

Bush Tax Cuts Sunset This Year, Act Now

There is an age old tax adage that for year-end tax planning one should defer the recognition of income and accelerate deductions. However, once every generation or so, there is a year when that advice is flipped because of radical changes in tax rates. 2010 is that year. Also, the stepped-up income tax basis at death rules that predated World War II are repealed for property passing from a 2010 decedent.

No More Good Ole Tax Rate Days

At the end of this year, the lower Bush Administration’s individual dividend, income, and capital gain tax rates regarding various individual rates sunset and become history. This table illustrates the changes on the highest rates:

Maximum Rate	2010	2011-2012	2013 & Later
Dividends	15%	39.6%	43.4%
Ordinary Income	35%	39.6%	43.4%
Net Capital Gain	15%	20%	23.8%

In addition to the maximum rates increasing, lower brackets also rise in 2011. The expiration of the 15 percent rate on qualifying dividends, the lowest rate since before World War II, is the most dramatic change. On January 1, 2011, the maximum individual rate rises to 39.6 percent because of the sunset provisions in the tax bills passed during the George W. Bush administration. Under the recently enacted health care legislation, individual “net investment income” (i.e., dividends, interest, rents, capital gains, and other passive income) will, beginning in 2013, be subject to an additional 3.8 percent Medicare levy for married taxpayers filing jointly with adjusted gross incomes exceeding \$250,000. This will bring the effective ordinary income rate on passive income to 43.4 percent from today’s 35 percent. Beginning in 2013, there will also be an additional .9 percent levy on compensation income for

those married taxpayers filing jointly whose AGI exceeds \$250,000. These effective in 2013 surtaxes are revenue raising provisions in the recent health care legislation.

Planning Implications

If one has income that can be taken either now or in the future, then there is a strong incentive to take the income this year. This is particularly true as maximum dividend rates increase from 15 percent to 39.6 percent next New Years Day. For example, a closely held C corporation could make an extraordinary dividend (this may involve some bank borrowing, but many are doing it) in 2010. Would the shareholders rather take a one-time large dividend at 15 percent today rather than a series of annual dividends at 39.6 percent (in 2011 and 2012) and at over 43 percent in 2013 and subsequent years? A perhaps more revealing economic analysis is what it takes in gross dividend to net \$1.00 at varying tax rates:

Tax Rate	Gross Dividend to Net \$1.00
15%	\$1.18
39.6%	\$1.66
43.4%	\$1.81

In plain English, on January 1, 2011, an additional 48 cents of gross dividend income (\$1.66 minus \$1.18) will be needed for an individual to still net \$1.00 The funding source for many companies with good balance sheets and cash flows is to approach the lender now and make appropriate liquidity arrangements.

Likewise, if an S corporation was at one time a C corporation and has C corporation earnings and profits, then if the corporation earnings are not extracted this year at a 15 percent rate, then they are locked in at tomorrow’s far higher tax level. There is a special election under Treas Reg 1.1368-1(f) to have the distribution treated as first coming from C corporation earnings and profits. Here again many are planning for this once in a generation opportunity at the end of 2010. Given

the lead times that may be involved, particularly if bank lending is necessary, the time to start to explore the issue with your clients and begin implementation is now rather than after Thanksgiving.

Does it make sense to sell an appreciated asset today at a 15 percent capital gains rate rather than at a 20 percent rate next year? In some cases it will. However the 5 percent (and 8.8 percent beginning in 2013) gap is not as glaring as that on qualified dividends.

If there will be large income this year because of special distributions or other acceleration of income, this has to be factored into alternative minimum tax (“AMT”) planning. Higher rates will lower the likelihood of being in an AMT situation and, if in AMT, will involve fewer dollars than would have been the case in the past. This needs to be balanced as to whether to take accelerated deductions through this year against higher income, or wait until next year. The answers to these questions lie in the numbers. It is strongly recommended that you and your client run some projections. This is a case where there are very real benefits to being proactive.

We have reviewed modeling of paying a capital gain tax on appreciated assets in “now versus later” scenarios. Models looking out five years may be quite advantageous, depending on what is realistic and we suggest conservative, assumptions you make to pay the tax now, rather than later. This also factors into Roth IRA planning. This is the year that a taxable conversion to a Roth IRA could be accomplished regardless of the income of the taxpayer. In many cases the income recognition on a Roth conversion, particularly with taxpayers who were closer to retirement, make a Roth conversion unattractive. However, those who were on the edge before, given the higher tax rates in the future, may benefit by making the Roth conversion in 2010, and recognizing the resultant phantom income.

Traditionally taxpayers have done some year-end “balancing” via selling some stocks at a loss to balance off gains realized earlier in the year. That exercise will be particularly important this year.

Inherited Property—Decades of Stepped-Up Basis Law Repealed For 2010

There is also a one-time tax trap for inherited property. For decades the rule was that if property was passed from a decedent, then the beneficiaries, estate, or trust, as the case may be, received a so-called “stepped-up basis” equal to the fair market value at the date of death under IRC 1014. As part of the one-year repeal of the estate tax in 2010, a) the IRC 1014 basis rules were also repealed, and b) a modified carryover basis regime applies to property passing from 2010 decedents. See IRC 1022 and 6018. The 2010 modified carryover basis rules apply regardless of the value of the decedent’s estate. For example, assume that a taxpayer who bought a stock 30 years ago for \$10 per share dies this year and the estate sells it for \$80 per share date of death value (that ratio of appreciation is less than the increase in the Dow Jones Industrials Average over that time). In 2010 only, there would be but a \$10 basis for the estate and a \$70 per share taxable gain. Clients who have inherited property from those dying this year need to factor this into their year-end planning. Likewise, terminally ill clients’ planning is impacted, particularly on loss assets. For example, if a terminally ill taxpayer bought stock a few years ago at \$50 per share and it is worth but \$10 today, if sold while the taxpayer is still alive, then a \$40 per share loss is recognized. That could be netted against gain realized by selling appreciated assets.

Action Steps

It is highly recommended that you meet with clients who will be affected by these changes, discuss them, and quantify the costs of various strategies. You will likely want to include the business owners, other clients,

and the respective accountants in this exercise. You will be serving your client well to trigger this process and present them with the opportunity to achieve considerable savings on income tax liabilities.



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