Washington National Tax

Capitol Hill Update: Overview of the American Taxpayer Relief Act of 2012 and its potential impact

Jan. 16, 2013

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Today's presenters

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Agenda

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Capitol Hill update

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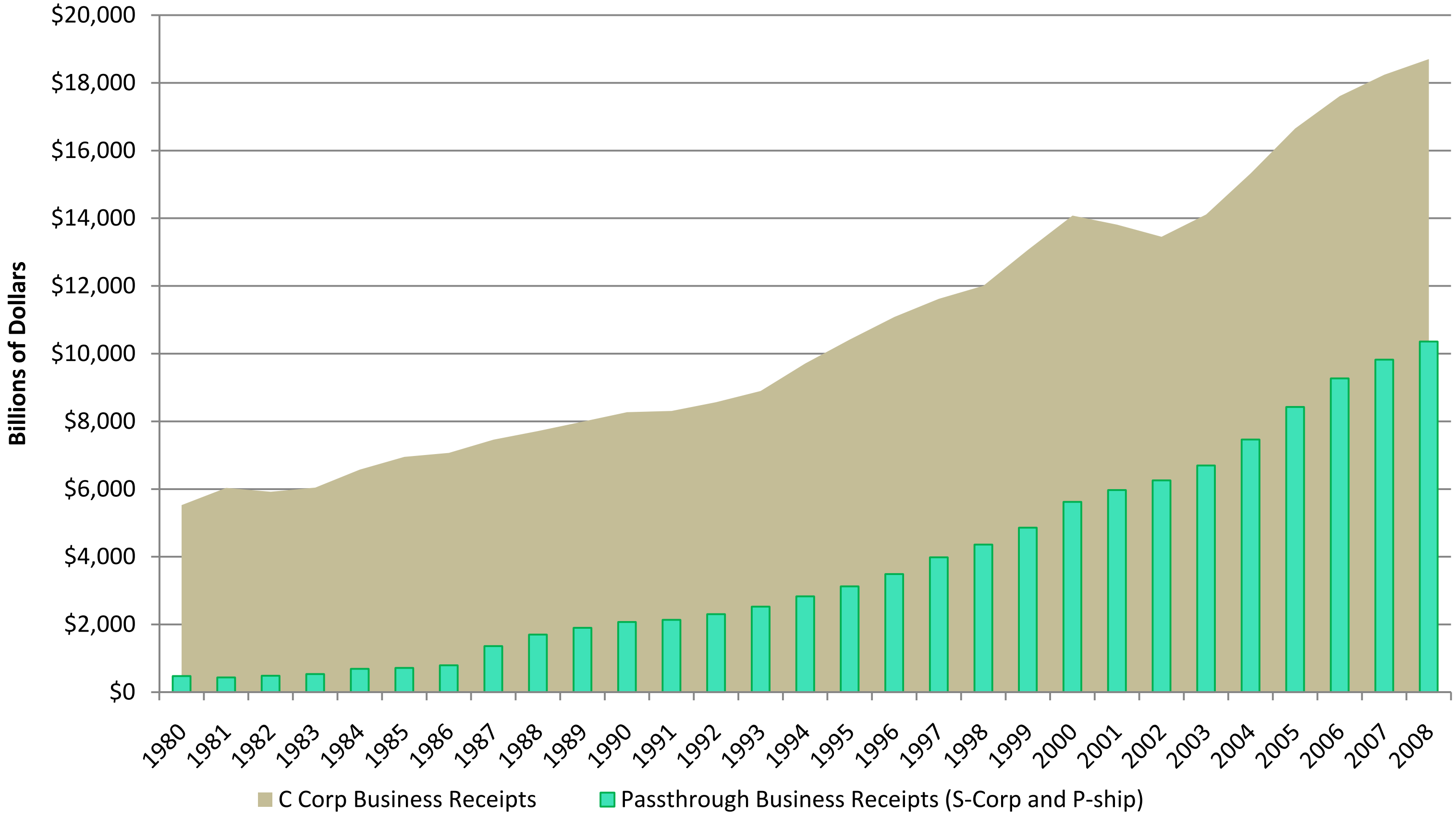
Business receipts of passthroughs now exceed 50 percent of C corp business receipts



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The American Taxpayer Relief Act of 2012 (ATRA)

- Individuals
  - Tax rates
  - Capital gains and dividends
  - Personal exemptions and itemized deductions
  - Payroll taxes
  - AMT
  - IRA provisions

- Estate and gift taxes

- Tax extenders

Real challenges: Spending cuts and tax policy

- Debt ceiling limit–recall August 2011
- Sequestration–merely deferred
- Continuing the continuing resolution
- Comprehensive tax reform
- Affordable Care Act

The estate and gift tax impact

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Summary of the estate, gift and GST rules

- Unified estate and gift tax system
  - Maximum tax rate increased from 35 to 40 percent
  - Lifetime credit equivalent maintained at $5.12 million
    - Subject to annual inflation increases
    - Projected 2013 lifetime credit projected to be $5.25 million
  - Portability of deceased spouse’s lifetime exemption is made permanent
  - Estate, gift and GST changes have been made permanent

Estate, gift and GST tax rates

- Maximum tax rate increased from 35 to 40 percent
  - Parties split the difference on the rates
    - Republican proposal of 35 percent versus Democratic proposal of 45 percent
    - Due to the high lifetime exclusion, the 40 percent rate serves as a flat rate for almost all taxpayers
    - State estate tax remain a federal estate tax deduction
  - Practical issue–with the higher rate, there may be an increased focus on asset valuation
    - Increased focus on qualified appraisals
    - Business planning strategy–review existing buy-sell agreements to assess reasonableness of transaction cost

Estate, gift and GST lifetime exclusion

- 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, but is not unified
    - 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

Estate, gift and GST lifetime exclusion (cont.)

