PRESENTATION

Estate Planning and Income Tax Considerations After the American Taxpayer Relief Act of 2012

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Legislative History

- Economic Growth and Tax Relief Reconciliation Act of 2001 (a/k/a the "Bush tax cuts" or "EGTRRA").
- Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "2010 Act").
- American Taxpayer Relief Act of 2012 ("ATRA").

Historical and Current Exclusions and Rates

YEAR	ESTATE TAX EXCLUSION	GIFT TAX EXCLUSION	MAX ESTATE AND GIFT TAX RATE	PORTABILITY OF EXCLUSION
2001	$ 675,000	$ 675,000	55%	No
2002	1,000,000	1,000,000	50%	No
2003	1,000,000	1,000,000	49%	No
2004	1,500,000	1,000,000	48%	No
2005	1,500,000	1,000,000	47%	No
2006	2,000,000	1,000,000	46%	No
2007	2,000,000	1,000,000	45%	No
2008	2,000,000	1,000,000	45%	No
2009	3,500,000	1,000,000	45%	No
2010	5,000,000	1,000,000	35%	Yes
2011	5,000,000	5,000,000	35%	Yes
2012	5,120,000	5,120,000	35%	Yes
2013	5,250,000	5, 250,000	40%	Yes

[1] Could elect to be subject to estate tax or no estate tax but carryover basis.
[2] As adjusted for inflation.

ATRA

- Eliminated sunset provisions of EGGTRA and 2010 Act.
- Raised estate tax rate 35% to 40%.
- Made portability of estate tax exclusion permanent.
- Technical amendment - DSUEA equal to lesser of (i) basic exclusion amount or (ii) applicable exclusion amount of last deceased spouse minus the last deceased spouse’s taxable estate.

(“Clawback” issue moot because no reduction of estate tax exclusion)

Effect of ATRA

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- Estimates of 2,636,000 deaths in 2013, only 8,700 706s required (3 out of every 1,000 deaths).
- If sunset had occurred, of 2,636,000 deaths in 2013 101,800 706s would have been required (39 out of every 1,000 deaths).

Items Not in ATRA but Still On the Watch List

- Restoration of estate tax parameters in effect in 2009.
- Elimination of valuation discounts for certain family entities.
- Require a minimum term for GRATs.
- Limit duration of GST tax exclusion to 90 years.
- Include grantor trusts in grantor's gross estate.

Portability Basics

- A person’s applicable exclusion amount is equal to the sum of the person’s “basic exclusion amount” plus the “deceased spousal unused exclusion amount” (if any) in the case of a surviving spouse.
- The “deceased spousal unused exclusion amount” (“DSUEA”) is the lesser of (a) the basic exclusion amount or (b) the last predeceased spouse’s remaining unused exclusion amount.

Portability Basics *(cont.)*

Election

- Surviving spouse can use DSUEA only if an election was made on predeceased spouse’s estate tax return.
- Election made by appointed executor or administrator, or if none, by any person in actual or constructive possession of any property of the decedent. Surviving spouse cannot compel election by executor of deceased spouse absent a mandate in the Will or an agreement between the spouses.

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Portability Basics *(cont.)*

- Portability election deemed made by timely filing 706. Can opt-out by checking election out box.
- Regulations allow for relaxed reporting requirements on the 706 where the return is made solely for the purpose of making the portability election.

Portability Basics *(cont.)*

- Address portability election in Wills.
- Address portability election in prenuptial agreements.

Factors Favoring Reliance on Portability

- Tax- deferred accounts.
- Step-up in income tax basis.
- Ease of planning.

Factors Favoring Reliance on Credit Shelter Planning

- Exclusion of post mortem appreciation.
- GST planning.
- Protection of assets.

Estate Planning After ATRA

3 basic categories of clients

1) Lower net worth clients.
2) “Mid-range” clients.
3) High net worth clients.

…and Finally

- Review existing estate plans to consider changes in law.

Questions

PRESENTATION

Income Tax Planning

After the American Taxpayer Relief Act of 2012 (The Fiscal Cliff Legislation)

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New Tax Brackets for High-Income Taxpayers

The Act creates a 39.6% income tax rate bracket and a 20% capital gains and qualified dividend rate bracket for "high-income taxpayers" that applies to income over a threshold amount, which will be adjusted for inflation in future years. The initial threshold amounts are:

- $400,000 for single individuals;
- $450,000 for married individuals filing joint returns;
- $425,000 for heads of households; and
- 1/2 of the married filing jointly threshold amount for married individuals filing separate returns.

New Tax Brackets for High-Income Taxpayers

Calculating capital gains taxed at 20%:

- The 20% capital gain rate applies only to the gain that, when added to other taxable income, exceeds the taxable income threshold for the 39.6% rate bracket.
- If taxable income, calculated before taking capital gain into account, would be taxed at a rate lower than 39.6%, then capital gains are taxed at 15% up to the taxable income threshold for the 39.6% rate bracket and 20% on the excess.

