# Be prepared: Planning in Uncertain Times

SCS Government Contracting Seminar

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# The Perfect Storm!

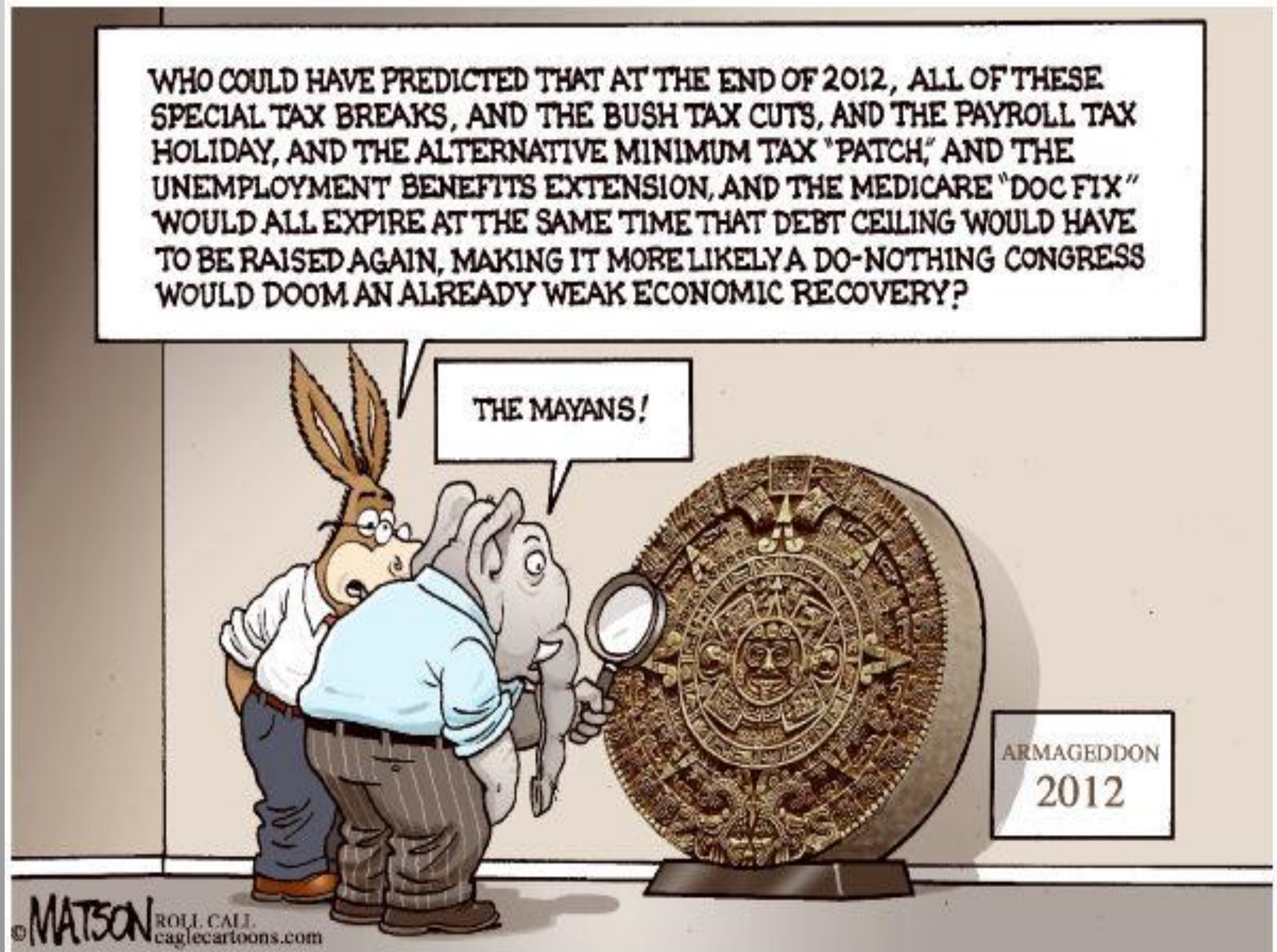
The largest tax increase in recent memory

