Be prepared: Planning in Uncertain Times

SCS Government Contracting Seminar

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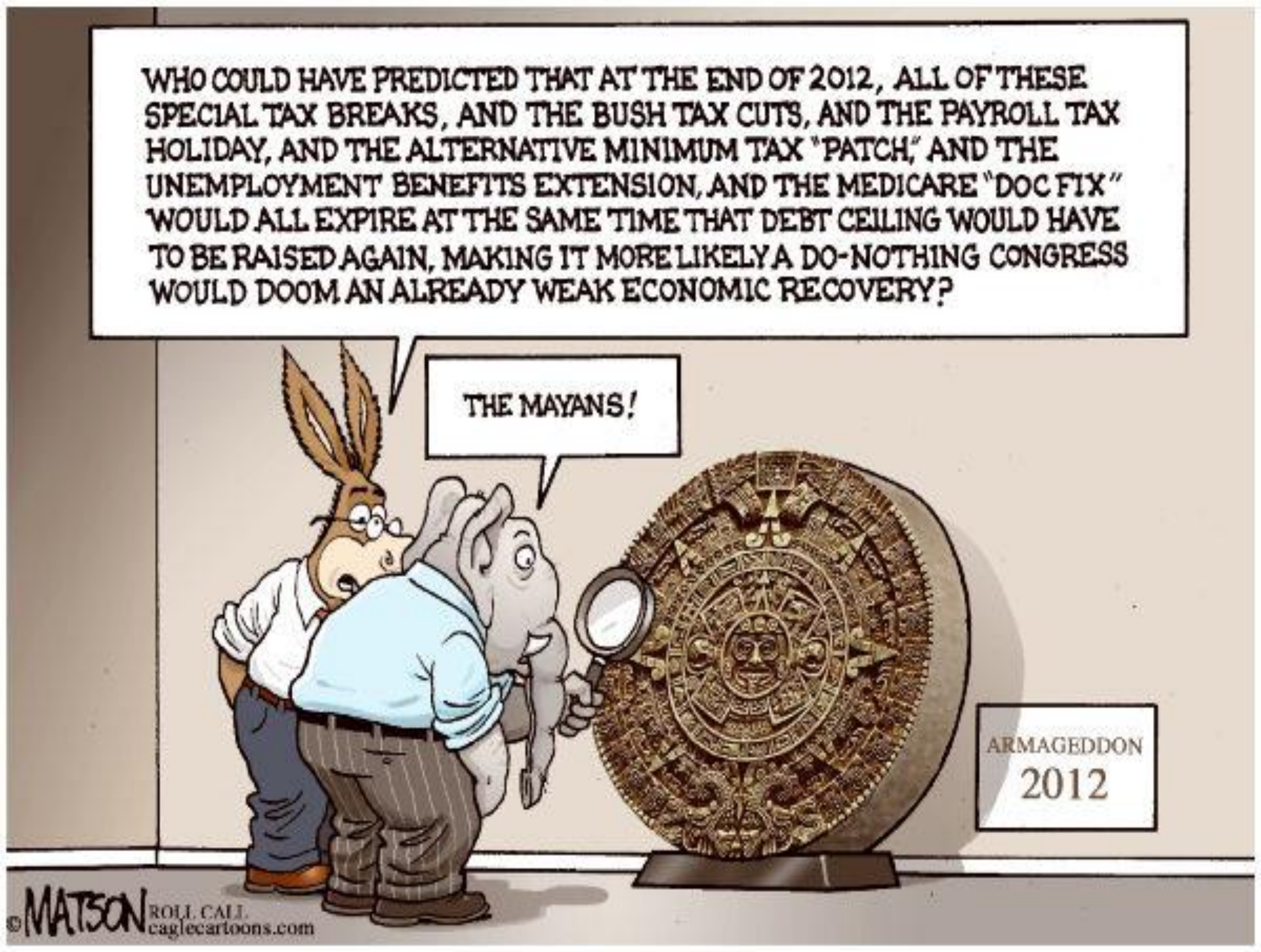
The Perfect Storm!

