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

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<table>
<thead>
<tr>
<th>Topic</th>
<th>Minutes</th>
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<tbody>
<tr>
<td>Welcome</td>
<td>10</td>
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<tr>
<td>Individual tax planning</td>
<td>30</td>
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<tr>
<td>Estate and gift tax planning</td>
<td>20</td>
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</tbody>
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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)

<table>
<thead>
<tr>
<th></th>
<th>2012</th>
<th>2013</th>
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<tbody>
<tr>
<td>Maximum bracket</td>
<td>35%</td>
<td>39.6%</td>
</tr>
<tr>
<td>Capital gains</td>
<td>15%</td>
<td>20%</td>
</tr>
<tr>
<td>Qualified dividends</td>
<td>15%</td>
<td>20%</td>
</tr>
<tr>
<td>Phase-out of itemized deductions</td>
<td>0%</td>
<td>3%</td>
</tr>
<tr>
<td>Phase-out of personal exemptions</td>
<td>0%</td>
<td>2%</td>
</tr>
<tr>
<td>Social Security tax</td>
<td>4.2%</td>
<td>6.2%</td>
</tr>
<tr>
<td>Medicare surcharge on unearned net investment income</td>
<td>0%</td>
<td>3.8%</td>
</tr>
<tr>
<td>Medicare surcharge on earned W-2 wages and self-employment income</td>
<td>1.45%</td>
<td>2.35%</td>
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## 2013 individual income tax rates

<table>
<thead>
<tr>
<th>Tax rate</th>
<th>Single</th>
<th>Married filing jointly</th>
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<tbody>
<tr>
<td>10%</td>
<td>$0-$8,925</td>
<td>$0-$17,850</td>
</tr>
<tr>
<td>15%</td>
<td>$8,926-$36,250</td>
<td>$17,851-$72,500</td>
</tr>
<tr>
<td>25%</td>
<td>$36,251-$87,850</td>
<td>$72,501-$146,400</td>
</tr>
<tr>
<td>28%</td>
<td>$87,851-$183,250</td>
<td>$146,401-$223,050</td>
</tr>
<tr>
<td>33%</td>
<td>$183,251-$398,350</td>
<td>$223,051-398,350</td>
</tr>
<tr>
<td>35%</td>
<td>$398,351-$400,000</td>
<td>$398,351-$450,000</td>
</tr>
<tr>
<td>39.6%</td>
<td>Over $400,000</td>
<td>Over $450,000</td>
</tr>
</tbody>
</table>
## 2013 alternative minimum tax rates

<table>
<thead>
<tr>
<th>Tax rate</th>
<th>Single</th>
<th>Married filing jointly</th>
</tr>
</thead>
<tbody>
<tr>
<td>26%</td>
<td>$0-$179,500</td>
<td>$0-$179,500</td>
</tr>
<tr>
<td>28%</td>
<td>Over $179,500</td>
<td>Over $179,500</td>
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<tr>
<td>Exemption</td>
<td>$51,900</td>
<td>$80,800</td>
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<tr>
<td>Phase-out</td>
<td>$115,400-$323,000</td>
<td>$153,900-$477,400</td>
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</table>
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
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
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
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**
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
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)
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
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)
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
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
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”
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.
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
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
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
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
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
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
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
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
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!
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
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
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**
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
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
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
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
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
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
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
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.
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
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
Thank you

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