Family Wealth Services
2013 year-end tax planning—considerations for high-net-worth individuals and families

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Assurance ▪ Tax ▪ Consulting

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Income tax planning

Year-end planning strategies

Then and now–income tax rate changes

The tax impact of increased rates

(assuming maximum tax bracket)

	2012	2013
Maximum bracket	35%	39.6%
Capital gains	15%	20%
Qualified dividends	15%	20%
Phase-out of itemized deductions	0%	3%
Phase-out of personal exemptions	0%	2%
Social Security tax	4.2%	6.2%
Medicare surcharge on unearned net investment income	0%	3.8%
Medicare surcharge on earned W-2 wages and self-employment income	1.45%	2.35%

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2013 individual income tax rates

Tax rate	Single	Married filing jointly
10%	$0-$8,925	$0-$17,850
15%	$8,926-$36,250	$17,851-$72,500
25%	$36,251-$87,850	$72,501-$146,400
28%	$87,851-$183,250	$146,401-$223,050
33%	$183,251-$398,350	$223,051- 398,350
35%	$398,351-$400,000	$398,351-$450,000
39.6%	Over $400,000	Over $450,000

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2013 alternative minimum tax rates

Tax rate	Single	Married filing jointly
26%	$0-$179,500	$0-$179,500
28%	Over $179,500	Over $179,500
Exemption	$51,900	$80,800
Phase-out	$115,400-$323,000	$153,900-$477,400

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Example: Phase-out of personal exemptions

- Gross salary $400,000
- Itemized deductions $35,000
- Personal exemptions $15,000 (married, two children)
- Phase-outs for AGI > $300,000 ($250,000)
- 2012–taxable income would be $350,000
- 2013–taxable income is higher at $365,000
  - Personal exemption phased out at rate of 2 percent * AGI excess / $2,500)
    - 2 percent * ($400,000 - $300,000) / $2,500 = 80 percent phase-out (lose $12,000)
  - At approximately $425,000, all phased out
    - 2 percent * ($425,000 - $300,000) / $2,500 = 100 percent phase-out

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Example: Phase-out of itemized deductions

- Gross salary $400,000
- Itemized deductions $35,000
- Personal exemptions $15,000 (married, two children)
- Phase-outs for AGI > $300,000 ($250,000)
- 2012–taxable income would be $350,000
- 2013–taxable income is $365,000
  - Itemized deductions phased out at rate of 3 percent * AGI excess
  - AGI of $400,000 results in $3,000 in lost deductions
    - 3 percent * ($400,000 - $300,000) = $3,000 in lost deductions

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Bush rates remain, but….

- Bush-era rates still apply to first $450,000 ($400,000) of taxable income
  - New marginal rate above $450,000 of taxable income
    - 39.6 percent on ordinary income (including short-term capital gains)–up from 35 percent
    - 20 percent on long-term capital gains–up from 15 percent
    - 3.8 percent for Social Security or section 1411 tax
    - 1.2 percent of AGI (estimate for impact of phase-outs)
  - Total marginal tax rate
    - 43.4 percent (44.6 percent) for ordinary income
    - 23.8 percent (25 percent) for long-term capital gains and qualified dividends
      - Planning to reduce 3.8 percent tax is possible

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Year-end income tax planning strategies

- Defer ordinary income
  - Look for deductions–depreciation, bonuses
  - Defer income–accounting methods
- Acceleration of itemized deductions
  - Cash-basis taxpayer
  - Charitable deductions (donor-advised, private foundations)
- The 3.8 percent net investment income tax
  - Consider grouping elections
- Harvest capital losses
- Direct gifts from IRA to charity
- Roth IRA conversions

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Planning strategies–look for deductions and credits

- Business deductions flowing to individuals
  - Section 179 expenses
  - Bonus depreciation
  - Work Opportunity Tax Credit (WOTC)
  - Research and development
  - Built-in gains for > 5-year-old S corporations
- Accounting methods
- Tangible asset and repair review
- Cash-method taxpayer planning
  - Timing of payments
  - Push two years of itemized deductions into one year

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Planning strategies—harvest losses in 2013 and avoid “wash sale” rules

- Sell and go to cash for 30+ days
  - Simple
  - High-risk proposition that reduces market exposure
- “Pair-up transaction” looks for similar securities for 30+ days
  - Stocks and bonds that have similar price movement
  - Market options and futures
  - Mutual funds and ETFs (market, country and sector)

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Planning strategies—charitable giving

- Consider donating appreciated securities versus cash
  - Deduction equal to fair market value (FMV)
  - Avoid capital gains tax
- Checks
- Credit cards
- Donor-advised funds
- Private foundations

