Planning in Case the Tax Cuts Go Away Next Year

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BY MICHAEL COHN

In the aftermath of the elections, the payroll tax cut appears to be one of the likely casualties of the scramble to resolve questions over expiring tax cuts and the looming fiscal cliff during the lame-duck session of Congress.

"There are a few things we can glean from last night," said Paul Dillon, director of tax services at Baker Tilly Virchow Krause, in an interview Wednesday after the election. "Even before knowing the election results, there didn't seem to be any support on either side of the aisle for extending the payroll tax cut. We know that's going to expire at the end of the year."

The composition of Congress is going to change somewhat. “It looks right now like the Democrats have gained a seat, possibly two, in the Senate, but I think there are a couple of undecided races out there,” said Dillon. “President Obama has been re-elected so health care [reform] is going to stand, and the 2.9 percent Medicaid tax is going take effect on the first of the year. Those are straightaway givens.”

“Obviously we still have divided government,” he acknowledged. “I think getting more tax revenue and the rates going up are going to happen just because the tax increase can happen by the current operation of the law. If a compromise can’t be reached, and if the President wants to, he can allow the Bush tax cuts to expire without congressional action, so there’s obviously an increase there. Hopefully that will lead to some kind of compromise, but I think we’ll see rates somewhere between where they are now and where the Bush tax cuts would take them back to.”

One approach for tax planning purposes could be accelerating income into the remainder of this year, Dillon advised.

“If you have capital gains, you want to take advantage of it because the capital gains rate will go up from 15 percent to 20 percent absent any action,” he said. “But on top of that, if you keep the thresholds, you would also be paying the increased Medicare tax on top of that as well of 3.8 percent.”

Dillon acknowledged that this is contrary to the standard advice that many accountants typically have given through the years. “The standard advice has always been to defer, defer, defer, but now I think people are going to look into accelerating income this year.”

Dillon recommends that clients and their accountants try to do a three-year tax projection and make their best estimates. “Any tax planning is hard to do the morning after the election where everybody is either feeling good about their candidate or licking their wounds,” he said. “Over the next week or two as well, we’ll have to see what compromises start to come out of the lame-duck Congress. They are indications they may start tipping their hands about where deals can be made so I think everybody really has to pay attention to the news coming out of Congress over the next two weeks, not the rhetoric over the next three days as to what the lame-duck Congress starts doing over the next three weeks.”

Dillon noted that there are many tax provisions expiring at the end of this year as well as an AMT patch that needs to be put in place. “That’s not the tax increase anybody has been talking about, but they will probably kick the can down the road for three to six months,” he suggested. “That’s one guess.”

Dillon belies it is highly unlikely there will be any comprehensive agreement over the next three weeks that would solve the many vexing tax problems confronting Congress and the Obama administration. “They will probably defer and hold some rather lengthy hearings, I can imagine,” he said. “With the payroll tax cuts, there was a two-month extension so they could take it up in full once they got back in January,” he recalled. “I think you will see something like that either tied to a March deadline or when we’re expected to reach the borrowing limits. An extension of the debt limits may have to be tied to it, and they may possibly push it back to June to give Congress the full six months to work on it."

Estate and gift taxes are another important component, Dillon noted. "This year the lifetime exemption is currently $5 million," he said. "People that are under the limit need to take a serious look at making gifts to the extent they can between now and the end of the year. This is probably a one-time opportunity to make more substantial gifts."

Accountants and estate lawyers will probably be extremely busy helping people with gift planning between now and the end of the year, Dillon predicted. "If you're going to give cash or marketable securities that you own outright, that's easily done quickly if you're inclined to do so," he said. "But if you're trying to get the partnership interest to a family member, for example, that could take some time. You would need an appraisal and possibly need to get the other partners' approval. Depending on the deal, you would need the lenders' approval if the partnership has been borrowing. But you need to be acting as quickly as possible because if you make the decision to make a gift like that on December 20, there just may not be enough time to get it done. You need to look closely at the nature of what you would like to gift and be very mindful of the working days between now and the end of the year."