ASPIRIANT

Insight

Wealth Management Commentary

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Fiscal Cliff Notes

Tax planning for an uncertain future

In the second article on imminent tax law changes (see the recent *Insight* on estate taxes), we're focusing this *Insight* on upcoming changes to the income tax law and how we're working with clients to respond.

What's scheduled for 2013?

Much has been written about the "fiscal cliff", the $100 billion of automatic spending cuts and $300 billion of across-the-board tax increases that will occur in January absent Congressional action in December. If Congress fails to pass income tax relief, taxes in three categories will automatically increase.

1. *The Bush-era tax cuts will lapse and federal income tax rates across all types of income (employment, capital gains, dividends and interest) will increase for all taxpayers. The exhibit below shows current tax brackets, the 2013 rates if Congress takes no action, and the tax brackets under the Obama administration's most recent proposal.*

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2. *Additional Medicare taxes in two flavors come into play:*

   - *Medicare Part A taxes increase by nearly 1% from 1.45% to 2.35% (2.9% to 3.8% for self-employed taxpayers) on employment income greater than $200,000 (single) or $250,000 (married).*

   - *A new Medicare contribution tax of 3.8% applies to the lower of net investment income (capital gains, dividends and interest) or adjusted gross income over $200,000 for single taxpayers and $250,000 for married taxpayers. As such, taxpayers with income less than $200,000 ($250,000 married) aren't exposed to this additional tax.*

3. *The Social Security payroll tax on employment income, which was temporarily reduced in 2011 in the face of waning economic growth, will increase by 2% to its regular rate of 6.2%.*

In short, the tax tides are scheduled to rise for everyone in 2013, and people with significant capital gain and dividend income relative to ordinary income (like wages) will see the most significant percentage increases.

Are changes coming before year-end?

There's broad, bipartisan concern among policy makers and economists that going over the fiscal cliff could push the fragile US economy back into recession. In fact, some economists estimate that the combination of spending cuts and tax increases could reduce US GDP growth by over 4% in 2013 (from an already anemic growth rate of less than 2%). Now that the election is over, there seems to be some movement (albeit frustratingly slow) toward a compromise.

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		ORDINARY INCOME			LONG-TERM CAPITAL GAINS*			QUALIFIED DIVIDENDS*		
MFJ	SINGLE	2012	2013	OBAMA PROPOSAL	2012	2013	OBAMA PROPOSAL	2012	2013	OBAMA PROPOSAL
< $17,400	< $8,700	10%	15%	10%	0%	10%	0%	0%	15%	0%
< $70,700	< $35,350	15%	15%	15%	0%	10%	0%	0%	15%	0%
< $142,700	< $85,650	25%	28%	25%	15%	20%	15%	15%	28%	15%
< $217,450	< $178,650	28%	31%	28%	15%	20%	15%	15%	31%	15%
< $250,000	< $200,000	33%	36%	35%	15%	20%	20%	15%	36%	20%
< $388,350	< $388,350	33%	36%	39.6%	15%	20%	20%	15%	36%	20%
> $388,350	> $388,350	35%	39.6%	39.6%	15%	20%	20%	15%	39.6%	20%

* Exclusive of the new Medicare tax on investment income

The details of that compromise, the exact timing of the changes, and the political brinksmanship that will occur before they're in place are all tough to guess. We hope to eventually see broad based reform that:

- *makes the tax system more efficient and growth-oriented,*
- *addresses the long-term fiscal issues with Social Security, Medicare and Medicaid,*
- *makes clear progress toward reducing and ultimately eliminating the large structural deficit, and*
- *lifts the cloud of uncertainty that currently exists over tax and fiscal policy, a fact that has hurt consumer and business confidence and delayed investment, thus hindering economic growth.*

Achieving such a broad compromise seems unlikely any time soon, especially during the current lame duck session of Congress. Instead, we expect that there will be incremental movements in that direction over the next year. In the meantime, lawmakers may pass a short-term extension of 2012 tax law into mid-2013 or some other tax band-aid, giving Congress and the President time to hash out a more permanent set of policies.

