Understanding the new “permanent” tax rules for 2013 and beyond

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Assurance ▪ Tax ▪ Consulting

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An overview of the current economic and tax environment

Questions you may be asking

What just happened to my taxes . . .

. . . and will they be changing again?

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What could trigger more changes?

- Political triggers?
- Buyer's remorse?
- Deficit concerns?
- Tax reform?
- 2014–Obamacare and another election?

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Four key questions

- How big and/or troublesome is the national debt/deficit?
- Is there any rational way to tell if we are spending too much or taxing too little–or is it just politics and finger-pointing?
- If health care spending is a problem, will Obamacare help or hurt?
- Are there any “magic bullets” in “tax reform”?

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What just happened to my taxes?

- ATRA effectively raised tax rates by 6 percent for joint filers with income over $300,000–and similar amounts for others
  - The $450,000 threshold is really $300,000
    - Phase-out of personal exemptions is the same as a 5 percent rate hike
    - Limits on deductions are the same as a 1percent rate hike
    - Little or no effect on incentives–operate like rate hikes
  - Watch for timing of capital transactions
  - Marital status may have larger tax effects

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What just happened to my taxes? (cont.)

- Obamacare raised taxes on most investment income by 3.8 percent for “upper-income” taxpayers (but no indexing)
  - With ATRA, base capital gains rates now range from 15 to 23.8 percent
  - New planning risks/opportunities for timing gains and losses
  - “Material participants” can avoid the tax
  - Marital status may also be important

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Marital status may become more important

- Getting a $300,000 exclusion from the cutbacks rather than two $250,000 exemptions could be costly
- So could getting a $450,000 exclusion from the top rate rather than two $400,000 exclusions

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Timing of discretionary events is more important

- Large bonus coming at year end?
- Potential capital gains from stock sale?
- Allocation from trust or family business?
- Sale of a business–possibility of installment sale?
  - All these events can be less taxing if they occur in a year in which the taxpayer is under an applicable AGI or MAGI threshold for cutbacks or the new 3.8 percent tax.

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What just happened to my taxes?

- Estate, gift and GST taxes set at 40 percent
  - Continues to closely match top income tax rate
  - For most of last generation, estate and gift tax rates were much higher than income tax rates
- Exclusions now indexed for inflation
- $5 million estate and gift exclusion is unified and portable
- A quadrupling of “real” exemptions compared to recent past, and substantial rate cut

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How do we measure or explain effects of the new law?

- Are you better off in 2013 than you were in 2012?
- Are you better off in 2013 than you were 13 years ago, before George W. Bush was elected?

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Total, lifetime cost of loss of Bush-era income tax rates

- For couple making $1 million per year for 30 years–added annual income tax hit is approximately $40,000–producing an estimated lifetime cost of $1.2 million (in 2013 dollars).

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Total, lifetime cost of loss of Bush-era income tax rates compared to estate tax benefits

- Note that a couple making $1 million annually for 30 years might build up an estate worth $10.5 million (in 2013 dollars)
- Under Clinton-era tax policies, their estate tax would be $4.7 million more (in 2013 dollars) than under ATRA
- Thus, they appear to lose $1.2 million of lifetime income tax benefits from Bush tax cuts, but retain $4.7 million of lifetime estate tax benefits from the Bush tax cuts

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Total, lifetime cost of loss of Bush-era income tax rates

- For couple making $3 million per year for 30 years–added annual income tax hit is approximately $140,000–producing an added, estimated lifetime cost of $4.2 million (in 2013 dollars)
  - $4.7 million of lifetime Bush-era estate tax savings are preserved for this couple, assuming they are able to accumulate an estate worth $10.5 million in 2013 dollars
  - This would require saving around $300,000 annually out of their $3 million earnings
  - Note that estates larger than $10.5 million also get a rate reduction from 55 percent to 40 percent

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Total, lifetime cost of loss of Bush-era income tax rates (cont.)