New Tax Brackets for High-Income Taxpayers

Example 1: Married filing joint return taxpayers earn $425,000 of ordinary income and $75,000 of net capital gains

Income Type	Amount	Tax Rate	Tax Due
Ordinary Income	$425,000		
Net Capital Gain (NCG)	$75,000		
Taxable Income	$500,000		
39.6% Threshold	$450,000		
NCG Below Threshold	$25,000	15%	$3,750
NCG Above Threshold	$50,000	20%	$10,000
Effective NCG Rate		18.33%	

New Tax Brackets for High-Income Taxpayers

Example 2: Married filing joint return taxpayers earn $150,000 of ordinary income and $350,000 of net capital gains

Income Type	Amount	Tax Rate	Tax Due
Ordinary Income	$150,000		
Net Capital Gain (NCG)	$350,000		
Taxable Income	$500,000		
39.6% Threshold	$450,000		
NCG Below Threshold	$300,000	15%	$45,000
NCG Above Threshold	$50,000	20%	$10,000
Effective NCG Rate		15.71%	

The New Tax on Net Investment Income Under The 2010 Health Care Act

- The 2010 Health Care Act increased the Medicare portion of the self-employment tax by .9% (**to 3.8%)** (the "Additional Medicare Tax") on earnings in excess of $250,000 in the case of married taxpayers filing a joint return, $125,000 for married taxpayers filing a separate return, and more than $200,000 for all other taxpayers, ***effective for tax years beginning after December 21, 2012.***
- Proposed Regulations dealing with the additional Medicare tax were issued on November 30, 2012, along with FAQs available at the following link:
  - http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Questions-and-Answers-for-the-Additional-Medicare-Tax

The New Tax on Net Investment Income

- The 2010 Health Care Act subjects investment income (rather than income derived from labor, as in the case of the SE tax), for the first time in the history of Social Security, to a similar tax (the "NII Tax").
- Effective January 1, 2013, new section 1411(a)(1) imposes a separate ***3.8% tax*** on the lesser of (a) "***net investment income***" or (b) the excess of modified adjusted gross income ("MAGI") over $250,000 in the case of married taxpayers filing a joint return, $125,000 for married taxpayers filing a separate return, and over $200,000 for all other taxpayers.

The New Tax on Net Investment Income

Application to Individuals

The tax is computed at 3.8% of the lesser of *Net Investment Income* or the amount by which a taxpayer's income exceeds $200,000 ($250k for Married Filing Jointly).

Application to Trust/Estates

The tax is computed at 3.8% of the lesser of the trust's undistributed *Net Investment Income* for such taxable year or the excess of the adjusted gross income **over** the dollar amount at which the highest tax bracket in section 1(e) begins for such taxable year.

The New Tax on Net Investment Income

- **Net Investment Income – (Section 1411(c)) the excess of the sum of:**
  i. gross income from interest, dividends, annuities, royalties, and rents, other than such income which is derived in the ordinary course of a trade or business of a non-passive activity (determined under 469),

  ii. other gross income derived from a passive (determined under 469) trade or business or financial instrument/commodity trading, and

  iii. net gain (to the extent recognized) attributable to the disposition of property other than property held in a non-passive trade or business.

OVER
The deductions allowed by this subtitle which are properly allocable to such gross income or net gain.

The New Tax on Net Investment Income

- **The exclusion language in 1411(c)(1)(A)(i) requires that the taxpayer clear two hurdles:**

  1) **The income must be from a non-passive activity; and**

  2) **The income must be derived in a trade or business.**

Hypo:
Take for example, the prototypical situation of a taxpayer who owns real estate that he leases back to his active trade/business.
- The activity is non-passive because Reg. 469-2(f)(6) tells us that the income derived from renting property to a trade or business in which the taxpayer is a material participant is not treated as passive income.

The New Tax on New Investment Income

I. Planning Considerations

A. Investment Planning

- **Purchase Municipal Bonds** – Municipal bond income is not subject to the tax on net investment income.
- **Purchase non-dividend paying growth stocks** – The appreciation built-in to the these products will not result in additional "investment income" until the shares are sold, which provides clients with the ability to control the timing of this tax's application.
- **Purchase Annuities** – Annuities can be used to manipulate net investment income by providing owners with an additional ability to control future income streams.
- **Whole Life Insurance** – The cash buildup within these policies will not generate investment income.