coupled with

Mandatory massive spending cuts

AND

Health Care Reform


WHO COULD HAVE PREDICTED THAT AT THE END OF 2012, ALL OF THESE SPECIAL TAX BREAKS, AND THE BUSH TAX CUTS, AND THE PAYROLL TAX HOLIDAY, AND THE ALTERNATIVE MINIMUM TAX "PATCH," AND THE UNEMPLOYMENT BENEFITS EXTENSION, AND THE MEDICARE "DOC FIX" WOULD ALL EXPIRE AT THE SAME TIME THAT DEBT CEILING WOULD HAVE TO BE RAISED AGAIN, MAKING IT MORE LIKELY A DO-NOTHING CONGRESS WOULD DOOM AN ALREADY WEAK ECONOMIC RECOVERY?
THE MAYANS!
ARMAGEDDON
2012
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# The Certainty of Uncertainty

## CHANGE: the only CONSTANT in the universe

1. Who will win the Presidential Election?

2. Who will take control of the Senate?

3. Will the Bush tax cuts be extended? Will Obama Care be repealed and the related tax increases?

4. What will happen with the $1 trillion in mandatory spending cuts that will begin in 2013?

5. Will the world come to an end in 2012 as the Mayans predicted?

# Today's Agenda

- Tax Law Changes

  1. Laws that have already expired
  2. Laws that take effect January 1, 2013
     - Bush Tax Cuts Expire
     - Estate Taxes
     - Bonus Depreciation & Sec. 179
     - Payroll Taxes
     - New 3.8% investment tax on high incomers

- Health Care Reform Basics

# Tax Provisions that Expired Last Year (2011)

Individuals

- Alternative Minimum Tax Patch *(or else additional 34 million taxpayers will pay AMT according to the Congressional Research Service)*
- Sales Tax Deduction
- Write-off for College Tuition and Related Expenses
- Direct, tax-free donation to charity from an IRA (up to $100,000) by taxpayers age 70-1/2 or older

# Alternative Minimum Tax

**<u>2011</u>**

- AMT Exemption for MFJ:

**$74,450**

**<u>2012</u>**

- AMT Exemption for MFJ:

**$45,000**

# Tax Provisions that Expired Last Year (2011) – Continued

Businesses

- Research & Development (R&D) Credit
- Credit for Hiring Disadvantaged Workers
- Significantly Reduced Section 179 expense
- Bonus Depreciation is 50% (Reduced from 100%)

# LAWS THAT TAKE EFFECT JANUARY 1, 2013

# Bush-Era Tax Rates Set to Expire

| Individual Income Tax Rates | | | |
|---|---|---|---|
| 2012 | **2013** | *Obama proposal* | *Romney proposal* |
| 10% | **15%** | 10% | 8% |
| 15% | **15%** | 15% | 12% |
| 25% | **28%**[1] | 25% | 20% |
| 28% | **31%** | 28% | 22.40% |
| 33% | **36%** | 33% and 36%[2] | 26.40% |
| 35% | **39.60%** | 39.60% | 28% |

1. For married filers, this rate would start applying at a significantly lower income level compared to where the 25% rate started to apply in 2012, because of the expiration of a marriage penalty relief provision.

2. Because of the $200,000, $225,000, $250,000 and $125,000 thresholds for tax increases under the Obama proposal, in this bracket only taxpayers exceeding the applicable threshold would see a rate increase to 36% (on the excess until the 39.6% rate applied).

