

# DOOM & GLOOM: IMPENDING TAX LAW CHANGES

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# Why Doom and Gloom?

- There's "a massive fiscal cliff" in our future

*Ben Bernanke, Federal Reserve Chairman*

- Simultaneous onset of
  - \$917 Billion in Mandated Spending Cuts
  - Expiration of the "Bush Tax Cuts" and more than 50 tax breaks
- If tax cuts expire and spending cuts are made, Congressional Budget Office predicts the US could enter another recession
- Extending the tax breaks and cancelling spending cuts are projected to add \$7 trillion to the national debt over the next 10 years
- Source: [www.picpa.org](http://www.picpa.org)

# Political outlook for tax increases

- **Republican position:**

- Extend the Bush tax cuts-pending reform of the tax code;
- Reform the tax code by reducing marginal tax rates by 20 percent across-the-board in a revenue-neutral manner;
- Eliminate the taxes on interest, dividends, and capital gains altogether for lower and middle-income taxpayers;
- End the Estate Tax; and
- Repeal the Alternative Minimum Tax.

- Source: [http://www.gop.com/2012-republican-platform\\_Restoring/#Item3](http://www.gop.com/2012-republican-platform_Restoring/#Item3)

# Political outlook for tax increases

- **President Obama's Position**

- Tax system should be simplified with lower individual and corporate tax rates and fewer brackets.
- Cut tax breaks that are inefficient, cutting tax preferences for high-income households; eliminating special tax breaks for oil and gas companies; closing loopholes for investment fund managers; and eliminating benefits for corporate jet owners.
- Cut the deficit by \$1.5 trillion over the next decade through tax reform, including the expiration of tax cuts for single taxpayers making over \$200,000 and married couples making over \$250,000.
- Buffett Rule No household making over \$1 million annually should pay a smaller share of their total income in taxes than middle-class families.
- Source: <http://www.whitehouse.gov/issues/taxes>

# Overlapping goals

- Tax Simplification
- Tax cuts and or no increases for “middle class” families.
  - Married taxpayers with income under \$250,000
- Reduction of tax benefits to the “rich”
  - “Lower the rates and broaden the base”
    - Mortgage interest
    - Charitable contributions
    - State & local income taxes
    - Real estate taxes
    - Etc.
- Deficit Reduction

# Negotiations – Washington Post 11/14/12

- President Obama is taking a hard line with congressional Republicans heading into negotiations over the year-end [“fiscal cliff,”](#) making no opening concessions and calling for far more in new taxes than Republicans have so far been willing to consider.
- “I don’t see how you do this without higher rates. I don’t think there’s any feasible, realistic way to do it,” Timothy Geithner (Sec. of Treas.) said at a conference in Washington. “When you take a cold, hard look at the amount of resources you can raise from that top 2 percent of Americans through limiting deductions, you will find yourself disappointed relative to the magnitude of the revenue increases that we need.”
- Jay Carney (White house press secretary) suggested that even the revenue generated by letting those (Bush) tax cuts end would not be enough to tame the national debt and reenergize the economy.

# What is the “Fair Share”



Percentage of Adjusted Gross Income (AGI) earned and Taxes paid by each group.

|      | <u>Top 1% Income Earners</u> |                              |                     | <u>Top 5% Income Earners</u> |                              |                     |
|------|------------------------------|------------------------------|---------------------|------------------------------|------------------------------|---------------------|
|      | <u>Breakpoint</u>            | <u>Share of Income (AGI)</u> | <u>Share of tax</u> | <u>Breakpoint</u>            | <u>Share of Income (AGI)</u> | <u>Share of tax</u> |
| 1980 | \$ 80,580                    | 8.5%                         | 19.1%               | \$ 43,792                    | 21.0%                        | 36.8%               |
| 1990 | \$ 167,421                   | 14.0%                        | 25.1%               | \$ 79,064                    | 27.6%                        | 43.6%               |
| 2000 | \$ 313,469                   | 20.8%                        | 37.4%               | \$ 128,336                   | 35.3%                        | 56.5%               |
| 2009 | \$ 343,927                   | 16.9%                        | 36.7%               | \$ 154,643                   | 31.7%                        | 58.7%               |

