The 2015 essential tax and wealth planning guide

Tax planning in a more stable environment
Dear Annual Wealth Guide Reader,

Each year as we prepare for the publication of our Annual Wealth Guide, we contemplate the current tax policy and political environment. That sentiment then determines our themes and areas of tax planning focus. This year’s edition therefore takes a hard right turn to reflect today’s reality of a more stable planning outlook. The debate has died down on many fronts and chances are that we’re looking at rules that look like they won’t substantially change in the near term.

Managing wealth isn’t about anticipating the next political skirmish anymore — it’s about careful planning and keeping informed of any changes that are anticipated on both the federal and state levels. In this more stable environment, it becomes even more important to rely on your trusted tax adviser to help you stay informed on the latest tax law changes, relevant planning opportunities that address your current tax situation, and financial and tax risks that lie ahead.

The purpose of the 2015 Annual Wealth Guide is to help you plan, through matching your personal circumstances with tax law realities. Effective planning means developing your own personal view of our economy and the markets, taxes, and tax rates that you may experience now and in the future. Although no one can predict the future, being informed will help you be prepared for future changes.

We hope that the new digital and visual layout of the Annual Wealth Guide enables you to tap into the content and the many planning considerations that are most relevant to your specific tax situation.

To find a member of the Deloitte Private Wealth practice who specializes in your area of interest, please contact us at PrivateWealth@deloitte.com.

Regards,

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Introduction: What happened to tax reform?

When the last edition of this Annual Wealth Guide went to press in the Fall of 2013, momentum appeared to be growing in Congress for a wholesale rewrite of the tax code. House Ways and Means Committee Chairman Dave Camp, R-Mich., and Senate Finance Committee Chairman Max Baucus, D-Mont., had teamed up on a series of informal bipartisan lunch meetings to discuss tax reform with small groups of lawmakers; a Simpler Taxes for America Tour to generate support for tax reform among the general public; and a Web site to allow the public to offer comments and suggestions on tax reform. Chairman Camp had released several discussion drafts of proposals to reform discrete areas of the tax code and was making it known that he hoped to have the Ways and Means Committee consider a comprehensive tax reform draft prior to the end of the year. Chairman Baucus had released a number of tax reform discussion drafts of his own, addressing fundamental changes to the tax code in areas such as tax accounting and energy.

By the end of 2013 and into early 2014, that momentum appeared to be dissipating. Chairman Camp announced that Ways and Means would not be considering a tax reform proposal prior to year-end after all. Across the Capitol, Sen. Baucus announced that he would retire from Congress to become U.S. ambassador to China and Sen. Ron Wyden, D-Ore., was tapped to take over the Finance Committee. Prospects for tax reform continued to decline when Chairman Camp released his comprehensive tax reform discussion draft in February of 2014 and it became apparent that Capitol Hill was not yet ready to tackle large-scale changes to the tax code.

The new uncertainty over the direction of tax reform has been exacerbated by the prospect of more leadership changes on the congressional taxwriting committees: Chairman Camp is not seeking reelection to another term in Congress, so a new leader will take the gavel at Ways and Means in the next Congress, and Sen. Wyden could be out as leader of the Finance Committee if Republicans gain control of the Senate in the upcoming midterm congressional elections in November.

“\textit{It became apparent that Capitol Hill was not yet ready to tackle large scale changes to the tax code.}”

This change in the trajectory of tax reform left taxwriters without a plan to address the 55 temporary and individual tax provisions that expired at the end of 2013. Chairman Camp and Sen. Baucus, who had consistently argued that temporary tax provisions should be addressed in the context of a broader overhaul of the tax code, did not mark up extenders legislation in their respective committees in 2013, leaving taxwriters to take action to extend them retroactively in 2014. But the House and the Senate have developed distinctly different approaches to tackling extenders and those differences are not expected to be resolved until Congress meets in a post-election “lame duck” session.

Going forward

Those concerned with tax planning must consider such questions as:

\begin{itemize}
  \item What changes affecting individuals and estates are on the agenda for the remainder of 2014?
  \item What is the timeframe for Washington to consider fundamental tax reform?
  \item What combination of political will, personalities, and economic factors will be necessary for that to happen?
\end{itemize}
This section examines the current status of the extenders debate and efforts to reform the tax code, including details on some of the more significant tax reform proposals that have been released to date. It also looks ahead to 2015 to consider who may be leading the charge going forward, the possibilities for congressional action, and how taxpayers can prepare in the face of an uncertain political environment.

In this section

- Extenders
- Leading figures in the tax reform debate
- Individual tax reform proposals
- Provisions in the Camp and Wyden plans
- Outlook: An unclear path forward for tax reform
- Ignoring tax reform would be a mistake

Extenders

Senate Finance Committee Chairman Wyden and House Ways and Means Committee Chairman Camp both believe that temporary tax provisions should either be eliminated or made permanent in the context of fundamental tax reform and that action on the current set of expired provisions should somehow serve as a bridge to a broader overhaul of the tax code. But they are approaching that goal in two distinctly different ways.
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Senate developments
The Finance Committee opted for a straightforward temporary extension of most — but not all — of the 55 tax deductions, credits, and incentives that expired at the end of 2013, with an eye toward giving Congress more time to evaluate each provision and determine whether it should be extended permanently or stricken from the code as part of tax reform.

For individual taxpayers, the Finance Committee bill, which was approved in April, would extend some provisions through December 31, 2015 (retroactive to December 31, 2013), including:

- Credit for health insurance costs of eligible individuals
- Deduction for state and local general sales taxes
- Above-the-line deduction for qualified tuition and related expenses
- Parity for exclusion from income for employer-provided mass transit and parking benefits
- Deduction for certain expenses of elementary and secondary school teachers
- Discharge of indebtedness on principal residence excluded from gross income of individuals
- Premiums for mortgage insurance deductible as qualified residence interest

The Finance Committee bill also would extend the following charitable giving provisions for the same period:

- Tax-free distributions from individual retirement plans by individuals age 70½ and older for charitable purposes
- Special rules for contributions of capital gain real property made for conservation purposes
- Enhanced charitable deduction for contributions of food inventory

- Modification of tax treatment of certain payments to controlling exempt organizations
- Basis adjustment to stock of S corporations making charitable contributions of property

Although the legislation was approved in the Finance Committee with bipartisan support, it has not received a vote on the Senate floor due to a dispute between Majority Leader Harry Reid, D-Nev., and Senate Republicans over a process for offering amendments.

House developments
In the House, Republican leaders opted to move permanent extensions of discrete extenders provisions rather than another broad temporary package as Congress has done in the past. This strategy was advanced by Ways and Means Chairman Camp as a way of building the budget baseline to make tax reform a less expensive proposition for a future Congress: specifically, building extenders into the budget baseline would make reform much easier because it would lower revenue targets and, in turn, give taxwriters more flexibility as they make decisions about what base broadeners would be necessary to achieve the desired level of rate reduction.

In July, the House approved permanent extensions of these charitable giving incentives:

- Tax-free distributions from individual retirement plans by individuals age 70½ and older for charitable purposes
- Special rules for contributions of capital gain real property made for conservation purposes
- Enhanced charitable deduction for food inventory contributions
- Basis adjustment to S corporation stocks making charitable contributions of property
The current environment

For individuals, the House also approved in July a permanent version of the above-the-line credit for qualified tuition and related expenses that would replace both the Hope Credit and Lifetime Learning Credit with a modified version of the American Opportunity Tax Credit.

Prospects unclear
Exactly how the Senate will resolve its partisan dispute over the Finance Committee package and how the two chambers will reconcile their competing approaches to extenders is likely to remain unclear until after the elections, but given the bipartisan support for addressing these provisions, we anticipate that they will largely be extended to cover 2014 and possibly 2015.

Leading figures in the tax reform debate
Although moving comprehensive tax reform legislation has proven to be an elusive goal in 2014, leaders of the congressional taxwriting committees and President Obama put forward new plans over the past year — or dusted off old ones — that could provide building blocks for a future tax code overhaul.

House Ways and Means Committee Chairman Dave Camp
As we’ve noted, Chairman Camp is retiring from Congress at the end of this year; but he has been a vocal advocate for tax reform throughout his time as leader of the Ways and Means Committee. His efforts culminated in February of this year with the release of a comprehensive tax reform discussion draft proposal (written in legislative language) that calls for lowering corporate and individual income tax rates and moving the United States toward a territorial system for taxing U.S.-domiciled multinational corporations. To accomplish those objectives, the draft includes a long list of base-broadening provisions that would have a significant impact on corporations, passthrough entities, individual taxpayers, and tax-exempt organizations.

Senate Finance Committee Chairman Ron Wyden
Chairman Wyden took the Finance Committee gavel in February of this year, but he stepped into the role of chairman with an established tax reform portfolio of his own. Chairman Wyden and Indiana Republican Sen. Dan Coats introduced comprehensive tax reform legislation in 2011 that generally would:

- Lower the corporate tax rate to 24% and compress individual tax rates to three brackets of 15%, 25%, and 35%
- Provide a temporary tax holiday for repatriated foreign income but eliminate deferral on foreign income
- Repeal the individual alternative minimum tax (AMT)
- Create new retirement savings incentives
- Eliminate numerous current-law credits, deductions, and exclusions
- Impose new taxpayer compliance provisions

Chairman Wyden introduced similar legislation with then-Sen. Judd Gregg, R-N.H., in 2010.

Chairman Wyden did not attempt to take up his tax reform proposals in the Finance Committee this year, explaining that his top legislative priority for 2014 was addressing the expired tax extenders provisions and using that legislation as a “bridge” to broader tax reform thereafter.
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Former Senate Finance Committee Chairman Max Baucus

As we’ve noted, Sen. Baucus was a leading proponent of tax reform during his time as chairman of the Senate Finance Committee and collaborated with Chairman Camp on a number of initiatives to educate other lawmakers and the general public on tax reform issues. In late 2013, he also released four staff-level discussion draft proposals for overhauling the tax rules related to multinational corporations, tax accounting and cost recovery, tax administration, and energy policy. (Like Chairman Camp’s proposal, the Baucus discussion drafts are written in legislative language.) Although he no longer has a direct influence on the tax policy debate, some of the proposals in his discussion drafts conceivably could shape any Democratic tax reform proposals in the Senate.

President Barack Obama

President Obama has called for tax reform during his time in the White House but has not so far advanced a detailed legislative plan for a tax code rewrite. In 2012, he introduced a relatively brief “framework” for corporate tax reform, but that document generally identifies tax reform goals without providing specific details on how to achieve them. The President’s public statements on tax reform generally have focused on targeting “loopholes” that, according to the administration, are being abused by high-income individuals and corporations. More recently he has advocated overhauling the corporate tax rules first and saving individual tax reform for a later date, though again without providing the level of specificity we have seen from the Camp, Baucus, or Wyden proposals. Although he has not been active in pushing for tax reform, the President remains an important figure in the debate and many believe reform is unlikely to advance materially without his active support.
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Individual tax reform proposals

The comprehensive tax reform discussion draft that House Ways and Means Committee Chairman Camp unveiled in February includes what is perhaps the most detailed overhaul of the individual tax rules released to date. Chairman Camp’s draft would reduce the top individual income tax rate to 25% (though with a 10% surtax on certain higher-income individuals), significantly expand the standard deduction while limiting or eliminating a number of current-law deductions and credits, and ensure that the reformed tax code would retain the levels of progressivity in place under current law.