Income tax planning amid uncertainty

Income tax planning in such an uncertain environment is challenging. Conventional planning would involve accelerating tax deductions into 2012 and delaying income into 2013. However, the possibility of higher tax rates in 2013 turns conventional tax planning on its head, causing clients to consider accelerating income (particularly capital gains) into 2012 and deferring tax deductions into 2013.

Federal capital gain tax rates are scheduled to increase by nearly 60% (from 15% to 23.8%, including the new Medicare contribution tax), so some clients will benefit from selling appreciated investments in 2012, intentionally triggering tax liabilities at today's lower tax rates. This applies primarily to clients for whom we'd otherwise sell investments in the next five years (e.g., for funding living expenses and/or for making manager changes in the portfolio). This strategy is less attractive for clients who aren't taking regular withdrawals from or otherwise changing their portfolio implementation because, with enough time, the benefit of delaying the capital gain tax outweighs the higher future tax rates.

"…the possibility of higher tax rates in 2013 turns conventional tax planning on its head."

We're performing a similar analysis for clients who may need to take large IRA or annuity distributions over the next few years, as it could make sense to accelerate those distributions into 2012. Similarly, many clients have decided over the last few years to convert some or all of their IRA accounts to tax-free Roth IRA accounts. Higher future tax rates make conversions after 2012 less attractive, so we're raising this issue again with any clients who have been "on the fence".

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Please see the sidebar for some other 2012 investment-related tax planning opportunities that we're considering with clients.

No easy answers

The conventional practice of accelerating tax deductions is less attractive if it looks like tax rates will increase in 2013. Tax deductions for charitable gifts and property tax payments, among others, may be more valuable in 2013 as long as the deductions aren't limited in the future; consequently, in some cases it makes sense to delay incurring these expenses until January.

That said, one of the proposals being considered as part of a "grand bargain" is to significantly revamp the tax code by reducing tax rates and eliminating or capping many popular tax deductions. While there are many details to iron out, this has the political appeal of potentially raising tax revenues while also reducing tax rates, and that would argue for a more conventional 2012 tax strategy of accelerating deductions and deferring income. Clients with significant concerns about future reduced deductions may want to accelerate those into 2012 also (e.g., frontloading future charitable gifts).

Each client's tax situation is entirely unique, and so we're working with clients, in concert with their tax advisors, to weigh the various considerations and determine the appropriate course.

Sandi Bragar
Director of Wealth Planning

Other Year-End Investment Planning Strategies

- Retirement plans for the self-employed. If you have self-employment earnings–for example, from consulting or service on corporate boards–you are eligible to contribute to your own retirement plan. Most of these plans must be established by December 31, so let us know if you have any self-employment earnings that we haven't already discussed.
- Catch-up 401(k) contributions. Individuals age 50 and older are eligible to make an additional $5,500 of "catch-up" contributions (on top of the $17,000 standard contribution) to a 401(k) plan in 2012. A recent paystub will show your total 2012 contributions, and if it's below $22,500, you'll want to increase contributions through year-end by filing paperwork with your HR department or 401(k) plan administrator.
- IRA and Roth IRA contributions. You have until April 15, 2013 to make $5,000 contributions ($6,000 if 50 or older) to IRAs and Roth IRAs. There are income limitations that disqualify many Aspiriant clients from contributing to IRA and Roth IRA accounts, but many clients' children are eligible if they've earned employment income during the year.
- Roth conversions. Regardless of your income level, you can convert your traditional IRAs to Roth IRAs. Doing so requires paying income tax on the conversion amount, but future earnings and distributions are entirely tax-free. You can unwind a 2012 conversion anytime before October 15, 2013, giving you a "free look" period. We can help you determine if a Roth conversion makes sense given your unique income, spending and estate planning objectives.
- Required minimum distributions. If you are over 70 1⁄2, you are required to take minimum distributions from your retirement accounts by December 31. Likewise, clients who have inherited an IRA account must take an annual distribution, regardless of their age. Aspiriant is working with IRA account custodians to calculate and distribute the necessary amount before the end of the year.
- Side-stepping capital gain distributions. Many mutual funds distribute taxable capital gains at year-end. We monitor estimated capital gain and dividend distributions and, if appropriate, will sell a fund to avoid adverse tax consequences.