AN ALERT FROM THE BDO PRIVATE CLIENT SERVICES PRACTICE

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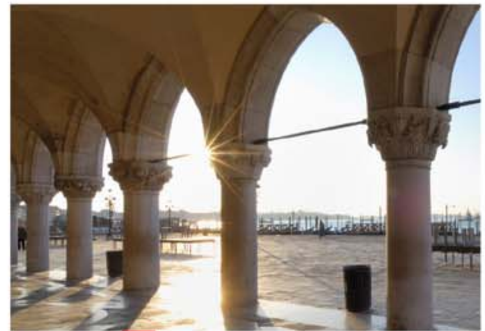
# PRIVATE CLIENT SERVICES



## SUBJECT

# PLANNING IN 2012 FOR SUBSTANTIAL TAX CHANGES COMING INTO EFFECT ON JANUARY 1, 2013

With 2013 fast approaching and the Supreme Court's decision to uphold the Patient Protection and Affordable Care Act, substantial tax law changes are looming for many Americans. The sunset of the "Bush tax cuts" is to take place at the end of this year, ushering in higher tax rates and a return to many pre-2001 policies. Only legislative action and compromise will prevent the sunset.

## BACKGROUND

The sunset of the Bush tax cuts and the effectiveness of new taxes will result in a number of changes for individual taxpayers. Of particular interest are the following changes:

**Income tax rates**

- 2012 top rates: Ordinary income — 35%; Long-term capital gain — 15%; Qualified dividend Income — 15%
- 2013 top rates: Ordinary income – 39.6%; Long-term capital gain — 20%; Qualified dividend income — 39.6%

**Medicare surcharges** (now a reality after the Supreme Court decision)

- 3.8% surcharge on unearned income (*i.e.*, interest, dividends, capital gains, passive income, including from partnerships and S corporations in which the taxpayer does not materially participate)
- Applicable to taxpayer's with adjusted gross income for 2013 exceeding $250,000 for married couples and $200,000 for single individuals. Thus, maximum long term capital gains rate in 2013 will be 23.8% and maximum rate on dividends will be at 43.4%.

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- 0.9% additional Medicare tax on compensation of more than $200,000 for an individual or $250,000 for married couple, imposed on both wages and self-employment income

### Itemized deduction limitation

- Certain itemized deductions will again have a limitation equal to the lesser of (a) 3% of the adjusted gross income over the "applicable amount" (expected to be approximately $170,000) or (b) 80% of the amount of the itemized deduction otherwise allowable for the taxable year.

### Estate and gift tax rates

- 2012 exemption amount: $5,120,000 per person
- 2013 exemption amount: $1,000,000 per person
- 2012 top rates: Gift tax — 35%; Estate tax — 35%
- 2013 top rates: Gift tax — 55%; Estate tax — 55%

## INCOME TAX PLANNING

In view of the uncertainty as to whether any legislative compromise can be reached prior to year-end, tax planning will be critical during the second half of 2012. While immediate action may not be necessary, a thorough review of your income tax situation for 2012 and 2013 is a must in the near term in order to plan for prudent decision making before year-end.

Common year-end income tax planning decisions:

- Recognize capital gains in 2012 or 2013
- Recognize capital losses in 2012 or 2013
- Potential acceleration of ordinary income in 2012 vs. 2013
- Timing of itemized deductions to maximize taxable benefit
- Convert traditional IRA into a Roth IRA in 2012
- Consider reconfiguring portfolio

The increasing tax rates and Medicare surcharge also may drive investment and income decisions for 2013. With qualified dividend income set to be taxed at a maximum 43.4% rate instead of the current 15%, the allocation of your current investment portfolio may result in a lower after-tax rate of return than a portfolio designed with the consideration of new tax rates (*i.e.*, more allocated to tax-exempt bonds, non-dividend yielding stocks, etc). Coordination between your investment and tax advisors is critical to maximizing after-tax returns if you believe your portfolio may not be currently aligned to account for increased tax exposure.

## ESTATE AND GIFT TAX PLANNING

The current gift and estate tax exemption is $5,120,000 per person, but will revert to $1,000,000 per person in 2013. Without legislative action, the opportunity to transfer wealth tax-free to future generations declines significantly starting on January 1, 2013. Even if there is legislative compromise in the gift and estate area, it is generally expected that the exemption will not remain at its current level. Strategic use of the increased exemption during 2012 can create significant wealth-transfer tax savings and the opportunity for additional wealth accumulation for children and possibly subsequent generations for years to come, free of additional wealth transfer taxes. A gift to a trust can provide more opportunity to leverage your exemption than an outright gift. A gift to a trust also provides creditor protection and can limit or control the access a family member/beneficiary may have to the funds placed in trust.

With the combination of historically low interest rates, large exemption amounts, and in some cases, relatively low asset values, it a good time to consider estate planning strategies where the strategy's success is largely dependent on these factors. Grantor retained annuity trusts, intra-family loans, and the transfer of assets (by sale or gift) to grantor trusts are a few of the opportunities that should be considered.

Many high net worth families have already taken, or will be taking, advantage of this unprecedented opportunity before the end of this year. It is important to begin the planning process now because good plans generally require input from multiple advisors followed by difficult decisions for you. A detailed review of your current balance sheet with your attorney and tax advisors is the best place to start and often leads to a meaningful strategy and successful implementation.

## THE NEXT STEPS

We are now less than six months away from significant tax law changes that are radically different from those in effect since 2001. Strategic income and estate tax planning in the second half of 2012 can result in income tax savings in the short term and substantial estate and gift tax savings in the future. We urge you to consult with your BDO advisor on your specific situation to develop a strategy to minimize your tax exposure and prepare for the changes ahead.