Likewise, the tax reform legislation that Finance Committee Chairman Wyden introduced in 2010 and 2011 generally would lower individual tax rates while eliminating numerous current-law credits, deductions, and exclusions. Chairman Wyden has stated that any tax reform legislation he moves through the Finance Committee will build on this proposal, but he has not indicated exactly how he would revise it to address the current fiscal environment.

Former Finance Committee Chairman Baucus did not release a discussion draft on individual tax reform issues.

For his part, President Obama has not yet put forward a detailed proposal for overhauling the individual tax rules. The administration’s fiscal year 2015 budget package, which was released in early March, re-proposes several revenue-raising provisions from previous budgets aimed squarely at upper-income taxpayers, such as implementing the so-called “Buffett Rule,” which would require households with incomes over $1 million to pay at least 30% of their income (after charitable giving) in taxes; capping the value of itemized deductions and certain income exclusions for high-income taxpayers at 28%; and taxing income from carried interests at ordinary rates. But it stops short of proposing changes to individual income tax brackets, or broader changes to the individual tax code. (The administration did, however, succeed in increasing the progressivity of the tax code with the enactment of the American Taxpayer Relief Act in early 2013, which permanently allowed the top rates on earned income, investment income, and estates and gifts to increase from their 2012 levels for more affluent taxpayers, while permanently leaving in place lower tax rates on lower-and middle-income taxpayers).

“President Obama has not yet put forward a detailed proposal for overhauling the individual tax rules.”
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Provisions in the Camp and Wyden plans

Given the relative lack of specific details on individual tax reform from Sen. Baucus and the Obama administration, the discussion below focuses on provisions in the Camp and Wyden plans.

Income tax brackets

Chairman Camp’s tax reform discussion draft would consolidate the current-law seven tax brackets into three new brackets of 10%, 25%, and 35%. However, the new 35% bracket is composed of the 25% rate and an additional 10% surtax on modified adjusted gross income (MAGI) in excess of $450,000 for joint filers ($400,000 for all others). The broader MAGI base would not apply to the 10% or 25% brackets.

For purposes of the 10% surtax on higher-income individuals, MAGI is defined as adjusted gross income (AGI) increased by:

- Amounts excluded from certain foreign income
- Any amount of interest received or accrued by the taxpayer during the taxable year which is exempt from tax (e.g., municipal bonds)
- The value of any employer-sponsored health coverage
- Amounts paid by a self-employed individual for certain health insurance deductions
- Pre-tax contributions to tax-favored defined contribution retirement plans
- Deductible health savings account contributions
- Excluded Social Security and tier 1 railroad retirement benefits

The resulting amount is then reduced by:

- Charitable contributions eligible for a deduction under Section 170 (but only if the taxpayer itemizes)
- Qualified domestic manufacturing income (QDMI); however, the full impact of this reduction would be phased in over three years

Chairman Wyden’s tax reform plans call for three individual income tax rate brackets — 15%, 25%, and 35% — and would substantially increase the standard deduction. According to a press release issued in conjunction with the 2011 proposal, Chairman Wyden would allow most individual taxpayers to file a new simplified one-page return (proposed 1040-IRS) instead of complying with the myriad current-law tax rules.

Alternative minimum tax

Both the Camp and Wyden plans would repeal the individual AMT regime. The AMT was designed to tax a small number of wealthy individuals who escaped owing significant regular income tax by using a variety of exclusions, deductions, and credits; but because it was not originally indexed for inflation, it subsequently grew to affect millions of unsuspecting upper-middle-class taxpayers. (The American Taxpayer Relief Act of 2012 permanently controls the growth of the AMT by indexing the AMT’s exemption amounts for inflation, thus ending what had become an annual ritual in Congress of approving temporary “patches”).
Capital gains and qualified dividends
Chairman Camp's proposal would repeal the current-law top rate for capital gain and dividends, and instead provide an above-the-line deduction equal to 40% of "adjusted net capital gain" (defined as the sum of net capital gain and qualified dividends, reduced by net collectibles gain). As a result, capital gain and dividend income would be taxed at 60% of the taxpayer's marginal ordinary income rate.

Similarly, Chairman Wyden's proposals would create a new 35% exclusion for capital gain and dividend income, but would also establish a progressive rate structure. The Wyden plan would reduce the holding period to six months (from one year today) for the first $500,000 of a taxpayer's capital gain income, which is significant because it determines whether capital gain is afforded short-term or more favorable long-term tax treatment.

Notably, both the Camp and Wyden plans would retain the current-law 3.8% tax on net investment income that was enacted under the Patient Protection and Affordable Care Act in 2010. The tax applies to income from interest, dividends, capital gains, annuities, royalties, and rents, other than income derived in the ordinary course of a trade or business and not treated as a passive activity.

Mortgage interest deduction
The Camp plan would reduce the current-law $1 million interest deduction limitation to $500,000 over four years. The provision would not apply to existing mortgages or the refinancing of those mortgages. The Wyden plan would retain the current-law deduction.

Exclusion of gain from the sale of a principal residence
Under current law, a taxpayer may exclude from gross income up to $500,000 (for joint filers) of gain on the sale or exchange of a principal residence as long as the taxpayer owned and used the residence for at least two of the previous five years.

Chairman Camp's draft would require the taxpayer to own and use the home as the principal residence for five out of previous eight years to qualify for the exclusion, and would permit a taxpayer to use the exclusion only once every five years. The exclusion also would be subject to an income phase-out, with the amount of excludable gain declining, dollar for dollar, as a taxpayer's MAGI exceeds $500,000 ($250,000 for single filers).

Chairman Wyden's proposal would retain current law.

Charitable contributions deduction
The Camp plan would make numerous changes to the charitable contribution deduction, such as allowing a deduction only to the extent that contributions exceed 2% of the individual's AGI and making the amount of any charitable deduction equal to the adjusted basis of the contributed property. The Wyden plan would retain the current-law deduction.
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Limitation on itemized deductions and personal exemption phase-out
Both the Camp and Wyden proposals advance the repeal of the overall limitation on itemized deductions (the so-called Pease limitation) and the personal exemption phase-out (PEP), which reduces a taxpayer’s personal exemptions by 2% for each $2,500 by which the taxpayer’s AGI exceeds $300,000 for joint filers ($250,000 for single filers).

Deduction for state and local taxes
The Camp draft would eliminate the deduction for state and local taxes. The draft does not call for phasing out the deduction or otherwise mitigating the immediate impact of this change. Chairman Wyden’s proposals would retain current law.

Other changes
Chairman Camp’s proposal would repeal a number of current-law provisions such as the deduction for trade or business expenses, the deduction for unreimbursed medical expenses, the exclusion for employee achievement awards, and the exclusion from income for air transportation provided as a no-additional-cost service to the parent of an employee.
### The current environment

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<th>Provision</th>
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<td>Income tax brackets</td>
<td>10%, 25%, and 35% (35% bracket composed of 25% rate plus 10% surtax on certain upper-income individuals)</td>
<td>15%, 25%, and 35%</td>
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<tr>
<td>Standard deduction</td>
<td>Increases</td>
<td>Increases</td>
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<td>Alternative minimum tax</td>
<td>Repeals</td>
<td>Repeals</td>
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<tr>
<td>Capital gains and qualified dividends</td>
<td>Repeals current-law top rate and replaces with above-the-line deduction equal to 40% of “adjusted net capital gain”</td>
<td>Repeals current law and replaces with 35% exclusion for capital gain and dividend income; establishes progressive rate structure; reduces holding period to six months (from one year) for first $500,000 of a taxpayer’s capital gain income</td>
</tr>
<tr>
<td>Net investment income tax (currently 3.8%)</td>
<td>Retains</td>
<td>Retains</td>
</tr>
<tr>
<td>Mortgage interest deduction</td>
<td>Reduces the current-law $1 million interest deduction limitation to $500,000 (phased in over four years)</td>
<td>Retains current-law provisions</td>
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<tr>
<td>Exclusion of gain from the sale of a principal residence</td>
<td>Retains current-law exclusion amount but (1) requires the taxpayer to own and use the home as the principal residence for five out of previous eight years; (2) permits a taxpayer to use the exclusion only once every five years; and (3) makes the exclusion subject to an income phase-out</td>
<td>Retains current-law provisions</td>
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<td>Charitable contributions deduction</td>
<td>Permitted only to the extent that contributions exceed 2% of AGI; the amount of any charitable deduction equal to the adjusted basis of the contributed property</td>
<td>Retains current-law provisions</td>
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<tr>
<td>Limitation on itemized deductions (Pease limitation) and personal exemption phase-out (PEP)</td>
<td>Repeals Pease limitation and PEP</td>
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<tr>
<td>Deduction for state and local taxes</td>
<td>Eliminates</td>
<td>Retains current-law provisions</td>
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The current environment

Outlook: An unclear path forward for tax reform

Although there have been some significant developments in the tax reform arena over the past year, pending leadership changes on the congressional taxwriting committees, uncertainties over the balance of power on Capitol Hill in the run-up to the midterm congressional elections, ongoing questions about the President’s commitment to overhauling the tax code, and the magnitude of fundamental policy decisions facing Congress make it difficult to determine whether tax reform can be enacted in the near term.

Ways and Means: Camp to retire

As already noted, Chairman Camp is retiring from Congress when his current term expires at the end of this year. But even if Chairman Camp had decided to remain on Capitol Hill, his time as the House’s top taxwriter was coming up against a hard stop: House Republican rules impose term limits on committee chairmen, and his tenure as the head of the Ways and Means Committee is scheduled to end after this year.

Assuming, as is generally expected, that Republicans retain control of the House following the 2014 midterm elections, Camp will be replaced as Ways and Means chairman by another Republican. What is unclear, however, is the extent to which a new chairman will follow Chairman Camp’s discussion draft as a roadmap for tax reform.

Budget Committee Chairman Paul Ryan, R-Wis., for example, also serves as a member of Ways and Means and is interested in becoming the next leader of that committee (although other Republicans on the panel have more seniority). The fiscal year 2015 budget blueprint that Chairman Ryan moved through The House calls for revenue-neutral tax reform that would cut the top corporate and individual tax rates (with a goal of 25% on the individual side), reduce the number of individual income tax brackets to two, eliminate the alternative minimum tax, and move toward a more competitive system for taxing the income of U.S. multinationals. Significantly, however, it stops short of calling for enactment of the Camp tax reform draft and instead urges Congress to consider “the full myriad of pro-growth plans” as it contemplates tax reform. While this is by no means an indication that Chairman Ryan would reject the Camp discussion draft if he took the top spot on the Ways and Means Committee, it does suggest that he is attempting to distance himself from the proposal so that he can put his own stamp on tax reform in the future.