The largest tax increase in recent memory

coupled with

Mandatory massive spending cuts


WHO COULD HAVE PREDICTED THAT AT THE END OF 2012, ALL OF THESE SPECIAL TAX BREAKS, AND THE BUSH TAX CUTS, AND THE PAYROLL TAX HOLIDAY, AND THE ALTERNATIVE MINIMUM TAX "PATCH," AND THE UNEMPLOYMENT BENEFITS EXTENSION, AND THE MEDICARE "DOC FIX" WOULD ALL EXPIRE AT THE SAME TIME THAT DEBT CEILING WOULD HAVE TO BE RAISED AGAIN, MAKING IT MORE LIKELY A DO-NOTHING CONGRESS WOULD DOOM AN ALREADY WEAK ECONOMIC RECOVERY?
THE MAYANS!
ARMAGEDDON
2012
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The Certainty of Uncertainty

CHANGE: the only CONSTANT in the universe

1. Who will win the Presidential Election?

2. Who will take control of the Senate?

3. Will the Bush tax cuts be extended? Will Obama Care be repealed and the related tax increases?

4. What will happen with the $1 trillion in mandatory spending cuts that will begin in 2013?

5. How will Tennessee's football season pan out?

6. Will the world come to an end in 2012 as the Mayans predicted?

Today's Agenda

- Tax Law Changes

  1. Laws that have already expired
  2. Laws that take effect January 1, 2013
     - Bush Tax Cuts Expire
     - Estate Taxes
     - Bonus Depreciation & Sec. 179
     - Payroll Taxes
     - New 3.8% investment tax on high incomers

- Tax Planning & Strategies

Tax Provisions that Expired Last Year (2011)

Individuals

- Alternative Minimum Tax Patch *(or else additional 34 million taxpayers will pay AMT according to the Congressional Research Service)*
- Sales Tax Deduction
- Write-off for College Tuition and Related Expenses
- Direct, tax-free donation to charity from an IRA (up to $100,000) by taxpayers age 70-1/2 or older

Alternative Minimum Tax

2011 Law

- AMT Exemption:
  - Married/Survivor - $74,450
  - Unmarried - $48,450
  - Married Filing Separate - $37,225

2012 NOW

- AMT Exemption:
  - Married/Survivor - $45,000
  - Unmarried - $33,750
  - Married Filing Separate - $22,500

Tax Provisions that Expired Last Year (2011) – Continued

Businesses

- Research & Development (R&D) Credit
- Credit for Hiring Disadvantaged Workers
- Significantly Reduced Section 179 expense
- Bonus Depreciation is 50% (Reduced from 100%)

LAWS THAT TAKE EFFECT JANUARY 1, 2013

Bush-Era Tax Rates Set to Expire

Individual Income Tax Rates			
2012	**2013**	*Obama proposal*	*Romney proposal*
10%	**15%**	10%	8%
15%	**15%**	15%	12%
25%	**28%**[1]	25%	20%
28%	**31%**	28%	22.40%
33%	**36%**	33% and 36%[2]	26.40%
35%	**39.60%**	39.60%	28%

1. For married filers, this rate would start applying at a significantly lower income level compared to where the 25% rate started to apply in 2012, because of the expiration of a marriage penalty relief provision.

2. Because of the $200,000, $225,000, $250,000 and $125,000 thresholds for tax increases under the Obama proposal, in this bracket only taxpayers exceeding the applicable threshold would see a rate increase to 36% (on the excess until the 39.6% rate applied).

Capital Gains – Current Law and Proposals

Long-Term Capital Gains Rates[1]				
	2012	**2013**	*Obama proposal*	*Romney proposal*
"Higher-income" taxpayers	15%	**20%**	20%[2]	15%[3]
"Middle-income" taxpayers	15%	**20%**	15%	0%
Long-term gain rate for taxpayers in the 10% and 15% ordinary rate brackets	0%	**10%**	0%	0%

1. Different rates apply to certain types of gain, such as gain attributable to certain recapture of prior depreciation on real property, gain on collectibles and gain on qualified small business stock held more than five years.

2. Would apply starting at taxable income of $200,000 (singles), $225,000 (heads of households) and $250,000 (married filing jointly; $125,000 for separate filers).

