Volume 8, Issue 3 *May 2013*

Weatherby & Associates, PC
Counselors at Law
Helping Families Preserve and Protect Assets and Values

The Wealth Counselor

A monthly newsletter for wealth planning professionals

Upcoming Events & Seminars

Estate Planning Seminars

Wednesday, June 5, 2013

2:30 PM OR 5:45 PM

"Don't Go Broke in a Nursing Home"

Simsbury, CT

Call Erin at 860-769-6938 to Register!!!

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From Henry C Weatherby

Weatherby & Associates, PC

34 Jerome Ave., Suite 310
Bloomfield, CT 06002

Thursday, June 6, 2013

2:30 PM OR 5:45 PM

"Don't Go Broke in a Nursing Home"

Simsbury, CT

Call Erin at 860-769-6938 to Register!!!

Continuing Education Webinars

May 21, 2013

CPA Workshop 8:00 AM - 5:00 PM

Windsor, CT

7 CPE Credits for only $129!

Register multiple CPA's and receive a $15 discount!

Call Erin at 860-769-6938 to Register!!

May 30, 2013

Financial Planners: Life Expectancy and Health Care Planning

At our office in Bloomfield

(860)-769-6938

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Our firm focuses our practice on Estate Planning, Business Planning, Trust Administration, Probate, Elder Law and Life Care Planning. We help families preserve and protect assets and values; we help business owners maximize their businesses' value.

Income Tax Planning: What Estate Planners Need to Know

The American Taxpayer Relief Act of 2012 (which became law on January 2, 2013) made permanent the temporary estate/gift/generation-skipping transfer tax exemptions established in December 2010, increased the rate on non-exempt estates/gifts/generation-skipping transfers to 40% and introduced substantial new income tax burdens on high income taxpayers and trusts. In addition, 2013 is the year in which both of the Medicare surtaxes of the Patient Protection and Affordable Care Act of 2010 (sometimes referred to as "Obamacare") kick in. As a result, many wealth planning professionals will be doing more income tax planning, and estate tax planning will become less of a driving force.

In this edition of *The Wealth Counselor*, we will examine some of the new income tax provisions clients will face in 2013 and beyond and potential planning opportunities that remain in light of these provisions, as well as some different ideas to consider.

Classic Income Tax Planning

Classic strategies for income tax planning have long included:

* Maximize deductions
* Reduce ordinary income to achieve capital gain
* Invest to achieve tax exempt income
* Shift deductible expenses and income to other taxpayers
* Defer taxes to the future
* Offset taxable income with tax losses

With these new tax laws, some review and new approaches will need to be considered for non-grantor trusts and high income taxpayers.

* For high income taxpayers, the new tax law takes away part of each deduction. Up to 80% of a deduction can thus be eroded. This can make the timing of when to take deductions especially important.
* Under the new law and with the Obamacare surtaxes, capital gain and ordinary income rates have moved closer together.

8:15 am - 10:00 am

Click Here To Register

or call
860-769-6938 to register.

June 6, 2013

CPA's:
Income-Shifting with Trusts & Partnerships

At our office in Bloomfield
8:15 am - 10:00 am

Click Here To Register

or call
860-769-6938 to register.

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* Delaying paying income taxes on earned income by funneling it into a 401(k) or into IRAs is not the automatic best choice anymore. For some clients, it may be better to recognize income now to achieve future tax-free growth (e.g., by doing a Roth conversion or paying life insurance premiums) since it does not appear that either federal or state income tax rates are likely to come down any time soon. For example, for Californians the top combined income tax rate now exceeds 54% and in New York City the combined total top rate for federal, state and city income tax exceeds 56%.
* Limited liability companies (LLCs) or other family entity/partnerships can be used to shift income from the founding generation to younger family members who are in lower tax brackets.
* Medical insurance is 100% deductible at the entity level but can be eroded by the 7.5% or 10% floor and the percentage reduction in deductions at the individual level.
* Long-term care and disability insurance premiums, too, are 100% deductible at the entity level but subject to up to 80% erosion at the individual level. Plus, entity plans for providing this kind of insurance can be discriminatory.