Finance: Will Wyden keep the gavel?

If Democrats retain control of the Senate following the mid-term elections, Sen. Wyden will remain leader of the Finance Committee. Sen. Wyden has said he will work to advance legislation based on his tax reform proposals, although he has also acknowledged that those proposals will almost certainly be modified as they move through the legislative process. If Democrats lose control of the Senate, however, current Finance Committee ranking Republican Orrin Hatch of Utah would most likely become the taxwriting panel’s new leader. Sen. Hatch is a proponent of tax reform and would be able to work with a Republican-controlled House in moving reform legislation through Congress; but he has not released a tax reform plan of his own and his specific priorities are not currently known.
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Partisan fissures
Democrats and Republicans in Washington remain divided by longstanding differences over what a reformed tax code should look like and what tax reform should accomplish. As this publication goes to press, Republicans appear poised to retain — and perhaps even increase — their majority in the House, but which party will win control of the Senate remains uncertain. If Democrats hang on to the upper chamber, the partisan breach between the two chambers likely will remain in place and the conditions that stifled action on tax reform in 2014 could well bog down progress in the next Congress.

“Democrats and Republicans in Washington remain divided by longstanding differences over what a reformed tax code should look like and what tax reform should accomplish.”
If voters give Republicans control the House and the Senate beginning in 2015, it could be easier — in theory, at least — for tax reform legislation to clear both chambers and make its way to the White House. But even if Republicans win the majority of seats in the Senate, they are unlikely to have the 60-vote supermajority that will be necessary to avert the threat of a filibuster and ensure the passage of tax reform — or almost any other major legislation.

Uncertain Presidential participation

Another ongoing source of uncertainty around the prospects for tax reform is the extent to which President Obama wishes to be seen as a leader in the debate. Although the White House has come out in support of tax reform, it has not released a detailed, comprehensive proposal of its own nor has it demonstrated a sustained commitment to getting tax reform enacted into law.

The last comprehensive rewrite of the U.S. tax code was enacted in 1986 when Republicans controlled the White House and the Senate, and Democrats controlled the House of Representatives. A key component of the 1986 tax reform effort was then-President Ronald Reagan’s willingness to negotiate with congressional Democratic leadership as well as his willingness to use the White House as a bully pulpit to pave the way for tax reform by getting in front of the issue, making the case to the public, and bringing Congress and Treasury together to work out a plan. By the time Congress began to focus on tax reform in 1985, the Reagan Treasury Department had already released over 1,300 pages of analysis, distributional tables, and revenue estimates covering various options for tax reform, and the President had sent a nearly 500-page report to Capitol Hill detailing his recommendations.

In contrast, it could be argued that President Obama thus far has not been a strong spokesman for tax reform. Although he has called for tax reform on more than one occasion during his time in office, his administration has not actively sought to negotiate a plan with congressional Republicans and he has not made a sustained effort to engage the public on — and build a base of support for — his vision of a reformed tax code. The corporate tax reform framework President Obama released in 2012 includes proposals for lowering the corporate tax rate to 28% while eliminating or revamping many current-law business tax expenditures, creating new incentives to promote domestic manufacturing, overhauling the international tax rules, and imposing a new “minimum tax” on multinationals; but it offers few details on how those proposals would operate. Moreover, aside from offering proposals in his annual budgets to increase taxes on wealthier individual taxpayers (by imposing a minimum tax under a so-called “Buffett Rule” and eliminating or tightening various deductions, credits, and incentives), the administration largely has ignored individual tax reform — something that concerns many congressional Republicans.

It is also not clear whether the possibility of dealing with a Republican-controlled House and Senate in 2015 would make President Obama more or less likely to engage in an effort to find common ground on tax reform than he has been in the past.

Difficult policy decisions remain

Ways and Means Committee Chairman Camp’s discussion draft, Finance Committee Chairman Wyden’s 2011 tax reform plan, and the four discussion drafts released by former Finance Committee Chairman Max Baucus before he became our ambassador to China may provide useful building blocks for tax reform going forward, but they also reveal the hard choices that policymakers need to make before tax reform can be enacted into law. For example:

- Congress must settle the longstanding question of whether reform should produce more overall revenue for deficit reduction (as Democrats generally want) or whether it should be revenue neutral and considered separately from a deficit reduction plan (as Republicans generally prefer)
The current environment

- Congress must also decide whether tax reform should be used to address income inequality (as Democrats generally want) or whether the tax code is already sufficiently progressive and doesn’t need to be made more so (as Republicans generally argue).
- Congress has yet to fully explore what sort of transition rules would be necessary to prevent tax reform from creating economic shockwaves.

Presumably, Democrats will “get” more than they “give” on some issues and the GOP will “get” more than they “give” on others. But given the many moving pieces, there are lots of ways these issues could get resolved — and lots of opportunities for gridlock.

Ignoring tax reform would be a mistake

Despite the uncertainty over whether tax reform can be enacted in 2015 or 2016 or whether it will have to wait until after President Obama leaves the White House, there are several important reasons why it would be a mistake for taxpayers to ignore the ongoing debate:

- Nearly everyone across the political spectrum believes that our current tax system is broken and in desperate need of reform. Our current tax rules are too complex for taxpayers to comply with and too difficult for the regulatory agencies to administer.
- Given our high marginal tax rates and narrow tax base (caused by the array of credits, deductions, exemptions, and exclusions in the code), tax reform is likely to be on the agenda for Congress until it is actually enacted — regardless of how long that takes.
- The work that the taxwriting committees have done so far and the work they do in the next Congress is likely to form the basis of future reform efforts. Stakeholders who fail to come to the table risk being left out of the discussion — or, even worse, finding themselves poorly positioned when Congress decides which tax preferences to reduce or eliminate.
- If Congress does not approve comprehensive reform, the focus may turn back to enacting tax legislation in a more piecemeal fashion which, in turn, will likely put pressure on “loophole closers” not tied to rate reduction.

As the debate moves forward, existing tax reform plans are likely to be refined and new ones may emerge. Individuals and businesses would be well served by analyzing and understanding all of these developments as part of their efforts to prepare for a transition to a revised tax code.

“Our current tax rules are too complex for taxpayers to comply with and too difficult for the regulatory agencies to administer.”
Income tax: Planning is still important

Tips discussed in this section*

*Refer to the text for the full picture on how to use these tips
Income tax: Planning is still important

Tax planning for individuals is more focused on your specific fact pattern and objectives than the tax increases we saw in 2013 — rather than focusing on issues related to changing income tax rates, you will likely focus on managing tax on income when it is realized and enhancing the benefit of deductions and exclusions.

Income tax planning is still important. By implementing a long-term commitment to thoughtful tax planning, you can better navigate today’s increased rate environment. Think about planning considerations in terms of categories of income, and also in terms of categories of tax. This approach can provide a solid foundation on which to focus your planning options.

The Annual Wealth Guide is designed to provide information to assist you in both short- and long-term tax planning. Of course, it goes without saying that you should focus your planning on your own specific fact pattern and objectives, as there is no one-size-fits-all approach. You should know that not all planning considerations are designed to save you taxes across the board — some planning considerations are designed to plan for income tax and AMT while others are designed to plan for healthcare taxes. In some instances, the considerations may save you on both fronts: alternatively, certain considerations decrease exposure to one tax but increase it for another — choosing one alternative may affect another, so you must always look at the total return to make decisions. You should also know that all planning considerations may not apply to you, and that you should always consult a tax adviser.

Categories of income
- Investment income
- Ordinary income
- Retirement savings
- Deductions

Categories of tax
- Income tax
- Alternative minimum tax (AMT)
- Healthcare taxes

“In implementing a long-term commitment to thoughtful tax planning, you can better navigate today’s increased rate environment.”
Income tax: Planning is still important

Recently enacted tax law changes affecting individuals

This section reviews certain important income tax developments and considerations that are critical elements of effective long-term tax planning.

The American Taxpayer Relief Act of 2012

Enactment of the American Taxpayer Relief Act of 2012 (ATRA) kept us from falling off the so-called fiscal cliff. It permanently extended the reduced Bush-era income tax rates for lower and middle-income taxpayers, also allowed the top rates on earned income, investment income, and estates and gifts to increase from their 2012 levels for more affluent taxpayers. ATRA permanently “patched” the individual AMT and also extended dozens of temporary business and individual tax “extenders” provisions through the end of 2013.

Income tax rates. ATRA permanently left in place the six individual income tax brackets ranging from 10% to 35% for unmarried taxpayers earning taxable income at or below $400,000 and married taxpayers earning taxable income at or below $450,000. For taxpayers earning annual taxable income above these thresholds, however, there is an additional bracket of 39.6%, equal to the top marginal rate in effect prior to 2001. As you can see from the Income Tax Rate Grid on page 24 the income thresholds are indexed annually for inflation, using the Consumer Price Index (CPI).

The top tax rate on income from qualified dividends and long-term capital gains was similarly changed under ATRA relative to 2012 law. The top rate on income from both sources increased to 20% (up from 15%) for unmarried taxpayers with income over $400,000 and married taxpayers with income over $450,000. The 15% rate for both long-term capital gains and qualified dividends has remained in place for taxpayers with annual income below those thresholds.

AMT relief. ATRA provided permanent relief from the individual AMT, thus ending what had become an almost annual ritual in Congress of adopting temporary “patches” to address the fact that the AMT exemption was not previously indexed for inflation. ATRA set the individual AMT exemption to $50,600 for unmarried filers and $78,750 for married filers for 2012 and has indexed these amounts annually for inflation. It also allows nonrefundable personal credits to be taken against the AMT.

PEP and Pease limitations. ATRA permanently reinstated the personal exemption phase-out (PEP) and limitation on itemized deductions (Pease) for single taxpayers with AGI above $250,000 and joint filers with AGI over $300,000, with the thresholds indexed annually for inflation. ATRA also permanently repealed PEP and the Pease limitations for taxpayers earning annual income below those thresholds.

ATRA highlights through the end of 2013

- Permanently extended the Bush-era income tax rates
- Raises top rates on earned income, investment income, and estates and gifts
- Permanently “patched” the individual AMT
- Extended temporary business and individual tax “extenders” provisions
Income tax: Planning is still important

Marriage penalty relief. In 2001, the EGTRRA protected some two-earner couples from the so-called “marriage penalty” by (1) expanding the standard deduction for joint filers to twice the deduction for single filers and (2) expanding the 15% bracket for joint filers to twice the size of the corresponding rate bracket for single filers. ATRA permanently extended these provisions effective for taxable years beginning after December 31, 2012.