- Under Clinton-era tax policies, estate tax would be $4.7 million more (in 2013 dollars) than under ATRA
- Thus, under ATRA, even a couple making $3 million annually for 30 years appears to be keeping more than half of the lifetime income and estate tax benefits of the Bush tax cuts
- They are better off than they were 13 years ago

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Will the changes stick . . .
. . . and what could change them?

- Political triggers?
  - No automatic expirations
  - Debt ceiling extensions?
  - Budget and spending bills?
- Buyer's remorse?
- Deficit concerns?
- Tax reform?
- Future of Obamacare?
- 2014 election?

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Four key questions

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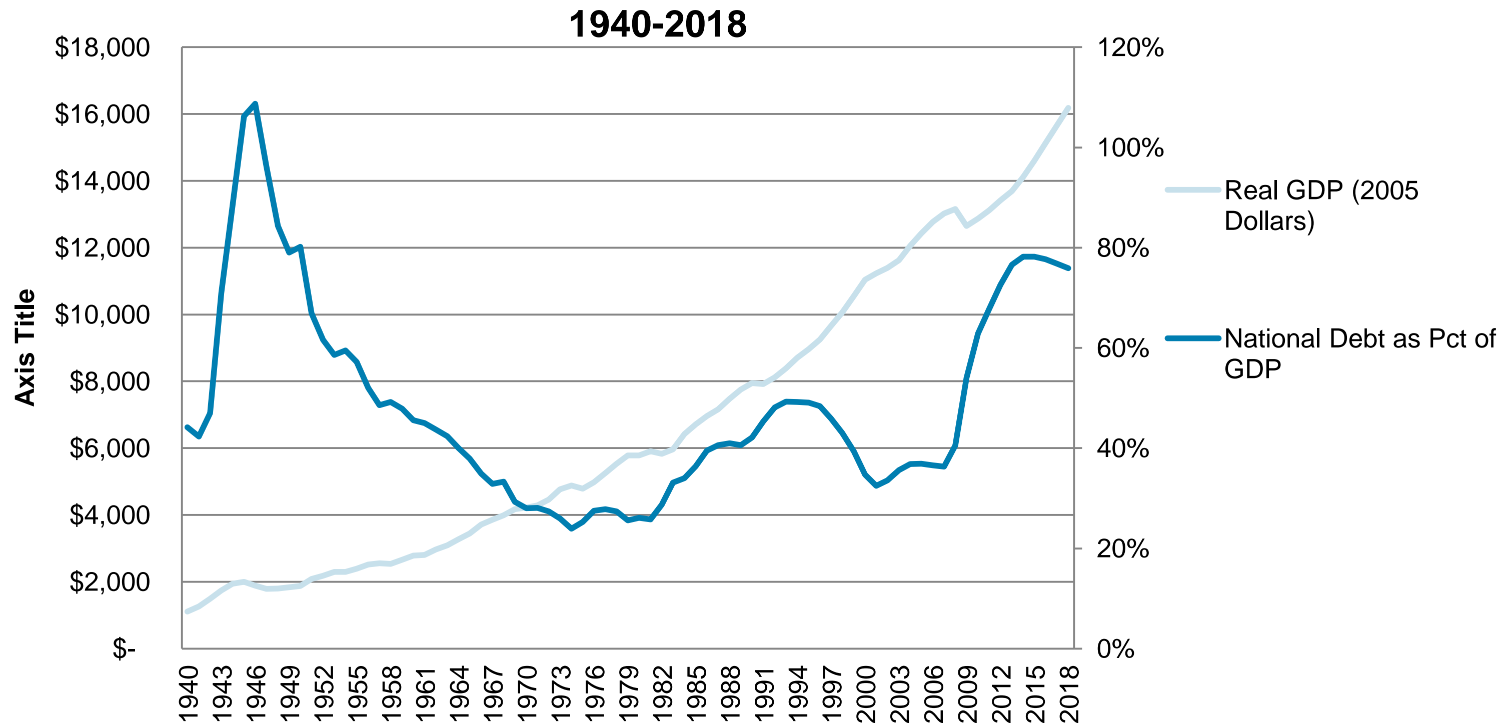
Does the national debt matter–even relatively? Does it appear to affect economic growth?