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# Capital Gains – Current Law and Proposals

| Long-Term Capital Gains Rates[1] | | | | |
|---|---|---|---|---|
| | 2012 | **2013** | *Obama proposal* | *Romney proposal* |
| "Higher-income" taxpayers | 15% | **20%** | 20%[2] | 15%[3] |
| "Middle-income" taxpayers | 15% | **20%** | 15% | 0% |
| Long-term gain rate for taxpayers in the 10% and 15% ordinary rate brackets | 0% | **10%** | 0% | 0% |

1. Different rates apply to certain types of gain, such as gain attributable to certain recapture of prior depreciation on real property, gain on collectibles and gain on qualified small business stock held more than five years.

2. Would apply starting at taxable income of $200,000 (singles), $225,000 (heads of households) and $250,000 (married filing jointly; $125,000 for separate filers).

3. Would apply starting at taxable income of $100,000 (singles), $150,000 (heads of households) and $200,000 (married filing jointly; $100,000 for separate filers).

# Qualified Dividends

| Income Tax Rates on Qualified Dividends | | | | |
|---|---|---|---|---|
| | 2012 | **2013** | *Obama proposal* | *Romney proposal* |
| "Higher-income" taxpayers | 15% | **36% or 39.6%** | 36% or 39.6%[2] | 15%[3] |
| "Middle-income" taxpayers | 15% | **28% or 31%** | 15% | 0% |
| Long-term capital gains for taxpayers in the 10% or 15% ordinary rate brackets | 0% | **15%** | 0% | 0% |

1. Dividends would be treated as ordinary income, so they'd be taxed at the taxpayer's marginal rate.

2. Dividends would be treated as ordinary income starting at taxable income of $200,000 (singles), $225,000 (heads of households) and $250,000 (married filing jointly; $125,000 for separate filers).

3. Would apply starting at taxable income of $100,000 (singles), $150,000 (heads of households) and $200,000 (married filing jointly; $100,000 for separate filers).

# Bush-Era Tax Cuts

- In 2013, the income-based phase-outs on itemized deductions and personal exemptions for high incomers will be reinstated
- Married taxpayers will once again be hit with the marriage penalty, involving standard deductions and the earned income tax credit.

# Estate Tax

## Current Law

| | |
|---|---|
| Exemption: | $5,120,000 |
| Top Tax Rate: | 35% |

## Next Year - 2013

| | |
|---|---|
| Exemption: | $1,000,000 |
| Top Tax Rate: | 55% |

# Depreciation – Bonus

- Taxpayers can currently expense 50% of the cost of NEW depreciable business assets in the year placed into service

  *Qualified property includes new (original use) assets with a MACRS recovery life of 20 years or less*

- No bonus depreciation for 2013

# Depreciation – Section 179

- Taxpayers can currently expense certain Section 179 depreciable business assets in the year placed into service
  - *Section 179 assets include machinery, equipment, other tangible personal property, and computer software*
  - *Computer software will no longer be considered a Section 179 asset in 2013*

- The maximum allowable expense and the investment ceiling is scheduled to decrease next year

| | 2012 | 2013 |
|---|---|---|
| Maximum allowable expense | $139,000 | $25,000 |
| Investment ceiling | 560,000 | 200,000 |

# Example – Dividends and Depreciation

UTK Corporation is a closely held “C” Corporation owned by the Dooley family. In 2013, the company generates taxable income ***before depreciation*** of $1 million. The company also purchases new equipment in the amount of $1,000,000. Family members working in the business have already been paid a “reasonable salary”, and the company wishes to pay out net cash flow as dividends to its owners.

# Example – Dividends and Depreciation

*(Note: example does not take into account the 3.8% medicare contribution tax on investment income beginning in 2013)*

**Under 2012 Law**

| | |
|---|---|
| Taxable income before depreciation | $1,000,000 |
| Tax depreciation: (Includes 50% bonus depreciation) | (600,000) |
| Taxable income | 400,000 |
| Federal/state taxes (40%) | 160,000 |
| Net distributed as dividend | 840,000 |
| Federal Tax to S/H on dividend (15%) | 126,000 |
| Tennessee Hall Tax to S/H on dividend (6%) | 50,400 |
| Net after-tax cash received | $ 663,600 |