Child tax credit and other family tax benefits. ATRA made permanent the $1,000 child tax credit and expanded refundability as provided under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), effective for taxable years beginning after December 31, 2012. ATRA also extended for five years (through 2017) the modifications to the credit enacted under the American Recovery and Reinvestment Act (ARRA) that allow earnings in excess of $3,000 to count toward the credit. ATRA also permanently extended the expanded 35% dependent care credit that applies to eligible child care expenses for children under age 13 and disabled dependents, the nonrefundable tax credit for qualified adoption expenses and the income exclusion for employer-assistance programs ($13,190 for 2014), and the tax credit for employers who acquire, construct, rehabilitate, or expand property used for a child care facility.
Income tax: Planning is still important

Education tax incentives. Expansions of education tax incentives enacted as part of EGTRRA are extended permanently under ATRA. These provisions include:

- The $5,250 annual employee exclusion for employer-provided educational assistance and its expansion to include graduate-level courses.
- Expansion of the student loan interest deduction beyond 60 months and increased income phase-out range.
- The increased Coverdell education savings account contribution limit (from $500 to $2,000) and expansion of the definition of “qualified education expenses” to include expenses most frequently and directly related to elementary and secondary school education.

American Opportunity Tax Credit. The modifications made by the ATRA to the American Opportunity Tax Credit are extended for five years (through 2017). These modifications include increasing the amount of the credit, extending it to cover four years of schooling, raising the income limits to determine eligibility for the credit, allowing up to 40% of the credit to be refunded, and expanding the expenses eligible for the credit.

Roth IRA conversions. To partially cover the costs of the two-month delay of the budget sequester that is part of ATRA, lawmakers included a tax revenue offset related to Roth conversions for retirement plans. Specifically, the revenue offset would allow individuals to convert any portion of their balance in an employer-sponsored tax-deferred retirement plan account into a Roth account under that plan. The conversion option for retirement plans would only be available if employer plan sponsors include this feature in the plan.

Extensions of temporary individual tax provisions. In addition to addressing the Bush-era tax cuts, ATRA also extended a number of expired temporary tax deductions, credits, and incentives for individuals. Among the so-called “extenders,” all of which expired at the end of 2013 and are awaiting action by Congress to extend them again, are the following:

- Deduction for state and local sales taxes – ATRA retroactively extended the election for taxpayers to deduct state and local general sales taxes under section 164(b)(5) through the end of 2013.
- Above-the-line deduction for tuition – ATRA retroactively extends the above-the-line deduction for qualified tuition expenses under section 222 through 2013 and keeps the maximum deductions based on income thresholds the same as under prior law.
- Distributions from individual retirement plans for charitable purposes – ATRA retroactively extends the tax-free distributions of up to $100,000 annually per taxpayer from an individual retirement arrangement held by an individual age 70½ or above through 2013 and allows individuals who took a distribution in December 2012 to contribute the amount to charity and have it count as an eligible rollover.
- Mortgage insurance premiums – ATRA retroactively allows taxpayers to deduct premiums for mortgage insurance as qualified residence interest through 2013.
- Exclusion of income from discharge of indebtedness on principal residence – ATRA extends through 2013 section 108(a)(1)(E), which allows a taxpayer to exclude from income up to $2 million in cancellation-of-indebtedness income from the forgiveness of mortgage debt on a principal residence.
Bonus depreciation. ATRA extended the 50% bonus depreciation for qualified property under section 168(k), which applies to qualified property placed in service before January 1, 2014 (before January 1, 2015 for certain longer-lived and transportation assets).

Section 179 expensing limitation. ATRA increased the maximum amount and phase-out threshold in 2012 and 2013 for small business expensing under section 179 to the levels in effect in 2010 and 2011. For tax years beginning in 2013, the limitation is raised to $500,000 and would be reduced if the cost of section 179 property placed in service exceeds $2 million. Within those thresholds, ATRA allows a taxpayer to expense up to $250,000 of the cost of qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property. Those limitation amounts will return to $25,000 and $200,000, respectively, in 2014 and beyond.

Section 1202 small business stock exclusion. ATRA extended the 100% exclusion for the gain on sale or exchange of qualified small-business stock acquired before January 1, 2014, and held for more than five years. For 2014 and beyond, this provision has expired.

Basis adjustment to stock of S corporations making charitable contributions of property. ATRA extended through 2013 the provision allowing S corporation shareholders to take into account their pro rata share of charitable deductions even if such deductions would exceed the shareholder’s adjusted basis in the S corporation. For 2014 and beyond, this provision has expired.

Special rules for contributions of capital gain real property made for conservation purposes. ATRA extended through 2013 the increased contribution limits and carryforward period for contributions of appreciated real property (including partial interests in real property) for conservation purposes.

Employer-provided mass transit and parking benefits. ATRA extended through 2013 the parity for exclusion from income for employer-provided mass transit and parking benefits.

PPACA of 2010
The Patient Protection and Affordable Care Act (PPACA), commonly called the Affordable Care Act (ACA), or Obamacare, created certain new tax requirements.

Medicare tax increase. The PPACA created an additional 0.9% Medicare Hospital Insurance (HI) tax on self-employed individuals and employees on earnings and wages received during the year above specified thresholds. This additional tax applies to earnings of self-employed individuals or wages of an employee in excess of $200,000. If an individual or employee files a joint return, then the tax applies to all earnings and wages in excess of $250,000 on that return. (For married couples filing separately, the threshold is one-half the amount for joint filers.)
Income tax: Planning is still important

Net investment income tax. The PPACA created a 3.8% NIIT on “unearned” income, including income from interest, dividends, capital gains (including otherwise taxable gain on the sale of a personal residence), annuities, royalties, and rents. Excluded income includes distributions from qualified plans and income that is derived in the ordinary course of a trade or business and not treated as a passive activity. The tax is applied against the lesser of the taxpayer’s net investment income or modified AGI in excess of the threshold amounts. These thresholds are set at $200,000 for singles and $250,000 for joint filers. (For married couples filing separately, the threshold is one-half the amount for joint filers.)

For estates and trusts, the tax applies on the lesser of the undistributed net investment income or the excess of AGI over the dollar amount ($12,150) at which the 39.6% tax bracket for estates and trusts begins.
Income tax: Planning is still important

Restrictions on health-related accounts and reimbursements. The PPACA tightened a number of the rules related to flexible spending arrangements, health reimbursement arrangements, health savings accounts, and medical savings accounts. These changes to medical savings vehicles are effective for tax years beginning after December 31, 2010.

- **Over-the-counter drugs.** The PPACA conformed the definition of medical expense for purposes of employer-provided health coverage — including reimbursements under employer-sponsored health plans, Health Reimbursement Arrangements (HRAs), Health Flexible Spending Arrangements (FSAs), Health Savings Accounts (HSAs), and Archer Medical Savings Accounts (Archer MSAs) — to the definition used for the medical expense itemized deduction. Thus, the PPACA eliminates nontaxable reimbursements of over-the-counter medications unless the over-the-counter medications are prescribed by a doctor. Prescribed medicines, drugs, and insulin will still qualify for nontaxable reimbursements from those accounts.

- **Limit on health flexible spending arrangements.** Beginning with years after 2012, the PPACA imposed a limit of $2,500 per taxable year on employee salary reductions for coverage under a cafeteria plan FSA. The limit, which does not apply to health reimbursement arrangements, is indexed for inflation after 2013; however 2014 is still $2,500. If a cafeteria plan does not contain the required limitation, then benefits from the FSA will not be qualified benefits.

- **Penalty on nonqualified health savings account distributions.** The PPACA increased the penalty on withdrawals from HSAs and Archer MSAs not used for qualified medical expenses from 10% to 20% for HSAs and from 15% to 20% for Archer MSAs.

**Itemized deduction for medical expenses.** The PPACA increased the threshold for claiming an itemized deduction for unreimbursed medical expenses for regular tax purposes from 7.5% of the taxpayer’s AGI to 10%. The PPACA does not change the current-law 10% of AGI threshold that applies under the AMT. For any taxpayer who is age 65 and older or whose spouse is 65 or older, the threshold for regular tax purposes remains at 7.5% until 2017.
Income tax: Planning is still important

Hiring Incentives to Restore Employment Act

Often characterized as a “jobs” bill, the Hiring Incentives to Restore Employment Act (HIRE) of 2010 provides payroll tax breaks and incentives for businesses to hire unemployed workers.

Reporting certain foreign accounts. Individuals with foreign accounts or foreign trusts may be subject to new foreign withholding and information reporting requirements. These changes include:

- Disclosure of foreign accounts. In addition to current Foreign Bank and Financial Accounts (FBAR) reporting requirements, new requirements cover a broader class of assets, extend the statute of limitations to six years, and increase the penalty from 20% to 40%. Some requirements applied beginning in 2011.

- New Passive Foreign Investment Companies (PFIC) disclosure requirements. All U.S. persons owning PFIC shares must disclose those annually, as determined by Internal Revenue Service (IRS) guidance.

- Unreimbursed use of foreign trust property. Such use will be treated as a deemed distribution from the trust to its beneficiaries, applicable from March 18, 2010.

- Interest income from bonds in nonregistered form. For bonds issued after March 18, 2012, such income generally will no longer qualify for the “portfolio debt exception.” Exceptions may apply as determined by IRS guidance.

- Required withholding on U.S.-source income received by U.S.-owned foreign entities. As determined by IRS guidance, such entities will generally be required to withhold 30% of U.S.-source income unless information identifying U.S. owners is furnished to the U.S. Treasury.

- Statutory reclassification of certain payments as dividends. The reclassification expands the types of payments requiring U.S. withholding.

Tax rates

As ATRA permanently extended the majority of tax provisions that were originally enacted as part of the Bush-era tax cuts and the significant tax rate increases previously enacted in 2013, tax bills for low, middle, and high-income taxpayers will generally go unchanged from 2013 to 2014.

For 2014, the top marginal tax rate is 39.6% for unmarried taxpayers with income over $406,750 and married taxpayers with income over $457,600. Tax rates continue to range from 10% to 39.6% and will remain in place permanently until further reform.
## Overview of tax rates for individuals from 2013-2014

<table>
<thead>
<tr>
<th>Provision</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Ordinary income tax rates</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>39.6%</td>
<td>39.6%</td>
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<td>10.0%</td>
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</table>

**Top rates for investment income**

- **Capital gains top rate**: 20.0%<sup>2</sup> 20.0%<sup>2</sup>
- **Qualified dividends top rate**: 20.0% 20.0%

**Marriage penalty relief**

- **Standard deduction**: Deduction for married-joint filers is twice that of single taxpayers
- **15 percent bracket**: Bracket expanded to twice that for single taxpayers
- **Child credit**: $1,000 $1,000
- **Limitations on personal exemptions (PEP) and itemized deductions (Pease)**: Single and joint filers with AGI above $250,000 and $300,000, respectively (annually indexed for inflation)
- **AMT exemption**: $51,900 Single; $80,800 Married $52,800 Single; $82,100 Married

**Healthcare taxes enacted in the Patient Protection and Affordable Care Act**

- **Net investment income tax (NIIT)**: 3.8% surtax on net investment income of single taxpayers with AGI over $200,000 ($250,000 for joint filers)
- **Increase in Medicare hospital insurance (HI) tax wage base**: 0.9% increase in employee portion of HI wage base of single taxpayers with AGI over $200,000 ($250,000 for joint filers)

**Estate and gift taxes**

- **Top rate**: 40.0% 40.0%
- **Exemption**: $5.25 million (indexed for inflation) $5.34 million (indexed for inflation)
- **Annual gift tax exclusion**: $14,000 $14,000

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1. The 39.6% top rate applies only to joint filers earning income above $457,600 and single filers earning above $406,750. On top of these stated rates, joint filers generally earning in excess of $250,000 and single filers generally earning over $200,000 may be subject to an additional 0.9% Medicare HI tax on wages and self-employment income. This provision was enacted in the PPACA and became effective on January 1, 2013.

