PUBLICATION

Year End Tax Planning in Uncertain Times - Part Two

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As was the case two years ago (see our November 18, 2010, Tax Alert), taxpayers are not able to plan ahead for calendar 2013. In addition to uncertainty over tax rates, the country is facing a fiscal cliff caused by the failure of Congress to deal with the nearly $1 trillion in across-the-board spending cuts that, absent action by Congress, will be effective in January 2013.

Congress has elected to follow a "hurry up and wait" approach and put off decisions until after the 2012 election determines what the political landscape will be for the next four (at least) years.

In the early 2000's, Congress enacted the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (both such prior Acts being referred to herein as EGTRRA), which lowered overall tax rates and, by their terms, expired at the end of 2010. In late 2010, Congress enacted the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (2010 Tax Relief Act), which extended the EGTRRA lower rates for two additional years.

FEDERAL INCOME TAX RATES

The following tables illustrate, for married individuals filing joint returns, the 2012 tax rates, the projected 2013 income tax rates if Congress does nothing, and the projected 2013 income tax rates if Congress again extends the lower rates.

Table 1. 2012 Rates

Taxable Income Over	But Not Over	Pay	% on Excess	Of the amount over-
$0	$17,400	$0	10%	$0
$17,400	$70,700	$1,740	15%	$17,400
$70,700	$142,700	$9,735	25%	$70,700
$142,700	$217,450	$27,735	28%	$142,700
$217,450	$388,350	$48,665	33%	$217,450
$388,350 & above		$105,062	35%	$388,350

Table 2. Projected 2013 Rates if Congress Does Nothing.

Taxable Income Over	But Not Over	Pay	% on Excess	Of the amount over-
$0	$60,550	$0	15%	$0
$65,550	$146,400	$9,082	28%	$60,550
$146,400	$223,050	$33,120	31%	$146,400
$223,500	$398,350	$56,882	36%	$223,050
$398,350 & above		$119,990	39.6%	$398,350

Table 3. Projected 2013 Rates if Congress Extends EGTRRA Lower Rates.

Taxable Income Over	But Not Over	Pay	% on Excess	Of the amount over-
$0	$17,900	$0	10%	$0
$17,900	$72,500	$1,790	15%	$17,900
$72,500	$146,400	$9,980	25%	$72,500
$146,400	$223,050	$28,445	28%	$146,400
$223,050	$398,350	$49,917	33%	$223,050
$398,350 & above		$107,766	35%	$398,350

The promise of increasing income tax rates frustrates the very core of modern tax planning. Nearly all tax-savings strategies are based on the two underlying principles that individual taxpayers benefit from: deferring income and accelerating deductions. This dual-principled approach is turned on its head, however, when an income tax rate increase is threatened. Instead, an analysis of one's potential tax liability may well prove that payment of tax at current rates results in a lower overall tax burden than if the payment is delayed. Consequently, in anticipation of some adjustment next year in the higher tax rates, individual taxpayers affected by such higher rates may be best served where practical by deferring deductions and accelerating income. Such taxpayers should consider (again, where practical to do so) the following planning opportunities to take advantage of any future rate increase:

- Recognizing deferred compensation during 2012;
- Accelerating the execution of profitable commercial contracts into 2012;
- Postponing charitable cash contributions until 2013; and

- Delaying mortgage interest or deductible health expenditures until 2013.

CAPITAL GAINS RATE

Since 2003, taxpayers have enjoyed a maximum tax rate of 15 percent on all long-term capital gains. In addition, dividends received by individuals have been taxed at the capital gains rate rather than being treated as ordinary income. Unless the law is changed, beginning January 2013, the capital gains rate will revert to the pre-2003 rates of 20 percent instead of 15 percent; and taxpayers in lower brackets who did not pay capital gains tax under the 2010 Tax Relief Act will be subject to a 10 percent capital gains tax rate in 2013. Dividends will no longer be taxed as capital gains.

In preparation, taxpayers should consider implementing the following techniques where practical:

- Accelerating the sale of property with built-in gains into 2012;
- Avoiding realization of losses on sale of depreciated property until 2013; and
- In the case of C corporations, declaring dividends this year.

ALTERNATIVE MINIMUM TAX

The Alternative Minimum Tax exemption has been increased by Congress over the last several years to protect many taxpayers who perhaps were not intended to be subject to the AMT. However, those increased exemptions expired at the end of 2011. If Congress does nothing, the Alternative Minimum Tax exemption will revert to $45,000 from the $74,450 level applicable prior to 2012, in the case of married taxpayers filing jointly.

MEDICARE CONTRIBUTION TAX

Beginning in 2013, individuals, estates and trusts are subject to a tax at the rate of 3.8 percent on the lesser of net investment income or excess modified adjusted gross income for the year over a threshold amount.

The tax is 3.8 percent of the lesser of the taxpayer's net investment income for the year or modified adjusted gross income in excess of $200,000 in the case of individuals, $250,000 in the case of joint filers and $125,000 in the case of married taxpayers filing separately.