**Under 2013 Law**

| | |
|---|---|
| Taxable income before depreciation | $1,000,000 |
| Tax depreciation: (Regular depreciation - No bonus) | (200,000) |
| Taxable income | 800,000 |
| Federal/state taxes (40%) | 320,000 |
| Net distributed as dividend | 680,000 |
| Federal Tax on dividend (39.6%) **Assume Top Individual Rate* | 269,280 |
| Tennessee Hall Tax on dividend (6%) | 40,800 |
| Net after-tax cash received | $ 369,920 |

# PAYROLL TAX CHANGES
# for
# 2013

# Payroll Tax Cut Expiring After 2012
# Social Security Tax – Employee Portion

**Current Law**

- SS Wage Base: $110,100
- Employee's Share of Social Security Tax
  - 4.2%
  - Self-Employed - 10.4%

**January 1, 2013**

- SS Wage Base: $113,700
- Employee's Share of Social Security Tax
  - 6.2%
  - Self-Employed - 12.4%

*For instance, an employee with taxable wage income of $115,000 will see an immediate tax increase of* ***$2,425*** *for 2013.*

# 0.9% Payroll Tax Increase for High Incomers (Employee Portion of Medicare Tax)

- Effective in 2013
- 0.9% additional tax on wages above the thresholds below
- Medicare Tax Rate for wages above the threshold will go from 1.45% to 2.35% (self employed: 2.9% to 3.8%)
- Applies only to EMPLOYEE'S share; the employer is not subject to additional tax

| Filing Status | Threshold Amount |
|---|---|
| Married Filing Jointly | $250,000 |
| Married Filing Separately | $125,000 |
| Single | $200,000 |
| Head of Household | $200,000 |
| Qualifying Widow(er) | $200,000 |

# New 3.8% Tax on Net Investment Income for 2013

## (To pay for Health Care Reform)

- 3.8% Additional Tax on "Net Investment Income"
  - Scheduled to take effect regardless of whether Congress extends the Bush tax cuts.
- For individuals, the tax is computed on the lesser of:
  - Net Investment Income or
  - Modified Adjusted Gross Income minus:
    - $200,000 for Single
    - $250,000 for Married Filing Joint & Surviving Spouse
    - $125,000 for Married Filing Separate

# New 3.8% Tax on Net Investment Income - Continued

- What Is "<u>Net Investment Income</u>"
  - Total of the following items less any deductions properly allocable to such income or gain:
    - Interest Income
    - Dividend Income
    - Capital Gains
    - Annuities, Rents, Royalties
    - Passive Activity Income
    - Does not include any income from ordinary course of trade or business (active participation)
  - Subject to Estimated Tax Penalties
- What is "Modified Adjusted Gross Income"?
  - Individual Adjusted Gross Income PLUS tax-free foreign earned income or foreign housing costs

# 3.8% Medicare Tax Example 1: Married Taxpayers

John and Jane, a married couple who file a joint return, collectively earn $270,000 in wages, and have $80,000 of net investment income, in 2013. Their modified AGI is $350,000. For 2013, the couple will incur a 3.8 percent unearned income Medicare contribution tax on the lesser of their: (1) $80,000 of net investment income, or (2) $100,000 of modified AGI in excess of the $250,000 threshold for married taxpayers filing jointly. Thus, John and Jane will incur a $3,040 (3.8 percent x $80,000) unearned income Medicare contribution tax in 2013.

# 3.8% Medicare Tax Example 2: Single Taxpayer

In 2013, Rodney, a single taxpayer, receives no wages or self-employment income. He does, however, earn $3.2 million in net investment income from a stock and bond portfolio that is not part of a qualified employee benefit plan. This is the total amount of Rodney's modified AGI for 2013. Rodney will incur a 3.8 percent unearned income Medicare contribution tax on the lesser of his: (1) $3.2 million net investment income, or (2) $3 million modified AGI in excess of the $200,000 threshold amount for a single taxpayer. Thus, Rodney will incur a $114,000 (3.8 percent x 3,000,000) unearned income Medicare contribution tax in 2013.

