

Insights on Income Tax Rates to Soar by 2013

Manage Rising Income Tax Rates

For the past 17 years, most tax rates which includes income tax, have declined or remained fairly constant. This will likely change in the not too far distant future. Planning ahead is key to this changing environment.

Under current legislation, the highest marginal Federal tax rate on net investment income after Dec. 31, 2012, will be 43.4%. This corresponds to 39.6% in ordinary income and 3.8% in medicare tax. State taxes could increase the maximum total tax rate to over 50%.

Strategies for Greater Tax Efficiency

There are various ways to align portfolios for greater tax efficiency. Because dividends and taxable interest will be less attractive than tax-exempt income in future years, shifting to tax-exempt bonds and low dividend stocks by December 31, 2012 can be an option. Placing investments that generate primarily taxable interest and dividends in a tax-deferred or tax-free vehicle is another possibility. Reconsider REITs. In 2013, the dividend rates will move to 39.6%, creating 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. If your tax savings exceed the cost of insurance, considering cash value life insurance as a source of funds could be another tax efficient option.

Under the new tax structures, now is a good time to review wealth management plans. It will help to identify ways to gain optimal benefits. Charitable deductions may become increasingly valuable, if they can offset higher taxes (unless tax laws are changed to limit the tax benefit of itemized deductions). For example, 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, but are taxed as ordinary income. Distributions are also included in the Modified Adjusted Growth Income (MAGI) threshold used to determine "high income taxpayer" 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 combining with grantor trusts for leveraged gifting is another option.

To begin planning for future tax increases in 2013, there are new tax rules and specific strategies that can assist certain types of investors. For business owners, it might make sense to accelerate income into 2011-2012 and to defer certain deductions until 2013. Think about establishing defined benefit pension plans and fund it to the maximum. If a business is sold after 2012, explore an installment sale to smooth income. For corporate executives, consider stock options before 2013. Think about making 83(b) elections on restricted stocks and explore taxable hedging strategies.

Another suggestion is to contribute the maximum allowed to retirement plans. For investors, suggested conversions to Roth should be made before 2013. Possibly consider deferring significant charitable gifts until 2013, unless tax law changes limit the tax benefit on itemized deductions. Before 2013, take profits and generate capital gains.

Highest Income Tax Rates 2011 through 2013
Under Current Legislation

| Federal Income Tax Rates* | 2011-2012 | 2013 | Income Tax Rates for Selected States | 2011 |
|---|------------------|-------------|---|-------------|
| Ordinary Income | 35% | 39.6% | California | 11% |
| Long-term Capital Gain | 15% | 20% | Connecticut | 7% |
| Qualified Dividend | 15% | 39.6% | Delaware (resident only) | 7% |
| | | | Florida | None |
| Medicare Tax on Net Investment Income | | 3.8% | Georgia | 6% |
| Medicare Tax on Wages - Employee | 1.45% | 1.45% | Massachusetts | 5% |
| Medicare Tax on Wages - Employer | 1.45% | 1.45% | Nevada | None |
| Medicare Tax on Wages - Employee (above threshold) | | 0.00% | New Hampshire | 5% |
| Social Security Tax Wages - up to \$106,800 in 2011 | 6.2% | 6.2% | New Jersey | 9% |
| | | | New York | 8% |
| | | | Ohio | 6% |
| | | | Pennsylvania (excludes local) | 3% |
| | | | South Dakota | None |
| | | | Texas | None |
| | | | Vermont | 9% |
| | | | Washington | None |

*"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. ²Hypothetical Effective Federal and State Tax Rate. ³Assuming qualified dividends are subject to Medicare Tax. ⁴Highest rate. ⁵Tax is assessed on the lesser net investment income or the excess of MAGI over the threshold amount. ⁶Based on current legislation threshold amounts: \$200,000 single; \$250,000 married filing jointly. ⁷Highest rate. Source: Tax-Rates.org.

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