In the case of an estate or trust, the tax is 3.8 percent of the lesser of undistributed net investment income or any excess of modified adjusted gross income over the dollar amount at which the highest bracket applicable to the year begins ($11,650 for 2012 and possibly $11,950 for 2013).

Separately, and also beginning in 2013, the employee's share of the hospital insurance tax will be increased by 0.9 percent on wages in excess of $250,000 for married taxpayers filing a joint return, $125,000 for married taxpayers filing separately, and $200,000 in all other cases; as well as will be imposed on net earnings from self-employment.

OTHER CHANGING PROVISIONS

In addition to the increasing income tax, capital gains, dividend, and estate tax rates, other expiring taxpayer-favorable provisions include:

- Phase-out of Personal Exemptions: The personal exemptions for taxpayers with higher incomes will once again be subject to phase-out when their adjusted gross income exceeds an inflation-adjusted threshold. It is estimated that the inflation-adjusted threshold will be $261,650.

- Reduction in Itemized Deductions: The overall limitation on itemized deductions under Section 68(g), generally known as the "Pease limitation" (named after the congressman who aided in the creation of the legislation) will be fully restored so as to limit itemized deductions after December 31, 2012, which will have the effect essentially of further increasing tax rates. This limitation will not apply to deductions for medical and dental expenses, investment interest, and casualty and theft losses.
- Reduction in Election to Expense Certain Depreciable Business Assets: Taxpayers may currently elect to expense certain depreciable business assets in the year of purchase rather than capitalize such costs. While the ability to make this election will continue into 2013, the limitations on the amounts for which a taxpayer may elect to expense under this election are drastically reduced.
- Reduction of Child Tax Credit: The maximum child tax credit will be reduced from $1,000 to $500 per child, and the credit may no longer be used to offset Alternative Minimum Tax liability.
- Reduction in Credit for Household and Dependent Care Expenses: The dollar limitation for qualified expenses will decrease from $3,000 to $2,400 for one qualifying individual and $6,000 to $4,800 for two or more qualifying individuals. Further, the Applicable Percentage used to determine the amount of expenses that are allowed as a credit will be reduced from 35 percent to 30 percent.
- Education Provisions

  - *Interest on Education Loans:* The ability to deduct interest payments on student loan debt will only apply to interest paid during the first 60 months of the period in which interest payments are required. Also, the deduction will phase out at modified adjusted gross income amounts, which are estimated to be $75,000 for joint returns and $50,000 for all other returns.
  - *Qualified Tuition and Related Expense:* The deduction provided for qualified tuition payments and certain related expenses will no longer be available.
  - *Coverdell:* The increase of maximum annual contributions to Coverdell education savings accounts (also known as Educational IRAs) from $500 to $2,000 under Section 530(b)(1)(A)(iii) will be eliminated after December 31, 2012. Furthermore, the definitional expansion of qualified education expenses will revert to its pre-2001 limitation under Section 530(b)(2), which will include the elimination of the definition of elementary and secondary education expenses under Section 530(b)(3). Finally, Section 530(b)(4), allowing current-year contributions to be made until April 15 of the following year, will be eliminated.
- Principal Residence Sales Exclusion: The $250,000 exclusion from gross income of gain on the sale of a principal residence will no longer apply to heirs, estates and qualified revocable trusts that were treated as owned by the decedent immediately prior to death.
- Increase in Floor for Deduction of Medical, Dental, etc. Expenses: As amended by the 2010 Patient Protection and Affordable Care Act, the current 7.5 percent floor for deduction medical and dental expenses will be increased to 10 percent.

ESTATE AND GIFT TAXES

The estate, gift and generation-skipping transfer (GST) tax laws are also scheduled to change significantly on January 1, 2013. Currently the highest estate tax rate is 35 percent and the applicable exclusion per person from the estate and gift tax is $5,120,000. Without Congressional action to alter the scheduled changes, the highest estate tax rate will rise to 55 percent (with a 5 percent surcharge on certain large estates), and the applicable exclusion will decrease to $1,000,000 on January 1, 2013. In addition, portability of the estate tax exclusion will expire on January 1, 2013. The following chart illustrates the dramatic changes in rates and exclusions for the estate, gift and GST taxes.

	2012	2013 and beyond

Highest Estate Tax Rate	35%	55%
Estate Tax Exclusion	$5,120,000	$1,000,000
Highest Gift Tax Rate	35%	55%
Gift Tax Exclusion	$5,120,000	$1,000,000
GST Tax Rate	35%	55%
GST Tax Exclusion	$5,120,000	$1,000,000*
Portability of Estate Tax Exclusion	YES	NO

***Indexed for inflation occurring after 1997**

Helpful to some extent, the annual exclusion for federal gift taxes is $13,000 in 2012 and is projected to be $14,000 for 2013.

SUMMARY

This Alert is intended to be a general review of various tax rates and other tax provisions that could change in the near future, and is not intended as advice under any specific facts and circumstances. Tax planning in these uncertain times starts with an understanding of your specific facts and circumstances. As a result, taxpayers should consider consulting with their tax advisors well before the end of 2012.

If you have any questions regarding the tax planning issues referenced above, or other questions relating to any other tax topics, please contact any attorney in the Firm's Tax Department.