2. The 20% top rate applies only to joint filers earning above $457,600 and single filers earning above $406,750. On top of these stated rates, joint filers generally earning in excess of $250,000 and single filers generally earning over $200,000 may be subject to a 3.8% NIIT on certain types of investment income. This provision was enacted in the PPACA and became effective on January 1, 2013.
Income tax: Planning is still important

**Underpayment penalties.** Federal law requires the payment of income taxes throughout the year as the income is earned. This obligation may be met through withholding, making quarterly estimated tax payments, or both. The penalty for underpayment is calculated as interest on the underpaid balance until it is paid, or until April 15, 2015, whichever occurs first.

For 2014, individuals will not be subject to an underpayment penalty if the balance due on their federal tax return (total tax liability for the year, less withholdings) is $1,000 or less. If the balance due is more than $1,000, the taxpayer will be subject to a penalty unless 2014 withholdings and estimated tax payments equal 90% of the 2014 tax liability, 100% of the 2013 tax liability (110% if 2013 AGI exceeds $150,000 for married taxpayers), or 90% of the 2014 tax liability based on quarterly annualized year-to-date income.

The table to the right illustrates the amount required to be paid (cumulatively) for 2014 taxes under each method by each date for calendar-year taxpayers.

<table>
<thead>
<tr>
<th>Cumulative amount of estimated taxes to be paid</th>
<th>Due date</th>
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</thead>
<tbody>
<tr>
<td>Current year’s tax or annualized income method</td>
<td>22.5%</td>
</tr>
<tr>
<td>Prior year’s tax – safe harbor for AGI of $150,000 or less</td>
<td>25%</td>
</tr>
<tr>
<td>Prior year’s tax – safe harbor for AGI over $150,000</td>
<td>27.5%</td>
</tr>
</tbody>
</table>
Income tax:
Planning is still important

Planning tip #1: Adjust withholding amounts to avoid penalties. Income tax withholdings are considered paid equally throughout the year, even if the withholdings are made near the end of the year. If you anticipate that you have underpaid your estimated taxes for 2014, consider adjusting withholdings for the remainder of the year to avoid penalties for underpayment of estimated taxes.

Planning tip #2: Account for supplemental wages. In certain circumstances, supplemental wages (e.g., bonuses, commissions, and overtime pay) may be subject to a flat 25% withholding rate. If this rate is different from your normal withholding rate, be sure to factor the different rate into your estimated tax calculations. Similar to withholding on regular wages, taxpayers may increase the withholding amount on their supplemental wages to avoid penalties for underpayment of estimated taxes. Supplemental wages in excess of $1 million are subject to withholding at the highest marginal income tax rate in effect for the year they are paid.

Planning tip #3: Cure underpayments through indirect rollover distributions. If you anticipate being liable for underpayment penalties on estimated tax, you may consider taking an indirect rollover distribution from a traditional or Roth IRA account during the year of underpayment. If an indirect rollover of an IRA occurs, the trustee of the IRA is required to withhold 20% of the funds distributed as a prepayment of federal income tax unless you elect not to have federal taxes withheld on Form W-4P. You may also elect to have an additional amount withheld from the distribution by providing the trustee of the IRA with Form W-4P. By triggering sufficient withholding tax, you can “cure” prior underpayments of estimated tax and avoid or reduce penalties. As long as you redeposit the gross amount of the IRA distribution to another IRA within 60 days, no adverse tax consequences result from the rollover, provided you meet the once-per-year rollover limitation.

Overpayment of estimated taxes. Just as you should avoid underpaying estimated taxes and incurring a penalty, you also should avoid overpaying estimated taxes. Overpaying taxes is the equivalent of providing an interest-free loan to the government. You may receive a refund eventually, but you have lost the opportunity to have the money working for you.

Planning tip: Monitor and adjust withholdings throughout the year. If you anticipate that you have overpaid estimated taxes (or withholdings have been too high during the year), consider reducing withholdings during the remainder of the year to create an early refund. Certain restrictions apply with respect to the number of allowances you may claim, which will affect the minimum amount that can be withheld; therefore, check with your tax adviser before submitting a new W-4 to adjust your withholdings for 2014. Also, estimate withholding for 2015 and file a new W-4 with your employer, if necessary.

Recognition of compensation income. Depending on your situation, you may be able to time the receipt of commissions, bonuses, or billings between one year and another. Income recognition timing is not easy, however. You need to consider the time value of money, the impact that acceleration or deferral might have on various deductions, credits, your projected income tax rate in both years, and other nontax financial factors. There are several income recognition techniques you may consider. Again, you must be aware of tax rules that impose an additional income tax of 20% or more on certain impermissible changes in the timing of compensation payments.

To further complicate the impact of today’s increased tax rate environment, when timing income recognition, taxpayers should also consider the interplay with AMT and the PEP and Pease deduction limitations also discussed in this publication.
Income tax: Planning is still important

Planning tip #1: Consider timing and character of compensation and bonuses. As discussed above, if you have the ability, consider delaying or recharacterizing compensation or bonuses where possible. For instance, analyze opportunities to make a Section 83(b) election on restricted stock to convert ordinary income to capital gains. Section 83(b) imposes ordinary income tax on property received as compensation for services as soon as the property becomes vested and transferable. If you receive the eligible property (such as restricted stock), within 30 days, you can elect to recognize immediately as income the value of the property received and convert all future appreciation to capital gains income, and convert all future dividends on the stock to dividends qualifying for the reduced rates. Keep in mind, however, that future capital gains and dividends may be subject to the 3.8% NIIT. This should be considered carefully as this election cannot be undone in the event the stock does not appreciate or never vests. Careful planning is required to make sure you comply with the strict rules and are able to properly weigh the benefits against the risks, for example, the risk of forfeiture. Consult with your financial adviser before making this election.

Planning tip #2: Consider NOL carryforwards. If you are generating a net operating loss (NOL), you should consider having your NOL carried forward to offset future ordinary income taxed at higher rates, rather than carried back to offset income taxed at lower rates. Careful modeling of this decision is critical and must focus on cash flow, as well as tax considerations. Note that one must affirmatively elect to carry forward an NOL. Without such an election, the NOL must be carried back.

Planning tip #3: Consider deferring bonuses to 2015. Income is usually taxable to an individual in the year of receipt. In most cases, therefore, deferring income to 2015 will defer the associated ordinary and Medicare taxes. If you have the ability, consider delaying the receipt of an annual bonus until shortly after December 31st, or waiting until January to bill for services. Check with your tax adviser prior to engaging in this type of planning to be sure you are not running afoul of constructive-receipt rules, which treat income as received even though you do not have the cash in hand, or subjecting the income deferred to the very stringent Section 409A rules imposed on nonqualified deferred compensation. Also, check with your tax adviser to determine whether you are subject to AMT in either year, as this may affect your ability to benefit from such a deferral strategy.

Investment income. In addition to consulting your tax adviser about planning techniques specific to your situation, you also should work with your investment adviser to determine whether it is better to invest funds in a taxable account or a tax-deferred account, and to consider your asset allocation and investment strategy in light of the impact of tax rates on portfolio income. Keep in mind that tax-exempt investment income, from municipal sources for example, are not affected by increased ordinary rates nor are they subject to the NIIT.
Income tax: Planning is still important

**Long-term capital gains tax rates.** The long-term capital gains tax rate is 20% for taxpayers in the top 39.6% bracket. The long-term capital gains rate for taxpayers in the 25%-35% tax brackets is 15% and for those taxpayers in the two lowest tax brackets, the long-term capital gains rate is 0%. In addition, capital gains may also be subject to the 3.8% NIIT. Gains from installment sales are taxed at the rate in effect on the date an installment payment is received.

Certain sales of capital assets do not qualify for the lower capital gains rate. Collectibles remain subject to a 28% maximum rate. Unrecaptured Section 1250 gain on real estate is subject to a 25% maximum rate. Qualified small business stock is generally subject to the 50% exclusion and the remainder is taxed at 28%, subject to certain exceptions discussed below in Planning Tip #5 — Sell a business through a stock sale.

**Capital gains and capital losses.** The decision to sell capital assets should be based on economic fundamentals, together with your investment goals; however, you should also consider the tax aspects. To illustrate, a taxpayer in the 39.6% tax bracket, is subject to a 20% capital gains tax rate on assets held for more than one year; thus, a 19.6% rate differential exists between said long-term capital gains and short-term capital gains (which are taxed at ordinary income rates). Both long and short-term gain on almost all assets will be subject to the 3.8% tax. Special attention should be given to the holding periods of assets to take full advantage of the long-term capital gains rates available for assets held more than one year.
Income tax: Planning is still important

When considering the following planning tips, you should also be mindful of how the 3.8% NIIT may affect your overall capital gain rate for 2014 and future years.

**Planning tip #1: Consider tax brackets when realizing capital gains.** If you anticipate being in a lower tax bracket in 2015 and future years or expect significant amounts of capital losses in 2015, you may want to consider realizing capital gains in 2014, but deferring tax recognition until 2015. You can accomplish this by using such strategies as entering into an installment sales agreement (but not when selling marketable securities, as such gain is not deferrable) or implementing other investment techniques. Consult your tax adviser for planning techniques specific to your situation.

**Planning tip #2: Offset capital gains with capital losses.** If you have short-term capital gains (which are taxed at ordinary income tax rates), consider selling capital assets that will generate a capital loss in order to offset the short-term capital gain. Taxpayers are allowed to deduct up to $3,000 of net capital losses against ordinary income each year. Any net capital losses in excess of $3,000 are carried over to future years. While harvesting losses can make sense from a tax perspective, make sure you are not overlooking investment implications and transaction costs that could more than offset the tax gains. In some cases, the primary benefit of harvesting a tax loss is simply to offset the payment of capital gains tax.

**Planning tip #3: Consider the wash sale rules.** Under the “wash sale” rule, if securities are sold at a loss and the same — or substantially the same — securities are purchased within 30 days before or after sale of the original securities, the loss cannot be recognized until the replacement securities are sold. These rules apply even if the purchased securities are in the seller’s IRA. There often is a satisfactory alternative, however. To realize the loss and maintain the ability to benefit from any market upside, consider selling a stock or mutual fund to realize a loss and then replacing it in your portfolio with one having similar characteristics in the same industry or style group, yet one outside the definition of substantially identical under Section 1091.