3. Would apply starting at taxable income of $100,000 (singles), $150,000 (heads of households) and $200,000 (married filing jointly; $100,000 for separate filers).

Qualified Dividends

Income Tax Rates on Qualified Dividends				
	2012	**2013**	*Obama proposal*	*Romney proposal*
"Higher-income" taxpayers	15%	**36% or 39.6%**	36% or 39.6%[2]	15%[3]
"Middle-income" taxpayers	15%	**28% or 31%**	15%	0%
Long-term capital gains for taxpayers in the 10% or 15% ordinary rate brackets	0%	**15%**	0%	0%

1. Dividends would be treated as ordinary income, so they'd be taxed at the taxpayer's marginal rate.

2. Dividends would be treated as ordinary income starting at taxable income of $200,000 (singles), $225,000 (heads of households) and $250,000 (married filing jointly; $125,000 for separate filers).

3. Would apply starting at taxable income of $100,000 (singles), $150,000 (heads of households) and $200,000 (married filing jointly; $100,000 for separate filers).

Bush-Era Tax Cuts

- In 2013, the income-based phase-outs on itemized deductions and personal exemptions for high incomers will be reinstated

- Married taxpayers will once again be hit with the marriage penalty, involving standard deductions and the earned income tax credit.

Estate Tax

Federal

- Current Law (2012)
  - Exemption: $5,120,000
  - Top Tax Rate: 35%

- Next Year (2013)
  - Exemption: $1,000,000
  - Top Tax Rate: 55%

Tennessee

- Current Law (2012)
  - Exemption: $1,000,000
  - Top Tax Rate: 9.5%
  - Gift Tax Repealed retroactive to Jan. 1, 2012

- Next Year (2013)
  - Bills have been passed that will eliminate the inheritance tax over the next four years

Depreciation – Bonus

- Taxpayers can currently expense 50% of the cost of NEW depreciable business assets in the year placed into service
  - Qualified property includes new (original use) assets with a MACRS recovery life of 20 years or less

- No bonus depreciation for 2013

Depreciation – Section 179

- Taxpayers can currently expense certain Section 179 depreciable business assets in the year placed into service
  - Section 179 assets include machinery, equipment, other tangible personal property, and computer software
  - Computer software will no longer be considered a Section 179 asset in 2013

- The maximum allowable expense and the investment ceiling is scheduled to decrease next year

	2012	2013
Maximum allowable expense	$139,000	$25,000
Investment ceiling	560,000	200,000

Example – Dividends and Depreciation

UTK Corporation is a closely held C Corporation owned by the Dooley family. In 2013, the company generates taxable income ***before depreciation*** of $1 million. The company also purchases new equipment in the amount of $1,000,000. Family members working in the business have already been paid a "reasonable salary", and the company wishes to pay out net cash flow as dividends to its owners.

Example – Dividends and Depreciation

(Note: example does not take into account the 3.8% medicare contribution tax on investment income beginning in 2013)

Under 2012 Law

Taxable income before depreciation	$1,000,000
Tax depreciation: (Includes 50% bonus depreciation)	(600,000)
Taxable income	400,000
Federal/state taxes (40%)	160,000
Net distributed as dividend	840,000
Federal Tax to S/H on dividend (15%)	126,000
Tennessee Hall Tax to S/H on dividend (6%)	50,400
Net after-tax cash received	$ 663,600

Under 2013 Law

Taxable income before depreciation	$1,000,000
Tax depreciation: (Regular depreciation - No bonus)	(200,000)
Taxable income	800,000
Federal/state taxes (40%)	320,000
Net distributed as dividend	680,000
Federal Tax on dividend (39.6%) **Assume Top Individual Rate*	269,280
Tennessee Hall Tax on dividend (6%)	40,800
Net after-tax cash received	$ 369,920

PAYROLL TAX CHANGES
for
2013

2012 W-2 Reporting

- Employers who filed 250 or more W-2’s for 2011 must begin reporting the cost of employer-provided health care coverage for 2012 W-2’s.
- They must be prepared to report this information for W-2’s distributed in January 2013.

