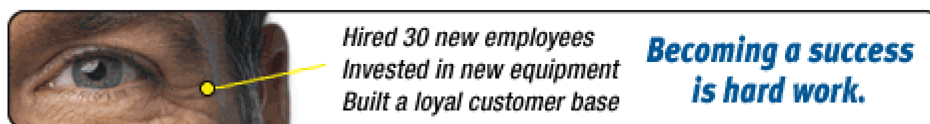

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A Two-year Income Tax Reprieve

Tax-planning strategies that make the most sense in light of the changing rates

By Christopher R. Hoyt

The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010,[1] among other things, ended the nail-biting uncertainty about the estate tax thresholds for 2011. (For more information, see "New Rates, New Exemptions, New Opportunities," in this issue, p. 20.) Signed into law on Dec. 17, 2010, this $858 billion tax legislation[2] also gave taxpayers a two-year income tax reprieve by extending into 2011 and 2012 the lower income tax rates and many of the other tax incentives that were enacted in 2001 and 2003 (the Bush tax cuts).[3]

Although taxpayers have temporary tax relief for the next two years, a sizeable tax hike is on the books for 2013. (See "Income Tax Rates," p. 17.) Not only will the Bush tax cuts expire, but also there will be new income taxes to pay for health care costs. Individuals who have over $200,000 of adjusted gross income ($250,000 on married joint returns) will incur an additional 3.8 percent tax on most investment income and an additional tax of 0.9 percent on earned income from wages and self-employment.

In light of the changing tax rates over the next three years, what tax-planning strategies make the most sense? One strategy that looks increasingly attractive is to do a Roth IRA conversion in 2011 or 2012, and then avoid large conversions in 2013 and later years. Beginning in 2013, taxpayers will be better off keeping their income under $200,000 ($250,000 joint) to avoid the health care taxes. Even though retirement plan distributions in 2013 and later years will be exempt from the 3.8 percent surtax, a very large Roth IRA conversion in 2013 or later years could push a person's income over the threshold and expose more of his other income to the taxes. Thus, 2011 and 2012 may be banner years for very large Roth IRA conversions with the benefits of such conversions significantly diminishing in 2013 and later years. (For the pros and cons of doing a Roth IRA conversion and the applicable administrative requirements, see the September 2009 issue of *Trusts & Estates*, which had several articles on the subject.)

2011

In addition to a continuation of most of the income tax rules that existed in 2010, most workers will experience a 2 percent pay increase because of a temporary reduction of social security and self-employment taxes. The 6.2 percent rate that an employee pays on the first $106,800 of his earned income was cut to 4.2 percent in 2011, though employers must continue to pay the full matching 6.2 percent payroll tax. Self-employed individuals will experience a corresponding tax cut from 12.4 percent to 10.4 percent. By comparison, the 1.45 percent Medicare/Medicaid tax (2.9 percent for self-employed individuals) remains the same.

2012

When they get their first paycheck in January 2012, taxpayers will notice a 2 percent pay cut, since the social security tax rates will return to 6.2 percent from the lower threshold of 4.2 percent in 2011. Furthermore, although most of the Bush tax cuts will apply through the end of 2012, the alternative minimum tax (AMT) patch and all of the "tax extenders" will expire at the end of 2011. The extenders consist of numerous tax provisions that have expiration dates but are repeatedly re-extended for one or two years. Based on past Congressional action, it's reasonably likely that the AMT patch and the extenders will be re-extended into the year 2012.

When will Congress enact the re-extenders? In 2008 and 2010, Congress didn't enact the re-extenders until December of each year and then the laws were made retroactive to the beginning of each respective year. The extender that may have been the most affected by the late December 2010 extension was the "charitable IRA rollover" provision. Many individuals who had wanted to make charitable gifts from their IRAs instead took distributions from their IRAs under the assumption that the law wouldn't be extended. They were frustrated when a temporary extension of the law into January 2011 didn't allow them to undo those taxable distributions.[4]

By way of background, a charitable IRA rollover permits individuals over the age of 70½ to make charitable gifts directly from their IRAs to most types of charities. The IRA owner can exclude the distribution from gross income, but isn't entitled to claim a charitable income tax deduction for the gift.[5] For many people, an important feature of this law is that the qualified charitable distribution counts against the required minimum distribution (RMD) from the IRA for the year. For example, if an individual is required to receive $10,000 from his IRA during the year and has made gifts of $8,000 from the IRA directly to an eligible charity, then the individual can simply receive $2,000. Because of the charitable IRA rollover provision, the taxpayer will only have to report gross taxable income of $2,000, yet that person will have satisfied the requirement that a minimum of $10,000 be distributed from the IRA during the year.

