The Tax Lawyer

Making Tax Decisions In Limbo

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One of the precepts of tax planning is to never pay a tax today if you can legitimately pay it tomorrow. Likewise, traditional tax planning says you should accelerate tax deductions and defer income. Claim deductions as early as possible. Attempt to push income into the future.

Yet these days many people are scratching their heads about whether these traditional notions are changing. The so-called Bush tax cuts are slated to expire at midnight Dec. 31, 2010, and the usual tax incentives are hard to assess. The top federal long-term capital gains tax rate will go from 15% now to 20% on Jan. 1. That rate spike is encouraging some people to sell assets now rather than waiting until 2011. Of course, it can be tough to predict how long it will take to sell some assets (i.e., real estate) and exactly when the closing will occur. Such practical considerations add to the uncertainty. (For advice on factoring state taxes, too, into deciding when to take capital gains, click here.)

Even more striking are dividend rates. Many dividends (so-called qualified dividends) are currently taxed at only 15%. Yet they will be taxed at up to 39.6% come January, a whopping increase by any measure. Unlike choosing to sell an asset now or in January though, most taxpayers have little control over whether or when companies pay dividends. That makes these enormous rate changes especially maddening.

Federal income tax rates on ordinary income, such as salary, now top out at 35%, but will climb to 39.6% as of the new year. That increase may not be enough to cause you to disregard the usual "defer income" mantra. However, if you have the flexibility to collect and pay tax on money now rather than in 2011, it might be time to turn traditional tax planning on its head to accelerate income and perhaps even defer deductions. In other words, consider reversing your usual strategy.

Another big change is estate tax, although short of planning to die in 2010, there's not much you can do to take advantage of the current hiatus. There's no estate tax in 2010, and we don't yet know exactly how 2011 deaths will be taxed. People who had the tax clairvoyance to die in 2010 may skate by without any federal estate tax, although a retroactive estate tax to scoop in 2010 estates is still quite possible.

If Congress tries to retroactively impose an estate tax on 2010 deaths, I'm betting there will be litigation raising constitutional issues. Texas oilman Dan Duncan and California real estate mogul Walter Shorenstein are among the billionaires who have died in 2010, so there are billions of tax dollars at stake. It seems unlikely that taxes of this magnitude will be paid without a fight, and such a fight may impact smaller estates too. If your family experienced a 2010 death, you should watch this area closely. (For more on the complications faced by such families, click here.)

Of course it is still possible Congress will extend the Bush tax cuts beyond 2010. In fact, it may seem more likely now given the bad economic news. The extension, if it comes, may be of all of the Bush changes, or only some. Uncertainty about legislative action makes tax planning even more difficult, compounding our deer-in-headlights reaction.

The uncertainty isn't just about tax rates, for the Bush tax cuts involved other changes. Starting in 2011 the so-called marriage penalty will get worse. The same is true for the phase-outs applying to high income taxpayers, which often result in miscellaneous itemized tax deductions and personal exemptions yielding little or no benefit. Such stealth tax increases can be more insidious than hikes in the marginal tax rate.

Whatever your strategy, try to be as nimble as you can. As 2010 creeps to a close, there are many worries over what transactions make sense in 2010 or 2011. Depending on the type of investment, you may not have control over timing a sale, but you may be able to accelerate or delay a closing if it's close to year-end. Watch what Congress is doing, crunch your numbers, and get some professional help.

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