LOEB & LOEB LLP

LOEB & LOEB adds Knowledge.

Tax Law

ALERT

SEPTEMBER 2012

Are You Prepared for Major Income Tax Changes on January 1, 2013?

Much has been written about changes to the estate and gift tax law scheduled to occur on January 1, 2013, particularly the reduction of the lifetime estate and gift tax exemption amount from its 2012 level of $5,120,000 to $1 million. The exemption for the generation-skipping transfer tax will also decrease from its 2012 level of $5,120,000 to a base level of $1 million. It is indexed for inflation from 2001, however, and is currently estimated to be $1,430,000. Significant changes to the income tax law are also scheduled to take effect at the same time, but these changes are only now beginning to receive similar attention. While Congress could still act to avert some or all of the changes, the divided nature of this Congress makes the prospect of any action before January 1, 2013, uncertain. This alert summarizes the most significant of the changes to the income tax law that will take effect on January 1, 2013, and suggests some steps you might consider to mitigate their impact.

Tax Rates

The maximum federal income tax rate on ordinary income will increase from its present level of 35 percent to 39.6 percent. The tax rate on long-term capital gain income will increase from its present level of 15 percent to 20 percent. The most dramatic increase will be to the rate at which qualified dividends are taxed. Qualified dividends are currently taxed at the same 15 percent rate as long-term capital gain income. Beginning January 1, 2013, dividends will be treated the same as other ordinary income and taxed at a maximum income tax rate of 39.6 percent.

Additional Medicare Taxes

Now that the U.S. Supreme Court has upheld the Patient Protection and Affordable Care Act of 2010, the additional Medicare taxes will take effect January 1, 2013, as planned, unless Congress acts to change them.

Employees currently pay a Medicare hospital insurance tax of 1.45 percent on their wages. Self-employed individuals pay 2.9 percent of net earnings from self-employment. Unlike taxes on wages and self-employment income for Old Age, Survivors and Disability Insurance, which are capped, the Medicare component of the social security tax has no ceiling. Beginning January 1, 2013, an additional 0.9 percent tax will apply to wages in excess of $250,000 for a married person filing a joint return ($125,000 for married persons filing separately) or $200,000 for an unmarried individual. This will make the total Medicare tax for these individuals 2.35 percent on their wages above the threshold amount. For self-employed individuals, the additional 0.9 percent will apply to their earnings from self-employment in excess of $250,000 for a married person filing a joint return ($125,000 for married persons filing separately) or $200,000 for an unmarried individual. The total Medicare tax for these individuals will be 3.8 percent on their earnings above the threshold amounts, which are not currently indexed for inflation.

Medicare Tax on Investment Income

A new Medicare tax on net investment income will also take effect beginning January 1, 2013. The rate for this new tax will be 3.8 percent and will apply to the lesser of an individual's i) net investment income; or ii) the excess of the individual's "modified adjusted gross income" over $250,000 in the case of a married couple filing a joint return ($125,000 for married persons filing separately or $200,000 for an unmarried

This publication may constitute "Attorney Advertising" under the New York Rules of Professional Conduct and under the law of other jurisdictions.

individual). Modified adjusted gross income is the adjusted gross income increased by the amount of the foreign earned income exclusion. For most taxpayers, their modified adjusted gross income will be the same as their adjusted gross income. The threshold amounts are not currently indexed for inflation.

In the case of an estate or trust that accumulates part of its income, the tax will apply to the lesser of i) its undistributed net investment income; or ii) the excess of its adjusted gross income over the dollar amount at which the highest tax bracket in Section 1(e) begins for the taxable year. This amount currently is scheduled to be $7,500. Since this is a much lower threshold amount than applies to individuals, in many cases, net investment income may be subject to the Medicare tax if it accumulated at the trust level, while it would not be subject to the tax if it is distributed to beneficiaries whose adjusted gross income is less than $250,000 if they file a joint return, or $200,000 if they are unmarried.

Net investment income is gross investment income reduced by those allowable deductions that are properly allocable to such income. Investment income includes interest, dividends, annuities, royalties, and rents, provided that this income is not derived from a trade or business that is not a passive activity for the taxpayer. It also includes gains from the disposition of property, so capital gains realized on the sale of appreciated investments will be subject to this new tax, as well as income derived from the business of trading financial instruments or commodities. If a business that is a passive activity for the taxpayer earns any of the above types of income, that income is also subject to the tax.