- The inflation index creates its own unique planning opportunity
  - Can continue to create taxable gifts not resulting in an out-of-pocket gift tax
    1. Requires the filing of a Form 709
    2. Full disclosure on Form 709 tolls the three-year statute of limitations

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Estate, gift and GST lifetime exclusion (cont.)

- 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

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
  - Most living trusts already account for the deceased spouse's lifetime exemption
  - Issue is whether the current trust was tax planning driven rather than personally driven
  - If desire is to pass estate to surviving spouse, then this can now be done without adversely impacting the estate tax cost

Portability is made permanent (cont.)

- Compliance requirement
  - To protect the deceased spouse's exemption, all estates must 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) are not required to establish fair market value via appraisals

Is it really permanent?

- Bi-partisan support
  - Approved in the Senate 89-8
  - Approved in the House 257-167
- Issues
  - Was bi-partisan support driven by the calendar?
  - Will permanency be impacted by elections in 2014 or 2016?
  - This legislation:
    - Does not attempt to do true tax reform
    - Modestly deals with federal spending
    - Puts off the issue of the debt ceiling
    - Conclusion–plan for the now!!

Planning for the now

- Important planning strategies left untouched
- Prior concern–Republican proposal to carryover and make permanent the estate and gift tax laws would have been in exchange for losing key estate and gift tax planning strategies
- In lieu of losing these planning strategies, there was an increase of the unified tax rate to 40 percent
- Advanced estate and gift planning strategies remain intact
- Issue–can the planning strategies be part of a future bargaining chip?
- Conclusion–take advantage of the strategies while we have them

Planning for the now (cont.)

- Key planning strategies available to the high-net-worth taxpayer
- Valuation discounts
  - Democratic proposal–eliminate valuation discounts on select asset transfers (gifts or sales) to related parties
- Grantor Retained Annuity Trusts (GRATs)
  - Democratic proposal–require a minimum 10-year GRAT term
- Intentionally Defective Grantor Trusts (IDGTs)
  - Democratic proposal–eliminate the gift and income tax benefits associated with IDGTs
- Dynasty Trusts
  - Democratic proposal–require a transfer tax to be paid on the 90th anniversary date of the irrevocability of the trust

Some practical insights going forward

- IRS hot buttons
- Valuations
  - Updated business succession plan
  - Qualified appraisals
- Substance over form
  - Is there economic substance to the tax planning strategy?
- Enforcement of basic compliance requirements
  - E.g., notices that enforce required Crummey notices on irrevocable life insurance trusts
  - Qualification of $14,000 annual exclusion gifts

Extension of expiring tax provisions

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Extenders background

- The rationale for tax expenditures
- Why so many temporary tax provisions?
- The annual extenders drama

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Individual extenders

Tax incentive	Expiration date	Period extended
Deduction for certain expenses of school teachers	12/31/11	2012 and 2013
Treatment of mortgage insurance premiums as qualified residence interest	12/31/11	2012 and 2013
Option to deduct state and local sales tax in lieu of income tax	12/31/11	2012 and 2013
Deduction for tuition and related expenses	12/31/11	2012 and 2013
Tax-free distributions from individual retirement plans for charitable purposes	12/31/11	2012 and 2013

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Business extenders

Tax incentive	Expiration date	Period extended
Research and development tax credit	12/31/11	2012 and 2013
Work opportunity tax credit	12/31/11	2012 and 2013
Shortened built-in gain recognition period for S corporations from 10 years to five years	12/31/11	2012 and 2013
Increased section 179 expensing limitations ($500,0000 maximum and $2 million phase-out threshold) and treatment of certain real property as section 179 property	12/31/11	2012 and 2013

Business extenders (cont.)

Tax incentive	Expiration date	Period extended
50 percent bonus depreciation	12/31/12	2013
50 percent bonus depreciation for certain long-lived assets and transportation property	12/31/13	2014
Election to refund AMT credit carryforward in lieu of bonus depreciation	12/31/12	2013
15-year straight-line recovery period for qualified leasehold improvements, qualified restaurant buildings and qualified retail improvements	12/31/11	2012 and 2013
7-year recovery period for motorsports entertainment complexes	12/31/11	2012 and 2013

Energy extenders

Tax incentive	Expiration date	Period extended
Section 40(b) cellulosic biofuel producer credit	12/31/12	2013
Section 40A biodiesel and renewable diesel credit	12/31/11	2012 and 2013
Section 45 wind energy production tax credit	12/31/12	2013
Section 45L energy-efficient new homes credit	12/31/11	2012 and 2013
Section 6426(d) alternative fuels excise tax credit	12/31/11	2012 and 2013

The new permanent income tax rates

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What do we mean by *permanent*?

