Family Wealth Services webcast

Year-end tax planning considerations for high-net-worth individuals and families

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Today’s presenters

Randy Abeles
Family Wealth Services National Practice & Great Lakes Region Leader
Principal, Chicago
randy.abeles@mcgladrey.com

Mathew Talcoff
Family Wealth Services Northeast Region Leader
Partner, Boston
mathew.talcoff@mcgladrey.com

Charles Schultz
Estate & Gift Tax Practice, Washington National Tax
Partner, Chicago
charles.schultz@mcgladrey.com
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<th>Topic</th>
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<td>The legislative scorecard—a post-election analysis</td>
<td>Randy Abeles</td>
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<tr>
<td>Year-end income tax planning update</td>
<td>Mathew Talcoff</td>
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<td>Year-end estate and gift tax planning update</td>
<td>Charles Schultz</td>
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<td>A final word</td>
<td>Randy Abeles</td>
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The post-election legislative scorecard
## Counting the seats

<table>
<thead>
<tr>
<th></th>
<th>Pre-election 2014</th>
<th>Post-election 2015</th>
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<tr>
<td><strong>House</strong></td>
<td></td>
<td></td>
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<tr>
<td>- Democrat</td>
<td>199</td>
<td>186</td>
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<tr>
<td>- Republican</td>
<td>233</td>
<td>244</td>
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<tr>
<td>- Vacancies or unknown</td>
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<td>5</td>
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<tr>
<td><strong>Senate</strong></td>
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<td></td>
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<tr>
<td>- Democrat</td>
<td>53</td>
<td>44</td>
</tr>
<tr>
<td>- Republican</td>
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<td>- Independent</td>
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<tr>
<td>- Undecided</td>
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## The legislative scorecard–A post-election analysis (cont.)

### Projected Congressional leaders

<table>
<thead>
<tr>
<th></th>
<th>Pre-election 2014</th>
<th>Post-election 2015</th>
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<tbody>
<tr>
<td><strong>House</strong></td>
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<td></td>
</tr>
<tr>
<td>- Speaker</td>
<td>Boehner</td>
<td>Boehner</td>
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<tr>
<td>- Ways and Means Chair</td>
<td>Camp</td>
<td>Ryan</td>
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<tr>
<td><strong>Senate</strong></td>
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<tr>
<td>- Majority Leader</td>
<td>Reid</td>
<td>McConnell</td>
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<tr>
<td>- Finance Committee Chair</td>
<td>Wyden</td>
<td>Hatch</td>
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Paul Ryan’s tax platform
- Simplify tax code
- Lower tax rates for individuals to a top individual rate of 25 percent
- Consolidate individual income tax brackets into just two brackets with a lower bracket of 10 percent
- Repeal alternative minimum tax (AMT)
- Cap corporate tax rate at 25 percent
- Transition tax code to a more competitive system of international taxation as a response to renunciation of citizenship and corporate tax inversion
The legislative scorecard–A post-election analysis (cont.)

- Orrin Hatch’s tax platform
  - Simplify the tax code
  - Lower tax rates for individuals and corporations
  - Repeal federal estate, gift and generation-skipping tax
  - Repeal AMT
  - Make permanent the favorable research and development tax credit
  - Repeal the Affordable Care Act (ACA)
The legislative scorecard—A post-election analysis (cont.)

- What we should expect
- Without a super majority in the Senate, bipartisanship will be a requirement
- The passage of the Obama administration’s tax proposal is dead
- New hope related to tax extender legislation?
- At least in the short term, dramatic changes in individual tax legislation are highly unlikely
2014 year-end income tax planning update
### Overview of the 2015 federal income tax