The tax does not apply to amounts distributed from qualified retirement plans. It also does not apply to any amount that is subject to the self-employment tax. This rule prevents the Medicare tax from applying twice to the same income. While income from a trade or business that is not a passive activity of the taxpayer will not be subject to the 3.8 percent Medicare tax on investment income, much of that income may be subject to the 3.8 percent Medicare tax on self-employment income. Some limited types of income may not be subject to either tax, but a lot of the detail on how the new tax will apply is still missing.

Phase-out of Itemized Deductions and Personal Exemptions

The phasing out of itemized deductions will also return to the tax law in 2013. Once again, an amount of a taxpayer's itemized deductions equal to 3 percent of adjusted gross income in excess of $100,000 (adjusted for inflation) will be disallowed, but not in excess of 80 percent of the taxpayer's total itemized deductions. The disallowance rule applies to all of a taxpayer's itemized deductions except for medical expenses, investment interest, and casualty and theft losses. For 2009, the last year to which the phase-out previously applied, the $100,000 amount had been inflation adjusted to $166,800. The amount for 2013 should be announced soon.

The personal exemption deduction of $3,700 (2011 amount) per taxpayer and dependent will once again be phased out. The deduction is phased out at the rate of 2 percent of the deduction for each $2,500 by which the taxpayer's adjusted gross income exceeds a threshold amount. The amount is inflation adjusted and for 2009, the last year to which the phase-out applied, was $250,200 for taxpayers filing a joint return. The deductions were completely lost if the taxpayer's adjusted gross income exceeded $372,700. The deduction amount and the threshold amount where the phase-out begins for 2013 should be announced soon.

What Should You Do to Prepare for 2013?

You should be prepared to take certain steps after the November elections and before the end of the year if it becomes apparent that Congress will not act to extend the current tax regime into 2013. Some of the considerations are described below.

Should You Sell Appreciated Capital Assets in 2012?

The idea of selling appreciated capital assets in 2012 and paying a federal tax of 15 percent, as compared to a tax of 23.8 percent after 2012, certainly has appeal, since the applicable rate is increasing by 58.67 percent of its present level. Even if you do not wish to part with a particular position, in the case of publicly traded securities, you can easily re-base an appreciated securities position by selling it and then buying the same security. No "wash gain" rule comparable to the wash sale rule for losses applies, and you can sell an asset at a gain today and buy the same asset tomorrow.

Whether this strategy will prove to be a winner over time, however, depends on a number of factors that often are difficult to quantify. Selling earlier than you otherwise would have sold means paying the resulting tax sooner, and once you pay the tax, that money no longer generates further returns for you. By keeping the amount you would have paid in taxes invested on a pre-tax basis, you might eventually generate enough additional return to offset the higher tax rate, or more.

You can model various scenarios, but the result the model generates will only be as accurate as the assumptions you build into it. You will need to predict the time you would otherwise sell the asset, how much the asset might appreciate between now and that time, and the tax rate that might apply. You must also take into account the transaction costs of selling and re-establishing the position. Taxpayers who are elderly or in failing health may want to hold appreciated positions because a basis increase to fair market value at death will still apply.

At the extremes, you can pretty easily determine what to do. For example, if you have a substantially appreciated stock position that you believe you would normally sell in 2013, it almost certainly will be advantageous to sell that holding in 2012. On the other hand, if you have a position that you expect to hold for 15 more years, you are most likely better off just keeping the position and not reducing your invested assets by paying tax now. Over a period of 15 years, by keeping the amount of tax you would pay now invested and generating additional return, you will most likely earn enough to pay the increased amount of income tax that will be due at the time you do sell the asset. You also need to consider the most effective use of capital loss carryovers you might have.

Between these extreme cases, however, the analysis becomes more difficult. The future holding period of the asset and the future return on it are inversely correlated. As the asset's future rate of return increases, the additional time that the asset must be held to overcome the higher tax rate decreases. As a rule of thumb, you might at least consider re-basing positions that you expect to sell within the next five years, and we are available to assist you in evaluating specific situations. Also, do not forget that the early payment of any applicable state income taxes will further diminish the amount of your invested capital going forward.