Payroll Tax Cut Expiring After 2012
Social Security Tax – Employee Portion

Current Law

- Employee's Share of Social Security Tax
  - 4.2%
  - Self-Employed - 10.4%

January 1, 2013

- Employee's Share of Social Security Tax
  - 6.2%
  - Self-Employed - 12.4%

For instance, an individual with taxable wage income of $100,000 will see an immediate tax increase of **$2,000** for 2013.

0.9% Payroll Tax Increase for High Incomers (Employee Portion of Medicare Tax)

- Effective January 1, 2013
- 0.9% additional tax on wages above the thresholds below
- Medicare Tax Rate for wages above the threshold will go from 1.45% to 2.35% (self employed: 2.9% to 3.8%)
- Applies only to <u>EMPLOYEE'S</u> share; the employer is not subject to additional tax

Filing Status	Threshold Amount
Married Filing Jointly	$250,000
Married Filing Separately	$125,000
Single	$200,000
Head of Household	$200,000
Qualifying Widow(er)	$200,000

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Additional 0.9% Payroll Tax - Continued

- Includes ALL wages currently subject to Medicare Tax if they are in excess of threshold

- Employer is responsible for withholding if wages are in excess of $200,000 in a calendar year

  - Begin withholding in the pay period when total wages exceed $200,000
  - Obligated to withhold even though employee may not ultimately be liable
  - Any amount over-withheld will be credited against total tax liability on individual 1040

New 3.8% Tax on Net Investment Income for 2013

(To pay for Obama Care)

- 3.8% Additional Tax on "Net Investment Income"
  - Scheduled to take effect regardless of whether Congress extends the Bush tax cuts.
- For individuals, the tax is computed on the lesser of:
  - Net Investment Income or
  - Modified Adjusted Gross Income minus:
    - $200,000 for Single
    - $250,000 for Married Filing Joint & Surviving Spouse
    - $125,000 for Married Filing Separate

New 3.8% Tax on Net Investment Income - Continued

- What Is "<u>Net Investment Income</u>"
  - Total of the following items less any deductions properly allocable to such income or gain:
    - Interest Income
    - Dividend Income
    - Capital Gains
    - Annuities, Rents, Royalties
    - Passive Activity Income
    - Does not include any income from ordinary course of trade or business (active participation)
  - Subject to Estimated Tax Penalties
- What is "Modified Adjusted Gross Income"?
  - Individual Adjusted Gross Income PLUS tax-free foreign earned income or foreign housing costs

3.8% Medicare Tax Example 1: Married Taxpayers

John and Jane, a married couple who file a joint return, collectively earn $270,000 in wages, and have $80,000 of net investment income, in 2013. Their modified AGI is $350,000. For 2013, the couple will incur a 3.8 percent unearned income Medicare contribution tax on the lesser of their: (1) $80,000 of net investment income, or (2) $100,000 of modified AGI in excess of the $250,000 threshold for married taxpayers filing jointly. Thus, John and Jane will incur a $3,040 (3.8 percent x $80,000) unearned income Medicare contribution tax in 2013.

3.8% Medicare Tax Example 2: Single Taxpayer

In 2013, Rodney, a single taxpayer, receives no wages or self-employment income. He does, however, earn $3.2 million in net investment income from a stock and bond portfolio that is not part of a qualified employee benefit plan. This is the total amount of Rodney's modified AGI for 2013. Rodney will incur a 3.8 percent unearned income Medicare contribution tax on the lesser of his: (1) $3.2 million net investment income, or (2) $3 million modified AGI in excess of the $200,000 threshold amount for a single taxpayer. Thus, Rodney will incur a $114,000 (3.8 percent x 3,000,000) unearned income Medicare contribution tax in 2013.

Strategies: Follow legislative action after the elections and be prepared to act before year end

- Consider realizing LT capital gains in 2012 and deferring capital losses to 2013 and beyond
- Consider accelerating 2013 income into 2012
- Consider electing out of installment sale treatment for 2012 sales
- Consider investing in tax-exempt securities
- Consider making gifts now, while estate tax still has $5 million exemption
- Consider paying dividends before 2013 for closely-held corporations w/sufficient earnings
- Consider Roth conversion in 2012
- Consider increasing income deferrals beginning in 2013 (including retirement plan contributions)
- Consider passive versus active status on investment income

Thank you!

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