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Tax Planning for Possible Tax Rate Changes in 2013

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Possible Increases in Marginal Rates Beginning in 2013

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Absent the passage of new legislation, marginal federal income tax rates will increase for taxable years beginning on or after January 1, 2013.

In 2012, the House of Representatives passed H.R. 8 (the Job Protection & Recession Prevention Act of 2012). This bill would extend the current rate structure through the end of 2013.

The Senate passed S. 3412 (the Middle Class Tax Cut Act) which would extend the current rate scheme for joint filers making less than $250,000 through the end of 2013.

On Aug. 28, 2012, Rep. Patrick Tiberi (R-Ohio), Chair of the House Ways & Means Select Revenue Measures Subcommittee, expressed the view that the possibility of legislation before 2013 was "difficult to imagine" regardless of the outcome of the election.

Accordingly, notwithstanding the passage of the 2 bills, it is likely that any action on tax rates in 2013 will not be taken until 2013 has already begun.

The Norquist Tax Pledge may make it is easier for Republicans to agree to a middle ground after tax rates have already increased.

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Without any action, the following tax rate increases will now automatically occur beginning in 2013:

1. Top marginal rate will increase to 39.6%

2. The 10% tax bracket will be eliminated

3. The maximum tax rate for capital gains will increase to 20% (with the 18%/8% rate structure for "qualified 5-year gain")

4. Dividends will (once again) be taxed as ordinary income instead of at capital gains rates.

5. Section 68 returns: The 3% haircut on itemized deductions.

The New Medicare Contribution Tax Regime

Code § 1411 closes the gap between the Social Security Tax Regime applicable to wages and investment income by subjecting investment income to Social Security Taxes. The tax is referred to as the Medicare Contribution Tax (the "MC Tax").

The new tax applies to individuals, trusts and estates.

The threshold for married individuals filing joint returns is $250,000. The threshold for trusts and estates is $11,600.

The new tax is applied at a flat rate of 3.8%.

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The MC Tax applies to net investment income.

Net investment income includes interest, dividends, annuities, royalties and rents, in each case, not earned in connection with the conduct of a trade or business in which the taxpayer materially participates.

The MC Tax also applies to trade or business income if the taxpayer does not materially participate or if the trade or business (passive activity income) is trading financial instruments or commodities.

The MC Tax will apply to capital gains, other than capital gains that are (i) not taxable or (ii) are derived in the conduct of non-passive activity or a trading business. Capital losses do not reduce the tax on dividends, etc.

The MC Tax applies to portfolio income earned on working capital.

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The MC Tax is not deductible from the regular income tax.

It also applies to the disposition of stock in S corporations and partnership interests to the extent that the gain is attributable to property that if sold would have generated capital gains subject to the MC Tax.

The application of the MC Tax to gains from the dispositions of interests in pass-thru entities will require taxpayers to separately compute MC Tax for such dispositions. The MC tax could apply even if there is an overall loss.

It is unclear as to whether subpart F income and QEF income is subject to the MC Tax.

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There are exclusions from net investment income:

1. Distributions from qualified plans

2. Income subject to self-employment tax

3. Items of income excluded from gross income, such as tax exempt interest and gain from the disposition of a principal residence to the extent excluded from gross income

What is deducted from gross investment income to arrive at net investment income?

Code § 1411(c)(1)(B) provides that deductions properly allocable to the items of gross income that are subject to the MC tax may be deducted to arrive at net investment income.

But what about Treasury Regulation § 1.161-1? This regulation prohibits double deductions. And the expenses attributable to gross investment income should be deductible. In another context, Congress permitted double deductions when "distinctly expressed or manifestly intended." Code § 7852(c). This seems like such a case, but there is no explicit coordination between the no double deduction rule and the allowance of deductions in computing the MC Tax.

The Hospital Insurance Payroll Tax Increase

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Code § 1401(b)(2) will impose a new .9% Hospital Insurance ("HI") tax on self-employment income on income over $250,000 for married joint filers beginning in 2013.

This new tax complements the MC tax as the surcharge brings the HI tax rate to 3.8% (2.9% existing + .9% surcharge). Note that ½ of the 2.9% tax is borne by the employer, so that the employee's burden will be 2.35%.

The .9% surcharge is not deductible from the regular income tax.

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The 2013 Federal Income Tax Rate Environment

	Current Top Marginal Income Tax Rates	2013 Top Marginal Income Tax Rates	2013 Additional Payroll Taxes	2013 Additional Taxes from Reinstatement of Limitations on Itemized Deduction	2013 Top Combined Marginal Rate	Change (%) between current and 2013 rate
Long Term Capital Gain	15%	20%	3.8%	1.2%	25%	66.7%
Qualified Dividends	15%	39.6%	3.8%	1.2%	44.6%	197.3%
Interest, rents, royalties, etc.	35%	39.6%	3.8%	1.2%	44.6%	27.4%
Wages (including Payroll tax)	36.45%	41.05%	0.9%	1.2%	43.15%	18.33%

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Installment Sales

Installment Sale and Gift to Non-grantor Trust

Gift and GST tax exemptions scheduled to decrease from $5.120MM to approximately $1MM on 01/01/13

Client establishes a non-grantor dynasty trust for the benefit of children and other descendants

Gift is made to the trust to utilize enhanced gift and GST tax exemptions

Structure depends on nature of asset

- Marketable securities must first be contributed to an entity taxed as a partnership for Federal income tax purposes
- Closely held stock or other assets may be sold to the non-grantor trust directly

