Planning in an Uncertain Tax Environment

One thing is certain: We are living in an uncertain tax world. Unless Congress acts within the next 4 months, Federal income tax brackets will revert to pre-Bush rates. This means that the top marginal rate will rise from 35% to 39.6%. In addition, long-term capital gain rates will rise from 15% to 20%. But the change in tax law that will catch many middle and upper class individuals by surprise is the change in tax treatment for ***unearned income***, as enacted by the Health Care Act. Ignoring these changes could be costly.

Currently, dividends are taxed at long-term capital gain rates. Beginning January of 2013, dividends will sunset to ordinary income tax rates. In addition, taxpayers with modified adjusted gross income, from both earned and unearned income, in excess of threshold limits ($200,000 for a single person and $250,000 for a married couple) will be subject to a new surtax of 3.8% on net investment income. The surtax tax is calculated by multiplying 3.8% by the lesser of (1) your net investment income for the year, or (2) the amount of your modified adjusted gross income that exceeds the above-mentioned threshold limits. It is important to note that the threshold amounts are not indexed for inflation. This means that a growing number of taxpayers will be ensnared by the additional 3.8% Medicare tax over time. This new Medicare tax also applies to estates and trusts and will be subject to the lesser of (1) undistributed net investment income, or (2) the amount by which adjusted gross income exceeds the top bracket for estate and trust income.

For people with taxable investment portfolios that are dependent upon income from passive sources of revenues (such as interest, rents, dividends, and capital gains), the sunset in tax law compounded with the new Medicare surtax could be costly. Assume you are currently in the top marginal rate and you own a dividend paying stock yielding 4%. Currently, your federal tax on the yield is 15%, netting an after-tax yield of 3.40%. Next year, your dividend will be taxed at the top marginal rate of 39.6% PLUS the 3.8% surtax, creating an after-tax yield of 2.26%. A 34% reduction!

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Determining your financial planning strategies now, before 2013, could help reduce the impact. For some individuals, the tax may be unavoidable. However, implementing a few of the strategies below could soften the blow.

Planning Strategies:

- Any taxpayer contemplating selling investment property for a taxable gain may want to consider selling the property prior to 2013. Next year, long term rates will increase to 20%. In addition, the gain could be subject to the 3.8% surtax. If you decide to delay the sale, it will become very important to keep accurate and detailed records to prove your property basis.

- For individuals in the high tax brackets and that are subject to the 3.8% surtax, shift high income and dividend paying investments to retirement accounts. Consider using tax-free bonds and/or exchange traded funds in taxable portfolios to minimize tax.

- Continue to harvest losses in taxable portfolios to off-set capital gains that are expected to be taxed at a higher rate next year.

- Because retirement plans are not subject to the surtax, consider increasing contributions. Distributions from qualified plans, 401(k) and 403(b) plans, IRAs, tax-sheltered annuities and eligible 457 plans are exempt from the Medicare surtax.

- Avoid undistributed income in trusts. In some cases, termination of the trust may be advisable if the trustee deems it to be in the best interest of the beneficiary.

- Taxpayers often classify investments in S corporations and partnerships as passive activities to avoid self employment taxes and to offset that income against passive investment losses. In light of the new Medicare tax on passive income, taxpayers may want to reconsider this strategy.