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AMT planning for 2013

- Separate tax system
  - Deductions limited
    - State and local taxes (consider timing)
    - Property tax deductions (consider timing)
    - Miscellaneous itemized deductions subject to two percent AGI floor
    - Certain home equity interest if debt not used for home improvements
  - Preferences added back
    - Certain tax-exempt interest
    - Accelerated depreciation
    - Incentive stock options (consider deferring)

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Section 1411 overview

- Applicable to 2013 (years beginning after Dec. 31, 2012)
- Applies to “net investment income” (NII)
- Flat rate of 3.8 percent (Medicare surcharge)
- Thresholds (lesser of excess of MAGI or NII)
  - Single taxpayers-$200,000
  - Married taxpayers-$250,000
  - Estates/trusts-$11,950 (consider distribution planning)
- Examples
  - Single with $190,000 of wages and $11,000 of interest is taxed on $1,000
  - Single with $190,000 of interest and $11,000 of wages is taxed on $1,000

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Section 1411 overview (cont.)

- Generally, NII IS:
  - Trade or business income
  - Interest
  - Dividends
  - Annuities
  - Royalties
  - Rents
  - Net gains from disposition of property
  - Income from a passive activity
    - In all cases, less any properly allocable deductions

- Generally, NII is NOT:
  - Income or gains from any trade or business in which the taxpayer "materially participates"
    - Applying the "passive loss" rules of section 469
    - Exclusion applies even if the income is also exempt from self-employment tax
  - Salary, wages or bonuses
  - Distributions from IRAs/qualified plans
  - Income taken in for self-employment tax purposes
  - Gain on the sale of an active interest in a partnership or S corporation
  - Tax-exempt bond interest
  - Capital gain excluded under section 121 for primary homes

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Section 1411 planning–section 469 planning

- Consider grouping of activities to meet material participation
  - Subject to section 469 regulations
  - Groupings cannot be changed unless clearly erroneous or material change in facts
- Examine “rents” to see if they are part of a larger business activity—“self rentals”

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Section 1411 planning–real estate professional exception

- Most rental activities are per se passive activities regardless of the extent of the taxpayer's participation
    - Therefore, rental income would generally be subject to the section 1411 tax
    - But, note that certain “rentals” in connection with active businesses are not treated as rental income
- Section 469(c)(7)(B):
    - A taxpayer is a qualifying real estate professional if:
        - More than half of the personal services performed in all trade or business activities during the year are performed in “real property trades or businesses” in which he/she materially participates, and
        - He/she performs more than 750 hours of services during the tax year in real property trades or businesses in which he/she materially participates
    - If a client qualifies as a real estate professional, consider election to aggregate all rentals as a single activity to meet the material participation test under section 469

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Section 1411 planning–strategies for reducing "net investment income"

1. Municipal bond investments
2. Tax-deferred annuities and life insurance
3. "Trade or business" real estate
4. Oil and gas investments
5. Timing of estate/trust distributions—65 day rule
6. Funds–are you active in a trade or business?
7. S corporation distributions rather than wages
8. Installment sales

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Medicare surcharge on earned income

- Applicable to 2013 (years beginning after Dec. 31, 2012)
- Flat rate of 0.9 percent (Medicare surcharge)
- Applies to earned income–Form W-2 and self-employment income
- Thresholds
  - Single taxpayers-$200,000
  - Married taxpayers-$250,000
- Example
  1. Single with $500,000 of self-employment income
     - $200,000@2.9 percent
     - $300,000@3.8 percent
- Planning–S corporation distributions, shifting income and expenses, self-rentals

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Income tax planning summary

- Many changes in 2013
- Opportunities exist
- Five major factors to consider
  1. Income tax
  2. AMT
  3. Phase-outs of exemptions and itemized deductions
  4. Net investment income Medicare surcharge
  5. Earned income Medicare surcharge

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Estate and gift tax planning

Year-end planning strategies

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 of $5.25 million
    - Permanently indexed for inflation from 2011
      - $5.34 million for 2014
  - Portability of deceased spouse's lifetime exemption has been made permanent
  - Estate, gift and GST changes have been made permanent

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Estate, gift and GST tax rates

- Maximum tax rate increased from 35 to 40 percent
  - The midpoint between the 2012 rate of 35 percent and the 2009 rate of 45 percent
  - 40 percent rate produces a “tax-exclusive” gift tax rate of about 28.57 percent, if the donor survives three years

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Estate, gift and GST lifetime exclusion

- The 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

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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?
  - You want specific assets (or amounts) to pass to certain beneficiaries
  - You want to leave property to a trust for beneficiaries instead of leaving property to beneficiaries outright
  - You have, or anticipate having, an estate large enough to require payment of estate tax
  - You want to protect your assets from potential claims by your creditors and beneficiaries
  - You or your spouse is not a U.S. citizen

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Portability is made permanent

- Portability of deceased spouse's lifetime exemption is made permanent (does not apply to GST exemption)
- Surviving spouse can bank the unused portion of the deceased spouse's lifetime exclusion by timely filing a Form 706
- Impacts estates that do not have an A/B formula
  - Most living trusts already account for the deceased spouse's lifetime exemption
  - If desire is to pass estate to surviving spouse, then this can now be done without adversely impacting the estate tax cost

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Is it really permanent?