Many people have done quite well by operating on a philosophy that says the future is uncertain and you should never pay any tax until you absolutely must, a reasonable position to adopt in many cases.

Do Dividend-yield Stock Portfolios Still Make Sense?

If your investment portfolio is significantly weighted in favor of high-dividend-paying stocks, you should probably ask your investment advisor whether this strategy continues to make sense for you in an environment where the tax rate on dividends is nearly three times what it was when the portfolio was established. While a greater emphasis on growth stocks or other asset classes may be appropriate, you should make that decision only after a discussion with your investment advisor.

Should You Accelerate Ordinary Income?

The acceleration of ordinary income into 2012 could have certain advantages. The 2012 maximum federal income tax rate on ordinary income is 35 percent, as compared to the 2013 rate of 39.6 percent, or 43.4 percent if the income is investment income subject to the 3.8 percent Medicare tax on net investment income. Having a higher adjusted gross income in 2012 and a comparatively lower adjusted gross income in 2013 may also ameliorate to some degree the impact of the itemized deduction phase-out that will apply again in 2013. Acceleration of income is even more attractive if you will be paying AMT (Alternative Minimum Tax) in 2012 and can recognize additional ordinary income subject to a 28 percent tax rate.

If you have discretion to accelerate a bonus or other earned income into 2012 instead of 2013, you can also avoid the 0.9 percent increase in the Medicare tax on wages or net earnings from self-employment that will occur in 2013.

If you are able to control the payment of dividends by a "C" corporation or an "S" corporation that has accumulated earnings from prior "C" corporation years, it may be advantageous to pay dividends in 2012 while the federal income tax rate is 15 percent, as compared to 2013 and later years when the rate may be as high as 43.4 percent.

Consider Roth IRA Conversions

It may also be worthwhile to visit or re-visit the subject of Roth IRA conversions before the end of 2012. The maximum income tax rate that will apply to the taxable amount of a Roth conversion in 2012 is 35 percent, as compared to 39.6 percent if the conversion occurs in 2013 or later. While income from a qualified retirement account is not subject to the 3.8 percent Medicare tax on net investment income, the income from the conversion will increase your adjusted gross income. In 2013 or later, if a Roth conversion causes your adjusted gross income to increase from an amount below $250,000 (on a joint return) to an amount above $250,000, the conversion will result in at least a part of your net investment income becoming subject to the Medicare tax. A Roth conversion after 2012 will also result in an additional disallowance of itemized deductions, since that disallowance also increases as your adjusted gross income increases.

What about Itemized Deductions?

Whether you are better off accelerating or deferring itemized deductions is somewhat complicated. Superficially, deferring discretionary payments (e.g., many charitable contributions and some state income taxes) from 2012 to 2013 makes sense because the deduction may result in greater tax savings due to the higher tax rate that will apply in 2013. The phase-out of itemized deductions will also have an impact, however. If a significant portion of the deduction would be disallowed under the phase-out rules in 2013, then you may be better off taking the deduction in 2012, albeit against a lower tax rate. In the case of charitable contributions, another risk of deferring contributions to 2013 is that Congress could always eliminate the deduction at fair market value for contributions of appreciated property. Certain itemized deductions, such as state income taxes, are not deductible for purposes of computing the AMT, so you are better off paying those kinds of expenses in a year where you have less exposure to the AMT.

Conclusion

While other changes to the income tax law also will take effect in 2013, the ones summarized above are the most significant for higher-income taxpayers. If you would like our assistance in evaluating your particular situation and determining your best course of action, please feel free to contact us.

This alert is a publication of Loeb & Loeb and is intended to provide information on recent legal developments. This alert does not create or continue an attorney-client relationship nor should it be construed as legal advice or an opinion on specific situations.

Circular 230 Disclosure: To ensure compliance with Treasury Department rules governing tax practice, we inform you that any advice contained herein (including any attachments) (1) was not written and is not intended to be used, and cannot be used, for the purpose of avoiding any federal tax penalty that may be imposed on the taxpayer; and (2) may not be used in connection with promoting, marketing or recommending to another person any transaction or matter addressed herein.

© 2012 Loeb & Loeb LLP. All rights reserved.