If Congress delays enacting the extenders until late 2012 (as was the case in 2008 and 2010), then there's a tax planning strategy for 2012 that can overcome the problems that many taxpayers had in 2010. Tax planners can suggest that clients make the qualified charitable distributions in 2012 as if the law were in place, but the total amount of such gifts made before the law is re-extended should generally be limited to that year's RMD. The taxpayer shouldn't lose. For example, the taxpayer discussed in the preceding paragraph should make the gifts of $8,000 when the charities need the donations — March, June, etc. If the charitable IRA rollover is enacted and made retroactive to the beginning of the year (as

has always been the case to date), the distribution earlier in the year will qualify for the favorable tax treatment.[6] If the law isn't re-extended, the taxpayer had to withdraw the $8,000 anyway. On the other hand, the taxpayer shouldn't make the maximum $100,000 gift from the IRA until the law is indeed re-extended. Instead, the taxpayer should feel that it's safe to make qualified charitable distributions of up to $10,000 (the year's RMDs).

2013

Unless there's new legislation that provides tax relief, two developments will cause high-income taxpayers to experience significantly higher marginal income tax rates in 2013: (1) the expiration of the Bush tax cuts, and (2) the imposition of new taxes to pay for health care.

The lowest marginal tax rate will increase from 10 percent to 15 percent. The highest individual marginal tax rate will rise from 35 percent to 39.6 percent. The historically low 15 percent tax rate on long-term capital gains will increase to 20 percent. But the official marginal tax rates that apply to the wealthy actually understate the true marginal rates that they will experience. That's because the expiration of the Bush tax cuts also means the return of many deduction phase-outs. First, taxpayers with incomes over approximately $180,000 will experience a 1 percent tax increase with the return of the 3 percent phase-out of itemized deductions.[7] When that taxpayer has an additional $100 of income, he will lose $3 of itemized deductions, which (at a 33 percent tax rate) translates into roughly a 1 percent tax rate increase. Phase-outs for personal exemptions of higher income taxpayers will also return, which further increases the effective marginal income tax rate.

The second major tax development for high-income taxpayers in 2013 is the introduction of the health care taxes. The taxes will generally apply to individuals who have over $200,000 of income ($250,000 on a joint return). Different tax rates apply to investment income versus income earned from labor (for example, wages and self-employment income).

First, there will be a 3.8 percent surtax on investment income (including long-term capital gains) for individuals who have over $200,000 of adjusted gross income ($250,000 on a joint return). Some income will be exempt from the surtax, including retirement plan distributions and partnership or Subchapter S corporation income, provided that the recipient is employed at the business. By comparison, trusts and estates will experience much harsher tax treatment. The 3.8 percent tax will be imposed on income retained by the trust or estate in excess of a mere $12,000.[8] Thus, beginning in 2013, estate planners will have an even greater incentive to distribute income to beneficiaries who have income under $200,000 ($250,000 joint) rather than retain the income in a trust or an estate, where it will be subject to considerably higher tax rates.

Second, there will be a 0.9 percent additional tax on the compensation income of individuals who have over $200,000 of income ($250,000 on a joint return). This will be in addition to the existing 1.45 percent Medicare/Medicaid tax that employees pay on all of their earned income and that's matched by employers. The 0.9 percent surtax is paid only by the individual — it's not matched by the employer as is the case with the 1.45 percent Medicare/Medicaid tax.[9]

Beginning in 2013, taxpayers with income under the threshold for the health care taxes may increasingly use strategies to keep income under those thresholds. In particular, they'll want

to avoid spikes in income that would bring their income levels over $200,000 ($250,000 joint). For example, a taxpayer with income of $100,000 might sell a business or land that may produce a $600,000 gain, triggering the 3.8 percent tax on much of that gain. What can be done to avoid this outcome? Several techniques can keep income levels lower. One is to make an installment sale in which the seller makes payments stretched over several years, thereby keeping gross income below the applicable thresholds. Another, if a cash sale is possible, is to transfer the property to a tax-exempt charitable remainder trust (usually a flip charitable remainder unitrust (Flip CRUT)[10] is best under these circumstances) before the sales negotiations are finalized.[11] The trust can make distributions over a person's life or simply for a term of years (up to a maximum of 20).[12] A host of other strategies can keep income below the thresholds, depending on the circumstances.

