

## OCTOBER 2012 NEWSLETTER

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# TAX PLANNING- THE 2013 TAX CHANGES- ARE YOU PREPARED?

## NEWS ALERT:

### 1. UPCOMING SEMINARS

Joseph R. Pozzuolo, Esquire will be presenting a continuing professional education (CPE) seminar for the Montgomery County of Certified Public Accountants on Wednesday, October 24, 2012 at the Cedarbrook Country Club in Blue Bell, PA from 8:30 am to 12:30 pm. The contact person is: DMcLeer @janney.com

2. Pozzuolo Rodden is pleased to announce that during the month of September 2012:

1) Joseph R. Pozzuolo, Esquire was consulted and quoted by Philadelphia Magazine as the tax/private foundation expert of an article written about the Shane Victorino Charitable Foundation; and,

2) Judith P. Rodden, Esquire was consulted and quoted by the Huffington Post as the employment law expert on an article about Obesity Discrimination.

### **3. NEWSLETTERS**

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During the month of September, 2012 many of our past newsletters have been republished by many TV stations through the United States on their websites and other national publications such as: beforeitsnews.com; estatelawyerreviews.com; digitaljournal.com; estateplanningadministration.com; brealawfirm.com; yahoo.com; topnewstoday.com; Money News; East Sussex, England; kcbd-TV, Lubbock, TX; wdrb-TV, Louisville, KY; and, Estate Planning News from around the world.

All past Estate Planning and Corporate Law Newsletters are available at:

[http://www.pozzuolo.com/Pubs\\_Newsletters.shtml](http://www.pozzuolo.com/Pubs_Newsletters.shtml)

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### **QUESTION OF THE MONTH:**

**My father is 73 years old and in good health. Should he have a power of attorney document?**

If there are any legal questions you would like this office to answer in the future, please email the question to us at [info@pozzuolo.com](mailto:info@pozzuolo.com). Each month, the question with the most relevance to our privately held business clients, advisors, and friends will be answered in our monthly newsletter. The questions can relate to any of the areas practiced by this office including business planning and transactions, corporate law, commercial litigation, employment law and litigation, commercial real estate and development, construction law and litigation, estate planning, estate administration, tax and pension law, family law litigation.

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## **TAX PLANNING-**

### **THE 2013 TAX CHANGES- ARE YOU PREPARED?**

With the end of the year creeping up, soon enough the new 2013 tax rules reversing much of the Bush administration tax breaks will be coming to a forefront. One notable tax change is the Obamacare 3.8% Medicare tax on investment income under 26 U.S.C. § 1411. This is an additional tax on what is called “net investment income” for individuals who have income above specific thresholds.

#### **What is Net Investment Income?**

First, net investment income is defined in § 1411 to include: (1) interest, dividends, annuities, royalties, and rents except where derived from most active trades or businesses; (2) gross income from passive activities or a trade or business in financial instruments or commodities; and, (3) net gains

attributable to the disposition of property other than that property held in most trades or businesses. This is a fairly wide tax base which includes generally all but wage/salary income and income from active business activity.

However, there is the ability to exclude certain types of income and the use of deductions to offset such income. Income that is normally tax exempt or non recognizable is not included in net interest income. Further, this does not apply to the sale of a partnership interest or S corporation stock to the extent any gain is due to an active business activity that would not have been taxable otherwise. Last, a notable exception is that net investment income does not include distributions from ERISA plans including qualified pension plans, 401(k) plans, tax-sheltered annuities, individual retirement accounts ("IRAs"), and 457 plans. However, Congress has explicitly left out nonqualified deferred compensation under 409A from the ERISA exception.

Further deductions are allowed to reduce net investment income to the extent "properly allocated." While the term has not been specifically defined yet in regulations, this would likely include depreciation, operating expenses, investment expenses, interest on funds to purchase investments, advisor/broker fees, and other such related expenses.