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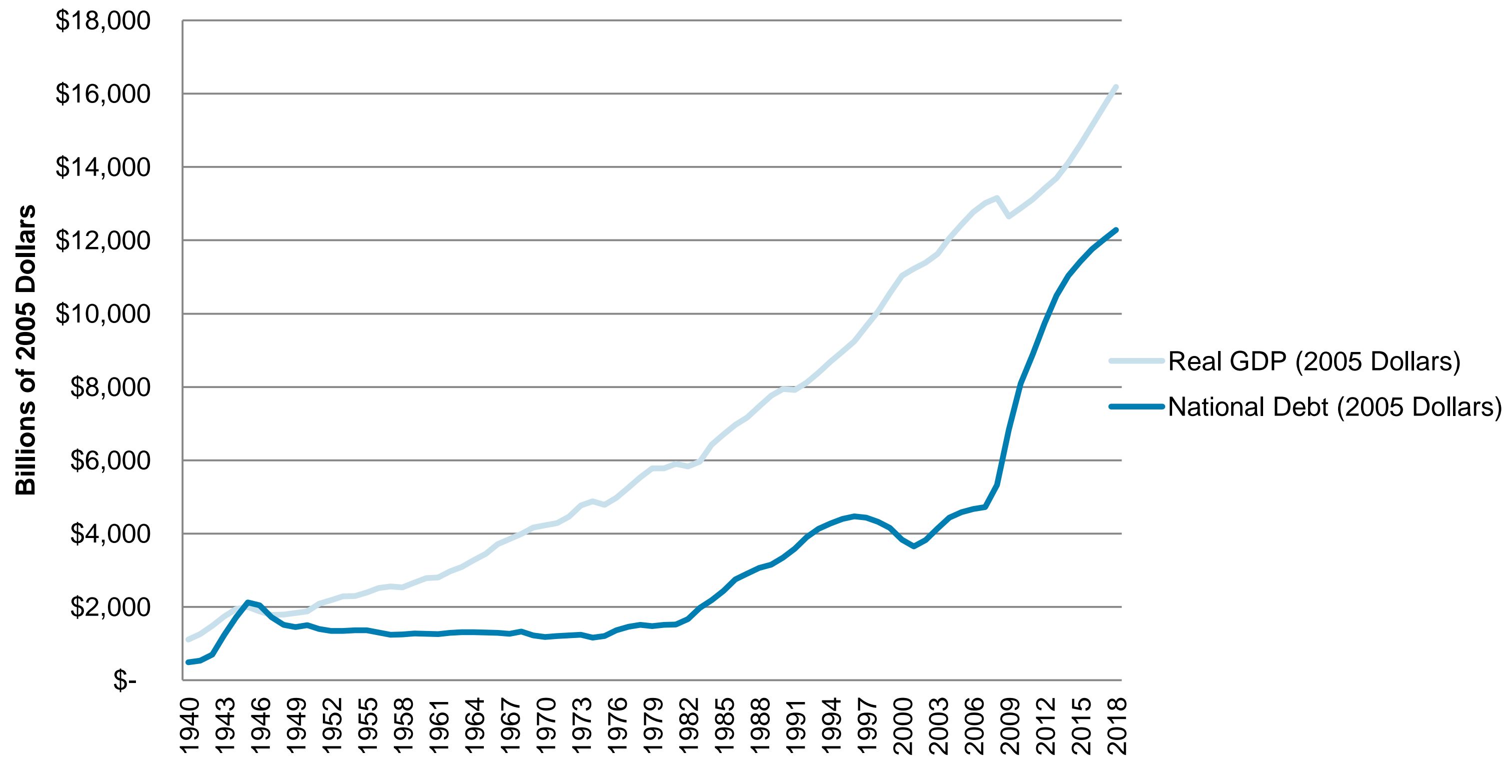
How comfortable do you feel with a “permanent” national debt approaching 90 percent of GDP?