<table>
<thead>
<tr>
<th></th>
<th>2013</th>
<th>2014*</th>
<th>2015*</th>
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<tbody>
<tr>
<td>39.6% bracket–MFJ</td>
<td>$450,000</td>
<td>$457,600</td>
<td>$464,850</td>
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<td>39.6% bracket–Trusts</td>
<td>$11,950</td>
<td>$12,150</td>
<td>$12,300</td>
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<tr>
<td>Personal exemption</td>
<td>$3,900</td>
<td>$3,950</td>
<td>$4,000</td>
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<td>Standard deduction–MFJ</td>
<td>$12,200</td>
<td>$12,400</td>
<td>$12,600</td>
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<td>Phase-out of itemized deductions–MFJ</td>
<td>$300,000</td>
<td>$305,050</td>
<td>$309,900</td>
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<td>AMT exemption–MFJ</td>
<td>$80,800</td>
<td>$82,100</td>
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<td>Medicare 3.8% threshold–MFJ</td>
<td>$250,000</td>
<td>$250,000</td>
<td>$250,000</td>
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<tr>
<td>Ordinary income tax (top rate)</td>
<td></td>
<td>←39.6%→</td>
<td></td>
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<tr>
<td>LTCG and qualified dividend income tax (top rate)</td>
<td></td>
<td>←20.0%→</td>
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<tr>
<td>Social Security tax</td>
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<td>←6.2%→</td>
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<tr>
<td>Medicare “Obamacare” 1411 tax (unearned–NII)</td>
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<td>←3.8%→</td>
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<tr>
<td>Medicare tax (earned–W-2 and SE income)</td>
<td></td>
<td>←2.35%→</td>
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Planning strategies—Manage adjusted gross income (AGI)

- Above-the-line adjustments (AGI)
  - AGI is key to Medicare tax and phase-outs
  - Defer income—manage Medicare and AGI phase-out thresholds
  - Harvest capital losses
  - Maximize deductible retirement plan contributions for 2014
    - $17,500 limit for 401(k) plans
    - $5,500 post-age 50 “catch up” amount
  - Manage for parallelism Schedule C and Schedule E losses
Planning strategies–Manage deductions

- Harvesting tax deductions
  - Calculate AGI to assess exposure to phase-outs
  - Properly planned itemized deductions may provide 43.4 percent federal tax benefit
  - Accelerate/decelerate deductions based upon AGI
  - Consider bunching miscellaneous deductions to exceed the 2 percent floor
  - Examine your flow-through/personal businesses
    - Accelerate/decelerate bonuses/other expenses
    - Section 179, tax credits and manufacturing incentives
    - Capture flow-through non-resident taxes
    - Captive insurance
Planning strategies—Harvest losses in 2014 and avoid “wash sale” rules

- Sell and go to cash for 30-plus days
  - Simple
  - High-risk proposition that reduces market exposure
- “Double down”—sell the original high-cost lot first
  - Have a value mentality
- “Pair-up transaction”
  - Look for similar securities for 30-plus days
  - Stocks and bonds that have similar price movement
  - Market options and futures
  - Mutual funds and exchange-traded funds (ETFs) (market, country and sector)
AMT planning for 2014

- **Separate tax system**
  - 28 percent tax rate, low exemption of $82,100 for married taxpayers filing jointly
  - Tax of the middle class
  - Deductions limited
    - State and local taxes (consider timing)
    - Property tax deductions (consider timing)
    - Miscellaneous itemized deductions subject to 2 percent AGI floor
    - Certain home equity interest
  - Preferences added back
    - Certain tax-exempt interest
    - Accelerated depreciation
    - Incentive stock options (consider deferring)
Planning strategies—Charitable giving

- Donating appreciated securities versus cash
  - Deduction equal to fair market value
  - Avoid capital gains tax
- Checks
- Credit cards
- Donor-advised funds
- Private foundations
- Charitable lead or remainder trusts
- Unfortunately no transfers from IRAs—YET
Trust income tax planning

- Trusts have extraordinarily low tax brackets
- 2014 trust taxable income > $12,150 will be subject to both the 39.6 percent bracket AND the 3.8 percent Medicare tax
- Where appropriate, shift income to beneficiaries in lower tax brackets
- Determine whether capital gains can be characterized as distributable net income in the trust
- Year-end distributions and the “65-day rule”
Section 1411 overview

