10%	Not over \$16,750	Not over \$16,700	Not over \$8,375	Not over \$8,350
15%	16,750 - 68,000	16,700 - 67,900	8,375 - 34,000	8,350 - 33,950
25%	68,000 - 137,300	67,900 - 137,050	34,000 - 82,400	33,950 - 82,250
28%	137,300 - 209,250	137,050 - 208,850	82,400 - 171,850	82,250 - 171,550
33%	209,250 - 373,650	208,850 - 372,950	171,850 - 373,650	171,550 - 372,950
35%	Over 373,650	Over 372,950	Over 373,650	Over 372,950

(\*From the Tax Foundation and Thomson Reuters)



## Where are We Now

- 2010 Rates for Capital Gains and Qualified Dividends:
  - 10% and 15% Ordinary Income Tax Brackets – 0%
  - All Other Ordinary Income Tax Brackets – 15%
- Exceptions:
  - Taxable gain from selling Section 1202 qualified small business stock is taxed at a maximum 28% rate.
  - Net capital gain from selling collectibles (such as coins or art) is taxed at a maximum 28% rate.
  - The part of any net capital gain from selling Section 1250 real property that is required to be recaptured is taxed at a maximum 25% rate.



## Where are We Now

- Estate Tax Repeal in 2010 – Retroactive Application?
  - On December 3, 2009, the House passed the Permanent Estate Tax Relief for Families, Farmers and Small Businesses Bill of 2009 (H.R. 4154), permanently extending the top federal estate tax rate of 45 percent with a \$3.5 million exclusion (and retaining the stepped-up basis regime).
  - The House Bill retains the same gift tax regime put in place by the Economic Growth and Tax Relief Reconciliation Act of 2009; lifetime exclusion remains at \$1 million after 2009.
  - On December 16, 2009, Senate Finance Committee Chair Max Baucus, D-Mont., tried and failed to extend current estate tax law by unanimous consent, and stated "We'll clearly work to [bring back the estate tax] retroactively so that if the law is changed, however it's changed, or if it's extended next year, it will have retroactive application."
  - Unless Congress acts to retroactively reinstate estate tax for 2010, carry-over basis regime would apply.



## Expiration of Bush Cuts; Higher Rate Environment

- Cuts from The Economic Growth and Tax Relief Reconciliation Act of 2001 (as accelerated by The Jobs and Growth Tax Relief Reconciliation Act of 2003, and extended through 2010 by The Tax Reconciliation Act of 2006) are set to expire on 12/31/2010.
- As a result, after 2010:
  - Dividends will be taxed at the taxpayer's ordinary income tax rate.
  - The long-term capital gains rate will be 20% (10% for taxpayers in the 15% tax bracket).
  - The qualified five-year 18% capital gains rate (8% for taxpayers in the 15% tax bracket) will be reinstated.



# Expiration of Cuts; Higher Rate Environment

- After 2010, ordinary income tax rates return to pre-2001 levels:
  - 15%
  - 28%
  - 31%
  - 36%
  - 39.6%
- Reinstate itemized deduction reduction of 3% of AGI exceeding the statutory floor, and personal exemption phase-out.
  - Charitable contribution planning issues.
- Decreased §179 expensing from \$134,000 for 2010 to \$25,000 for 2011.
- Estate tax revived after 2010, with \$1 million exemption and 55% maximum rate. Stepped-Up basis rules also revived.



# Administration Proposals; Higher Rate Environment

- Permanently extend the rates under The Economic Growth and Tax Relief Reconciliation Act of 2001, except that in 2011:
  - Reinstate the top marginal rate of 39.6%.
  - Reinstate the second highest marginal rate of 36% for taxpayers with income less than the level at which the 39.6% rate would apply but over \$250,000 for joint filers and \$200,000 for single filers.
- Permanently extend the 0% and 15% rates on capital gains and qualified dividends for taxpayers with income up to \$250,000 (joint) and \$200,000 (single), except that in 2011:
  - 20% capital gain and qualified dividend rate for taxpayers with income over \$250,000 (joint) and \$200,000 (single).
  - Eliminate reduced rates on gains on assets held over five years.