Adjusted Gross Income (AGI) Is Key
The application of the deduction limitation is determined by the taxpayer's adjusted gross income (AGI), *not* taxable income. AGI is the last line on page one of the Form 1040 or 1041 tax return. It includes wages and salaries, capital gains, income from business entities that are reported on Schedule C, and income reported on K-1s and 1099s. The Medicare surtaxes application is determined by a slightly modified AGI (MAGI). AGI and MAGI can be driven up dramatically by a one-time event (such as the sale of a business, investment property or farmland), and can push a client who usually has average income to the highest tax rates and deduction limitations.

Individual Income Tax Rates
The new tax law made permanent individual income tax rates of 10%, 15%, 25%, 28%, 33% and 35% for taxpayers with AGI at or below $450,000 for joint filers and $400,000 for single filers and non-grantor trusts with non-distributed income of less than $11,950. These thresholds are all indexed for inflation after 2013.
* The 39.6% rate applies above the income threshold amounts.
* The 3.8% Medicare surtax on investment income and the 0.9% Medicare surtax on earned income have a $250,000 joint/$200,000 single/$11,950 trust or estate MAGI threshold.

Planning Tip: There are different thresholds for head of household and married filing separately taxpayers.

Capital Gain and Dividend Rates
The new tax law made permanent individual capital gain and dividend tax rates of 15% maximum (0% for taxpayers in the 10% and 15% tax rate brackets) for taxpayers with AGI at or below $450,000 for joint filers and $400,000 for single filers.

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You have received this newsletter because I believe you will find its content valuable, and I hope that it will help you to provide better service to your clients. Please feel free to [contact me](#) if you have any questions about this or any matters relating to estate or wealth planning.

* A new 20% rate applies to capital gains and dividends to the extent they plus other taxable income exceeds these AGI threshold amounts.
* The 3.8% Medicare Surtax applies on the lesser of (a) total investment income and (b) MAGI over $250,000 joint, $200,000 single and $11,950 trusts and estates.

Planning Tip: As with the income tax rates, there are different capital gains and dividend tax thresholds for unmarried head of household and married filing separately taxpayers.

Planning Tip: The increase in the top capital gain and dividend tax rate from 15% to 20% is a 5% increase in the tax *rate*, but results in a 33% increase in the *amount* of the tax. Adding in the 3.8% Medicare surtax bumps the combined tax rate to 23.8%. That is an 8.8% increase in the tax rate and a 59% increase in the amount of the tax.

Itemized Deductions Phase Out
At least as significant for high income taxpayers as the rate increases and surtaxes is the itemized deduction phase-out. For taxpayers with AGI over $300,000 joint ($250,000 single), itemized deductions are reduced by 3% of AGI over the threshold level, up to a maximum of 80%total reduction. The phase out applies to deductions other than medical expenses, investment interest expenses, casualty losses (which have severe restrictions) and gambling losses (which can only be offset against gambling income).

NOTE: Mortgage interest and charitable deductions are included in the phase out.

Planning Tip: As with the income, capital gains, and dividend tax rates, there are different phase-out thresholds for unmarried head of household and married filing separately taxpayers.

Planning Tip: The timing of the deduction now becomes more important for the high income taxpayer. A client may want to delay a substantial charitable gift to a year in which his AGI is lower in order to fully utilize the deduction.

Planning Tip: The itemized deduction phase out makes the direct IRA to charity transfer doubly important to eligible (i.e., over 70.5) high income taxpayers. Amounts so transferred do not increase AGI and are not subject to the itemized deduction phase-out.

Medical Expense Deduction Floor Increase
This is a change that affects all taxpayers who itemize deductions. The floor on deductibility of medical expenses has increased from 7.5% of AGI to 10% of AGI for taxpayers under age 65. For the others, the new floor takes effect starting in 2017. Previously, a family with $100,000 AGI would have to have medical expenses of more than $7,500 before being able to take any as an itemized deduction; now they would have to have more than $10,000.

