LIFE DRIVEN TAX STRATEGIES IN THE MIDST OF 2012 FEDERAL TAX TRANSITIONS

A Tax Department Publication

Author,
Suzanne L. Shier,
Tax Strategist

February 17, 2012

"Appreciate the moment in the moment." Source unknown

One constant feature of the current tax landscape is change. This environment of perpetual transition highlights the wisdom of identifying wealth management goals and the tax strategies presently available to achieve those goals. Following is a brief overview of a number of recent tax developments affecting individual tax planning.

Expired Tax Provisions

Sixty federal tax provisions expired in 2011. Of particular significance are the expiration of certain personal credits allowed against the alternative minimum tax (AMT) and the decrease in the level of the AMT exemption, which will result in increases in the income subject to the AMT for affected taxpayers. For 2001 through 2011, all non-refundable credits were allowed against the alternative minimum tax. In 2012 only three limited credits will be allowed (adoption and child care credits and the credit for elective deferrals and IRA contributions). In addition, the AMT exemption amount will decrease to 2001 levels in 2012 – from $74,450 to $45,000 for a married couple and from $48,450 to $33,750 for a single taxpayer.

Corporations that make an S corporation election in 2012 and have gain attributable to pre-election appreciation of property commonly will be subject to tax on built in gain at the corporate level for property disposed of within 10 years. This 10-year look back period replaces the shortened 7-year period in effect for 2009 and 2010 and the 5-year period in effect for 2011.

For tax years 2006 through 2011 taxpayers age 70-1/2 and older have been able to satisfy all or part of the requirement minimum distribution requirement from individual retirement accounts by direct distributions to a qualified public charity. However, this qualified charitable distribution alternative is not presently available for 2012.

Although it has been the practice of Congress to enact "extenders" of expired tax provisions after year-end in the past, it is not known whether extenders will be enacted for 2012.

Pay-Roll Tax Cut

The pay-roll tax cut continues under review, but it is reported that the Payroll Tax Conference Committee negotiations are slowing down. The 2% reduction in the employee and self-employed share of payroll taxes was extended at year-end to February 29, 2012. However, absent consensus and passage by both houses of Congress of an extension prior to month-end the pay-roll tax cut patch will expire.

FACTA

Taxpayers with foreign accounts in excess of $50,000 in the aggregate will be required to file new Form 8938 Statement of Specified Foreign Financial Assets with their 2011 federal income tax returns. This filing is in addition to the separate Form TD F 90-22.1 Report of Foreign Bank and Financial Accounts which is not related to individual income tax filing. The Internal Revenue Service has also released extensive Proposed Regulations regarding required information reporting by foreign financial institutions with respect to U.S. accounts. For additional information regarding FACTA, see the January 2012 Northern Trust Company Tax News You Can Use.

Pending Changes

Looming at the end of 2012 is a host of significant expiring tax provisions. Absent further legislation, the 15% qualified dividend and long-term capital gain tax rates will expire, as will the 35% gift, estate and generation-skipping transfer (GST) tax rate and the $5.12 million gift and estate exclusion amounts and GST exemption amount. Dividends will again be taxed at applicable ordinary income tax rates and long-term capital gains will be taxed at 20%. The marginal gift, estate and GST tax rates will increase to 55% and the exclusion and exemption levels will fall to $1,000,000 (with an inflation adjustment for the GST exemption).

2013 Medicare Tax

On the horizon for 2013 is the Medicare tax. The Medicare tax will affect both taxpayers with earned income and those with investment income. Individuals who earn more than $200,000 ($250,000 for joint filers) will pay an additional .9 percent in Medicare tax. Individuals with adjusted gross income of more than $200,000 ($250,000 for joint filers) will pay a new Medicare tax of 3.8% on “net investment income.” Net investment income for purpose of the Medicare tax includes interest and dividends and other income from passive activities as well as gains from property that is not used in an active business, including investments and residential and vacation property (subject to any available exclusion of gain from sale of a principal residence). This new tax in 2013 and the increase in the long-term capital gain tax rate in 2013 will generally make the tax cost of sales of appreciated property in 2013 greater than in 2012.

Pending Initiatives

There are a plethora of tax related initiatives at various stages in Washington. The January 2012 White House “Blue Print for an America Built to Last” sets forth four core themes. First, is to create jobs in America, discourage “out-sourcing” and encourage “insourcing.” It is proposed that American companies pay a minimum tax on overseas profits, thus eliminating any tax disparities arising from lower tax rates of other countries. In addition, deductions related to costs of closing domestic operations and moving overseas would be eliminated and a new tax credit would be enacted to cover relocation expenses for companies that close overseas operations and commence domestic operations. Additional tax credits are proposed to increase manufacturing jobs in the U.S. A second theme is to provide additional work opportunities through job training, education and small and start-up businesses supported by tuition tax breaks and small business tax cuts. Third is to make the most of American’s energy resources. Here again, tax policy plays a part, through the use of clean energy tax credits. Last is what is referred as “fair” taxation. Central to this final theme are a number of principles for tax reform – the so-called “Buffett Rule” to provide a minimum effective tax rate of at least 30% and eliminating tax deductions for taxpayers making in excess of

$1,000,000. Although the future of the individual income tax charitable deduction has been in question, indications are that any changes in the individual income tax would be made so as not to disadvantage individuals who make substantial charitable contributions.

Paying for Tax Expenditures

Paying for what is referred to as "tax expenditures" is a recurring subject of debate. By way of example, on February 7, 2012, certain modifications were introduced to the pending "Highway Investment, Job Creating and Economic Growth Act of 2012" to pay for the expenditures under that Act. In very brief summary, the circumstances in which distribution from an inherited tax-deferred retirement or individual retirement account could be deferred beyond a maximum period of five years would be significantly limited, thus narrowing the circumstances in which "stretch IRAs" payable over the life expectancy of a designated beneficiary would be available for income tax planning purposes.

Making the Most of the Moment

Yes, many favorable tax benefits have expired and numerous more restrictive tax provisions loom on the horizon. However, at the present moment we have the opportunity to, where appropriate, recognize gains and also to make gifts at historically low tax rates, and in the case of gifts, high gift tax exclusion and GST exemption levels. Thus, making the time to take a comprehensive look at our wealth management and transfer goals and utilize the tax planning opportunities currently available in 2012 makes good sense.