

Higher Anticipated Taxes in 2011 Prompt More Aggressive Planning

Absent Congressional action, the 2011 tax year will result in higher taxes for nearly every individual taxpayer. The most significant changes set to take place in 2011 are a result of the scheduled sunset of tax cuts from the Bush administration and include changes to the individual income tax brackets, long-term capital gains rates, dividend rates and the estate tax system. As a result, the 2010 tax year provides many taxpayers a unique opportunity to save taxes through a variety of tax planning techniques including opportunities to accelerate taxable income from 2011 to 2010 and taking advantage of current preferential tax rates.

INDIVIDUAL INCOME TAX BRACKETS

The changes likely to affect the largest number of individual taxpayers will be the changes to the individual income tax brackets. As a result of the 2001 and 2003 Bush administration tax cuts, the individual brackets gradually changed during the past decade to establish a 10% bracket and to lower the top bracket from 39.6% to 35%. The tax brackets were also adjusted to eliminate the "marriage penalty", whereby married taxpayers could end up paying higher income taxes than two single taxpayers earning the same amount of money. The tax cuts resulted in the following tax brackets for 2010:

Tax Bracket	Married Filing Joint 2010	Single 2010
10%	\$0 - \$16,750	\$0 - \$8,375
15%	\$16,751 - \$68,000	\$8,376 - \$34,000
25%	\$68,001 - \$137,300	\$34,001 - \$82,400
28%	\$137,301 - \$209,250	\$82,401 - \$171,850
33%	\$209,251 - \$373,650	\$171,851 - \$373,650
35%	Over \$373,651	Over \$373,651

However, at the end of the year, unless Congress intervenes, the above tax cuts are set to expire resulting in increasing the top tax bracket to 39.6%, eliminating the 10% bracket and increasing the remaining tax brackets. The increase in the tax brackets provides taxpayers an incentive to shift income from the 2011 to the 2010 tax year by accelerating income or deferring deductions. There are a variety of techniques to accomplish income shifts and will depend on the taxpayers current method of accounting, entity type, and tax attributes. Some examples of tax planning techniques to shift income include altering the timing of payments, depreciation choices (especially with regards to IRC Section 179 decisions), methods of accounting, etc.

LONG-TERM CAPITAL GAINS AND DIVIDEND RATES

Tax law changes affecting investment income are an increase to the long-term capital gain and qualified dividend tax rates. The top long-term capital gain rate is currently 15% and is scheduled to increase to 20% in 2011. The upcoming 5% increase in the tax rate provides taxpayers



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an incentive to have their capital gains taxed in 2010 rather than 2011. There are a few options taxpayers can consider to accomplish this goal. One option is to consider electing out of the installment sale method if the taxpayer will be receiving payments over multiple years. Generally, with sales eligible for the installment sale method of accounting, taxpayers are taxed on the gain from the sale of property over the period in which the payments are received. By electing out of this treatment the entire gain will be taxed in the year of the sale which can provide taxpayers the opportunity to take advantage of the 15% tax rate. However, taxpayers will need to carefully consider the cash flow implications of this decision as it could result in a large amount of taxable income before the cash flow is available to pay the tax. Another method available is to accelerate the sale of gain stocks to 2010 and defer the sale of loss stocks to 2011. It is important to note that the decision to sell stocks at any given time should not be made solely for tax purposes but should be done as part of an overall investment strategy. It may make sense to repurchase the asset sold at a gain in 2010 to preserve the investment and still take advantage of the historically low tax rates.

The qualified dividend rate is currently tied to the long-term capital gain rate (15%) but it is set to expire and go back to the ordinary income rate in 2011. This could potentially result in the dividend rate increasing from 15% to 39.6% for some taxpayers. As a result, it may make sense to accelerate dividend income to avoid a nearly 25% increase in the tax rate. Owners of C Corporations, and S Corporations that have C Corporation earnings and profits, will want to carefully consider whether it makes sense to pay out a dividend of C Corporation earnings and profits to its' owners to take advantage of the current rates. Owners of S Corporations typically take distributions from their S Corporations as a return of capital to the extent of the accumulated adjustment account (S Corporation earnings subject to a few adjustments) before they are required to pay a dividend from their C Corporation earnings and profits. However, given the potentially drastic change in the qualified dividend tax rates, it may make sense to elect to have C Corporation earnings and profits be paid out before the accumulated S Corporation earnings.

CANCELLATION OF DEBT INCOME

As a result of the American Recovery and Reinvestment Tax Act of 2009, taxpayers were given the opportunity to defer recognition of cancellation of debt income until 2014 and to spread the recognition of the income over 5 years. This election was available to taxpayers with qualified debt repurchased by the debtor during 2009 and 2010. Electing this opportunity depended on a variety of factors. If it is a beneficial transaction, working with lenders to try to have the event conclude during 2010 could provide taxpayers an opportunity to benefit from this long-deferral period.

ESTATE TAXES

The estate tax is set to expire in 2010 and, without congressional action, will be reinstated at



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a 55% tax rate. Planning is important since there is no single method of estate planning that makes sense for each taxpayer. It is typical to use a variety of different planning techniques depending on the particular assets owned by the taxpayer.

TAX LAW CHANGES

In addition to the changes to existing law discussed above, Congress is currently considering a couple of new tax law changes that could impact many taxpayers during 2011. In fact, the House of Representatives recently passed the American Jobs and Closing Tax Loopholes Act of 2010 which extends some current tax laws and introduces some significant changes. One such change relates to S Corporations and self-employment taxes. Currently, S Corporation owners only pay self-employment tax on S Corporation earnings to the extent the earnings were paid out as wages. This provided taxpayers the incentive to pay out low wages and take the remainder of the money out as a distribution. To combat perceived abuses under the current rules, the recently passed Act would subject all S Corporation earnings in professional service firms that have three or fewer key employees to self-employment tax. Those subject to this new law include doctors, dentists, architects, consultants, engineers, lawyers and many more.

Another change that may come from the American Jobs and Closing Tax Loopholes Act of 2010 is to tax 75% of the "carried interest" as ordinary income. This carried interest legislation has been described as closing down the hedge fund tax loophole, but it has significant implications to other areas of business as well, including the real estate market. Currently, hedge fund managers are generally compensated for services they provide to manage the fund by taking a percentage of the profits of the company in excess of the percentage of capital they have invested. In a hedge fund, this allocation of income is typically made up of investment income including capital gains. As a result, hedge fund managers are usually allowed to have a significant portion of their income taxed at preferential capital gains rates. This perceived abuse may be eliminated by the new law which converts 75% of the portion of their income that is disproportionate to their investment as ordinary income.

While the fate of this bill, and the two key provisions previously discussed, is uncertain, the impact of its passage could be substantial.

We do not have the ability to predict Congressional action and decisions that may affect tax laws, however, it is important for taxpayers to consider implications on their future taxes and look for opportunities to minimize any negative impact through planning. Tax planning techniques should be used after considering the overall financial situation of the taxpayer. For more information or to discuss, please contact John Kammerer, CPA, at jkammerer@hlbtr.com or 651-255-9305.