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The income tax impact

Fair share tax (FST)–the Buffet Rule

- 30 percent tax on adjusted gross income
- Operate like an alternative minimum tax
- Would phase-in at $1 million for married filing jointly; phase-out at $2 million
- 28 percent credit offered on itemized charitable contributions
  - After three percent, overall phase-out of itemized deductions
- Tax is in addition to the 3.8 percent Medicare tax on investment income

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Reduction of certain deductions and tax expenditures

- Value of tax benefits capped at 28 percent
- High-income taxpayers (in excess of the 28 percent bracket) would no longer be able to offset income against deductions on a dollar-for-dollar basis
- Includes the following
  - Itemized deductions
  - Municipal bond interest
  - Health insurance costs
  - Retirement plan contributions
    - Tax basis added for income taxes paid
- Excludes the following
  - Life insurance cash surrender value
  - Annuities

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Carried interest rule

- Increase the income tax rate imposed upon certain managers and executives by re-characterizing the income from capital gain to ordinary income
- Income subject to self-employment tax
- Impacts the following entities
  - Private equity firms
  - Venture capital firms
  - Hedge funds
  - Certain investment partnerships
- Proposed planning strategies
  - Restructure compensation arrangement
  - Sale to an affiliate to accelerate capital gain treatment

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Other issues of note

- Life insurance
  - Limitation of life settlement transactions
    - Invoke section101 transfer for value rules for third-party sales of a life insurance interest
    - Dramatically impact the life settlement market
  - Corporate owned life insurance (COLI) limitations
    - The interest deduction of a business is reduced to the extent the interest is allocable to unborrowed policy cash values (based on a statutory formula)
    - Excluded from this reduction are contracts that cover officers, directors, employees, or 20percent owners of the taxpayer
    - Administration's proposal would exclude only 20 percent owners

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The estate, gift and retirement planning impact

Summary of the estate, gift and GST rules: Where we are now

- Unified estate and gift tax system
  - Maximum tax rate set at 40 percent
  - 2013 lifetime credit equivalent at $5.25 million
  - Portability of deceased spouse's lifetime exemption is made permanent
  - Estate, gift and GST changes have been made permanent

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Summary of the estate, gift and GST rules: Where we are now (cont.)

- The projected 2013 $5.25 million lifetime exclusion
  - The estate and gift tax calculation is now unified
    - $5.25 million serves as a “planning bank,” whereby this lifetime exemption can be offset by accumulated taxable gifts and the estate
  - GST exemption is also $5.25 million
    - The GST bank is used only against transfers that skip a generation
    - Gifts made to children do not impact the GST exclusion
    - Proper planning dictates that gifts and bequests made to grandchildren be accounted for separately

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Estate, gift and GST lifetime exclusion

- Since the $5.25 million lifetime exclusion was made permanent, do I still need to plan?
  - Gift tax leverage
    - Valuation discount strategies
    - State estate tax avoidance
    - Transfer of future asset appreciation
  - Non-tax issues
    - Asset protection
    - Preserving the personal legacy

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Portability is made permanent

- Portability of deceased spouse's lifetime exemption is made permanent
- Surviving spouse can bank the unused portion of the deceased spouse's lifetime exclusion by timely filing a Form 706
  - Form 706, Part 6 calculates remaining deceased spouse's exemption
  - The executor can elect out of the portability election
- Impacts estates that do not have an A/B formula
- There are no state portability statutes

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Portability is made permanent (cont.)

- Compliance requirement
  - To protect the deceased spouse's exemption, all estates should timely file a Form 706
    - Absent a timely filed return, the surviving spouse loses the deceased spouse's exemption
    - To encourage filing, modest estates (gross value below the lifetime exemption) can file a simpler return
      - Assumes assets will be taxed at spouse's death anyway
      - Not required to establish fair market value with qualified appraisals, however
      - Remember that these values will create a basis adjustment for capital gains purposes

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Is the 2012 Tax Act really permanent?