Source: Tax Foundation Fiscal Facts No. 285

<http://taxfoundation.org/article/summary-latest-federal-individual-income-tax-data-0>

# Average tax rates

- Percentage of Adjusted Gross Income paid in income taxes

|      | <u>Top 1%</u> | <u>Top 5%</u> | <u>Between<br/>5% &amp; 10%</u> | <u>Between<br/>10% &amp; 25%</u> | <u>Between<br/>25% &amp; 50%</u> | <u>Bottom 50%</u> |
|------|---------------|---------------|---------------------------------|----------------------------------|----------------------------------|-------------------|
| 1980 | 34.5%         | 26.9%         | 17.1%                           | 14.8%                            | 11.9%                            | 6.1%              |
| 1990 | 23.3%         | 20.5%         | 13.6%                           | 12.0%                            | 9.7%                             | 5.0%              |
| 2000 | 27.5%         | 24.4%         | 15.5%                           | 12.0%                            | 9.3%                             | 4.6%              |
| 2009 | 24.0%         | 20.5%         | 11.4%                           | 8.3%                             | 5.6%                             | 1.9%              |

Source: Tax Foundation Fiscal Facts No. 285

<http://taxfoundation.org/article/summary-latest-federal-individual-income-tax-data-0>

# The National Deficit and Debt

- 2012 Deficit \$1.089 trillion
  - 2013 likely the 5<sup>th</sup> straight annual deficit in excess of \$1 trillion
- National Debt \$16.1 Trillion as of September 2012
- Present value of unfunded liabilities in 2009
  - Off-Balance Sheet Financing \$45.8 Trillion
    - Approx \$7.7 trillion relates to Social Security
    - Approx \$38.2 trillion relates to Medicare

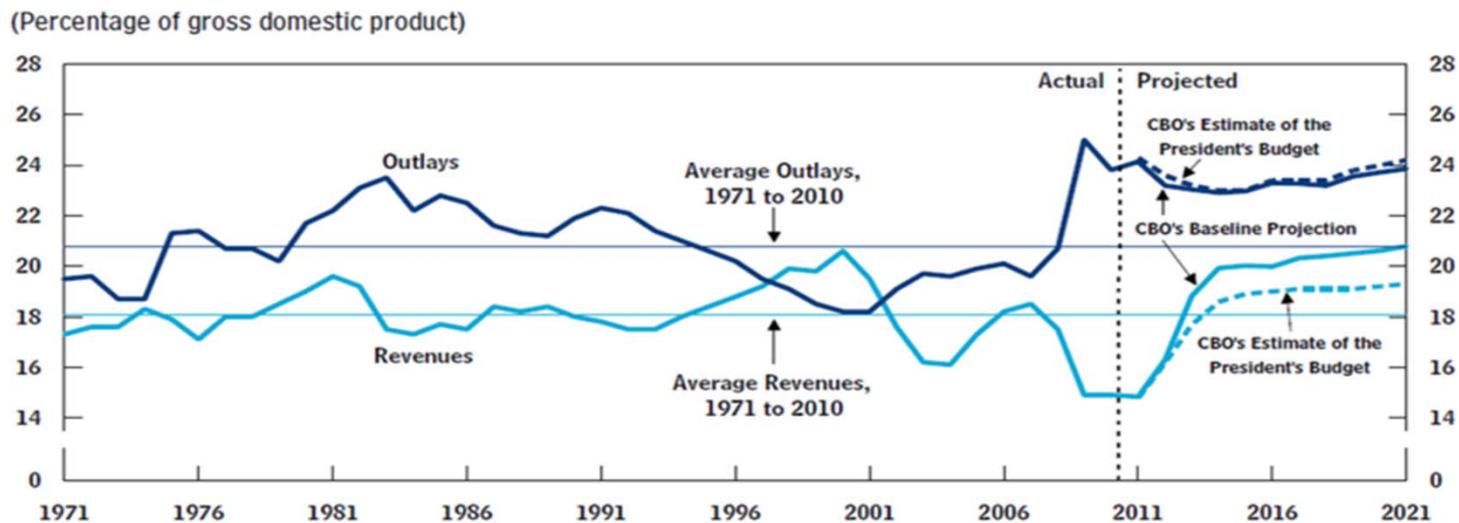
- Source: Peter G. Peterson Foundation (April 2010). "[Citizen's guide 2010: Figure 10](#)", p. 30. Peter G. Peterson Foundation [website]. Retrieved February 5, 2011.