Tax Group

MICHELLE W. ALBRECHT	MALBRECHT@LOEB.COM	212.407.4181
JOHN ARAO	JARAO@LOEB.COM	310.282.2231
MARLA ASPINWALL	MASPINWALL@LOEB.COM	310.282.2377
RYAN M. AUSTIN	RAUSTIN@LOEB.COM	310.282.2268
AMY BELL	ABELL@LOEB.COM	310.282.2170
LAURA B. BERGER	LBERGER@LOEB.COM	310.282.2274
LEAH M. BISHOP	LBISHOP@LOEB.COM	310.282.2353
SUSAN G. BLUMENTHAL	SBLUMENTHAL@LOEB.COM	202.618.5009
DEBORAH J. BROSS	DBROSS@LOEB.COM	310.282.2245
TARIN G. BROSS	TBROSS@LOEB.COM	310.282.2267
CHRISTOPHER W. CAMPBELL	CWCAMPBELL@LOEB.COM	310.282.2321
THERESA R. CLARDY	TCLARDY@LOEB.COM	310.282.2058
REGINA I. COVITT	RCOVITT@LOEB.COM	310.282.2344
TERENCE F. CUFF	TCUFF@LOEB.COM	310.282.2181
LINDA N. DEITCH	LDEITCH@LOEB.COM	310.282.2296
PAMELA J. DRUCKER	PDRUCKER@LOEB.COM	310.282.2234
PAUL N. FRIMMER	PFRIMMER@LOEB.COM	310.282.2383
ANDREW S. GARB	AGARB@LOEB.COM	310.282.2302
ELIOT P. GREEN	EGREEN@LOEB.COM	212.407.4908
RACHEL J. HARRIS	RHARRIS@LOEB.COM	310.282.2175
TANYA A. HARVEY	THARVEY@LOEB.COM	202.618.5024
KAREN L. KUSHKIN	KKUSHKIN@LOEB.COM	212.407.4984
THOMAS N. LAWSON	TLAWSON@LOEB.COM	310.282.2289
JEROME L. LEVINE	JLEVINE@LOEB.COM	212.407.4950
JEFFREY M. LOEB	JLOEB@LOEB.COM	310.282.2266
MARY ANN MANCINI	MMANCINI@LOEB.COM	202.618.5006
ANNETTE MEYERSON	AMEYERSON@LOEB.COM	310.282.2156
CAITLIN L. MURPHY	CMURPHY@LOEB.COM	202.618.5026
DAVID C. NELSON	DNELSON@LOEB.COM	310.282.2346
LANNY A. OPPENHEIM	LOPPENHEIM@LOEB.COM	212.407.4115
RONALD C. PEARSON	RPEARSON@LOEB.COM	310.282.2230
ALYSE N. PELAVIN	APELAVIN@LOEB.COM	310.282.2298
STANFORD K. RUBIN	SRUBIN@LOEB.COM	310.282.2090
LAURIE S. RUCKEL	LRUCKEL@LOEB.COM	212.407.4836
JOHN F. SETTINERI	JSETTINERI@LOEB.COM	212.407.4851
C. MICHAEL SPERO	CMSPERO@LOEB.COM	212.407.4877
ANDREW K. STEENBOCK	ASTEENBOCK@LOEB.COM	310.282.2242
REBECCA M. STERLING	RSTERLING@LOEB.COM	310.282.2301
MEGAN A. STOMBOCK	MSTOMBOCK@LOEB.COM	212.407.4226
ADAM F. STREISAND	ASTREISAND@LOEB.COM	310.282.2354
ALAN J. TARR	ATARR@LOEB.COM	212.407.4900
STUART P. TOBISMAN	STOBISMAN@LOEB.COM	310.282.2323
JESSICA C. VAIL	JVAIL@LOEB.COM	310.282.2132
NICHOLAS J. VAN BRUNT	NVANBRUNT@LOEB.COM	310.282.2109
GABRIELLE A. VIDAL	GVIDAL@LOEB.COM	310.282.2362
JOHN S. WARREN (Ret.)	JWARREN@LOEB.COM	310.282.2208
BRUCE J. WEXLER	BWEXLER@LOEB.COM	212.407.4081
DANIEL M. YARMISH	DYARMISH@LOEB.COM	212.407.4116