**Planning tip #4: Gift appreciated assets.** Taxpayers interested in family wealth planning should consider gifting appreciated assets (or those that are expected to appreciate) to their children who are not subject to the kiddie tax and are in the lowest two tax brackets. Because taxpayers in the highest five tax brackets are taxed at 15% or 20% long-term capital gains rates versus a 0% rate for taxpayers in the lowest two tax brackets, you may realize an immediate tax savings. Combining utilization of the gift tax annual exclusion with a gift of appreciating assets can be a powerful wealth transfer planning tool. Keep in mind that the applicable age for applying the kiddie tax is children under age 19 or full-time students under age 24 (more details on the kiddie tax are discussed later in this section).

**Planning tip #5: Sell a business through a stock sale.** If you are considering selling a business, you may attempt to structure the transaction as a sale of the company’s stock rather than a sale of the company’s assets. In most circumstances, a sale of the company’s stock will constitute a sale of a capital asset eligible for the lower capital gains tax rate, as opposed to a sale of the assets, a portion of which may be subject to tax as ordinary income. Additional tax savings accrue if the business constitutes a qualified small business, the stock of which has been held for at least five years. Generally, 50% of the gain on such a stock sale (limited to the greater of 10 times the taxpayer’s basis in the stock or $10 million) is excludable from income with any remaining gain being taxed at 28%. The qualified small business stock exclusion is 75% for stock acquired after February 17, 2009 and on or before September 27, 2010, and 100% for stock acquired after September 27, 2010, and before January 1,
Income tax:
Planning is still important

2014 (as discussed above, ATRA temporarily extended the exclusion of 100% of the gain from January 1, 2012 through December 31, 2013). The buyer will typically want to structure the transaction as a sale of assets in order to take advantage of certain depreciation rules; therefore, some negotiation is to be expected. Note that for stock acquired on or after September 27, 2010 and before January 1, 2014, the associated AMT addback is also eliminated.

Planning tip #6: Invest inside and outside of retirement accounts. If you expect to be in a higher tax bracket in future years or you expect tax rates to increase significantly in your retirement years, it may be more advantageous to invest in equities outside of your retirement accounts as you approach retirement. By doing so, you can obtain the favorable capital gains tax rate when you sell the investment. You also may consider investing in taxable bonds in your retirement accounts, where the ordinary income generated can be deferred. Retirement plan distributions are generally taxed at ordinary income tax rates, which can be as high as 39.6%. You should run a multi-year tax projection to determine the best method of investing for retirement while keeping taxes to a minimum.

Planning tip #7: When selling S-corp or C-corp stock, consider electing to use disposition of assets treatment. If planning on selling C-corp or S-corp stock, consider electing to have certain dispositions treated as a disposition of assets rather than disposition of stock. The election allows a step-up in the basis of the entity’s assets upon the disposition, thus equalizing the inside and outside bases of the assets and eliminating the built-in gain on a future disposition of the underlying assets. Purchasers other than corporations (e.g., individuals, trusts, estates, and partnerships) may be able to benefit from this type of election that requires the consent of sellers and purchasers. Because the availability and advisability of making this election depends upon each taxpayer’s factual circumstances, you should consult with your tax adviser to explore the possibility of making an election.

Tax rates on qualified dividends. Similar to long-term capital gains rates, the top qualified dividends rate is 20% for taxpayers in the top 39.6% bracket. The 15% qualified dividends rate applies for taxpayers in the 25%-35% tax brackets and for those taxpayers in the two lowest tax brackets, the qualified dividend rate is 0%. Dividends may still be subject to the 3.8% NIIT in 2014 and future years.

“Extraordinary” dividend income. The receipt of “extraordinary” dividends may cause unexpected tax results. Extraordinary dividends are typically the result of larger-than-normal dividends and/or a very low basis in the stock. Dividends are considered “extraordinary” if the amount of the dividend exceeds 10% of the shareholder’s adjusted basis in the stock (5% if the shares are preferred). All dividends with an ex-dividend date within the same 85 consecutive days are aggregated for the purposes of computing whether this threshold is met. Individuals who receive extraordinary dividends and later sell the stock on which the dividends were paid must classify as a long-term capital loss any loss on the sale, to the extent of such dividends. This rule applies regardless of how long the stock was held. Thus, for the investor who anticipated receiving short-term capital loss treatment on the sale, presumably to offset short-term capital gains, unexpected tax consequences may result. Absent this rule, a taxpayer who had already realized a short-term capital gain could buy a stock that was expected to pay out large dividends, hold the stock only long enough to receive the dividend, and then sell the stock at a loss to offset the short-term capital gain while enjoying favorable tax rates on qualified dividends.
Income tax:
Planning is still important

Planning tip #1: Plan for investment interest expenses. Investment interest expense is only deductible to the extent of current year net investment income. Dividends that are taxed at the lower qualified dividends reduced rates are not treated as investment income for purposes of this calculation; therefore, you should consider electing to tax a portion of qualified dividends (or capital gains) at ordinary income rates to increase use of the investment interest deduction. You may elect to recognize just enough of the qualified dividends to be taxed at ordinary income tax rates to offset investment interest expense and allow the remainder of qualified dividends to be taxed at the lower 15% or 20% rate (or 0% rate for lower-income taxpayers). Alternatively, if you anticipate being in a higher tax bracket in 2015, you should consider whether carrying over an investment interest expense into a future year is more advantageous than electing to recognize qualified dividend income (and/or capital gains) as ordinary income for a current-year offset.

Planning tip #2: Consider reducing payments in lieu of dividends. Some margin accounts allow a broker to borrow shares held in the margin account and return the shares at a later date. In practice, the broker borrows shares from a pool of investors in order to lend the shares to another investor to execute a short sale. For tax purposes, payments that are made while the shares are on loan are considered “payments in lieu of dividends,” rather than dividends, and thus will not qualify for the lower 15% or 20% rates (or 0% rate for lower-income taxpayers). Unless your broker already has notified you of its policies regarding share borrowing, consider consulting with your broker to see whether it is the broker’s policy to borrow shares from noninstitutional investors. In certain cases, an investor may want to transfer dividend-paying shares into a cash account or place a restriction on the broker’s ability to borrow the shares. Alternatively, an investor may want to have the ability to call back shares of stock before the dividend date so that he or she will be the owner of the shares on the dividend record date.

Planning tip #3: Consider holding underlying stock for at least 61 days. In order to qualify for the reduced rates, the underlying stock upon which a dividend is paid must be held for at least 61 days during the 121-day period, beginning 60 days before the ex-dividend date (91 days of the 181-day period for preferred stock). In order to qualify, the shares must not be subject to a hedging transaction during this time period; therefore, if you regularly engage in hedging transactions or other derivative transactions, you may want to consider more complicated investment techniques, such as selling a qualified covered call, in order to take advantage of the lower rates.
Income tax: Planning is still important

The kiddie tax. The so-called kiddie tax originally was enacted to prevent the transfer of unearned income from parents to their children in lower tax brackets. It targets investment income earned on investments in the name of a child, taxing such income at the same rates that apply to their parents. For 2014, the kiddie tax may apply if the child’s investment income exceeds $2,000. The kiddie tax applies to: 1) all children under age 19, and 2) full-time students under age 24. Note that the kiddie tax does not apply to a student over age 17 who has earned income that accounts for more than half of the student’s support.

Stock option planning. Traditionally, a favorite form of performance compensation for corporate executives has been the granting of stock options. Stock options provide executives with the flexibility to determine when they want to exercise the options and therefore, control the timing of the tax event. Section 409A changed the tax rules for certain compensatory options. If you now hold or subsequently receive as compensation options on property other than employer common stock (or analogous partnership equity interests in the case of a partnership employer) or with an exercise price less than the fair market value of the property on the date it is granted, discuss the impact of Section 409A with your tax adviser. If you have exercised any such options, determine whether additional income taxes apply or if you can take an alternative position to address potential additional income taxes.

There are two types of stock options: nonstatutory options (also known as nonqualified stock options, NSOs, or NQSOs) and statutory options (also known as incentive stock options, ISOs, or employee stock purchase plan options). Generally, NQSOs generate compensation income when exercised. At exercise, the taxpayer pays tax at ordinary income tax rates on the spread between the fair market value of the property received and the exercise price. Historically, taxpayers have waited until near the end of the exercise period in order to delay the tax consequences.

Incentive stock options have a different tax consequence. An ISO cannot be granted with an exercise period longer than 10 years, but the period can be shorter if the company so chooses. Exercising an ISO does not affect a taxpayer’s regular taxable income; however, the exercise may affect the taxpayer’s AMT. Therefore, taxpayers should plan for and control the timing and exercise of ISOs.

Planning tip #1: Consider exercising ISOs. When exercising ISOs, consider holding the stock for the required holding period to lock in post-grant appreciation at long-term capital gains rates. As many taxpayers have realized over the last few years, however, continuing to hold ISO stock in a volatile market may prove disadvantageous. The long-term capital gains rate should be but one consideration in determining whether to sell or hold ISO stock. A taxpayer is eligible to use the lower capital gains tax rates if ISO stock is held for two years after the option was granted and more than one year after the option is exercised. The lower capital gains tax rate makes exercising ISOs more attractive. In some cases, exercising ISOs could trigger AMT, but with careful planning, you may avoid the AMT. An eligible person who, in order to comply with federal conflict-of-interest requirements, sells shares of stock after October 22, 2004, that were acquired pursuant to the exercise of an ISO will be treated as satisfying the statutory holding-period requirements for capital gains tax treatment, regardless of how long the stock was actually held.
Income tax:
Planning is still important

Planning tip #2: Consider exercising ISOs at retirement or termination of employment. Many taxpayers continue to hold ISOs at retirement or termination of employment. As a general rule, retirees have only three months after separating from service to exercise the options as ISOs, at which point these ISO’s convert to NSO’s. If you are approaching retirement or planning to change jobs, determine whether it is beneficial to exercise any remaining ISOs.

Passive gains and losses. Net losses from passive activities currently cannot be deducted against income from other sources. Instead, these losses are suspended, to be deducted when the activity that generated the loss is disposed of in a taxable transaction, or when the taxpayer’s passive activities begin generating taxable income. Credits arising from passive activities are subject to similar rules. In addition, gifts (either to family members or charity) do not permit the use of suspended passive losses or credits. Planning for passive activities has become increasingly important as passive income may be subject to the 3.8% NIIT in 2014.

The tax law treats two types of activities as passive activities. The first is any business activity in which the investor does not materially participate. The second is most rental activities, regardless of the investor’s level of participation (subject to special rules for real estate professionals).

Individuals who own rental properties and are actively involved in management decisions pertaining to such property are able to deduct up to $25,000 of losses per year against other income. This amount generally is phased out by 50% of the amount by which the investor’s income exceeds $100,000. Therefore, the deduction is fully phased out if the investor has AGI of $150,000 or more.

