Countdown to a Tax Hike

Unless Congress Acts, a Slew of Tax Rates Are Set To Jump on Jan. 1. Here's What You Need to Know

By Laura Saunders

The tax code is in flux—and taxpayers should prepare for a wild ride.

The best advice, experts say: make a few important moves now, and be ready to react quickly in the months ahead.

To recap: At year's end, rates on ordinary income, interest, capital gains, dividends, gifts and estates are set to jump—in some cases sharply. Other tax benefits will lapse as well, affecting all levels of taxpayers. (Please see the tables at left and on Page B10.)

Few observers expect any major tax legislation before the Nov. 6 election. After that, there won't be much time. The House of Representatives has scheduled only 16 working days before its adjournment on Dec. 14. While the Senate has more days in session, "they don't have much incentive to act if the House isn't there," notes Clint Stretch, a lawyer and former executive at Deloitte Tax LLP in Washington.

Experts foresee two possible outcomes. One is that after the election both houses of Congress agree to extend the current rules for up to a year, buying time to make fundamental changes to the tax code while avoiding the economic consequences of huge tax increases.

The other possibility is that the election changes the political equation so much that one party blocks a tax-rate extension, allowing the current rules to expire and pushing tough decisions into 2013.

Lawmakers return in early January, but Mr. Stretch and others believe it could take them several months to reach an agreement and make changes retroactive to the beginning of the year.

In that scenario, most Americans would be affected. Employees could see their take-home pay fall as higher tax rates kick in, for example, while the heirs of people who die will face a much harsher estate-tax regime.

Lawrence Carlton, an accountant in Bedford, Mass., says he is getting more than a dozen calls a week asking what tax rates will be next year: "My clients don't believe me when I say, 'I'm sorry, I just can't tell you.'"

So how should you prepare for the uncertain months ahead? Tax experts surveyed by the Wall Street Journal offered several dos and don'ts:

◆ **Do consider the effect of higher taxes on investment returns next year.** If the current rules expire on Dec. 31, the top tax rate on long-term capital gains will revert to 20% from its current 15%. President Barack Obama has called for a 20% top rate as well.

The stakes for dividends are even higher. Currently, qualified dividends are taxed at the same 15% top rate as long-

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Do

Consider the effect of higher taxes on investments next year

Expect an alternative minimum tax "patch"

Take seriously higher gift-and-estate taxes

Don't

Count on an extension of this year's Social Security tax cut

Rush to lock in investment gains

Withdraw IRA funds if you want to give them directly to a charity

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For the week: **DJIA** 13090.84 ▼ 67.13 0.51% **10-Yr. Treas.** ▲ 1 2/32 yield 1.564% **GOLD** $1684.60 ▲ $14.6

RATE SHOCK

	2012	2013
Top income-tax rate	35%	39.6%
Top rate on long-term capital gains	15	20
Top rate on qualified dividends	15	39.6
Top estate/gift tax rate	35	55
Social Security tax rate‡	4.2	6.2
Medicare tax‡*	1.45	2.35
Investment income tax*	0	3.8

*2013 tax applies to couples with adjusted gross income above $250,000 ($200,000 for singles)

‡Employee's portion

Source: Tax Policy Center

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term capital gains, but if the rules expire they will be taxed as ordinary income, at nominal rates up to 39.6%.

That would be a bitter pill for investors who, fed up with low yields on bonds, have poured money into dividend-paying stocks in recent years.

One thing is for certain: A new 3.8% flat surtax will arrive in January. Enacted in 2010 to help pay for the health-care overhaul, the tax applies to the investment income of most married taxpayers with adjusted gross income of $250,000 or more ($200,000 for singles).

TAX REPORT

There isn't any formal IRS guidance yet, but the tax applies to interest (except from municipal bonds), dividends, rents and royalties, among other things.

The good news is that the tax won't apply to individual retirement account payouts or Social Security income. But such income can swell a taxpayer's adjusted gross income above the $200,000 or $250,000 threshold, making it more likely that at least some investment income is subject to the tax.