- Generally, net investment income (NII) is*:
  - Trade or business income
  - Interest
  - Dividends
  - Annuities
  - Royalties
  - Rents
  - Net gains from disposition of property
  - Income from passive activity
  - Capital gain on primary home in excess of section 121 exclusion

- Generally, NII is not:
  - Income or gains from any trade or business in which the taxpayer is active
    - 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 home

*In all cases, less any properly allocable deductions
Section 1411 planning—Section 469 planning

- Consider grouping of activities to meet material participation—an election
  - 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”
Section 1411 planning—Strategies for reducing NII

- Investing in municipal bonds
- Tax-deferred annuities and life insurance
- “Trade or business” real estate
- Oil and gas investments
- Timing of estate/trust distributions—65-day rule
- Funds—Are you active in a trade or business?
- S corporation distributions rather than wages
- Installment sales
- Convert C corporation to S corporation prior to sale
The active business exception

- Does not include C corporations
- Does not include the business of trading financial instruments or commodities
- Generally, does not apply to “rental” activities
  - Rental means all rent-like income, including from personal property, e.g., a copy machine or automobile
  - Exceptions
    - Short-term (hotel or a short-term car rental)
    - Substantial services provided (hospital room)
    - “Self-rental” and “real estate professionals”
The active business exception (cont.)

- Exception includes proprietorships, partnerships, limited liability companies (LLCs) and S corporations
- Activity is defined under section 469
  - Common annual hourly threshold is 500 hours of activity in a year
  - Greater than 100 hours active participation rule
  - Consult your tax advisor to determine activity
- Business owners may consider S corporation election to mitigate the tax
The active business exception—Trusts?

- Can the trust qualify as active?
- Can only an individual and not an entity qualify for this exception?
- Must all trust assets be subject to the 3.8 percent Medicare tax?
Frank Aragona Trust et al. v. Commissioner, 142 T.C. No. 9, No. 15392-11(2014)

- Human being/trustee, acting as trustee, may qualify the trust
- Absolute voting control by active trustee(s) over trust was not required
- Court did reject IRS view that “trust” could not be “real estate professional”
- Court rejected IRS view that special language in trust was required
- With planning, active business interests held in trusts can avoid this tax, but you must plan carefully
Affordable Care Act–Individual shared responsibility provision

- Effective Jan. 1, 2014, all legal residents are required to do one of the following:
  - Hold qualifying minimum health care coverage,
  - Have an exemption from coverage, or
  - Pay the penalty when filing the income tax return

- The penalty is as follows:
  - 2014: Greater of $95 per person (including $47.50 per child under 18) or 1 percent of household income
  - 2015: Greater of $325 per person (including $162.50 per child under 18) or 2 percent of household income
  - 2016: Greater of $695 per person (including $347.50 per child under 18) or 2.5 percent of household income
  - Penalties are capped to the cost of a “bronze plan”
ACA–Individual shared responsibility provision (cont.)

- Taxpayer, who is not a participant in an employer plan, has adjusted gross income of approximately $200,000. She has decided not to purchase any health insurance for herself, her husband and her two children for ACA purposes. The estimated penalties are as follows:
  - 2014: $1,800
  - 2015: $3,600
  - 2016: $4,500

- Penalties are due upon the filing of the taxpayer’s return
Among the exemptions from penalty are the following:

- Uninsured for less than three months of the year
- Lowest-priced coverage available is greater than 8 percent of your household income
- Not required to file a tax return because income is too low
- Not lawfully present in the United States
- Qualify for a hardship exemption
Income tax planning summary

- Opportunities exist
- Five major factors to consider
  - Income tax
  - AMT
  - Phase-outs of exemptions and itemized deductions
  - NII Medicare surcharge
  - Earned income Medicare surcharge
2014 year-end estate and gift and planning update
## Estate and gift tax overview

