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## Act Now to Avoid Paying More Taxes

Gray Reed & McGraw Legal Alert

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One of the implications of the so-called “fiscal cliff” is higher income taxes beginning January 1st, 2013. Of course, no one knows what Congress and the President will ultimately do; but almost everyone predicts that income taxes will rise in 2013, whether that comes about by means of increased tax rates, decreased deductions, or a combination of the two.

We do know for certain that under the health care reform law, the employee’s portion of the Medicare tax will increase 0.90% beginning January 1, 2013 (from 1.45% to 2.35%) on wages that exceed \$200,000 for single employees and \$250,000 for married employees who file jointly. The combined rate for employers and employees increases from 2.9% to 3.8%. Additionally, in 2013, the scope of the Medicare tax will be expanded to include certain unearned income and imposed on investors at a 3.8% rate.

Accelerating certain types of income into 2012, rather than paying tax on those amounts in 2013 or later, could present a serious tax planning opportunity.

### **Executive Compensation**

Vesting and payment of various forms of incentive compensation into 2012, rather than paying those amounts in 2013, could present an opportunity for executives of private companies. Strategies worth considering include:

1. Accelerating into 2012 payments of annual bonus and other incentive amounts that otherwise would be paid in 2013.
2. Exercising stock options and stock appreciation rights in 2012, and accelerating the vesting of these amounts to the extent necessary to permit such exercises.
3. Accelerating the vesting of restricted stock.
4. Accelerating the vesting of restricted stock units and phantom stock that are payable on the vesting date.

If clients are interested in pursuing any of these strategies, we need to review the controlling plan documents and agreements to see whether they presently allow

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acceleration of vesting and payment, or whether these arrangements need to be amended. Special care must be taken to ensure compliance with Internal Revenue Code Section 409A, which governs deferred compensation. Failure to strictly comply with such rules can subject the recipient to an additional 20% excise tax.

### **Medicare Tax on Unearned Income**

Commencing in 2013, the scope of the Medicare tax will be expanded to include a number of forms of investment income including interest, dividends, capital gains, annuities, royalties, rents, and pass-through income from passive businesses such as S-corporations and partnerships. Technically, this additional tax is called the unearned income Medicare contribution tax, and was enacted as part of the health care reform laws. The unearned income Medicare contribution tax is an additional tax of 3.8% imposed entirely on the investor. Single taxpayers with adjusted gross income above \$200,000 and married taxpayers with adjusted gross income above \$250,000 may be subject to this tax. The calculation is somewhat complex and subject to a number of exceptions. Corporations may want to accelerate dividend distributions into 2012 versus 2013.

### **Corporate Dividends**

Due to uncertainties in the economy, some companies have found themselves sitting on significant amounts of undistributed earnings. In addition to likely increases on the amount of income tax payable with respect to earned income, it is a virtual certainty that the tax rates attributable to dividends will rise. Dividends declared and paid in 2012 will have the benefit of the current 15% tax rate on qualified dividends. Whether the company's financial circumstances can afford payment of dividends needs to be carefully considered. Actual payment of dividends will, at minimum, require a resolution of the corporation's board of directors in accordance with the company's bylaws.

### **Don't Wait Until It Is Too Late To Act**

It is natural and normal for companies to want to delay taking action until there is a better understanding of what a possible fiscal cliff deal may look like. But clients must have all mechanisms in place and be ready to make any accelerated payments on or before Monday, December 31st, 2012. Being able to take such action requires preparation that should begin now.

If you have any questions, contact your attorney or Gray Reed tax attorneys are available at your request.