Planning tip #1: Closely monitor participation in activities. Increase your participation in what would otherwise be treated as a “passive activity” or dispose of passive activities with suspended losses or credits. This approach could allow you to use passive activity losses or credits currently that otherwise would be deferred. Alternatively, ask your tax adviser whether decreasing your participation in a profitable business activity will make the income passive so that it can be sheltered by losses from other passive activities. Note however, that passive income may be subject to the 3.8% NIIT in 2014.

Planning tip #2: Consider tax benefits of passive activity dispositions. Passive losses that are “freed up” (generally through disposition of the activity to an unrelated party) may be used to offset ordinary income. Any applicable capital gains generated by the disposition may be eligible for the lower long-term capital gains tax rate and will be treated as passive income to allow utilization of suspended passive losses from other activities. Carefully coordinate the timing of the disposition of a passive activity with other activities throughout the year in order to provide the best possible results.
Income tax: Planning is still important

Planning tip #3: Understand the ins and outs of transfers of passive activities. Remember that, generally, a disposition must be part of a taxable transaction if it is to “free up” any suspended losses. If the activity that generated the passive losses is disposed of in a transaction other than a taxable sale, the suspended losses may be lost to the original holder. For example, if the activity is transferred by gift, suspended passive losses are added to the donee’s (recipient’s) basis and are not deductible by the donee until the activity is sold, at which time the unused losses will reduce gain/increase the donee’s loss. If the activity is transferred by divorce, the suspended passive losses are added to the former spouse’s basis, and the spouse who gives up the property loses the suspended losses. If the activity is transferred by sale to a related party, the suspended losses remain as suspended losses to the seller; when the related party sells the property to an unrelated party in a taxable transaction, the original seller may be able to deduct any remaining suspended losses. If a decedent holds a suspended passive loss upon death, the passive loss is reduced to the extent of any stepped-up basis, if any, and the remainder is deductible on the decedent’s final return. If you are an heir of a 2010 decedent subject to the carryover basis rules rather than the fresh-basis-at-death rules that apply to most decedents, consult your tax adviser regarding the interaction of the carryover basis rules and the passive loss rules.

Planning tip #4: Be mindful of suspended AMT losses. Each passive activity will almost certainly have a suspended AMT loss. Suspended AMT losses are generally smaller than their regular tax counterparts because each passive activity’s AMT preferences and adjustments are added back. The difference between the regular tax and AMT suspended passive loss is recognized as a separate AMT adjustment in the year of disposition. If the difference is significant, any regular tax benefit may be lost if the taxpayer is in AMT. Further compounding the problem is that the AMT basis of the disposed passive activity will be greater than the regular tax basis in an amount roughly equal to the difference between the suspended losses under the regular tax and AMT. The result is reduced AMT capital gain (thus decreasing the applicability of preferential capital gains rates), or worse, creation of an AMT capital loss, which will be deductible only up to the capital loss limitation of $3,000. Passive activity planning is a complicated area of the tax law — one that you should discuss with your tax adviser.

See the Healthcare taxes section for additional ideas related to passive activities.
Income tax: Planning is still important

Alternative minimum tax

The individual AMT system originally was designed in 1969 to prevent the very wealthy from using a variety of special tax incentives to avoid paying income tax.

The AMT, however, has evolved into an unwieldy system that continues to tax millions of unsuspecting taxpayers. Those living in states with high income taxes (such as California, New York, Hawaii, Oregon, and Vermont) or high property taxes (such as New York, Illinois, and New Jersey) and who have deductible personal exemptions are more likely to be affected. However, now that ordinary rates and the AMT exemptions have increased, it is likely that fewer taxpayers will be subject to AMT going forward.

Planning for AMT has become increasingly difficult. Taxpayers must be especially mindful of year-end cash payments, such as fourth quarter state income taxes, pre-payment of investment and tax adviser fees, and charitable contributions. Current-year planning around timing of the payment of expenses that constitute itemized deductions not deductible under the AMT system is certainly important, but it may not be enough. In addition, projecting taxable income from hedge funds and managing private activity bonds are among activities that take on special significance. More than ever, meaningful AMT planning requires examining multi-year scenarios.
Income tax: Planning is still important

**AMT rates, exemptions, and credits.** The AMT exemption for 2014 is $82,100 for married couples filing jointly and $52,800 for single filers. These exemptions are indexed for inflation and phased out as taxpayers reach higher levels of AMT income (AMTI). For instance, the 2014 $82,100 married exemption is reduced by 25% of the amount by which AMTI exceeds $156,500. The phase out for the $52,800 exemption begins as AMTI exceeds $117,300.

The ability to apply most nonrefundable personal credits (including the Dependent Care Credit, the credit for the elderly and disabled, the credit for interest on certain home mortgages, and the Hope Education Credit) against the AMT expired at the end of 2011, but was reinstated again on a permanent basis as part of ATRA.

**Planning tip #1: Perform an AMT self-diagnosis.** Falling victim to AMT has many possible causes, but you may be particularly prone to AMT if you have any of the following circumstances:

- Large state and local income or sales tax or property tax deductions
- Large long-term capital gains or qualified dividends
- Large deductions for accelerated depreciation
- Large miscellaneous itemized deductions
- Mineral investments generating percentage depletion and intangible drilling costs
- Research and development expenses in activities in which you do not materially participate
- An exercise of ISOs
- Large amounts of tax-exempt income that is not exempt for state tax purposes
- A large number of dependents
- Tax-exempt income from private activity bonds

If you are affected by one or more of these circumstances, you should discuss your AMT situation with your tax adviser.
Planning tip #2: Consider accelerating ordinary income and deferring certain deductions. If you expect to be subject to AMT in 2014 but not subject to AMT in 2015, consider accelerating ordinary and short-term capital gain income and deferring certain 2014 deductions to 2015 (especially any deductions not deductible for AMT, such as state and local income taxes, real estate taxes, and investment advisory expenses). This approach is contrary to typical planning, but it may reduce your ultimate tax bill.

Planning tip #3: Consider accelerating certain expenses. If you are not subject to AMT in 2014 but expect to be in 2015, accelerate expenses that are not deductible for AMT into 2014. For example, consider paying off home equity debt, as the interest expense is often not deductible for AMT purposes.

Planning tip #4: Do a multi-year analysis of potential planning options. Some of the differences between the AMT and regular tax systems are merely matters of timing. For instance, AMT generally requires slower depreciation than is permitted for regular tax purposes. Other differences are permanent; for example, state income or sales taxes can never be deducted under the AMT system, while under the regular system they are deductible when paid. Paying AMT in one year may generate a credit against a future year’s regular tax when adjustments are due to timing differences. Overall, you may be better off paying AMT currently in order to gain a credit in a later year — but only a multi-year analysis modeling the potential effect of planning options will tell.

Planning tip #5: Consider disqualifying ISO dispositions. Consider whether any stock obtained by exercising ISOs should be disqualified before the end of the year to reduce AMT liability if the stock has dropped in value. A disqualifying disposition will limit compensation income to the difference between the exercise price and the lower value of the stock at sale. If there is a wash sale (i.e., you repurchase the same stock within 30 days of the disqualifying disposition), compensation will be computed on the spread at exercise (at the old, higher value).

Planning tip #6: Watch out for other AMT traps. Income from private activity (municipal) bonds is taxable for AMT purposes, except certain private activity bonds issued in 2009 and 2010. Certain mortgage interest, such as from a home equity loan, is not deductible for AMT purposes as home mortgage interest if the funds from the loan are not used to buy, build, or substantially improve a primary or second home. Be sure to tell your tax adviser if you used the borrowed funds in your business or to make investments, as the home equity loan interest may still be deductible.
Income tax: Planning is still important

Healthcare taxes

In addition to giving thought to income taxes and AMT, taxpayers also need to be mindful of the combined impact of healthcare taxes, which target earned and investment income of high-income taxpayers.

Medicare Hospital Insurance (HI) Tax. The top individual income tax rate of 39.6% in 2014 does not include the rate increases included in the Reconciliation Act. Rather, an additional 0.9% HI tax will apply to earnings of self-employed individuals or wages of an employee received in excess of $200,000 ($250,000 if filing jointly). Self-employed individuals will not be permitted to deduct any portion of the additional tax. If a self-employed individual also has wage income, then the threshold above which the additional tax is imposed will be reduced by the amount of wages taken into account in determining the taxpayer’s liability.

Net investment income tax. An additional 3.8% NIIT also will be imposed on unearned income (income not earned from a trade or business and income subject to the passive activity rules) such as interest, dividends, capital gains, annuities, royalties, rents, and income from businesses in which the taxpayer does not actively participate. Because the tax applies to “gross income” from these sources, income that is excluded from gross income, such as tax-exempt interest, will not be taxed. The tax is applied against the lesser of the taxpayer’s net investment income (after investment related and allowable deductions) or modified AGI in excess of the threshold amounts. These thresholds are set at $200,000 for single filers and $250,000 for joint filers. Some types of income are exempt from the tax, including income from businesses in which the taxpayer actively participates, gains from the disposition of certain active partnerships and S corporations, distributions from qualified plans and IRAs, and any item taken into account in determining self-employment income.

For estates and trusts, the NIIT applies on the lesser of the undistributed net investment income, or the excess of AGI over the dollar amounts at which the 39.6% tax bracket for estates and trusts will begin. This threshold is $12,150 in 2014. Because this threshold is so low, consideration should be given to distributing income to beneficiaries who may be in lower effective tax brackets.
Income tax: Planning is still important

Planning tip #1: Defer capital gains and harvest losses. As discussed above in the capital gains and losses section, consider deferring capital gains or harvesting losses when possible. As part of the analysis as to whether to harvest losses, it is also important to analyze transaction costs, as well as the underlying economic considerations.

Planning tip #2: Consider installment sale treatment. For 2014 sales, consider electing into installment sale treatment (where available) and deferring the gain over the payment period (instead of recognizing the entire amount of gain in the year of sale). This would allow you to defer the income and the associated capital gains tax over the installment payment period. Sales of marketable securities are not eligible for installment sale treatment.

Planning tip #3: Rebalance your portfolio. Consider rebalancing your investment portfolio by increasing investments in growth assets and decreasing emphasis on dividend-paying assets. This will remove income from your earnings and manage your exposure to the NIIT. Keep in mind that sales of taxable income-producing assets will be subject to capital gains rates and potentially to the 3.8% NIIT. You should work with your investment adviser to review your investment strategy in light of the impact of higher tax rates. If you anticipate your tax rate to increase in the future, tax-exempt investments may produce a greater yield than taxable investments.

Planning tip #4: Consider investment interest expenses planning. If you have an investment interest expense carryover into 2014, and do not expect to have nonqualified investment income or short-term capital gains in the future, yet anticipate having qualified dividends and/or long-term capital gains, you may consider electing to tax those qualified dividends and long-term capital gains at ordinary tax rates (instead of the reduced qualified rates) on your 2014 income tax return. As discussed earlier, investment interest expense is only deductible to the extent of current-year net investment income. Long-term capital gains and dividends that are taxed at the 20%, 15%, or 0% reduced rate are not treated as investment income for purposes of this calculation unless the election is made to tax them at ordinary rates to allow the investment interest expense.