### **What is a High Income Taxpayer and How are They Taxed?**

The Medicare Tax applies only to a certain class of taxpayers with income in the excess of "the threshold income". The tax amount is 3.8% multiplied by the lesser of "net investment income" or a modified aggregate gross income ("AGI") in excess of the threshold amounts. These thresholds are \$200,000 for individuals, \$250,000 for joint filers, and \$125,000 for those married but filing separately. However, for trusts and estates the threshold amount is the amount for the highest tax bracket and the current amount is \$11,351.

The tax works such that if an individual taxpayer Andy has an modified AGI of \$500,000 with net investment income of \$100,000, the investment income is less than the excess over the \$200,000 threshold. Thus, Andy would be taxed \$3,800 on the \$100,000. On the other hand, if Andy only had \$220,000 of modified AGI, since the excess over the threshold is only \$20,000, Andy's extra tax would only be \$760 (3.8% x \$20,000). If either of these incomes were in trust, the tax would be \$3,800 as the \$100,000 of net investment income easily clears the difference between \$11,000 and modified AGI.

### **How Does This Interact with Other Tax Changes?**

This tax becomes more significant when put into perspective with the other tax changes for 2013. The highest two ordinary income tax rates of 33% and 35% are increasing to 36% and 39.6%, the dividends tax rate is increasing from capital gains treatment at 15% to the aforementioned ordinary income tax rates, capital gains taxes are to increase from 15% to 20%, and employers are to withhold an extra .9% for wages in excess of similar threshold amounts for the Medicare tax. Taken together, the 3.8% boosts the ordinary tax rates to 39.8% and 43.4% which is a significant percent of income for certain taxpayers especially considering these taxpayers were paying a maximum marginal tax rate of

35% in 2012.

### **How to Protect Oneself?**

There are a couple ways to minimize the impact from the investment tax, but no real silver bullet to avoiding this tax. First, is to have income characterized as ordinary non-investment income. However, with this, wages are subject to the extra .9% of Medicare tax for amounts in excess of the threshold amounts. Further, this may convert a capital gain taxed at 20% to an ordinary gain at 39.6%. One may consider accelerating income to year 2012 instead of 2013 before the tax is fully implemented. The issue is timing, however, one may not want to dispose of the asset generally or prior to 2013 for other reasons.

Another way is to utilize the ERISA and qualified plan exception as distributions are not taxed. However, for most high income taxpayers, they have already maxed out the benefits of using qualified plans due to maximum benefit limitations. Last, is to look at tax exempt options which may make municipal bonds relatively more attractive. However, municipal bonds may not carry the same after-tax yield as other taxable bonds.

### **Conclusion:**

The 3.8% is another tax for certain successful risk taking individuals for redistribution purposes. The arguments for both sides have been heard with the coming election. Some argue the wealthy can easily afford and should take the redistributions with open arms. On the other hand it is argued that the Medicare tax is a spiteful nearsighted tax placing an unfair burden on business persons who drive the economy and will hinder future investments and employment. Whether it will help the economy or hinder it, no one has a crystal ball, but the tax is in place and is yet another tax that needs to be planned around.

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### **QUESTION OF THE MONTH:**

#### **My father is 73 years old and in good health. Should he have a power of attorney document?**

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The answer is yes. First, no one is immune to old age. Everyone's health will fail eventually, their mental acuity will decline, and their ability to function and manage their day to day lives will falter. In your father's case, despite his good health, his age dictates that he should have a power of attorney document. He may be healthy now, but at his age, once his physical and mental health begins to decline, it may decline rapidly.

Second, no one is immune to emergency. That is, your father could suddenly have a stroke or heart attack and be left in a vegetative state. At that point, it will be too late to have him sign a power of attorney. Still, he will need someone to handle the business of his life such as paying bills, managing investments or making key financial decisions. He also will need someone to oversee his healthcare and make important medical decisions for him.