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# Strategies: Follow legislative action after the elections and be prepared to act before year end

- Consider realizing LT capital gains in 2012 and deferring capital losses to 2013 and beyond
- Consider accelerating 2013 income into 2012
- Consider electing out of installment sale treatment for 2012 sales
- Consider investing in tax-exempt securities
- Consider making gifts now, while estate tax still has $5 million exemption
- Consider paying dividends before 2013 for closely-held corporations w/sufficient earnings
- Consider Roth conversion in 2012
- Consider increasing income deferrals beginning in 2013 (including retirement plan contributions)

# An Overview of Healthcare Reform

# Health Care Reform

*INTENDED TO INCREASE THE NUMBER OF AMERICANS WITH HEALTH COVERAGE*

1. Individual Obligations and Penalties
2. Employer Obligations and Penalties
3. Exchanges
4. Employer Considerations

# Individual Obligation

Individuals must obtain "minimum essential coverage" through one of the following or pay a penalty:

1. Employer
2. Exchange
3. Individual Policy
4. Government (Medicare or Medicaid)

# Individual Penalties

**Penalty is the greater of**:

- $95 or 1% of income in 2014
- $325 or 2% of income in 2015
- $695 or 2.5% of income in 2016
- Dollar amount is indexed for 2017 and beyond
  (% remains at 2.5%)

**Family Maximum Penalty is 3x individual**

- So for 2016 maximum family penalty is $2,085

# Employer Obligation

Employers are not required to offer medical coverage, **BUT** a <u>penalty</u> applies to employers with 50 or more employees who do not offer "MINIMUM ESSENTIAL COVERAGE"

OR

who offer coverage but the coverage does not provide "MINIMUM VALUE" or is not "AFFORDABLE"

*NOTE: special and detailed rules to determine 50-employee threshold, "minimum essential coverage", "minimum value", and "affordable"*

# Employer Penalties

Penalty is $2,000/year for each full-time employee who is not offered “minimum essential coverage” (basic) if any employee receives a premium tax credit

- Excludes the first 30 employees
- Penalty is calculated monthly

# Employer Penalties - Continued

If the employer offers a benefit, but it is not "AFFORDABLE" or it does not provide "MINIMUM VALUE", a penalty of <u>$3,000/year</u> is due for each full-time employee who receives a premium tax credit

*If the "no offer" penalty is smaller, pay that instead*

# Exchanges – What are these?

- Exchanges are intended to make it simpler for individuals and small employers to purchase health insurance. They are established by states by 2014, or else federal government will run the exchange for the state. There may be multi-state exchanges.

- Exchanges WILL NOT PROVIDE INSURANCE

- Exchanges will be somewhat like Orbitz or Expedia – will provide information on plan benefits and costs to make comparing options easier; will provide website, navigators, and other enrollment assistance to individuals

- Exchanges will oversee the plans that health insurers offer

- Exchanges will determine the eligibility for premium tax credits

# Exchange Requirements - Continued

Plans offered on the exchange must meet two requirements:

1. "<u>cost sharing</u>" - deductible cannot exceed $2,000 for single or $4,000 for family; out-of-pocket cannot exceed $6,250 for single or $12,500 for family

2. "<u>essential health benefits</u>" – outpatient care, emergency services, hospitalization, maternity/newborn care, mental health/substance abuse, prescription drugs, rehabilitative services, laboratory, preventative and wellness care, pediatric care

# Exchanges – Coverage levels of plans

- Platinum: cover 90% of costs
- Gold: cover 80% of costs
- Silver: cover 70% of costs
- Bronze: cover 60% of costs

# Employer Considerations

- Maintain current health program
- Reduce benefits to “minimum value”
- Restructure contribution levels
- Discontinue coverage and rely on the exchanges

# Thank you!

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