- Rates can be changed by future legislation
  - One Congress cannot bind a future Congress
- Rates will not change without affirmative legislative action by a subsequent Congress
  - Thus, if there is political gridlock, that favors preservation of the status quo
  - Plus, having just reached a deal on a “permanent” tax structure, anyone seeking to quickly reopen that deal may be criticized as not having negotiated in good faith

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

- What is the baseline for comparison?
  - The temporary rules in effect for 2012 returns?
  - The permanent rules that were in effect in 2000, when President Clinton left office, and before the Bush tax cuts?

How do we measure or explain effects of the new law? (cont.)

- 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?

American Taxpayer Relief Act’s new permanent income tax rules

- Bush-era tax rates generally retained
  - 2012 Bush-era rates continue for most taxpayers
  - This includes reduced rates for capital gains and qualified dividends
  - Only incremental taxable income (from either source) that exceeds $450,000 ($400,000 for singles) is taxed at a new, higher tax rate
    - New top ordinary income rate is 4.6 points higher (35 to 39.6 percent)
    - New capital gains rate is 5 points higher (15 to 20 percent)
  - Marriage penalty is much larger–by about $20,000

American Taxpayer Relief Act's new permanent income tax rules (cont.)

- 2012 level of AMT exclusions is retained and made permanent
- Clinton-era cut backs to personal exemptions and itemized deductions are permanently repealed for those with adjusted gross income (AGI) below $300,000 ($250,000 single)
  - For others-itemized deductions and personal exemptions are reduced as AGI exceeds $300,000 ($250,000)
  - In effect, this is more like a tax on AGI, not really a cut back to deductions–as was discussed during the election
  - It generally does not influence incentives

Example of cut back

- Gross salary (and AGI) equal $400,000 for the sole earner of married couple with two kids
- Itemized deductions of $35,000 plus personal exemptions around $15,000
- That would have produced taxable income for 2012 of $350,000
  - Thus, Bush-era rates continue to apply to all of this taxable income
  - cut backs occur because AGI is $100,000, more than threshold

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Example of exemption cut back

- AGI is $400,000, threshold is $300,000, and excess is $100,000
- Personal exemption is around $15,000
  - Cut back is 2 percent x ($100,000/$2,500) = 80 percent
  - When AGI hits approximately $422,500, the exemptions are fully gone, and there is nothing more to disallow
  - Thus, the tax benefits of the $15,000 of personal exemptions (about $5,000) is phased out as AGI goes from $300,000 to $422,500
  - No additional effect as AGI exceeds $422,500

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Example of deduction cut back

- AGI is $400,000, threshold is $300,000, excess is $100,000, three percent of excess is $3,000, and itemized deductions are $35,000
- cut back reduces itemized deductions from $35,000 to $32,000
- As long as some deductions (like state income taxes) are roughly proportional to AGI, the cut back is unlikely to influence whether to incur a deductible expense
  - It is more like a flat tax of about 1 percent on AGI– expressed as a cut back to itemized deductions
  - 35 percent x 3 percent x Excess AGI = 1.05 percent tax on Excess AGI

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Combined effects of cut backs and new rates

- Deduction and exemption cut backs start at AGI of $300,000 ($250,000)
- Bush-era rate benefits still apply to first $450,000 ($400,000) of taxable income
- New marginal tax rate above $450,000 of taxable income is sum of–
  - 39.6 percent on ordinary income (20 percent on capital gains), plus
  - 1.2 percent of AGI
  - 3.8 percent for Social Security or Obamacare

Combined effects of cut backs and new rates (cont.)

- Total marginal tax rate–
  - 44.6 percent for ordinary income
  - 25 percent for long-term capital gains (and qualified dividends)
    - Planning to reduce or eliminate 3.8 percent tax may be possible
- The marriage penalty is now substantially increased
- Getting a combined $450,000 exclusion from the new higher rates -- rather than two separate $400,000 exemptions -- could be costly.

Combined effects of cut backs and new rates (cont.)

- Getting a $300,000 exclusion from the deduction cut back rather than two $250,000 exemptions could be costly
  - Marriage is generally beneficial, tax wise, for spouses with unequal earnings. Note the possibility that alimony may split a single earner’s salary between two divorced former spouses, which could not happen if they had never married.

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)
  - Note that a couple making $1 million annually for 30 years might build up an estate worth $10.5 million (in 2013 dollars)
  - This would involve saving $300,000 of their annual $1 million in earnings – easier in a low-cost area, or where taxes are at capital gains rates
  - 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
  - They are still substantially better off than they were 13 years ago

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

- 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.

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

- Under Clinton-era tax policies, their 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

Other issues

- The payroll tax holiday is over
- Other changes
- No “Buffett Rule”
- No carried interest changes
- No cut back to the ordinary income/capital gain difference
- Qualified dividends taxed at capital gain rates

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