# The National Deficit and Debt

|                  | <u>Total</u>         | <u>Indiv. Income tax<br/>provides 42% of<br/>Federal Income</u> | <u>Top 1% share<br/>36.7% of Tax</u> | <u>Top 5% share<br/>58.7% of tax</u> |
|------------------|----------------------|---|--------------------------------------|--------------------------------------|
| Deficit          | \$1,089,000,000,000  | \$457,380,000,000   | \$167,995,674,000                    | \$268,299,108,000                    |
| Debt             | \$16,100,000,000,000 | \$6,762,000,000,000   | \$2,483,682,600,000                  | \$6,609,855,000,000                  |
| # of Taxpayers   |                      | 137,982,203   | 1,379,822                            | 6,899,110                            |
| Share of Deficit |                      | \$3,315   | \$121,752                            | \$38,889                             |
| Share of Debt    |                      | \$49,006  | \$1,800,002                          | \$958,074                            |
| Average income   |                      | \$56,713  | \$959,959                            | \$359,828                            |

# Debt and Deficit Outlook

CBO – Revenues and Outlays as % GDP



Source: CBO – Analysis of the President's Budgetary Proposals for 2012

# Looming tax increases

- Increased Rates
  - Expiration of “Bush tax cuts” effective 1/1/2013
- Expiring Tax Breaks
  - Deductions, Credits, etc. effective 1/1/2012 and 1/1/2013
- New Medicare Tax
  - Applies to investment income and earnings (at different rates) effective 1/1/2013
- Alternative Minimum Tax
  - Still no “patch” for 2012 effective 1/1/2012
- Expiring Business deductions and credits

# Increasing Rates

| <u>Taxable Income over</u> | <b>Married Filing Joint Filing Status</b> |                                   |                                   |
|----------------------------|---|-----------------------------------|-----------------------------------|
|                            | <u>2012 Top Rate</u>                      | <u>2013 EGTRRA sunset applies</u> | <u>President Obama's proposal</u> |
| \$0                        | 10%                                       | 15%                               | 10%                               |
| \$17,400                   | 15%                                       |                                   |                                   |
| \$17,800                   |   |                                   | 15%                               |
| \$60,550                   |   | 28%                               |                                   |
| \$70,700                   | 25%                                       |                                   |                                   |
| \$72,300                   |   |                                   | 25%                               |
| \$142,700                  | 28%                                       |                                   |                                   |
| \$145,900                  |   |                                   | 28%                               |
| \$146,400                  |   | 31%                               |                                   |
| \$217,450                  | 33%                                       |                                   |                                   |
| \$222,300                  |   |                                   | 33%                               |
| \$223,050                  |   | 36%                               |                                   |
| \$246,200                  |   |                                   | 36%                               |
| \$388,350                  | 35%                                       |                                   |                                   |
| \$397,000                  |   |                                   | 39.6%                             |
| \$398,350                  |   | 39.6%                             |                                   |

# Expiring Individual Tax Breaks 12/31/12

- Temporary payroll tax cut expires
- Long term capital gains – maximum rate changes from 15% to 20%. All dividends taxed at ordinary income rates
- Reduction in itemized deductions reappears for higher income taxpayers
- Phase-out of personal exemptions reinstated for higher income tax payers
- Refundable credit for unused AMT credit comes to an end
- Child credit – maximum drops from \$1,000 to \$500
- Expanded Hope credit for qualified tuition and related expenses reduced

# Expiring Individual Tax Breaks (Con't)

- Marriage Penalty Reduction – higher taxes for those filing jointly
- Earned Income Tax Credit changes. Stricter requirements for eligibility
- In 2013 – Deductible medical expenses must exceed a 10% AGI floor for those under 65. Presently the floor is 7.5%.