Producing Greater Tax Benefits

Taxpayers have a two-year income tax reprieve and, unless the laws are changed, they'll have a minor tax increase in 2012 and a sizeable one in 2013. Rather than just bask in the warm light that the low rates produce, it may make sense to take steps in 2011 and 2012 to produce greater tax benefits in 2013 and in future years. For the highest income taxpayers who believe that they'll experience higher income tax rates in future years, a Roth IRA conversion in either 2011 or 2012 continues to make sense. Locking in the low 15 percent rate on long-term capital gains may prove beneficial in 2012. Taxpayers with incomes under the threshold for the health care taxes might begin to explore strategies that can avoid spikes in income that would bring their income for the year over $200,000 ($250,000 joint) in 2013 and later years. Finally, those taxpayers who benefit from the provisions in the "extenders" should be aware that those tax provisions will expire in 2011, so 2012 may be another nail-biter year. For a summary of the tax changes for 2011 and 2012, see "Tax Changes Through the Years," this page.

Endnotes

1. Pubic Law 111-312.
2. Estimated budget effects of the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, Joint Committee on Taxation (JCX-54-10 - Dec. 10, 2010).
3. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA).
4. "IRS: No Charitable IRA Do-Over," *The Wall Street Journal*, Jan. 5, 2011.
5. Internal Revenue Code Section 408(d)(8).
6. Internal Revenue Service Notice 2007-7, 2007-5 IRB 1, Q&A 38.
7. IRC Section 68.
8. IRC Section 1411(a)(2)(B)(ii). The 2011 threshold when trusts and estates pay the highest marginal income tax rate is $11,350. Revenue Procedure 2011-12, 2011-2 IRB 1. That threshold will likely rise with inflation to be closer to $12,000 in the year 2013.
9. IRC Section 1411 (as modified by Section 1402 of The Health Care and Education Reconciliation Act of 2010 (Pub. L. 111-152) (3.8 percent investment income surtax)) and IRC Section 9015 (as modified by Section 10906 of The Patient Protection and Affordable Care Act, Pub. L. 111-148 (0.9 percent compensation surtax)).
10. A flip charitable remainder unitrust is a charitable remainder unitrust (CRUT) that has

two stages. First it begins as a net-income-with-make-up trust — a trust that pays the lesser of that year's net income or a fixed percentage (at least 5 percent and no more than 50 percent) of the value of the trust's assets each year (redetermined annually) to one or more income beneficiaries, typically for life. Then the trust converts into a standard unitrust the year after a specified date or a “triggering event” occurs (typically the sale of the property contributed to the trust.) Hence the trust is the best type of CRUT to receive a contribution of illiquid property. Upon the termination of the trust, the trust's assets are distributed to one or more charitable organizations. Treasury Regulations Section 1.664-3(c).

11. Revenue Ruling 78-197, 1978-1 C.B. 83.
12. IRC Section 664.

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Income Tax Rates

A sizeable hike is in the works for 2013

Highest federal tax rates on:	**2011-12**	**Without Bush Tax Cuts**	**2013**
Investment income (interest, rent)	35%	39.6%	43.4%
Wages (1.45% health insurance + 0.9%)	36.4	41.0	41.9
Dividends	15	39.6	43.4
Long-term capital gains	15	20	23.8

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Tax Changes Through the Years

Some rates and allowances for 2013 are still up in the air

	2011	**2012**	**2013**
Social security rate cut to 4.2% (self-employed to 10.4%)	•		
Lowest tax rate 10%; maximum tax rate 35%	•	•	
No phase-out of itemized deductions	•	•	
No phase-out of personal exemption	•	•	
Capital gains and dividends maximum 15% tax rate	•	•	

No “marriage penalty tax” for taxpayers in 15% tax rate	•	•	
$1,000 child tax credit rather than $500	•	•	
Exclude $5,250 for employer-provided assistance	•	•	
Expanded ability to deduct student loan interest	•	•	
Bonus 1st year depreciation 100% in 2011; 50% in 2012	•	•	
Section 179 equipment $500,00 in 2011; $125,00 future years	•	•	
Alternative minimum tax relief	•		
“Extenders” enacted for 2010 and 2011, including:			
Charitable IRA rollover	•		
Itemized deduction for state sales taxes	•		
Deduction for tuition and fees	•		
15-year deduction for restaurant improvements	•		
New 3.8%/0.9% health care taxes if adjusted gross income greater than $200,000 ($250,000 joint return)			•

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