

Tax insights



With the Bush tax relief set to expire at year-end, now is the time to plan for potential tax increases

Regardless of what emerges from the legislative process this year, tax rates are likely to climb in 2011 and beyond. The rate increases could have significant tax planning implications for businesses and high-income individuals. Companies and individuals should be thinking about potential tax scenarios now and plan accordingly. Analyzing their specific circumstances will help both corporate and individual taxpayers determine their best course of action to prepare for the potential tax changes.

Unless Congress acts, the 2001 and 2003 tax relief will expire at the end of this year. The Obama administration has indicated its support to extend the tax relief for low- and middle-income taxpayers, but not for those with incomes above \$250,000 for joint filers, and \$200,000 for individuals. This means now is the time for high-income individuals – and various types of businesses – to plan for higher rates in 2011.

Absent congressional action, here is what will happen:

- ▶ The two highest marginal rates will rise to 36% and 39.6% from 33% and 35%, respectively.
- ▶ The tax rate on qualified dividends will rise from 15% to a maximum rate of 39.6%.

- ▶ The maximum rate on long-term capital gains will rise from 15% to 20%.
- ▶ The estate tax will be restored, with a \$1 million exemption and a 55% top rate.
- ▶ Limitations on itemized deductions and personal exemptions will be reinstated for high-income individuals.

Also, under recently enacted health care reform legislation, high-income individuals, beginning in 2013, will be subject to an additional Medicare tax of:

- ▶ 0.9% on wages (on amounts over the \$250,000/\$200,000 thresholds), and
- ▶ 3.8% on the lesser of net investment income (e.g., interest, dividends, capital gains and certain types of business income) or the amount of modified adjusted gross income over the \$250,000/\$200,000 thresholds.

Business considerations

For businesses whose shareholders, executives and employees might be affected by these tax changes, there are corporate tax planning considerations regarding a company's dividend policy and executive compensation.

For public companies, evaluating dividend policies is a first step in planning for the possible rate changes. For those companies with strong balance sheets, this may be a good time to think about accelerating (or raising the amount of) dividend distributions to shareholders in 2010. Public companies might also explore stock distributions or spin-offs, which can significantly alter a company's earnings and profits profile.

If dividend tax rates increase from 15% to 39.6% for individuals, a stock buy-back plan can be a tax-efficient alternative to making ordinary dividend distributions. Stock buy-backs or redemptions may be accomplished in a manner that results in potential capital gain treatment for the shareholder.

When structuring a stock buy-back program, companies should take into account the manner in which the stock will be repurchased and should consult their tax advisors for guidance.

Closely held C corporations, however, may wish to consider a different approach. Stock buy-back plans often do not provide a tax benefit to shareholders of closely held C corporations. Shareholders of these companies will likely be better served by accelerating dividends into 2010 to take advantage of 15% dividend rates. If cash is not available, the distribution of a note to shareholders can be considered. If a note is distributed, the fair market value of the note will be considered a dividend in 2010, thereby capturing the low dividend rate for individual shareholders. Of course, the shareholders will need to receive a sufficient amount of cash in the distribution to pay their income taxes.

S corporations with accumulated E&P from prior years as a C corporation may want to consider accelerating a distribution of C corporation earnings and profits into 2010. Whether that action makes sense for S corporation shareholders depends on a number of different factors. Taxpayers should consult their tax advisors for guidance.

All business entities may wish to weigh changes to executive compensation, such as accelerating the payment of bonuses and deferred compensation into 2010. It should be noted, however, that options for accelerating deferred compensation are limited by the Internal Revenue Code and increasing governance-related scrutiny in this area. In addition, the IRS and the SEC have both increased their focus on executive compensation, making changes to compensation increasingly a board-level discussion. Because the rules governing deferred compensation are complex, and the penalties for violating those rules are significant, a comprehensive analysis is necessary before undertaking any changes to compensation structures.

High-income individuals

Enacted and pending tax law changes may have a profound impact on high-income individuals. These taxpayers face an increase in the top income tax rate, a higher tax rate on qualified dividends, an increase in the capital gains rate and a new Medicare tax on net investment income. The magnitude of the tax effect and where it will hit hardest will depend largely on the level and composition of the taxpayer's income, and on whether the taxpayer is paying the alternative minimum tax (AMT). Taxpayers who pay the AMT may find that the change in the effective rate on dividends and capital gains may have a more significant effect than the increase in the top marginal rates.

