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Congress Throws New Tax Curves

by William E. Roberts, CLU, ChFC

Chances are you have been inundated with e-mails, newsletters and articles on the new provisions of the American Taxpayer Relief Act of 2012 ("ATRA") and your first reaction was likely similar to many of our clients - if Congress is selling us on a "Tax Relief Plan"... hold on to your wallet. Well you should! Some of the biggest changes under the new Act include an income tax increase on "high wage earners" (defined as $400,000 of income for single taxpayers and $450,000 for taxpayers filing jointly), the expiration of the payroll tax cut which raises the social security tax by 2%, a capital gains tax increase from 15% to 23.8% for those with incomes of $400,000 and an estate tax increase from 35% to 40%.

These changes have been well documented in news articles, newsletters and other forms of communication. I would like to focus on the "planning implications" of these changes and their impact on you as a successful business owner. I would then suggest you consider meeting with your team of advisors to discuss what changes might be in order.

The biggest negative affect is likely to be felt by the closely held business owner whose business is operated as an S Corporation, LLC or LLP. These entities are all described as "flow-through" entities, because the earnings of the entity flow through to the owners on a pro-rata basis. Those earnings, if they drive income above the $400,000 or the $450,000 threshold, will now be taxed at a 39.6% rate, whether you take the money out of the company or leave it in to fund future growth.

ATRA was sold on the basis of not increasing the tax on American businesses, and in fact the C-Corp maximum rate was left at 35%. However a significant portion of American small businesses are S-Corps, LLC's or LLP's and the owners of those entities are going to experience a 13% increase in their tax bill. Somehow that seems deceitful, which is nothing new when tax law is in play. Some advisors are discussing with owners whether it's worthwhile to change to C-Corp status to reduce the maximum tax rate to 35%. While that might seem to make sense if evaluating from a pure tax viewpoint, advisors are cautioning to look at other advantages of operating as an S-Corp, LLC or LLP before making any changes.

One of these advantages would come into play if the owner intends to sell the company. If a C Corp is sold, and the sale is an asset sale as opposed to a sale of stock, the unrealized gain is first taxed at the C-Corp level and then Capital Gains tax is imposed on the owner. Although the tax rate remains at 35%, C-Corps are still subject to a double layer of taxation. S-Corps, LLC's and LLP's are generally not subject to this result.

The lesson here is to have a thorough analysis completed before making any major changes.

As the estate tax rate was increased from 35% to 40%, the exemption amount allowed for individuals held constant and for 2013 is $5.25M (indexed for inflation). If married, you currently have the ability to protect $10.5M from estate tax. Furthermore, the Act permanently unifies the federal gift and estate tax systems. Said another way, individuals "retained the right" to gift up to $5.25M to their heirs tax- free, something you probably all heard was threatened if Congress did not act to extend it. During 2012, with the future status of the gift tax exemption uncertain, many taxpayers decided to make significant gifts. Some experts expect that gift tax returns filed for 2012 might be double that of prior years. If you did not gift and are still contemplating the wisdom of such a move, now you can take a deep breath and thoughtfully think it through without the threat of a deadline.

While there are a plethora of issues around gifting, that is a subject for another day, but one new wrinkle the new tax law introduces is "narrowing the difference" between the estate tax rate and the maximum capital gains rate.

For taxpayers whose ordinary income exceeds $400,000 ($450,000 for married taxpayers) the maximum capital gains rate is 20%, but the Affordable Care Act (ObamaCare for many of you) adds an additional tax of 3.8%. And for those of you living in states with a state income tax, such as California, this could raise the total tax on capital gains to over 30%. Lifetime gifts retain their basis in the hands of the recipient, while assets passed at death get a step- up in basis to their date of death fair market value. If the asset gifted is a low basis asset, the difference between a 40% estate and a 30%+ capital gains tax appears to make the gifting less attractive, however, like the C-Corp/S-Corp issue there are many tax and non-tax reasons to consider gifting. For example, if the gift is stock in the family held business with no intention of ever selling, the basis issue is a moot point and from a tax standpoint, gifting makes more economic sense as it also removes the growth on the gifted asset from the 40% estate tax.

These are but a few of the new issues to consider in the months ahead. We are still learning the subtleties of this new law and the implications to business owners and their planning. Our firm is happy to answer any questions you might have regarding the new tax law and how it might impact your particular situation. Please feel free to call and schedule a time for a consultation, we welcome the opportunity to share what we have learned with you.

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