A power of attorney puts a plan in place in case of failing physical and mental health, or in case of emergency. A power of attorney allows your father, the *principal*, to appoint another person, his *agent* or *attorney-in-fact*, to manage his affairs, whether financial, health or otherwise, in accordance with the powers granted to the agent under the document. There are two kinds of power of attorney documents: (1) springing power of attorney; and (2) durable power of attorney. A springing power of attorney only goes into effect upon the incapacitation of the principal. In other words, suppose your father had a stroke and was left in a vegetative state, and he had appointed

you as his agent under his springing power of attorney. In order for you to act as his agent, you would have to obtain statements or certificates exercised by one or two doctors stating that your father is, in fact, incapacitated. Only then could you exercise the powers granted to you under the document.

A durable power of attorney, on the other hand, takes effect immediately upon execution. The agent does not need to prove that the principal is incapacitated. The agent will be able to exercise immediately all the powers granted to him under the power of attorney document.

Within the power of attorney, your father can designate its purpose and the powers granted to his agent. He could give his agent financial decision making power, such as the power to pay his bills, open or close his bank accounts, or sell or buy property. Your father could grant to his agent the power to make healthcare decisions on his behalf, so that agent may oversee and make decisions regarding his health and medical care. For example, the agent could be granted the power to make end of life decisions, such as to keep your father on life support, or whether to admit your father to a medical institution.

Finally, your father should execute a power of attorney now in order to prevent later family distress. Suppose your father becomes incapacitated without having executed a power of attorney. At that point, his family would have to go through the process of petitioning the local probate court to have a guardian or conservator appointed for him and his estate. Seeking guardianship may be a costly and drawn out legal process, and in the end, the court may not appoint whomever you seek to have appointed guardian. Add to that the fact your family may be struggling emotionally with the incapacitation of your father, and the process becomes a greater burden. In the event a guardian is appointed, that guardian then must operate under the watch of the court rather than through the powers which would have been expressly granted to him under a power of attorney document.

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### **Publications**

All of the following professional publications and past newsletters written by attorneys of this office are available by clicking here: [http://pozzuolo.com/Pubs Articles.shtml](http://pozzuolo.com/Pubs%20Articles.shtml)

#### **Corporate/Tax Articles**

Design Buy-Sell Agreements For Maximum Utility

Deferred Compensation Rewards And Retains Key Employees

How To Use Non-Qualified Deferred Compensation Arrangements As A Business, Retirement And Tax Planning Tool

Protecting A Client's Business From Unfair Competition Using Restrictive Covenants

Money Purchase Pension Plan Falls Out Of Favor

Why An Employment Contract Is Mandatory

What Type of Qualified Corporate Retirement Plan Best Serves Your Business, Tax And Retirement Needs

Structuring Loans From Qualified Plans - How To Handle The Strict Tax Rules

How An S Corporation Avoids The Double Taxation Incurred When Excessive Compensation Is Treated As A Dividend

Bankruptcy - How To Prevent It And How To Cope With It Should It Happen To Your Business

How To Look, Act And Sound Like A Professional Corporation

How Mortgage Lenders Should Draft Broker Agreements To Avoid RESPA Violations

How to Structure a Suitable Buy-Sell Agreement

## **Estate Planning Articles**

Estate Planning For Pet Owners

The Limited Liability Company -A Sophisticated Tool For Estate Planning

Diversify Strategies For An Effective Estate Plan

Use Wills To Maximize Family Protection And Minimize Tax

Six Proven Estate Planning Techniques

Divorce Raises The Need For Performing An Estate Planning Review

Divorce and Estate Planning

Remarriage Situations Can Raise Special Estate Planning Considerations

College Funding Tool Offers Estate Planning Advantage

Drafting The Durable Power Of Attorney For Wealth Protection Purposes

Why Living Wills Advance Directives Are An Essential Part Of Estate Planning

Special Needs Trust - An Estate Planning Tool For The Disabled

Adapt Estate Planning Strategies to Fit the Needs of Same-Sex Couples

***Actual resolution of legal issues depends upon many factors, including variations of facts and state laws. This newsletter is not intended to provide legal advice on specific subjects. It is to provide insight into legal developments and issues. You should always consult with legal counsel before taking any action on matters covered in our updates.***

This newsletter is courtesy of Pozzuolo Rodden, P.C.

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