

More Tax un(Certainty)

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The beginning of 2010 brought us not just a new decade, but more tax uncertainty as the seemingly unthinkable happened with respect to estate taxes. There's no doubt that you've heard about the expiration of the estate tax for one year as a result of Congress' inaction in addressing the estate tax. So as of today, there is no estate tax, and if Congress continues fails to act, the estate tax will come back in 2011 with a vengeance. For years, this country's top estate planning practitioners had said that this day would never come. Well, never say "never."

Let's turn our attention to income taxes and the uncertainty that is swirling about these days. With the passage of the Healthcare Act, officially known as the Health Care and Education Reconciliation Act (HCERA), there are essentially two important tax issues that will most likely affect you. There are also several important tax breaks that will be going away at the end of 2010 if Congress takes no action, and at this rate, it's quite possible that the unthinkable could happen once again: this time for income taxes. We've compiled a summary of some of the selected tax changes below and added some financial planning implications where appropriate.

Two Tax Changes Brought on By the Health Care and Education Reconciliation Act

- Medicare Tax – There are two elements to the Medicare taxes that are assessed to individuals, both of which are not scheduled to take effect until 2013.
 - The first change pertains to Medicare payroll taxes (either withheld from paychecks or assessed to self-employed individuals). The current Medicare tax rate that is assessed to employees is 1.45%. HCERA imposes an additional 0.9% Hospital Insurance tax on earned income that exceeds \$200,000 for individuals and \$250,000 for married taxpayers.
 - The second change is the imposition of an additional 3.8% Medicare contributions tax on unearned income. This tax is assessed on the lesser of (a) net investment income or (b) excess of modified adjusted gross income (MAGI) for individuals with earned income in excess of \$200,000 and married taxpayers with earned income in excess of \$250,000.

- **Itemized Deduction for Medical Expenses** – The current threshold for deductibility of medical expenses is 7.5% of adjusted gross income (AGI). HCERA increases the threshold to 10% of AGI beginning in 2013, thereby making it even more difficult to attain a deduction. In essence, this will bring the regular income tax calculation on par with the deduction eligibility for alternative minimum tax purposes (AMT), which is currently at 10%. HCERA does provide temporary relief for individuals age 65 and older. For those taxpayers, the current 7.5% threshold will remain in place from 2013 until 2017.

Tax Breaks Expiring at the End of 2010

Unless our elected officials in Washington, DC enact new tax legislation to replace the one that is currently in effect, there will be a slew of changes heading our way. Many of the current tax rates and breaks that we are subject to today will expire at the end of 2010. Here are some of the more noteworthy ones:

- **Tax brackets are resetting.** The current maximum personal income tax rate is 35%. Absent any changes, this will reset to pre-2001 levels, which means that income that today is subject to a 35% tax rate will be taxed at 39.6% beginning in 2011. Also worth noting is that the 10% income tax bracket will cease to exist. Income that is currently

subject to tax at 10% will be taxed at 15%. This can present a unique “opportunity” to accelerate income and lock in today’s tax brackets. One way to accelerate income is to take distributions from an IRA, and perhaps convert it to a Roth IRA.

- **The 15% tax rate on qualified dividends will retire.** As a result, dividends will be subject to ordinary income tax rates, which, as per the previous bullet point, may reach as high as 39.6%, and that’s before the 3.8% Medicare tax that will take effect in 2013. As a result, come 2013, dividends could be taxed at a rate as high as 43.4%. This will certainly make tax-sensitive portfolio management ever so crucial to retaining and preserving investment returns.
- **For the remainder of 2010, long-term capital gains are subject to tax at a rate of 15%, before reverting back to 20% starting in 2011.** This may be an opportune time to take gains and reduce exposure to concentrated positions since the low rate is expiring. Like the dividend tax rate hike, this will also call for active tax-management of portfolios. This also increases the value of tax losses that had been harvested throughout 2008 and early 2009. While they may have been painful to realize at the time, their value will actually increase with the resetting of the capital gains rate.

- The alternative minimum tax (AMT) exemption will revert back to pre-2001 levels, and it is not updated for inflation. The exemption will drop from \$70,950 to \$45,000 for married taxpayers and from \$46,700 to \$33,750 for single taxpayers. Left unchanged, AMT will ensnare far more taxpayers than ever anticipated when this tax was born several decades ago. This has been an annual concern, with Congress enacting one year patches for the last several years, when the increased exemption had been set to expire. Although not part of the Economic Growth and Tax Relief and Reconciliation Act of 2001 (EGTRRA), it's important to note that the temporary exemption of interest from private activity municipal bonds for AMT purposes will also vanish beginning in 2011.
- Since 2010 marks the expiration of the EGTRRA, there are a host of other tax breaks that are sunseting. Additionally, many of the tax breaks that came out of the American Recovery and Reinvestment Act of 2009 are also expiring. While too numerous to list, here are a few of the more well-known ones:
 - Reinstatement of the marriage penalty with respect to tax brackets and deductions as they relate to married taxpayers versus single taxpayers.
 - The "Making Work Pay" tax credit, a refundable tax credit of up to \$800 for working families and \$400 for working individuals will go away at the end of 2010.
 - The expanded definition of what constitutes a qualified education distribution from a 529 plan that includes computers and related technology will no longer apply. Qualified education expenses will be limited to generally tuition, room and board, books and mandatory fees.
 - The American Opportunity Education Credit, a partially refundable credit of up to \$2,500 for education expenses, which was a replacement for the HOPE scholarship credit, is being replaced in 2011 by the very credit it replaced in 2009.

While there are a lot of changes coming down the pike, it's important to reiterate that, with the exception of the enactment of HCERA, nothing is permanent. It is possible that Congress will act before year-end, changing the course of direction for the tax breaks and rates that are scheduled to sunset at the end of this year. However, it is also quite possible that Congress will not do anything and simply let the current rates and breaks expire. There are some proposals floating around Washington, but it's far too early to speculate on whether they will be able to pass anything, let alone trying to guess what will be in there.

Uncertainty aside, we do know that the

Medicare taxes are the most impactful changes in HCERA with respect to individual income taxes. The change does not go into effect until 2013, so it does offer some planning opportunities until then. One important distinction to point out is that while distributions from a traditional IRA are not considered earned income, they are included in the calculation of MAGI for purposes of calculating the additional 3.8% Medicare tax. As a result, the planning opportunity that should garner the most attention as a result of the additional taxes is a Roth IRA Conversion, and this makes 2010 a more compelling consideration. This is especially the case for high tax-bracket individuals who expect to remain there indefinitely. Taxes can have a meaningful impact on one's ultimate net worth. That's why our focus is not so much on

what you earn, but rather, what you keep after taxes. That said, we are very sensitive to the tax issues our clients face today and in the future. We have to, because after all, we live here, too.

If you have any questions about how these changes will affect you or to discuss any particular planning ideas, please feel free to contact your Wealth Manager. As always, we remain committed to helping you achieve your long-term financial goals and will make ourselves available every step of the way.

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