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Dangling Over the Fiscal Cliff

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Since the November election, we have wondered what kind of deal Congress and the President would strike by year end to avoid the fiscal cliff that Washington created in the first place. And after dangling over the cliff in 2010 and again in 2012, we have a deal.

Perhaps we will all appreciate the wisdom of an old truism that belongs on our New Year's resolution list, to "not put off until tomorrow what you can do today." Like it or not, most of the expiring tax rate provisions were amended and pushed forward without an automatic reversion to those of 10+ years ago. Some tax expenditures, like the §179 depreciation limit and phase out, and 100% exclusion of gain on purchases of certain small C corporation stock under §1202 were just pushed forward another year, the former without indexing. However, Congress has yet to address the $16.3 trillion debt ceiling or spending cuts that might make the ceiling avoidable in the future. On the regulatory front, we await releases from the Department of Health and Human Services providing guidance on some of the more expensive provisions of the Affordable Care Act, for example on how and whether coverage will be extended to part time, temporary and seasonal employees, beginning perhaps as soon as February. We will have to see how these crises are dealt with.

To help all of us rethink business planning under the modified tax code, below I have charted the rate related changes with comments.

Expiring Tax Cuts: The following chart illustrates what actually happened to some of the expiring Bush Tax Cuts in the American Taxpayer Relief Act of 2012 (the Act) passed by Congress, and signed with an autopen by the President on January 2, 2013.

	2012	2013
Top cap gains rate	15%	20% @ $400K single, $450K MFJ
Top rate on dividends	15%	20% @ $400K single, $450K MFJ
Top individual income tax rate bracket	35%	39.6% @ $400K single, $450K MFJ, $425K HOH
Lower individual income tax brackets	10%, 15%, 25%, 28%, 33%	10%, 15%, 25%, 28%, 33%, 35%
Personal Exemptions	not reduced by income	eliminated by income, with indexing @ $250K single, $300K MFJ, $275K HOH
AGI Itemized Deduction limitations	suspended through 2012	3%/80% reduction returns, with indexing@ $250K single, $300K MFJ, $275K HOH
Estate/gift tax lifetime exemption	$5 million, with indexing	$5 million, with indexing
Top estate, gift & GST rate	35%	40%

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Some other items addressed in the Act:

- Bonus depreciation and §179 depreciation annual limit and phase-out were extended through 2013, removing indexing adjustments.
- The AMT patch was made permanent, with indexing.
- Unemployment benefits for long term unemployed were extended through 2013.
- Blocked the 27% Medicare payments cut to doctors through 2013 (originated in the 1997 budget formula).
- Delayed for two months $109 billion of across-the-board spending cuts.
- §1202 small C corporation 100% gain exclusion was extended for stock purchased through 2013.
- Extended the shortened five year built in gains recognition period through 2013 and applies it to all future payments received in an installment sale.
- The research credit and domestic production activities deduction were extended through 2013.
- Exclusion from income of certain individual retirement plan distributions for charitable purposes, extended through 2013.
- The alternative sales tax deduction was extended through 2013.
- Extended through 2017 expansions of the child tax credit, earned income tax credit and college tuition credit.
- Removed the prohibitively expensive long-term care requirement in the Affordable Care Act before it became effective.

Some things did expire, like:

- the 2% reduction in employee's FICA rate and
- the patience of the American public.

These and many other focused extensions and changes are included in the Act.

Planning Opportunities:

Business & investment planning are viewed differently whenever a tax act changes rates, especially where the relationship changes between rates applied to different kinds of entities, and different kinds of strategies. For example, dangling over the fiscal cliff was enough to motivate many wealthy individuals to accelerate estate and gift planning in order to avoid a possible plunge back to a $1 million exemption and 55% rate. History has reinforced this lesson many times. Here are a few initial observations of potential planning opportunities for 2013.

- The top marginal rates for individuals and C corporations were equal at 35% through 2012. So when the Act moved the top individual marginal rate to 39.6%, with a 3.8% investment tax kicker, an 8.4 percentage point differential or more was created. Is this sufficient to encourage some businesses back to C corporations, even with the potential for double taxation on distributions and liquidations? Businesses and their owners will have to consider if the maximum dividend rate is low enough at 23.8% (20% + 3.8%). Will deferral be long enough to capitalize on the rate differential? Or will businesses perceive that the double tax harvest IRS may ultimately collect is not worth the gamble, and loss of basis build-up, loss of access to single tax operating distributions, single tax income shifting opportunities, etc.? I expect by this time next year we will find out.

- An obvious example of a planning opportunity preserved is the IC-DISC (Interest Charge – Domestic International Sales Corporation). Preserving a meaningful difference between an individual 23.8% dividend rate and 40.5% ordinary earned income rate (39.6% + 0.9% Medicare tax) makes this an even more attractive arrangement, providing the potential for a permanent tax deferral for exporters of software, designs, manufactured goods, etc.

- With the top marginal rate starting at incomes of $400,000 for single and $450,000 for married filing jointly, it is imposed precisely on those taxpayers who are most likely to close on some of the more complex strategies, providing even greater motivation for them to do so.

    - ◊ For companies with substantial cash flow and flexibility, captive insurance companies with risk pooling agreements have become very attractive. They can provide a current tax deduction for a payment to a related US company that receives the premium tax deferred. Business and tax risks can be resolved with experienced managers, market underwriting and pricing, and safe harbors under established tax law. A captive can provide ancillary benefits that may include estate planning, and funding for future equity transfers even for flow through operating companies.

    - ◊ The tax code remains friendly to life insurance with the potential for a permanent deferral of earnings on investments inside the policy and receipt of death proceeds income tax free. Flexibility in structuring policies allows variation in the amount driving cash accumulation and death proceeds, diversification of investments, and can allow access to some of the earnings through policy loans during lifetime. It is critical to understand the related issues including proper policy design, costs and risks, including contract risk, investment risk and sometimes tax risk. Strategies include a Roth IRA substitute, funded executive benefit plan, private equity hedge and foreign private placement insurance just to name a few. These are not suitable for everyone, but in the right circumstances they can be powerful.

As we have time to absorb these changes in the law, those coming later in the year and what they mean for our clients, we should be in a better position to counsel and plan accordingly.

If you have any questions about this or any other tax issue, please contact Gary M. Harden at 419-241-6000 or visit our website at www.eastmansmith.com.