# New Medicare Tax

Beginning January 1, 2013:

- Additional .9% Medicare payroll tax
  - Applies to singles earning >\$200,000 and married couples earning >\$250,000
- 3.8% Medicare tax on net investment income
  - Applies to interest, dividends, annuities, royalties, rents and other gross income attributable to a passive activity, including capital gain
  - Does not apply to nontaxable income, distributions from annuities or retirement accounts
  - Applies to net investment income of single taxpayers with AGI >\$200,000 and joint filers >\$250,000

# Alternative Minimum Tax

- Currently no “patch” for 2012
- Exemption falls from \$74,450 to \$45,000 for joint filers and from \$48,450 to \$33,750 for single filers
- Ability to use nonrefundable credits to offset AMT is no longer allowed.
- If no “patch” is enacted, many more taxpayers will fall into the AMT “trap”.

# Expiring Business Deductions & Credits

- 1/1/12 – maximum amount that can be expensed under Code Sec. 179 reduced from \$500,000 to \$139,000
- 1/1/13 – maximum amount expensed under 179 is \$25,000
- 1/1/12 - 100% bonus first-year depreciation allowance for qualified property no longer allowed (50% is allowed)
- 1/1/12 - Research & Development credit expires
- 1/1/12 - Work opportunity tax credit (WOTC) for non-veterans expires
- Various energy credits available to businesses no longer in effect

# How Does It Add Up

| <b>Income</b>              | <b><u>2011</u></b> | <b><u>2012</u></b> | <b><u>2013</u></b> |
|----------------------------|--------------------|--------------------|--------------------|
| Wife - Self Employment     | 150,000            | 150,000            | 150,000            |
| Husband - Salary           | 150,000            | 150,000            | 150,000            |
| Long-Term Cap Gain         | 50,000             | 50,000             | 50,000             |
| Interest & Dividend        | 1,000              | 1,000              | 1,000              |
| <b>Total Income</b>        | <b>351,000</b>     | <b>351,000</b>     | <b>351,000</b>     |
| Adjustments                | 8,629              | 8,835              | 9,058              |
| Itemized Deductions        | 53,000             | 53,000             | <b>48,086</b>      |
| Exemptions                 | 14,800             | 15,200             | <b>6,240</b>       |
| <b>Taxable Income</b>      | <b>274,571</b>     | <b>273,965</b>     | <b>287,616</b>     |
| Regular Tax                | 67,973             | 67,225             | <b>80,126</b>      |
| Alternative Min. Tax       | 6,335              | <b>15,257</b>      | 2,343              |
| Self Employment Tax        | 15,124             | 15,498             | <b>18,116</b>      |
| Medicare                   | -                  | -                  | <b>2,285</b>       |
| <b>Total Tax Liability</b> | <b>89,432</b>      | <b>97,980</b>      | <b>102,870</b>     |

## Potential Year-End Planning Moves for Individuals

- Sell long-term capital gain property to take advantage of current 15% capital gain rate.
- Consider a Roth conversion – take advantage of current low tax rates. (This is a tax planning strategy.)
- If under age 65, accelerate deductible medical expenses into 2012 while the 7.5% AGI floor is still available. “Stack” deductions
- Avoid generating taxable income subject to the 3.8% Medicare surtax – Watch potential change to taxation of Municipal Interest
- Accelerate charitable giving
- Accelerate income and defer deductions
- Pay down Mortgage Debts (longer term, not year-end specific)

## Potential Year-End Planning Moves for Businesses

- Consider putting new business equipment and machinery in service before year-end to qualify for the 50% bonus first-year depreciation allowance.
- Consider making expenses qualifying for the business property expensing option. The maximum amount you can expense for a tax year beginning in 2012 is \$139,000 of the cost of qualifying property placed in service for that tax year.
- For both items above, consider cash flows and tax rates. Time value of money may trump higher rates.
- If you are thinking of adding to payroll, consider hiring a qualifying veteran before year-end to qualify for a work opportunity tax credit (WOTC).

# Potential Year-End Planning Moves for Businesses (Con't)

- Acceleration of income, deferral of deductions
  - Long term deferral vs. short term
- Structuring income to avoid Self-Employment tax
- Consider activity groupings to avoid passive income subject to 3.8% Medicare tax
- Consider paying out C Corporation dividends

# The Required Disclosure...

- Every individual and business is different. These ideas are general and may or may not apply to your specific situation, consult your tax advisor before taking any actions.
- The information presented herein, unless otherwise cited is the opinion of the presenter.
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