- Administration's FY 2014 Budget
  - Refocuses on high-net-worth individuals
  - Renews old proposal
  - Provides a few new surprises
  - Remember, this is still a "wish list"

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Administration's FY 2014 budget

- Bring back the 2009 tax law
- Effective Jan. 1, 2018
- 45 percent top tax bracket
- Estate and GST lifetime tax exemption of $3.5 million
- Gift tax exclusion of $1 million
- No adjustment for inflation
- Portability stays
- "Clawback" issues
- Key planning/compliance strategy–bank the deceased spouse's lifetime exclusion

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These are 2018 changes, why worry? Planning for the now

- Administration's proposal as a harbinger to 2013 changes?
  - Important planning strategies were left untouched
  - Limitations on these planning strategies are a part of the Administration's proposal
  - Conclusion: take advantage of these strategies while we have them

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Planning for the now

- Key estate and gift planning strategies available to the high-net-worth taxpayer
  - Grantor Retained Annuity Trusts (GRATs)
  - Intentionally Defective Grantor Trusts (IDGTs)
  - Dynasty trusts
  - Valuation discounts

- Key retirement planning changes
  - $3 million qualified plan limitation
  - Five-year payout of inherited IRAs

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Grantor Retained Annuity Trusts (GRATs)

- Proposed changes
  - Minimum ten-year term
  - Maximum grantor's life expectancy plus ten years
  - Level annuity payment
  - Required remainder interest greater than zero (no "zero-out" GRATs)
    - Requires a Form 709 filing
  - Effective for GRATs executed upon the date of enactment

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Intentionally Defective Grantor Trusts (IDGTs)

- Proposed changes
  - Assets received by the IDGT plus all retained income and appreciation are subject to the following:
    - Transfer tax reduced by consideration received by the grantor
    - If grantor dies with an IDGT, then it is subject to estate tax at death
    - If grantor defect is terminated during the grantor's life, then it is subject to gift tax upon termination of the defect
    - Third-party IDGT distributions subject to gift tax
  - Exceptions
    - Irrevocable life insurance trusts subject to section 677(a)(3) defect, and
    - Nonqualified deferred compensation plans (e.g., Rabbi trusts)
  - Effective for transactions executed after date of enactment

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Dynasty trusts

- Proposed changes
  - Terminate GST exempt status on the 90th anniversary of the GST tax trigger
  - Taxable terminations and distributions would be subject to GST after the anniversary date
  - Eliminate GST tax treatment for Health, Education, and Exclusion Trusts (HEETs)
    - GST payments for tuition or medical care would need to come from a living donor
  - Effective for trust contributions made after enactment date

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Valuation discounts

- Have been eliminated from the Administration's proposal
  - Is elimination of this provision a good thing?
  - Valuation discounts have been on the IRS radar screen for several years
  - Fundamental dislike of marketability discounts between related parties
    - Demonstrate a true marketability limitation
    - Demonstrate a valid business purpose
  - Use section 2704 as platform to limit discounts
    - Valuation discounts related to marketable securities partnerships were the chief issue of the Administration's 2012 proposal
    - Struggle with entities that hold both marketable securities and closely held business interests

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Retirement plan proposal

- Require "Automatic IRAs"
  - Employers in business for two years
  - Ten or less employees
  - Exempts employers already sponsoring a qualified plan
  - Exempts RMD for aggregate plans under $75,000
  - Non-spousal rollovers permitted
- Limit of tax-favored retirement benefits
  - Limit a 100 percent joint and survivor annuity (starting at age 62) at $205,000 per year
  - This limit represent a $3.4 million lump sum value
- Eliminate stretch IRAs
  - Require distributions within five years
  - Limitations
    - Special needs beneficiaries can have lifetime distributions if no more that ten years younger than the participant
    - Minor beneficiaries–five-year distribution commences upon age of majority

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A final word

- Proposals are only a wish list
- Still provides a harbinger to plan presently–particularly if the client is currently motivated to plan
- Important to keep these issues on your radar screen to ensure planning is timely
- Good luck!

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Thank you

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