- Bipartisan support
  - Approved in the Senate 89-8
  - Approved in the House 257-167
- Issues
  - Was bipartisan support driven by the calendar?
  - Will permanency be impacted by elections in 2014 or 2016?
  - FY14 “Greenbook” revives the proposal to return estate, gift and GST taxes to their 2009 levels but retain portability beginning in 2018
    - 45 percent rate
    - $3.5 million for estate & GST exemption
    - $1 million of the gift tax exemption
- Conclusion–plan for the now!

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Planning for the now – tip #1

- Who's affected: Married couples and their loved ones
- Planning tip: Consider credit shelter (or bypass) trust at the first to die
- Portability is a federal concept, and currently, no states allow portability of a deceased spouse's state exemption amount
- Portability does not protect future growth on assets
- If the surviving spouse eventually remarries, the ability to use the deceased spouse's exemption may be lost. You can only use the exemption of the last spouse you survived

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Planning for the now – tip #2

- Who's affected: Families and their loved ones
- Planning tip: You may pay tuition and medical expenses without the payment being treated as a taxable gift, as long as the payment is made directly to the provider
- Tuition is not limited to college tuition; any qualified school's tuition can be excluded
- Medical expenses include co-pays and health insurance premiums

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Planning for the now – tip #3

- Who's affected: Individuals who own life insurance
- Planning tip: Assign life insurance policies (including group term) to irrevocable life insurance trust
- Assets are removed from your gross estate
- Trust can be drafted to provide for surviving spouse and future generations

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Planning for the now – tip #4

- Who's affected: Families who are just starting to plan
- Planning tip: Gifts up to $14,000 per recipient are generally covered by the gift tax annual exclusion and are not subject to gift tax. The annual exclusion is adjusted for inflation in increments of $1,000. Plan to take full advantage of annual exclusion gifts prior to considering more advanced planning
- In 2013, a couple with three married children could give $168,000 without incurring a taxable gift

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Planning for the now – tip #5

- Who's affected: Individuals who have significant wealth in a residence or second home
- Planning tip: A qualified personal residence trust (QPRT) allows you to give your home to your children today–removing it from your taxable estate at a reduced tax cost (provided you survive the trust's term)–while you retain the right to live in it for a certain period

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Planning for the now – tip #6

- Who's affected: Individuals holding property with the potential for significant appreciation
- Planning tip: A grantor-retained annuity trust (GRAT) works similarly to a QPRT but allows you to transfer other assets; you receive payments from the trust for a certain period

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Planning for the now – tip #7

- Who's affected: Owners of closely held business interests
- Planning tip: You can leverage your gift tax exclusions and exemption by gifting ownership interests, which may be eligible for valuation discounts
- For example, if the discounts total 30 percent, you can gift an ownership interest equal to as much as $20,000 tax-free because the discounted value does not exceed the $14,000 annual exclusion
- Warning: A professional, independent valuation is recommended

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Planning for the now – tip #8

- Who's affected: Families of significant wealth
- Planning tip: A GST–or "dynasty"–trust can help you leverage both your gift and GST tax exemptions, and it can be an excellent way to potentially lock in the currently high exemptions
- The wealth accumulated in the trust thereafter avoids both estate and GST tax at each subsequent generation until such time as the trust terminates

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Planning for the now – tip #9

- Who's affected: Families that already have a plan
- Planning tip: The indexing feature applied to the $5.25 million exclusion amount provides its own unique planning opportunity
- One can reasonably expect that the annual increase will be not less than 2 percent. At 2 percent, the annual increase should not be less than $100,000 in any given year
- Consider instituting a program of transferring the annual index increase at the beginning of each calendar year

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Planning for the now – tip #10

- Who’s affected: Families of significant wealth
- Planning tip: Don’t overlook the advantages of gifts made to a grantor trust. If the grantor retains certain powers, the income of the trust is taxed to the grantor
- Interestingly, the retention of some of these powers will not cause the trust to be disregarded for transfer tax purposes

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Planning for the now – tip #11

- Who's affected: Families that already have a plan
- Planning tip: If you have an existing GST trust that has an inclusion ratio of between zero and one (a trust where a distribution to a skip person would be partially subject to GST), you should consider allocating the increased exemption to such a trust

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Planning for the now – tip #12

- Who's affected: Families of significant wealth
- Planning tip: The effective tax rate for gifts is always lower than for bequests because they share the same rate structure. Thus, the "tax exclusive" nature of the gift tax makes gifting a generally more efficient method of transferring wealth

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Key planning strategies unchanged "for now"

- 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

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Thank you

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