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- Installment sale of assets (or interest in entity holding the assets) by settlor to a non-grantor trust
  - Term not to exceed 25 years
  - Interest rate at AFR
  - Interest only, balloon principal payment at maturity
- Client has until April 15, 2013 to decide whether to elect out of installment sale treatment
  - If elects out, then gain recognized in 2012
  - If does not elect out, then gain recognized when principal payments are made or if asset sold within two years of transaction date
  - Could wait until October 15, 2013 to make an election but then client may be subject to underpayment penalties for not paying estimated taxes with filing of extension
  - Interest surcharge on installment notes exceeding $5MM applies if Client does not elect out of installment sale treatment

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Using Constructive Sales to "Wait & See" if Marginal Tax Rates Increase

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Constructive Sale Analysis

- What financial instruments are affected?
- When does a constructive sale occur?
- What happens if the rules apply?
- How can the rules be used pro-actively to achieve beneficial results?

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What financial instruments are affected?

- Appreciated financial positions are impacted:
  - Positions in stock, debt instruments and partnership interests (special rules are provided for non-publicly traded positions)
  - Positions include futures & forward contracts
  - Debt instruments are excluded if:
    - Debt has a specified principal amount
    - Interest payments are fixed or based on qualified variable rate
    - Debt is not convertible

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When does a constructive sale occur?

- Entering into a forward or future contract to deliver the same or substantially identical property
  - Forward contracts must be to deliver a substantially fixed amount of property for a substantially fixed price
- Short sale of the same or substantially identical property
- Offsetting swap with respect to the same or substantially identical property
- Mirror rules apply to appreciated short positions

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What happens if the rules apply?

- Gain is recognized on the date that the constructive sale occurs
- Basis is increased by the amount of gain recognized
- Holding period for the property restarts on the date of the constructive sale

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Special Rules on when a constructive sale occurs:

- Constructive sale treatment will not apply to transactions involving non-marketable securities if the transaction settles within 1 year from inception
- Special Rules for Closed Transactions
  - If transaction closes on or before 30th day after end of tax year; and
  - Taxpayer holds appreciated financial position “naked” for 60 days after closing of constructive sale

  The constructive sale transaction will be ignored

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How can the rules be used pro-actively to achieve beneficial results?

Publicly-Traded Securities

- Constructive sales can be used to accelerate income in 2012 when capital gains rates are low
- Example: enter into a short sale in 2012. If marginal rates increase, then leave short sale on past January 2013 so special rule will not apply. If marginal rates remain the same, take short off during January 2013. Position must remain unhedged for 60 days thereafter.

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How can the rules be used pro-actively to achieve beneficial results?

Closely-Held Business Interests

- Constructive Sale rules apply to non-traded stock and partnership interests
- In 2012, enter into a forward contract to sell the privately-held stock for settlement in 13 months. If marginal rates do not increase in 2013, cancel the forward contract. If rates increase, forward contract can be cash or physically settled.

Accelerating Dividend Income to Take Advantage of the Qualified Dividend Income Rules

Qualified Dividend Income (QDI) Rules

- Through the end of 2012, QDI is taxed at the same rate as capital gains (15% maximum)
- QDI includes dividends paid by US corporations & non-US corporations resident in certain Treaty jurisdictions
- Common stock must be held for 61 days unhedged, beginning from the date begins 60 days before ex-dividend date (longer for preferred stock paying dividends attributable to periods of more than 366 days)
- If a QDI dividend is an extraordinary dividend, any loss on the sale of the stock (regardless of when incurred), up to the amount of the extraordinary dividend, is a long-term capital loss.

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What happens if Congress does not extend the QDI Rules?

- QDI becomes taxable as ordinary income.
- Ordinary income rates are currently 35%, but in the absence of Congressional action, the maximum rate will increase to 39.6%
- In addition, beginning in 2013, the Tax Law will impose a Social Security tax of 3.6% on investment income, including dividend income.
- Accordingly, if Congress fails to act, beginning in 2013, QDI will be taxed at a maximum rate of 43.2%.
- This rate increase suggests that owners of closely-held business interests in corporate form should consider stripping out as much of the earnings of their businesses as possible in 2012.

What is an extraordinary dividend?

An extraordinary dividend on common stock is a dividend that exceeds 10% of the shareholder's adjusted basis in the stock.

An extraordinary dividend on preferred stock is a dividend that exceeds 5% of the shareholder's adjusted basis in the stock.

All dividend paid within an 85 days period are aggregated for purposes of determining whether the dividend threshold is breached.

Dividends are extraordinary dividends if the amount of dividends with ex-dividend dates within a 365-day period exceeds 20% of the shareholder's adjusted tax basis.

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How can QDI be accelerated in 2012?

The closely held corporation can redeem shares of stock held by the owner in a transaction that is treated as a dividend.

A stock redemption is taxed as a dividend if the proportionate ownership of the shareholder is not reduced.

Example: Parent (P) owns 50% of common stock. Children (C) and grandchildren (GC) own remaining 50% of common stock. Corporation redeems shares from P. The redemption is treated as a dividend because P is attributed with ownership of stock held by C & GC. As a result, P's proportionate ownership is not reduced.

How can QDI be accelerated from non-US corporations?

If the non-US corporation is a controlled foreign corporation, then gain on the disposition can be treated as a dividend under Code § 1248.

IRS Notice 2004-70 provides that amounts treated as dividends under Code § 1248 can be treated as QDI.

The IRS position that subpart F income is not QDI has been upheld in litigation.