BPM

Tax Planning for Individuals and Businesses – The Countdown to 2013 Continues

09.06.12

As 2012 winds down, the likelihood of higher taxes for most individuals and businesses in 2013 is all but certain. Tax rates are scheduled to increase with the imminent expiration of the Bush-era tax cuts, generous estate and gift tax rules will expire, and itemized deductions will be subject to more limitations. As the law stands today, these changes will take effect on January 1, 2013. It will take an act of Congress and presidential approval to prevent these changes from happening.

Effective tax planning requires an in-depth look at multiple years. It cannot be focused entirely on one year with no consideration of events that may impact finances sometime in the future. At the same time, it is very difficult to predict what will happen. This is particularly true given the current political climate, the upcoming election, and the lame duck session between the election in November and January 1, 2013. Still, it's important to develop a plan based on what we know today.

Unless federal law is changed, the Bush tax cuts will expire at the end of 2012 and moreover, a number of tax increases related to the 2010 health care reform legislation will become effective as of January 1, 2013. Individual tax rates, as well as estate and gift tax rates, are set to increase, and new provisions are due to take effect. Most taxpayers will end up paying more to Uncle Sam. Let's take a closer look at how these tax increases currently break down:

- Taxes on **earned income** (such as salary, director fees, self-employment income and business income) are subject to increases in ordinary income rates from 35% or 39.6% (at the highest tax bracket), increases in the Medicare tax (.9%) and the phase out of itemized deductions.
- Taxes on **unearned income** (including interest, non-qualifying dividends, rents, partnership income, S-Corporation income, and fiduciary income) could be subject to the increases on earned income plus an additional 3.8% (net investment income tax).
- Taxes on **long-term capital gains and capital gain dividends** could increase from 15% to 20% plus the 3.8% surcharge on unearned income and the phase out of itemized deductions.
- Taxes on **qualified dividends** could increase from a base rate of 15% to 39.6% plus the surcharge on unearned income and the phase out of itemized deductions.

Estate and Gift Tax

Along with individual income tax, estate and gift tax will also see significant increases in 2013. Currently, the estate and gift tax exemption amount is $5,120,000 per person. For married couples, a surviving spouse can add to their own exemption any unused exemption remaining upon the death of the first spouse to die. As a result, the exemption amount for a surviving spouse could be as high as $10,240,000. Any excess value could be subject to federal estate tax of 35%.

Additional Provisions

The end of Bush era tax cuts also means an end to the tax credit for research and development, a substantial reduction in first year depreciation, and an end to the write off for qualified leasehold improvements, as well as restaurant and retail improvements in real property.

Why Your 2013 Planning Can't Wait Any Longer

It is impossible to predict what laws will ultimately be enacted that will affect 2013. While tax planning often focuses on the deferral of income, this year is different. Serious consideration should be given to the timing of income recognition and deductions. It's more important than ever to be proactive in tax planning. There's little doubt that tax rates for 2013 will be higher than 2012. Changes in estate and gift tax rates and exemption amounts will likely result in tax increases as well. Tax planning should start today to provide adequate time for the design and implementation of a plan that minimizes any tax burden and maximizes any opportunities that may not exist after 2012.

Actions to Consider

© 2020 BPM

- Consult with your tax advisor and run tax projections that cover a period of several years. Effective tax planning cannot focus on one year alone.
- Consider accelerating income into 2012. Tax rates may increase significantly after the end of the year. Itemized deductions will be subject to phase out beginning in 2013. For some taxpayers, recognizing income in 2012 results in less income in 2013. Less income means lower adjusted gross income. Lower adjusted gross income means a smaller reduction in itemized deductions subject to phase out after 2012.
- Consider harvesting long-term gains. Capital gain rates are going up. Gross proceeds from the sale of assets may be subject to a 3.8% excise tax in addition to income tax on capital gains.
- Business owners should consider accelerating research and development activities. Although a credit for R&D activities exists today, there is no guarantee it will be available in the future.
- Consider the purchase of business assets before the end of the year to take advantage of bonus depreciation that may not be available after 2012.
- Consider paying dividends to shareholders in 2012. After 2012, dividends will be taxed at ordinary income rates and may be subject to an additional 3.8% excise tax on investment income.
- Consider gifting. At the end of 2012, the maximum gift tax rate increases from 35% to 55%. A decrease in the lifetime exemption results in an increase in gifts subject to tax.
- Review your wills and trusts. Estate planning is a must. Re-drafting legal documents is a lengthy process. Attorneys need adequate time to formulate an estate plan that makes sense for you today. Avoid an unintended result that may be caused by the wording in an older document.

This is only a partial list of possible steps to consider. Planning is specific to each individual taxpayer's overall financial situation. Pro-active planning can help avoid unintended results. A decision not to plan is also a planning decision, which may or may not work out to your benefit.

There's no time like the present to be a proactive participant in the tax planning process. Talk to your tax advisor if you'd like to discuss tax planning opportunities or pitfalls that may have an impact on you.

© 2020 BPM