What Smart People Are Doing about Upcoming Tax Changes

by L. Joseph Comeau

The U.S. government has been playing “kick the can” with our tax system for the past four years or so. The Bush tax cuts that dropped the top personal income tax rate and significantly reduced the tax on capital gains and dividends were scheduled to expire at the end of last year. Instead, faced with the skittish stock market, Congress and President Obama extended the cuts, which are now scheduled to expire at the end of 2012. In the meantime, there have been plenty of stories about taxes being too high — or too low. The following discusses some basic facts.

In 2009, the latest year of IRS taxpayer data, the number of households with income in excess of $10 million dropped 40 percent from 2008, the year of the market crash. The average tax rate on that income was 26 percent. In 2010, more than 1,700 taxpayers made taxable gifts to family members or trusts in excess of $1 million. The average gift was almost $3.5 million.

Perhaps the biggest media coverage on taxes has gone to Warren Buffett. He has complained that his taxes are less than those of his secretary, who pays 35.8 percent in federal taxes. What Mr. Buffett and the media don’t report is that to pay an incremental tax rate of 35.8 percent, the secretary has to have taxable income that puts her in the TOP 4 percent of the 140 million tax returns filed last year. Taxpayers at that income level, on average, paid LESS tax (as a percentage) than those wealthy taxpayers with over $10 million of income. That actually makes sense, doesn’t it? Not everyone can shelter their income tax bill by giving money to their captive personal charity or can afford to give a lot of money away to charity.

So what do we know about taxes to come?

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What We Know

Taxes on Income

	Today	2013
Maximum Rate	35%	39.6%
Medicare Rate	1.45%	2.35%
Payroll Base	Payroll	Includes many Non payroll Items
Investment Tax	-0-	3.8%
Capital Gain	15%	20%
Qualified Dividend	15%	39.6%

Estate / Gift Tax

Exemption	$5M	$1M
Rate	35%	55%

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If the government does nothing, the chart above tells the big-picture story. The widely understood pieces — capital gains rates going up to 20 percent and dividends, interest and wages being taxed at almost 40 percent — will be expensive changes for some, especially for those who are retired and who live off of their dividends and interest.

It is the less publicized items that will surprise many, though. These include the fact that the Medicare tax — which has no upper limit — is going up over 60 percent to 2.35 percent. This is a tax on any earned income, including wages. Worse, the healthcare tax, which was passed as part of Obamacare, but which did not take effect right away, will pop up in 2013 — at 3.8 percent. This is a tax on investment income such as dividends, gains and interest. It is IN ADDITION to the regular income tax rate of as much as 39.6 percent.

This potential reality has smart taxpayers taking preventive action. Some have converted their retirement accounts into Roth IRAs. They pick up income in the current year, at today's lower rates. Then they never pay tax again on those balances or what they grow to. With many people having cash on the sidelines that currently pays very little interest, some are harvesting their capital gains and re-buying the stocks. They will pay tax at the current 15 percent rate and get a new tax basis going forward. They figure that paying tax today at 15 percent will be better than paying tax later at 23.8 percent. By year-end, especially if it looks like there will be an expiration of the current rates, many people who are considering selling their businesses or homes will pocket more cash if they do it this year. Finally, businesses that want to help their employees take home more cash will be paying their annual profit-sharing bonuses before December 31 this year, rather than waiting until March of 2013.

One final point is worth noting, and it relates to the impending changes in the estate and gift tax. In this country we have a transfer tax system that taxes the giver, not the receiver. Therefore, when someone makes a gift, it is his or her responsibility to pay any gift taxes due and the recipient has no taxable income. Current law has large exemptions that allow all but the very wealthy to avoid the gift and estate tax. Today, a married couple has to have more than $10 million of assets before they have an estate tax on death. However, if those exemptions expire as scheduled, that same couple will pay taxes if they have more than $2 million. Included in that figure, by the way, is the value of any 401(k) or IRA money saved. This impending change has motivated many "middle American" families to make transfers of assets to trusts for the benefit of family members before time runs out.

If the government kicks the can farther down the road by extending the status quo for another year or so, we will be back in limbo. Most crystal balls agree on one thing though: taxes will not be getting lower any time soon. That means it is probably time to take action before the year closes out.

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