The New Tax on New Investment Income

B. Retirement Planning

- **Retirement Accounts** – Although distributions from qualified accounts are not subject to the tax on net investment income, distributions from a traditional IRA or 401(k) will increase a recipients modified adjusted gross income higher, which may result in an avoidable expose to the surtax. As such, those with higher incomes or the potential to receive higher incomes in future years are incentivized to contribute (if possible), or convert (if beneficial), to Roth IRAs or Roth 401(k)s because distributions from these accounts will neither be subject to the surtax nor result in a higher modified adjusted gross income.

Recap: Scope of 3.8% NII Tax Under The 2010 Health Care Act Effective 1/1/2013

Earned Income Taxed at 3.8% (formerly 2.9%)

FICA- payroll tax on wages (1/2 employer, ½ employee)

SECA- self-employment tax on net earnings from self-employment (NESE)

Note: NESE includes partnership distributive share unless the partner is a "limited partner" under section 1402(a)(13)

Net Investment Incomes (NII) Taxed at 3.8%

Interest, dividends, annuities, royalties, rents, gains from disposition of property, and gross income from business constituting a passive activity with respect to taxpayer under section 469, or constituting "trading in financial instruments or commodities."

Exempt from Medicare and NII Tax as Neither Earned Income or NII:

Municipal bond interest, distributions from qualified retirement plan or IRA, active trade or business income passed through to "non-passive" S corporation shareholders, and limited partners and LLC members meeting the requirements for the limited partner exception.

Source: ABA Section of Taxation Committee on S Corporations and Small Business

Tax Changes Under the Fiscal Cliff Legislation 5-Year S Corporation Built-in Gain Recognition Period Section 1374

- When a C corporation makes a subchapter S election, the corporation is generally required to recognize income at the highest corporate tax rate on its net unrecognized built-in gain for a period of 10 years following the election. For purposes of determining the net unrecognized built-in gain for taxable years beginning in 2012 or 2013, however, the built-in gain recognition period is treated as a 5-year period instead of a 10-year period.

- Also, if an S corporation sells an asset and reports gain on the installment method in 2012 or 2013, the treatment of all payments are governed by the BIG rules applicable in the taxable year in which the sale was made.

Tax Changes Under the Fiscal Cliff Legislation
5-Year S Corporation Built-in Gain Recognition Period

Planning Opportunities:

- S corporations with BIG recognition periods starting in years 2004 through 2008 can dispose of assets or liquidate in 2013 without recognizing NUBIG.
- S corporations that disposed of assets or liquidated in 2012 should confirm that they did not report NUBIG when it was not required.
- S corporations that sell assets and report the gain on the installment method will be treated as if the BIG recognition period is 5 years for all payments received from the sale.
  - S corporations with BIG recognition periods starting in 2008 or later can reduce BIG for installment payments received more than 5 years from the effective date of their S elections.
  - Consider stretching out installment sales and backloading installment payments to years for which the BIG recognition period is deemed to have expired.

Tax Changes Under the Fiscal Cliff Legislation
Election to Expense & Bonus Depreciation

Section 179 Expensing:

- Maximum amount that can be expensed for 2012 and 2013 is $500,000.
  - This is a windfall for taxpayers who expected to be subject to a $139,000 limit in 2012.
- Investment-based phase-out amount for 2012 and 2013 is $2 million.
- After 2013, maximum expensing amount drops to $25,000, and investment-based phase-out amount drops to $200,000.
- Off-the-shelf computer software can be expensed under Section 179 if placed in service in a tax year beginning before January 1, 2014.

Tax Changes Under the Fiscal Cliff
Depreciation Allowances

Election to Expense & Bonus Depreciation

- 50% bonus depreciation under Section 168(k) is extended to apply for qualified property acquired and placed in service before January 1, 2014.
- The 15-year cost recovery period for certain leasehold improvements, restaurant buildings and improvements, and retail improvements is extended to cover those that are placed in service before January 1, 2014, and up to $250,000 of such property can be expensed under Section 179.

Tax Changes Under the Fiscal Cliff Legislation
New Markets & Low-income Housing Credits

- The $3.5 billion cap on the maximum annual amount of qualifying equity investments is extended through 2013, and the carryover period for unused new markets tax credits (including credits from 2010 and 2011) is extended through 2018 (they previously could not be carried forward to any year after 2016).
- The low-income housing tax credit is extended through 2013.

Tax Changes Under the Fiscal Cliff Legislation - Individuals

- Permanent AMT Relief
- Limitation on Itemized Deductions for High-Income Individuals
- Personal Exemption Phaseout for High Income Individuals
- Child Tax Credit Made Permanent
- Earned Income Credit Enhancements

Individual Tax Extenders in the Fiscal Cliff Legislation

- Teachers' Classroom Expense Deduction – for 2013
- Exclusion of COD Income on Principal Residence – for 2013
- IRA Distributions to Charities – through 2013
- State and Local Sales Tax Deduction in Lieu of State Income Tax Deduction – for 2013
- Research Tax Credit – through 2013