For example, say a widow has $40,000 of interest, dividends and capital gains. If she earns $120,000 from taxable pension, Social Security and regular IRA payouts, she wouldn't be subject to the 3.8% tax because her total adjusted gross income is below $200,000.

But if she has $180,000 from the same sources, then she would owe a 3.8% tax on up to $20,000 of her $40,000 investment income because that much is over the limit. (For more details, see "Get Ready for the New Investment Tax," June 30.)

◆ **Don't rush to take all of your capital gains.** The prospect of a top long-term capital gains rate of 18.8% to 23.8% next year (15% to 20% plus the 3.8% surtax) is good reason to wrap up planned sales of large assets such as companies or property before year-end, experts say.

But the same experts caution against panicking and trying to sell every single stock gainer. Doing so would indeed allow you to lock in the current tax rate on capital gains. But that means giving up to 15% of your gains to Uncle Sam. That "leaves less money to grow going forward," says Robert Gordon, a tax strategist who is head of Twenty-First Securities in New York.

The best strategy: sell only those assets you already were planning to sell—but do it before the end of the year.

◆ **Do consider whether to accelerate Roth IRA conversions.** Roth IRAs differ from regular IRAs in that they require taxpayers to contribute after-tax money rather than pretax income—but any capital gains and income thereafter are tax free for qualified withdrawals.

Tax experts like Roth IRA income because it isn't taxable and doesn't raise reported income in a way that triggers tax on Social Security payments or higher Medicare premiums. It also isn't subject to the new 3.8% tax on investment income.

The only problem is that full income taxes are due on conversions of regular IRAs to Roth accounts.

Then again, rates might be higher next year, and the 3.8% surtax could nevertheless sting some higher-earning taxpayers making conversions then.

Here is how: Say a couple has adjusted gross income of $200,000, which includes $20,000 of interest, dividends and capital gains not subject to the 3.8% tax because their adjusted gross income is below $250,000. If they convert as little as $70,000 of IRA assets to Roth IRAs, then the entire $20,000 will be subject to the 3.8% tax because their AGI is now above $250,000.

If this situation applies to you, it might be smart to covert to a Roth IRA now, experts say.

◆ **Don't count on an extension of this year's Social Security tax cut.** Experts say the current two-percentage-point cut in the 6.2% employee's portion of Social Security taxes, in place for two years but expiring on Dec. 31, has little support from either side of the congressional aisle.

"Conservatives are uncomfortable with using the cut as a stimulus, and liberals worry that it undermines the viability of Social Security," Mr. Stretch says.

If the cut isn't renewed, individuals who earn wages above about $110,000 will owe about $2,200 more in 2013.

◆ **Do expect an AMT "patch" for 2012.** There are unknowns for the 2012 tax year as well. The

Other Tax Benefits in Limbo

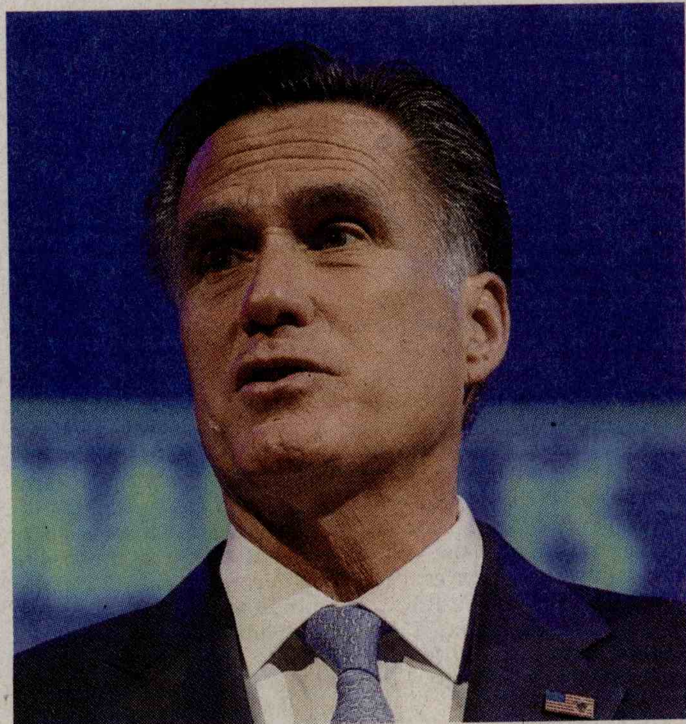
Already expired, but up for renewal:

- Alternative minimum tax adjustment
- Deduction for state and local sales taxes
- IRA charitable donation provision for taxpayers 70 ½ and older
- Educators' classroom expense deduction

Expiring for 2013:

- Temporary Social Security tax cut
- Enhanced dependent-care credit
- Enhanced child credit
- Enhanced adoption credit
- Enhanced earned-income credit
- Repeal of personal exemption phase-out
- Repeal of limit on itemized deductions (Pease)
- Enhanced student-loan-interest deduction
- Enhanced depreciation
- Exemption for mortgage-debt forgiveness

Massive Tax Hike: What to Do



(l-r): Associated Press; European Pressphoto Agency

President Barack Obama and Republican presidential nominee Mitt Romney have starkly different views on taxes and other policy issues.

most important concerns the alternative minimum tax—an add-on levy that was intended to ensure that wealthier households pay tax but now affects a broader swath of people.

The problem: The AMT, enacted in 1969 and updated since, wasn't indexed to inflation, so as each year passes more earners are subject to the tax.

In recent years, Congress has passed "patches" to minimize the damage to middle-class taxpayers.

If Congress failed to enact an AMT adjustment this time, 33 million U.S. taxpayers would owe this levy for 2012 instead of merely 4.4 million, according to the Internal Revenue Service.

Congress's neglect of this and other lapsed provisions is causing nightmares at the IRS. In April, Commissioner Doug Shulman warned that delaying a retroactive fix for 2012 could cause a "real disaster" in the spring tax-filing season, with "some people filing under one law and others under another."

In other words, this problem is so large that something probably will be done, experts say.

◆ **Don't take money from your IRA if you are 70½ or older and want to donate money from it.** Another highly popular provision that expired at the beginning of 2012 allows taxpayers to donate up to $100,000 of IRA proceeds directly to a charity each year. The gift counts as all or part of the mandatory annual IRA payout for people age 70½ or older. While there isn't a deduction, neither does the payout count as income.

The reason to wait: For the donation to count as part of the mandatory payout, the gift must be the first dollars withdrawn from IRA. Many taxpayers were left in the lurch when this provision lapsed for most of 2010. Congress restored it retroactively in December of that year, but taxpayers who already had made withdrawals for personal use couldn't put the money back in and make the donation.

◆ **Do prepare for the possibility of less-generous gift- and estate-tax rates and exemptions after 2012.** These taxes are lower than they have been in recent decades, with a top rate of 35% and an exemption of $5.12 million per individual, or twice that per married couple. Those terms are slated to worsen to a 55% top rate and a $1 million exemption per individual in 2013.

(Note: this exemption is separate from the $13,000 individual exemption that all taxpayers can use to make annual gifts to recipients, which remains unaffected.)

Few experts expect next year's tax rules to stick for long, but the terms could become less generous than they are now. President Obama favors a $3.5 million exemption and a 45% top rate.

Some also would like to shrink to $1 million the portion of the total exemption a taxpayer can use to make gifts while alive. This would leave wealthy families with less ability to transfer appreciating assets long before death.

Under current law, a wealthy individual with $6 million in assets may give away up to $5.12 million while she is alive or leave assets of $5.12 million at death free of tax—or some combination of the two. Assets above that total are subject to tax. If the limit on gifts drops to $1 million, this taxpayer could give away only that amount while alive.

Taxpayers contemplating large gifts this year face other limits, however. It always is hard to give up control of assets, and doing so often requires three to six months of work, notes David Lifson, an accountant with Crowe Horwath in New York: "It's almost too late to start planning this year."