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Taxmageddon – 1/1/2013: Pending Increases in Income Tax Rates

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As we approach the fall election, one of the most discussed topics is *Taxmageddon*: the pending, significant increases in individual income tax rates despite a weak — and apparently weakening — economy. If Congress fails to act, and there is no expectation that it will do so prior to the election, U.S. federal income tax rates will *automatically* increase on January 1, 2013. While the Administration seeks an extension of the "Bush Tax Cuts" for those earning less than $250,000 and Republicans press for an extension for all taxpayers, it is possible and perhaps probable in the current political climate that there will be no extension for any taxpayers. Indeed, some Democrats have advocated for this outcome unless Republicans agree for the more modest extension of the tax cuts, especially in view of the widening budget deficit. There is also the possibility that there will be no tax act in 2012 and then a retroactive tax decrease for some taxpayers next year.

Linked here is a detailed presentation on the expected increase in tax rates. [1] In summary, the maximum federal long-term capital gain rate will increase from 15% to 23.8%, including a new 3.8% "healthcare tax" on interest, dividends, capital gains, and other passive income realized by "high earners." The Supreme Court recently upheld the tax as part of its decision on the healthcare act and the tax would apply to individuals earning more than $200,000 per year ($250,000 in aggregate for married taxpayers). The maximum tax rate on passive, ordinary income, such as interest and dividends, would increase from 35% to 43.4%, including the healthcare tax. The new 3.8% tax also would apply to wages of these earners, increasing the current "Medicare" tax borne by individuals from 2.9% to 3.8%. In this connection, the "employee portion" of the tax would increase from 1.45% to 2.35%. The "employer portion" would remain the same at 1.45%.

Some states are also considering tax increases. For example, in the fall election, California voters will be asked to increase the maximum individual California income tax rate on all sources of income, including capital gains, from 10.3% to 12.3%. This increase would take effect on January 1, 2013 as well and the highest rate would apply to an individual's California taxable income in excess of $500,000. Assuming this referendum passes, which has been aggressively supported by California Governor Jerry Brown, a California resident's total capital gains tax rate could increase to as much as 36.1% (23.8% federal and 12.3% state) — over a 60% increase over the current rate (15% federal and 10.3% state)!

The impact of these increased tax rates could be substantial on the after-tax proceeds realized by the holder of appreciated property, such as equity in a business, intellectual property (e.g., a patent), or real property.

For example, assume that a founder of a business resident in California expects to realize $50 million from the sale of her business and that she has a $10 million tax basis in her stock. If she sold the business in 2012, she would pay approximately $10.1 million in taxes (($50 million – $10 million) x 25.3% aggregate tax rate), netting approximately $39.9 million in after-tax proceeds from the sale. By contrast, if she sold in 2013, she would pay approximately $14.4 million in taxes (($50 million - $10 million) x 36.1%), netting approximately $35.6 million in after-tax proceeds from the sale. Thus, after tax proceeds would be reduced by over 10% — and this example is "real world."

A typical sale transaction can take months to complete from the time the decision to sell is made. Accordingly, the owner of a business seeking to sell the business in the near term should take immediate steps to increase the likelihood of completing the sale before year-end. If the owner's business is in demand, he or she may be able to negotiate a "tax indemnity" under which the purchaser would indemnify the owner for the increase in rates if the transaction doesn't close in time. There also are certain tax-acceleration techniques that a seller could use to accelerate taxable gain into 2012 at the lower rates. For example, a seller could sell his or her company for a promissory note for most of the proceeds payable in 2013. The seller could "elect out" of the installment method and recognize all of the gain in 2012. Under appropriate facts, the seller might be able to "rescind" the sale and not recognize any gain from the sale. Similarly, the buyer could escrow the sale proceeds in 2012. If the deal closed in 2013, the proceeds could be distributed to the seller and the seller could potentially (again, under the right facts) recognize the gain in 2012. Alternatively, a seller could use the "constructive sale" provisions of Section 1259 of the Internal Revenue Code to recognize gain this year without actually selling the appreciated property. There are several options available for gain acceleration under Section 1259. Sellers are urged to talk to their tax advisors.

The Bottom Line

If you hold appreciated property, wish to obtain liquidity from the property in the near future, and have not begun to consider monetization transactions, you should do so as soon as possible to take advantage of lower tax rates that will expire at the end of this year under current law. Even if you cannot complete a sale by the end of the year, there are techniques under which you potentially could accelerate taxable gain into 2012 and therefore pay tax under the lower rates even if liquidity doesn't occur until thereafter.

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Endnotes

1 This presentation was prepared together with The Sage Group, LLC, an established Los Angeles-based investment bank.