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<th></th>
<th>2013</th>
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<tbody>
<tr>
<td>Maximum tax bracket</td>
<td>40%</td>
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<tr>
<td>Lifetime exemption</td>
<td>$5,250,000</td>
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<td>Annual exclusion</td>
<td>$14,000</td>
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<tr>
<td>Foreign spousal</td>
<td>$143,000</td>
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<tr>
<td>exclusion</td>
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Basic gift planning

- Outright gifts
- “KISS” method of planning (keep it simple)
- Seize the valuation discount opportunities
  - Liquidity/non-marketability of closely held interests
  - Minority interests in closely held corporations or non-controlling interests in a limited partnership
- Potential state estate tax savings
State estate tax and planning

- An aggressive gifting strategy can eliminate state estate tax
- Many states have their own estate/inheritance tax
  - Only one state has a gift tax—Connecticut
  - Only two states account for accumulated taxable gifts for estate tax purposes—New York and Vermont
The key driver to year-end planning–The current economic environment

- Interest rates remain near historical lows
  - Leverage modest lifetime exclusion through grantor retained annuity trusts and sales to grantor trusts
  - Take advantage of the low interest rate environment (e.g., the December 2014 section 7520 rate is a modest 2.0 percent)
  - Can use this rate the following two months
  - Take advantage of valuation discounts between related parties
Low interest rate environment and leveraging gifts

- Great strategies for those who have already utilized their $5.34 million lifetime exemption
- Grantor retained annuity trusts (GRATs)
  - Two advantages
    - Banking the valuation discount
    - Banking the capital appreciation
    - Strategy—funding the GRAT with an LLC holding liquid assets
- Sale to a defective grantor trust
  - Using the low applicable federal rates
  - Avoidance of capital gain recognition
Grantor retained annuity trust (GRAT)

- **Donor**
  - Gift of remainder interest in assets
  - Annuity for term of years

- **Trust**
  - At end of term

- **Remainder Beneficiaries**
Zeroed-out or “Walton” GRAT and transfers of closely held interests—example

- $1 million S corporation value
  - 32 percent valuation discount creates a $680,000 value

- $680,000 is used to calculate the annuity payment

- GRAT is calculated to create a nominal gift tax liability
Zeroed-out or “Walton” GRAT and transfers of closely-held interests—example (cont.)

1,000 shares valued at $680,000

$134,379 Year 1 payment*
$161,255 Year 2 payment*
$193,506 Year 3 payment*
$232,207 Year 4 payment*

Remainder interest: $126,774**

*Assumes a 5 percent growth of $1,000,000 S corporation value.

**Assumes section 7520 rate of 2.2 percent.
Sale to a defective trust

- Sale to intentionally defective grantor trust (IDGT)
  - Estate freezing technique
  - Rate arbitrage—low interest rate note in exchange for a highly appreciated asset
  - Non-recognition of capital gain
Sale to a defective trust (cont.)

Assumptions: Grantor holds shares of ABC S corporation worth $1.385 million

1. Gift – Seed money ($100,000)
2. Sale - Discounted interest in ABC ($900,000 assuming 35% discount)
   - $900,000 promissory note
   - 30 year term
   - 3.00% interest rate
Sale to a defective trust (cont.)

- Capital gain recognition – the unintended turning off of the defect
- Flow-through entities
  - IRS crackdown of tax-driven LLCs and family limited partnerships
  - Important elements required
    - Business purpose test
    - Lack of marketability discount
A final word—What to watch in 2015

- Take advantage of the current planning environment
  - Take advantage of the low interest environment
  - Take advantage of valuation discounts

- However, valuation will continue to be the battleground
  - Opinion of value can always be attacked
  - Recent taxpayer victory and discount for special assets such as artwork and collections—*Elkins v. Commissioner*
  - Harbinger of the future—valuation of related-party promissory notes and the *Woelbing v. Commissioner* case