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Fears of Fiscal Cliff Prompt Action Now

Tax experts don't know if Congress and President Barack Obama will reach some sort of accord to avoid "the fiscal cliff" — a combination of tax hikes and spending cuts many think would put the country in recession.

And they don't know, even if an accord is reached, whether it will limit tax deductions, change tax rates or eliminate rules that benefit some investors.

"We know two things," said Chuck Baracco, a certified public accountant and partner at The Bonadio Group. "We know taxes on capital gains are going up at least 3.8 percent, and we know taxes aren't going down."

The 3.8 percent tax increase won't affect everyone. It is a Medicare tax, part of the Affordable Care Act, the law often referred to as "Obamacare," that will apply to investment income of single taxpayers who make more than $200,000 or couples who make more than $250,000.

For high earners, that tax hike will show up in a 0.9 percent increase in payroll deductions, said Carolyn Lawless, a CPA and principal at Testone, Marshall & Discenza. Taxpayers will pay the remaining 2.9 percent when they file their tax returns, she said.

Beyond that, tax experts are forced to advise their clients based on informed assumptions.

"This year, I think it's driving all accountants mad," said Lawless.

Given the known increase in taxes on investments, attorney Richard Sargent is telling clients that if they plan to sell stocks in the next several months, they're better off doing it before December ends.

"Because we don't know what tax rates will be, sell it now," Sargent said from his office at Tully Rinckey, a law firm with offices in Syracuse.

The savings can be dramatic, said Gary Grossman, of Grossman St. Amour CPAs, the firm formerly known as Green & Seifter.

Grossman offered an example: An investor who bought stock for $50,000 and earned 6 percent per year until it was worth $100,000 could save 54 percent in taxes by selling before Dec. 31 rather than waiting until the New Year.

"You're better off harvesting it now," he said.

Tax changes aren't a concern only for high earners or those who live off investments. Social Security payroll taxes are scheduled to return to 6.2 percent from the 4.2 percent rate they were held at the past two years.

"For a family that has wage income of $75,000, it's a $1,500 issue," said Sargent.

"That's another reason to shift wages," Grossman said.

Clients who have bonuses or other income they can shift from one year to another often push it into the future, deferring taxes until later. But with the president pushing for tax rate increases for high earners, experts are advising clients to take the revenue — and pay the taxes — now.

For some it might make sense to pay extra taxes now.

For instance, Lawless said, someone with a conventional individual retirement account should consider converting it to a Roth IRA. Contributions to a conventional IRA are not taxed. Contributions to a Roth IRA are taxed, but withdrawals are not taxed.

Rising tax rates — for top earners, the rate is set to rise from 35 percent to 39.6 percent plus the 3.8 percent Medicare tax — suggest it's better to convert a conventional IRA to a Roth IRA and pay the taxes this year.

The simple uncertainty about next year's tax rules might make it a good idea for businesses to buy equipment now, rather than wait, said Baracco. He said tax changes might make it beneficial to depreciate a piece of equipment rather than to take a deduction for it. If a company gets a filing extension, it can have until Sept. 15 to figure out how to handle the matter. He expects the tax picture will be clearer by then.

Don't buy the equipment just for tax reasons, Baracco said. For his clients, he said, "if it makes good business sense and has a tax impact involved, then they'll do it."

"Don't let the tax tail wag the dog," Grossman said.

The goal isn't to minimize taxes, it's to maximize after-tax earnings.

Grossman said it seems clear high earners will be paying more in taxes and will have to make up for the difference. People, even high earners, "tend to live at a level very close to their income," he said.

If people have to pay more in taxes, they are going to reduce spending somewhere else.

"It's going to have a major impact on the quality of life in our country," Grossman said. "Maybe this needs to happen, but it's not going to be pretty."

The season to 'gift'

Tax experts advise against acting rashly out of fear, but there are some areas where moving fast might bring dramatic tax savings.

The estate tax exempts the first $5.12 million of an individual estate and $10.24 million for a couple. If the Bush tax cuts lapse, that exemption will drop to $1 million for an individual and $2 million for a couple. The decline in the exemption means that someone leaving investments, a business or other assets to their children might want to consider "gifting" some of the assets now.

Here's an example: A business owner has $6.12 million in assets and gives them to his children in the form of gifts this year. The first $5.12 million is exempt from federal taxes. On the remaining $1 million, he would pay a maximum tax rate of 35 percent, so the most that would be paid in taxes is $350,000.

If the Bush tax cuts lapse and the business owner dies, his heirs would find $1 million is exempt from taxes and the new maximum rate on the remaining $5.12 million had climbed to 55 percent. Taxes would top $2.8 million.

CPA Chuck Baracco said "the word on the street" is that lawmakers will compromise with a $3.5 million exemption and a maximum rate of 54 percent. "Either way you are losing some of that exemption," he said. "But, anything could happen."