Phase Out of Personal Exemptions
There's good news and bad news about the personal exemption. The good news is that it is increased for 2013 from $3,800 to $3,900. The bad news is that, similar to the phase out of itemized deductions, personal exemptions are phased out if AGI is over the $300,000 joint ($250,000 single) threshold. The phase-out rate is 2%/$2,500 of above-threshold AGI.

Planning Tip: There are different thresholds and phase-out rates for unmarried head of household and married filing separately taxpayers.

Medicare Surtax on Investment Income
The Obamacare Medicare surtax on net investment income (NII) applies for tax years starting after December 31, 2012. The surtax is 3.8% of the lesser of (a) total NII; and (b) MAGI in excess of $200,000 for single filers, $250,000 for joint filers, $125,000 for married taxpayers filing separately and $11,950 for estates and trusts.

Planning Tip: Previously, investment (also called "passive") income was taxed at a lower rate than earned or "active" income and could be offset against deductions on real estate. Examples of passive income would include payouts to a participant in an LLC who is not involved in management or to a former business owner who is now in a limited partner role.

Medicare Earned Income Surtax
There has been a lot of publicity about the 3.8% Medicare surtax, but it is not the only Medicare surtax in Obamacare. Obamacare also includes a 0.9% Medicare surtax on wages and self- employment income. This surtax is on the amount by which wages and self-employment income minus MAGI exceeds $200,000 for single filers, $250,000 for joint filers and $125,000 for married taxpayers filing separately. It, too, is effective for tax years starting after December 31, 2012.

Summary of Major Tax Rate and Deduction Changes for Ordinary Income

Thresholds	*Single*	*Head of Household*	*Married Filing Jointly*	*Married Filing Separately*
.9% Medicare Earned Income Surtax	$200,000	$200,000	$250,000	$125,000
Phase Out of Deductions	250,000	275,000	300,000	150,000
Personal Exemption	250,000	275,000	300,000	150,000

Phase-out				
39.6% Rate	400,000	425,000	450,000	225,000
Top Cumulative Marginal Rate	43.4%	43.4%	43.4%	43.4%

Planning Tip: Remember that state and local income taxes are in addition to the federal income tax. These taxes, which can exceed 11%, are also subject to the itemized deduction phase out.

Planning Tip: Income tax planning does not focus on the client's *average* tax rate, which is the cumulative effect of the various tax brackets and the combined deductions and credits. Tax planners look at the client's highest *marginal* rate. Deductions that can be taken and income that can be deferred/offset/eliminated saves at the marginal rate. A lot of people think they are in a lower tax bracket than they actually are and are surprised to learn their marginal tax rate.

Summary of Tax Rates on Investment Income

Thresholds	*Single*	*Head of Household*	*Married Filing Jointly*	*Married Filing Separately*
3.8% Medicare NII Surtax	$200,000	$200,000	$250,000	$125,000
Phase Out of Deductions	250,000	275,000	300,000	150,000
Personal Exemption Phase-out	250,000	275,000	300,000	150,000
20% Capital Gains/Dividend Rate	400,000	425,000	450,000	225,000
Top Cumulative Marginal Rate	24.592%	24.592%	24.592%	24.592%

Income Tax Minimization Strategies for Non-Estate Tax Clients
* *Charitable trust planning* can create a partially taxable income stream for the philanthropic. Charitable remainder trusts are more attractive now with the higher capital gains tax rates, but some or all of the deduction may be lost due to deduction phase-out for high AGI taxpayers. Non-grantor charitable lead trusts can be more attractive for these taxpayers because the deduction is taken over the term of the charitable distributions rather than at the trust's inception.

* *Annuities* remain attractive for the right client in this environment. A 70-year-old client with a 16-year life expectancy can place $1 million into a single premium immediate annuity (SPIA) and receive about $70,000 a year in guaranteed cash flow. A good amount of this

annuity's cash flow income is tax-free because it is a return of the client's own capital. For the rest, the income tax on the growth inside the annuity is deferred to the year in which the distribution is received, which can be after the client's retirement. An annuity can be coupled with a life insurance contract held in an irrevocable life insurance trust to provide for the family in the event the client becomes incapacitated or does not live long enough to collect the full annuity payments.

