Title: Consider Taking Advantage of Opportunities in 2012 – Your Taxes May Rise in 2013

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As of this writing, it's difficult to speculate as to what U.S. income tax rates will be in the year 2013. This has become especially apparent due to the effect of the so-called "fiscal cliff" and the results of the November elections.

The "fiscal cliff" is actually the result of the Budget Control Act of 2011, a law passed to stave off the crisis associated with the U.S. government reaching its debt ceiling (the maximum amount by law that the government is allowed to borrow). In order to persuade Congress to authorize additional increases in the debt ceiling, the Act imposed certain spending cuts and required that additional spending cuts be made by December 31, 2012. If those additional spending cuts are not made by the end of 2012, the so-called "Bush tax cuts" will automatically expire and Federal discretionary spending, both defense and non-defense, will automatically be cut through a process known as "sequestration."

The expiration of the Bush tax cuts would mean that marginal income tax rates would increase for all taxpayers. The 10% and 15% tax brackets would be combined into a 15% tax bracket; the 25% tax bracket would see its marginal rate increase to 28%; the 28% bracket would increase to 31%; the 33% bracket would increase to 36%; and the 35% bracket would see its marginal rate increase to 39.6%.

As we approach the December 31 deadline, it is becoming more and more likely that at least some of these tax rates will rise. President Obama, in particular, focused during his campaign on seeking to increase tax rates for households earning over $250,000 per year (who would be in the top two brackets). He has continued to emphasize this position, although he has indicated that he would not necessarily require that marginal rates for such taxpayers increase to the pre-Bush tax cut rates of 36% and 39.6%, respectively. Although Republicans in the House of Representatives have indicated that they do not want to raise tax rates for anyone – including those earning more than $250,000 per year – they would need to make a deal of some sort with the White House in order to avoid the fiscal cliff, which would wind up raising tax rates for everyone – an even less desirable result.

With tax increases pending, what can be done to mitigate the damage? One tactic that some corporations have taken has been to declare dividends payable before the end of 2012. Under the Bush tax cuts, dividends from most corporations have generally been taxed at a 15% rate. With those cuts expiring, the tax rates for dividends would rise to equal the tax rates for ordinary income – as high as 39.6%. Among the corporations which have recently announced special dividends – all to be paid before the year ends – are Walt Disney Co., Costco Wholesale Corp., Carnival Corporation, Las Vegas Sands Corp., Wynn Resorts Limited, Guess? Inc., Trans World Entertainment Corporation, Farmers National Banc Corp., and Brown-Forman Corp. (Some other corporations, including Wal-Mart Stores Inc., have rescheduled their regular dividends that would otherwise have been paid in January 2013 to be paid this month instead.) Anyone who owns, or controls, a dividend-paying corporation which has cash available to distribute to shareholders should consider taking the opportunity to pay a special dividend in December, before the tax rates for dividends rise as expected.

Although most taxpayers don't have the opportunity to decide when to receive dividends, taxpayers do have the opportunity to decide when to realize capital gains by selling assets such as stocks. And it's likely that taking capital gains in 2012 will be a better idea for tax purposes than taking them in 2013. In 2012, the tax rate on long-term capital gains is 0% for taxpayers in lower tax brackets and 15% for taxpayers in higher tax brackets. But in 2013, these rates are scheduled to sunset along with the rest of the Bush tax cuts, resulting in the long-term capital gain tax rates increasing to 10% and 20%, respectively. In addition, the Patient Protection and Affordable Care Act ("Obamacare") established an additional 3.8% tax on net investment income for high-income taxpayers (married couples filing jointly with adjusted gross income over $250,000, or individuals with adjusted gross income over $200,000), effective January 1, 2013. "Net investment income" includes gross income from interest and dividends as well as net capital gains (less allocable deductions). Thus, to avoid both the increased capital gains rates and the new 3.8% tax, taxpayers should consider selling stocks and similar assets which have gained in value before the year ends.

Another tax provision which will expire at the end of 2012 is the lifetime gift tax exemption of $5,120,000. To understand this, one must first understand the gift tax in general. Generally, each individual may give gifts up to $13,000 per recipient, per year, without incurring any tax liability. (That amount will increase to $14,000 per recipient, per year, in 2014.) Gifts beyond that amount are taxable. However, donors are entitled to an exemption against tax even on those taxable gifts. Currently, that lifetime exemption is $5.12 million. (For example, if someone has made $3 million in combined taxable gifts to all recipients in previous years, that person would only be able to exempt $2.12 million of taxable gifts in 2012.) But due to the sunsetting of the Bush tax cuts, the lifetime exemption will be reduced to $1 million in 2013. Hence, taxpayers considering large gifts should consider making those gifts in 2012. Even if the lifetime gift tax exemption winds up being indexed for inflation in the future, it may be years before the exemption comes anywhere near the current $5.12 million.

If you'd like to discuss these or other issues related to your tax planning, please call Marc Lane at (312) 372-1040 or (800) 372-1040, or e-mail him at mlane@marcjlane.com.

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