## Administration Proposals; Higher Rate Environment

- Reinstatement of itemized deduction reduction of 3% of AGI exceeding statutory floor (for 2011, AGI floors would be adjusted for inflation, starting with a 2009 value of \$250,000 for joint filers and \$200,000 for single filers).
- Reinstatement of personal exemption phase-out for taxpayers with income over \$250,000 (joint) and \$200,000 (single). AGI floors adjusted for inflation starting with a 2009 value of \$250,000 for joint filers and \$200,000 for single filers.



## House Proposal – Surtax on Wealthy

- House proposal to pay for health care reform, beginning in 2011.
- The surtax would start at 1% for income exceeding \$350,000 (joint) and \$280,000 (single), and rise to 5.4% percent on income exceeding \$1,000,000.
- Combined with the expiration of tax cuts enacted during the Bush administration, the surtax would drive the top federal tax rate to 45 percent.



## Planning Possibilities – Accelerate Income

- Convert traditional IRA and certain other qualified retirement accounts to Roth IRA.
  - No income limitations for conversions.
  - Contributions of pre-tax dollars (and growth) subject to tax on conversion, but recognized over 2011 and 2012.
- Conversion may make sense if:
  - Account funded with after-tax dollars and at relatively low point in value (all traditional IRA accounts considered).
  - Expect to be in high bracket when traditional IRA required minimum distributions begin, particularly for taxpayers who do not need IRA distributions in retirement.
  - Business losses and other deductions available to offset.
  - Young enough to recoup the cost of conversion.



## Planning Possibilities – Accelerate Income

- Accelerate existing installment obligations to 2010:
  - Sale, exchange or other taxable dispositions.
  - Substantial modifications.
  - Non-liquidating distributions by S corporations.
- Elect out of installment method for 2010 transactions (consider sales of capital assets, real estate or other nonpublicly traded property sales).
- Must analyze whether acceleration of tax at lower rate is worth more than deferral of income and higher tax paid on deferred payments.



## Planning Possibilities – Accelerate Income

- Do not elect to defer COD income under §108(i) upon reacquisition of debt instrument in 2010.
- Trigger income on previously deferred COD income by sale of assets or cessation of business prior to 2011.



## Planning Possibilities – Accelerate Income

- Accelerate income the timing of which can be controlled:
  - Bonuses (beware unreasonable compensation problems).
  - Consulting or other self-employment income.
  - U.S. Treasury bill income.
- Accelerate retirement/qualified plan distributions, if not required:
  - Two years of needs in first year?
  - Present value tax analysis.



## Planning Possibilities – Defer Recognition of Income

- Where there is control or influence, maximize employer sponsored benefits that are not currently taxable:
  - Flexible benefit accounts.
  - 401(k) and other qualified retirement plans.
  - Medical expense reimbursement plans.
- Consider establishing qualified plans, especially for individuals not covered by corporate plan.
- Consider buying variable annuities, or other so-called “investment” insurance products.



## Planning Possibilities – Defer Recognition of Income

- Instead of investing in stocks or ordinary income producing assets, consider increased investment in principal residence.
  - Gain up to \$500,000 (joint) excluded from income.
  - Gain in excess of \$500,000 is capital gain.
  - Impact on needed liquidity.
- Proposition 13 considerations – may be affected by age and prior changes in residences.



## Planning Possibilities – Defer Deductions

- Defer deductions and accelerate them after rate increase.
- Charitable deductions – large donations to donor advised funds after rate increase to make up for deferred donations and to spread out over time.
- Defer business capital expenditures until after rate increases to maximize value of depreciation deductions.
- Other deductions and credits:
  - State income tax and property tax payments.
  - Mortgage and margin interest.
  - Residential energy credits.
  - AMT considerations.



## Planning Possibilities – Viability of C Corporations

- Compare ordinary income tax rates with corporate tax rates:
  - If corporate rate on first \$50,000 (or some other amount then relevant) remains favorable (currently 15%) and the qualified dividend rate remains at 20%, total tax may be less than the applicable individual ordinary income rate.
- Invites comparison between compensation rates of tax on individuals to dividend rates on corporate earnings.
  - E.g., shift, where reasonable, compensation paid by closely held corporations to qualified corporate dividend.