Potential tax rate increases at a glance

Description	Current rates	Scheduled rates for 2011	Obama FY2011 budget
Individual income tax rates	10%; 25%; 28%; 33%; 35%	15%; 28%; 31%; 36%; 39.6%	36% and 39.6% top rate for high-income filers*
		Reinstate personal exemption phase-out (PEP) and Pease limitation on itemized deductions	Itemized deductions capped at 28% on high-income filers; reinstate PEP and Pease limitation for those taxpayers
Qualified dividends	0%; 15%	Individual income tax rate, with top rate of 39.6%	20% for high-income filers
Long-term capital gains	0%; 15%	20%	20% for high-income filers
Estate tax	0	55% top rate; \$1 million exemption	45% top rate; \$3.5 million exemption

*High-income filers are generally defined as taxpayers with income more than \$250,000 for joint filers, and \$200,000 for individuals. The Obama Administration would retain the current tax rates for lower- and middle-income individuals, and set the estate tax at 2009 levels.



To plan for rising tax rates, higher-income individuals should review their portfolio allocations now. If the 2001/2003 tax relief is allowed to expire, accelerating capital gains so they are taxed at the 15% rate this year instead of at a potential 20% rate next year could be advantageous. Conversely, deferring the recognition of capital losses until 2011 to offset future gains that would be taxed at a higher rate may make sense. A \$3,000 limitation on the use of capital losses applies if the taxpayer does not have any offsetting capital gains, so if losses are deferred they will not provide a significant benefit unless there are gains to offset.

Deferring itemized deductions, such as charitable contributions, to 2011 could similarly offset a portion of the higher tax expected next year. But taxpayers thinking about deferring itemized deductions should also consider the 3% phaseout on itemized deductions scheduled to be reinstated starting in 2011, and the potential applicability of the AMT, which may limit, or even eliminate, the tax benefit from claiming certain types of itemized deductions. In addition, President Obama's FY2011 budget proposal would cap the tax value of itemized deductions at 28% for taxpayers in the 36% and 39.6% brackets. If this proposal is enacted, affected taxpayers should evaluate accelerating deductions into 2010. In light of the potential for legislative changes throughout the year, and the alternative strategies available, taxpayers should work with their advisors to model out the various scenarios before deciding on a course of action.

Other strategies for individuals might include a shift from taxable to tax-exempt investments, although taxpayers should analyze whether the benefit of the lower tax would outweigh potentially lower returns from the tax-exempt investment. Individuals might also explore adjusting their taxable and tax-deferred investment portfolios to take into account the likely increase in the tax rate on dividends. Executives and board members will want to look into accelerating the exercise of stock options and reconsider their deferred compensation elections, as deferred compensation might seem less attractive in a longer-term high-tax environment.

Now is a good time for investors with traditional IRAs to consider the possibility of converting to a Roth IRA and paying the tax on the conversion in 2010, while tax rates are lower than they are likely to be in the future. Also, in light of the scheduled reinstatement of the estate tax, taxpayers should revisit their estate plans, focusing on the tax characteristics and distribution plan for their assets.

Choice of entity

The anticipated increases to federal individual income tax rates mean that for the first time in many years, the highest marginal individual rate will likely exceed the highest marginal federal corporate rate. This rate disparity means that some S corporations and other partnerships may want to consider a conversion to C corporation status.

A reduction in corporate tax rates in the future, as has been suggested as a means to increase US competitiveness, would further affect the analysis on S status versus C status. A straight rate-to-rate comparison, however, is not a complete evaluation. A number of factors must be considered, including the level and components of taxable income, policies on earnings distribution, the shareholders' eventual exit strategy, likely future tax rates, and various limitations that may apply to S and C corporations regarding certain deduction items. Undoing a change in status can be very costly in the long term, and therefore a thorough numerical analysis should precede such a conversion.

With the forthcoming Medicare tax increase on unearned income, S corporations should examine their shareholders' level of participation and determine whether modifying that level of activity, or regrouping the corporation's activities, could lessen the impact of the new Medicare tax.

One size does not fit all

Next year's likely increase in tax rates may require a rethinking and change in tax strategies. Faced with the potential for higher taxes, companies will have to make important decisions that could have implications for their shareholders, executives and employees, while individual taxpayers may wish to rethink their short-term and long-term financial strategies.

In advance of these changes, businesses and individuals should take a close look now at their specific financial circumstances and model out the various scenarios to determine the most appropriate course of action.

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