Contingency Planning in an Uncertain Tax Environment

11/3/2010

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The scheduled expiration of the Bush-era tax cuts at the end of this year has caused considerable uncertainty regarding year-end tax planning. These tax cuts, which include significant income tax rate changes, the gradual elimination of the estate tax and other tax relief, were included in legislation that contains sunset provisions. These provisions generally phase out the tax cuts after the end of the year.

Impact on Individual Taxpayers

Most of the attention has focused on the replacement of the lower Bush-era marginal income tax rates with the rates in place before the tax-cut legislation. The tax cuts reduced the ordinary income marginal tax rates to 10%, 15%, 25%, 28%, 33% and 35%, and the tax rates on long-term capital gains and qualified dividends to 0% and 15%. The scheduled sunset of the Bush-era tax cuts will mean the expiration of the 10% tax bracket. The 25%, 28%, 33% and 35% tax brackets will revert to the 28%, 31%, 36% and 39.6% tax brackets, respectively.

The maximum tax rates on long-term capital gains and qualified dividends will increase from 15% to 20%. "Qualified dividends," which were taxable at long-term capital gain rates under the tax-cut provisions, are scheduled to be taxed at ordinary income tax rates, as under prior law. This would mean a 164% increase in the tax on these dividends (from 15% to 39.6%) for some taxpayers.

In addition to increases in marginal income tax rates, the scheduled expiration of other Bush-era tax reduction provisions would increase taxes for many families. These include the reintroduction of the limitation on itemized deductions and the personal exemption phaseout for higher income taxpayers. The marriage penalty relief provisions would also be eliminated under the sunset provisions as well as the alternative minimum tax relief provisions.

The Obama administration has proposed retaining certain tax cuts. The proposals would allow the top two individual income tax brackets to return to 36% and 39.6% from their current levels of 33% and 35%, respectively, for single filers making more than $200,000 and joint filers making more than $250,000. In addition, the administration has proposed allowing the maximum tax rates on both long-term capital gains and qualified dividends to increase from 15% to 20% for these higher-income taxpayers. The administration also proposed allowing the return of the personal exemption phaseout and the limitation on itemized deductions, but only for single filers making more than $200,000 and joint filers making more than $250,000.

To date, Congress has not taken any action to prevent the expiration of any of the Bush-era tax cuts, including the ones the Obama administration proposed extending. However, it is possible that Congress will take some action before the end of the year. Any changes this year will probably be enacted after the November elections.

It is difficult to predict the future of the Bush-era tax cuts. Even if the Republican Party gains control of Congress, it is extremely unlikely that they will have a veto-proof majority. On the other hand, some Democrats have supported the extension of the tax cuts for all taxpayers, at least in the short term, to stimulate job growth. While we cannot predict the final resolution of these issues, we can offer some general tax planning guidance that should be considered later when the tax rules applicable to next year may be more clear. To help you prepare for possible action by Congress, the following guidance considers three possible scenarios of Congressional action.

Extension of Tax Cuts

If Congress extends all of the Bush-era tax cuts, you should consider a traditional strategy of deferring income and accelerating tax deductions. This could include maximizing 401(k) plan contributions, prepaying property taxes and charitable contributions, and other similar strategies.

Expiration of Tax Cuts

Tax planning becomes more complicated if Congress allows the Bush-era tax cuts to expire. Under these circumstances, you should consider the following possible tax-saving strategies:

- Take dividends from your closely held corporations.
- Sell long-term capital gain assets; defer sale of long-term capital loss assets.
- Accelerate payment of itemized deductions to avoid deduction limitations.
- Convert an S corporation to a C corporation.
- Convert a traditional IRA to a Roth IRA.

The efficacy of these strategies depends upon each taxpayer's individual situation and should therefore be implemented only with the guidance and advice of your tax professional.

Adoption of Obama's Proposals

If Congress ultimately adopts the Obama administration’s proposals, single filers making more than $200,000 and joint filers making more than $250,000 would generally be subject to expiration of many of the Bush-era tax cuts, except that qualified dividends of these taxpayers would be taxed at a top rate of 20%, and not at the higher ordinary income tax rates. Taxpayers with income below these limits would generally continue to benefit from the tax cuts.

Conclusion

The unprecedented uncertainty surrounding the expiration of the Bush-era tax cuts, which is compounded by this fall's mid-term elections, means that taxpayers are currently unable to confidently implement year-end tax planning. Working closely with tax advisers, taxpayers should begin making contingency plans they can adopt later this year when the fate of the tax cuts should finally be resolved. The efficacy of these strategies depends upon each taxpayer's individual situation and should therefore be implemented only with the guidance and advice of your tax professional.