* *The Alaska Community Property Trust* provides a way for married taxpayers resident in any of the non-community-property states to get the double stepped-up basis on the first death that was formerly available only to residents of the 9 community property states. An Alaska community property trust can save a married couple a considerable amount in capital gain taxes. The right type of client for an Alaska community property trust has assets with high value and low basis and is in a long-term stable marriage.

* *Family income shifting through family entities.* This was mentioned earlier in the classic strategies. If the client has enough money to live on, he can hire a family member to manage the assets in a family entity and shift income to someone in a lower tax bracket.

* *Installment sales of real estate and business assets or entities*. Instead of taking a lump sum payout and increasing AGI greatly for one year, taking the payout over time will help to keep AGI at more reasonable levels.

* *Tax-free cash value and guaranteed growth of life insurance held in an accessible grantor retirement trust*. Because growth in a life insurance policy is tax free if the policy is held to maturity and policy cash value growth is subject to a guarantee, life insurance is more and more often thought of as an asset class.

* *Remove or reduce IRA and 401(k) assets from owner and beneficiary income taxes*. Eventually someone will have to pay the taxes on these tax-deferred assets, and the beneficiary may be in a higher tax bracket than the owner. Also, often the smallest tax to pay is the soonest tax to pay and instead of continuing to put money in, some clients may be better off to pay the taxes now and take money out or, better still, convert the account to a Roth.

Planning Tip: Use IRA annuitization combined with an ILIT. The client can buy a single premium annuity within an IRA (it's part of the investment, not a distribution). The annuity then provides a guaranteed cash flow stream that can be distributed and used to make gifts to an ILIT to pay life insurance policy premiums. This can result in paying the least amount of income taxes and providing a greater benefit, especially in the case of the premature death of the insured.

Planning Tip: Use a retirement trust for maximum IRA stretch out over the beneficiary's lifetime to save income taxes. Ideal is a beneficiary with the least amount of income (lowest tax rate) and longest life expectancy.

* *Potential IRA/401(k) Roth conversions*. Start timing these conversions to start sooner rather than later. Remember, it is better to pay a little tax now to avoid a larger tax later.

* *Intra-family loans and sales.* Money can be loaned or property sold for an installment note with 3 - 9 year rates as low as 1% in May 2013 (1.2% Section 7520 rate). This makes now an ideal time for intra-family loans and sales.

Planning Tip: Loans can go the other direction as well. A child with substantial income can loan money to a parent at the applicable federal rate instead of investing it, thereby lowering the child's income tax rate.

Business Tax Extensions (Opportunities)
For clients who changed from a C Corporation to an S Corporation between 2003 and 2009 and have gain in real estate assets that are trapped in the C Corporation, 2013 is a great year in which to sell those assets. That is because for 2013 the S Corporation recognition holding period is reduced from 10 to 5 years. Carryforward and installment sale rules are also clarified.

Also, there is a 100% exclusion for capital gain from sale of qualified small business stock extended for stock acquired before January 1, 2014, if the stock was owned longer than five years. (The AMT preference rules also do not apply.)

Endangered Strategies
President Obama's 2014 budget proposal released in April mentions several estate planning tax strategies, which puts them on the endangered list. While no action has been taken on the budget or any of the strategies yet, the fact that the President included them in his 2014 budget proposal gives us some insight into possible future estate tax changes.

* Grantor trusts still avoid estate tax, including intentionally defective grantor trusts (IDGTs) and irrevocable life insurance trusts (ILITs).
* Discounts are still allowed on non-business interests or for transfers to minority interests.
* The ten-year minimum term for grantor retained annuity trusts (GRATs) was not enacted. Two-year rolling GRATs remain available.
* No 90-year limit on the GST tax exemption was adopted. Dynasty trusts are still possible.
* Proposed $3.4 million limitation on 401(k)s and retirement plans.

Conclusion
With the enactment of the new Tax Act, income taxes have taken a sharp hike, deductions are being reduced, and everything hinges on

adjusted gross income. The advisor who understands this is in a unique position to help clients reduce AGI and save taxes, and will be an invaluable member of the advisory team.

Visit our Website
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