Insights

Income Tax Rates to Soar by 2013

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WEALTH MANAGEMENT

Managing Rising Income Tax Rates

For the past 17 years, most tax rates — including income tax — have declined or remained fairly constant. That situation is set to change in the not too distant future, and it will likely be a long time before investors again see income tax rates at their current level. This Insights piece has been created to help investors and their advisors prepare for the changing tax environment.

Planning Ahead

Under current legislation, after December 31, 2012 the highest marginal Federal tax rate on net investment income will be 43.4%. This represents:

- 39.6% ordinary income tax, plus
- 3.8% Medicare tax on net investment income

When assessing the impact of these increases, the following considerations can be helpful:

- For high income taxpayers[1], 2011-2012 may be the lowest tax years for decades to come
- In 2013, investors will see their after-tax income shrink. For example:
  - $200,000 in qualified dividends will net $158,000 after a 21% tax[2] in 2011-2012
  - In 2013[3], the net after-tax amount will be $105,280 — A 33% decrease

Strategies For Greater Tax Efficiency

Investments

While individual investor circumstances vary, there are ways to align portfolios for greater tax efficiency:

- Shift to tax-exempt bonds and low dividend stocks
  - Tax-exempt income is more attractive in future years
  - Dividends and taxable interest will be less attractive
- Place investments that generate primarily taxable interest and dividends in a tax-deferred or tax-free vehicle
- Reconsider REITs: in 2013 dividend rates move to 39.6%, so REITs will be on an equal footing with investments paying dividends and taxable interest
- Consider Master Limited Partnerships because a portion of the distributions are considered a return of capital
- Consider cash value life insurance as source of funds
  - If tax savings exceed cost of insurance

Wealth Planning

Review wealth management plans to identify ways to gain optimal benefits under the new tax structures:

- Charitable deductions will become increasingly valuable, as they can offset higher taxes
  - Consider charitable trusts to smooth income and provide charitable deductions
- Retirement plans, other than Roth IRAs and Roth 401(k)s, can accumulate assets pre-tax. Distributions are:
  - Not subject to the 3.8% Medicare tax on net investment income
  - Taxed as ordinary income
  - Included in the Modified Adjusted Growth Income (MAGI) threshold used to determine "high income taxpayers" who are subject to the Medicare tax
- Consider trust provisions favoring income distributions rather than income accumulation in the trust
- Installment sales for wealth transfer
  - Combine with grantor trusts for leveraged gifting

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Begin to Plan for Future Tax Increases

Under the new tax rules, specific strategies can assist certain types of investors.

Business Owners

- Accelerate income into 2011-2012
- Defer deductions until 2013
- Establish defined benefit pension plan, and fund to maximum
- For sale of a business after 2012, explore an installment sale to smooth income

Corporate Executives

- Exercise stock options before 2013
- Make §83(b) elections on restricted stock
- Explore taxable hedging strategies
- Contribute maximum allowed to retirement plans, including deferred compensation

Investors

- Make Roth conversions before 2013
- Consider deferring significant charitable gifts until 2013
- Take profits — generate capital gains — before 2013
- Diversify throughout 2011-2012
- Take advantage of qualified plans to accumulate assets

The impact of Alternative Minimum Tax (AMT) should be considered. AMT planning often results in opposite strategies to regular tax planning.

Highest Income Tax Rates 2011 through 2013

Under Current Legislation

Federal Income Tax Rates[4]	2011-2012	2013
Ordinary income	35%	39.6%
Long-term capital gain	15%	20%
Qualified dividend	15%	39.6%
Medicare tax on net investment income[5]		3.8%
Medicare tax on wages - employee	1.45%	1.45%
Medicare tax on wages - employer	1.45%	1.45%
Medicare tax on wages - employee (above threshold)[6]		0.9%
Social Security tax wages - up to $106,800 in 2011	6.2%	6.2%

Income Tax Rates for Selected States[7]	2011
California	11%
Connecticut	7%
Delaware (resident only)	7%
Florida	None
Georgia	6%
Massachusetts	5%
Nevada	None
New Hampshire	5%
New Jersey	9%
New York	8%
Ohio	6%
Pennsylvania (excludes local)	3%
South Dakota	None
Texas	None
Washington	None

[1]"Medicare tax," "high income taxpayers," and "MAGI" refers to provisions in the Patient Protection and Affordable Care Act enacted on March 23, 2010 and the companion Health Care and Education Reconciliation Act of 2010 enacted on March 30, 2010. [2]Hypothetical Effective Federal and State Tax Rate. [3]Assuming qualified dividends are subject to Medicare Tax. [4]Highest rate. [5]Tax is assessed on the lesser net investment income or the excess of MAGI over the threshold amount. [6]Based on current legislation threshold amounts: $200,000 single; $250,000 married filing jointly. [7]Highest rate. Source: Tax-Rates.org.

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