By electing to tax qualified dividends and long-term capital gains at the higher ordinary rate, you can utilize the investment interest expense that you would otherwise not be able to use currently (assuming you only have long-term capital gains and qualified dividends in the future).

Conversely, if you do anticipate having nonqualified investment income and short-term capital gains in the future, it may be more beneficial to hold the investment interest expense as a carryover to future years and offset the income subject to the higher ordinary tax rates, as well as reduce exposure to the 3.8% NIIT.
Planning tip #5: Consider regrouping, recharacterizing and disposing of passive activities. In 2014, passive income may be subject to the 3.8% NIIT; therefore, if you have multiple passive activities, consider reviewing current grouping elections for each activity that may change such activity from passive to active or vice versa. Passive activity losses (PALs) can be deducted only against passive activity income, which would allow you to reduce the amount of passive activity income subject to the 3.8% NIIT; regroupings may release the otherwise suspended losses.

Alternatively, an appropriate recharacterization from active to passive status may suspend otherwise allowable losses, which could be considered more valuable when projected to be released in a future year when your tax rate may be higher. If you anticipate being in a higher tax bracket in 2015, consider delaying the disposition of the passive activity in order to release the suspended losses in 2015 when the losses would be more valuable. However, if you think your rate will be lower in 2015, consider accelerating the disposition of a passive activity to free up losses in 2014. Timing of dispositions of passive activities and PAL carry forwards should be carefully coordinated. Passive activity planning is a complicated area of the tax law — one that you should discuss with your tax adviser as it relates to each of these matters.

Planning tip #6: Use a charitable remainder trust (CRT) to defer capital gains. For anticipated sales in 2014 and later, consider using a charitable remainder trust (CRT) to defer capital gains, provided that you also have a charitable intent. Use of a net income makeup charitable remainder unitrust (NIMCRUT) may allow for a longer income-deferral period. This technique is not available with S corporation stock, and may not be appropriate for some partnership interests.

Planning tip #7: Donate appreciated securities. Consider donating appreciated securities, rather than cash, to charity to receive a charitable deduction equal to the fair market value of the securities and also avoid paying capital gains tax on stock security appreciation. Having preserved the cash, consider purchasing new investments with a “refreshed,” higher basis with the cash you would have donated, potentially lowering exposure to the 3.8% NIIT.

Planning tip #8: Take advantage of self-employed retirement contributions. Consider establishing an appropriate retirement savings vehicle, such as a Keogh or a SEP IRA, which would allow for maximum contribution to a qualified plan based on self-employment income.

Planning tip #9: Consider converting to an S-corp to save self-employment tax. Eligible single-member LLCs (SMLLCs) that are disregarded for federal tax purposes may consider converting to an S corporation under certain circumstances. Active shareholders of an S corporation receiving reasonable salaries are not subject to the self-employment tax on distributed and undistributed income passing through to the shareholders.
Planning tip #10: Pay HI tax via quarterly installments. For taxpayers expecting to be subject to the 0.9% HI tax, consider accounting for the additional tax in 2014 quarterly estimates. All wages that are currently subject to Medicare tax are subject to additional HI tax if the wages are in excess of the applicable threshold for an individual’s filing status. The statute requires an employer to withhold the additional HI tax on wages or compensation paid to an employee in excess of $200,000 in a calendar year. However, couples filing under the married filing joint status with separate salaries below the threshold, but once combined are in excess of the threshold, should plan to incorporate the additional liability in their quarterly payments or request that their employer withhold an additional amount of income tax withholding on Form W-4 for 2014 and beyond.

Deductions: With respect to deductions, the key planning issue is determining in which year the deduction will generate the greatest tax benefit. Understanding this allows you to determine the most appropriate timing for deductions. As your tax rate rises, deductions are likely to be more beneficial; conversely, if your tax rate declines, they likely will become less beneficial.

For example, a taxpayer subject to AMT does not receive benefit for many of his or her deductions, including state taxes, real estate taxes, and 2% miscellaneous itemized deductions, whereas an individual in a lower rate environment who is not paying AMT may receive more benefit from deductions than an individual in a higher rate environment who is paying AMT. With increased ordinary income tax rates and increased AMT exemptions adjusted for inflation, individual taxpayers are less likely to be in AMT. As such, performing multyear AMT planning with an emphasis upon whether acceleration versus deferral of deductions will reduce AMT exposure and, therefore, provide a more significant benefit for your tax deductions is very important. It is critical that you discuss your AMT situation with your tax adviser.

In addition to AMT limiting tax deductions for certain earners, taxpayers may also face the phase out of personal exemptions (the “PEP limitation”) and limitation on itemized deductions (the “Pease limitation”). For 2014, a married couple’s deduction for personal exemptions may be reduced if their AGI exceeds $305,050, and is completely phased out when AGI exceeds $427,550 ($254,200 and $376,700, respectively, for single taxpayers). To illustrate, a family with three children who makes $450,000 a year would lose a $19,750 ($3,950 per person) personal exemption deduction in 2014.

The Pease limitation is the lesser of 3% of a taxpayer’s AGI over the threshold amount ($305,050 for a married couples and $254,200 for single taxpayers) or 80% of the certain Pease itemized deductions (qualified mortgage interest, state income and sales taxes, property taxes, charitable contributions, and miscellaneous itemized deductions). Assuming the same family has $50,000 of gross itemized deductions, they could potentially lose approximately another $4,400 worth of itemized deductions due to the Pease limitation.

Whether you are navigating ways to reduce the impact of PEP and Pease limitations, identifying where the increased rate spread between ordinary income and AMT rates may lessen exposure to AMT, or reducing unearned income subject to the NIIT through deduction planning, you will need to model your analysis carefully, as all will have significant bearing on the result.
Income tax: Planning is still important

Charitable contributions

Charitable contributions or donations must take the form of money or property, and do not include a taxpayer’s time or services. A donation in the form of cash (or check or credit card charge) is considered a donation of money, the value of which is your total out of pocket cost. A taxpayer’s donation of property (for example, household goods, clothing, and motor vehicles) is generally measured by the fair market value of the property donated, with certain exceptions discussed below. Donated clothing and household goods must be in good condition. The IRS has discretionary power to disallow the deduction based on condition. Household items include furniture, furnishings, electronics, appliances, linens, and other similar items. Food, paintings, antiques, objects of art, jewelry and gems, and collections are excluded from the provision and are subject to different rules.

When making donations, one must be mindful of the recordkeeping requirements for sustaining a charitable income tax deduction. For a monetary gift of any amount, either a written record (such as a credit card statement or cancelled check) or a written contemporaneous acknowledgement from the charity is required. For donations of $250 or more, a written acknowledgment from the charity is required, stating the amount of any benefits received in return for the donation. If no benefits were received, the acknowledgment must say so. When property other than cash, inventory, and publicly traded securities is donated to charity, and such property is valued above $5,000, the property must be appraised and summarized on the donor’s income tax return in order to claim a charitable deduction. If the value exceeds $500,000, the appraisal must be attached to the donor’s income tax return, whether the donor is an individual, partnership, or corporation.
Income tax:
Planning is still important

With respect to contributions of intangibles, if a donor contributes a patent or other intellectual property (other than certain copyrights or inventory) to a charity, the donor’s initial charitable deduction is limited to the lesser of basis or fair market value. If the donated property provides income to the charity, the donor may deduct certain additional amounts in the year of contribution or subsequent years, based on a specified percentage of the income received by the charity.

**Planning tip #1: Donate to a qualified charity.** Gifts to qualified charities qualify for an unlimited deduction for gift tax purposes; therefore, the $14,000 limit that applies to gifts to others does not apply to gifts to charities. In other words, outright gifts in any amount can be made to a qualified charity without paying gift tax. Gifts in trust for charity and gifts of partial interests in property, however, may be subject to gift tax. It is also important to note that certain limitations exist with respect to the aggregate amount of income tax deductions for charitable contributions.

**Planning tip #2: Donate appreciated securities.** If you are planning to make a contribution to a public charity, consider a gift of appreciated securities. By making such a contribution, you may be able to deduct the full market value of the gift for both regular and AMT purposes (if the securities were held for more than one year), whereas, if the securities are sold and the after-tax proceeds donated, both you and the charity will receive a lesser benefit.

For example, if you contribute an appreciated security that has a basis of $20,000 and a fair market value of $100,000, you may take a deduction equal to $100,000 (subject to certain limitations) and the charity receives a gift worth $100,000. If you sold the securities and donated the after-tax proceeds, the charity may receive only $84,000 ($100,000 — ($100,000 — $20,000) x 20%). The tax will be even larger if the sale is subject to the 3.8% NIIT discussed above. In addition, you would receive a smaller income tax charitable deduction.

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Income tax: Planning is still important

Planning tip #3: Replace donated securities to refresh basis. In addition to receiving a greater tax benefit from donating appreciated securities (rather than cash) to charity, you can use the cash that would have been donated to charity to purchase new investments with “refreshed” basis. For example, assume a taxpayer would like to provide a public charity with a $100 benefit, and the taxpayer is indifferent as to whether the donation is made in cash or other assets.

The taxpayer has XYZ stock in his or her portfolio, with a cost basis of $10 and a fair market value of $100. If the taxpayer donates the stock to the charity, he or she will get a charitable deduction of $100, subject to certain limitations. The taxpayer can then use the $100 that he or she otherwise would have donated to charity to repurchase XYZ stock. The basis of the taxpayer’s new XYZ stock is $100. In effect, the taxpayer received a step-up in basis of the XYZ stock from $10 to $100 in addition to meeting his or her charitable goals. Remember that the wash sale rules apply only to losses upon sale, not gains; therefore, the wash sale rules do not apply to this situation.

Planning tip #4: Maintain proper records. Each single donation of $250 or more requires a contemporaneous, written description of the contribution from the charity in order to qualify for the charitable contribution deduction. A cancelled check is not sufficient to support the deduction, nor is an acknowledgement received after a tax return has been filed. These rules apply even if the donation is made to your own family foundation. Also, any gift in excess of $5,000, other than cash or stock in a publicly traded company, requires an appraisal from a qualified appraiser in order to qualify for the deduction. Gifts of closely held stock valued up to $10,000, inventory, or vehicles also do not require an appraisal in most cases; consult your tax adviser if you think these exceptions might apply to you.

If you donate a used vehicle, boat, or airplane worth more than $500, the deduction will equal the fair market value of the contribution only if the charity uses the property in its tax-exempt function. If the charity sells the item, your deduction will generally be limited to the proceeds the charity actually receives. The charity will be required to furnish donors with a receipt that documents sales proceeds.

When making a noncash donation, consider the following requirements:

<table>
<thead>
<tr>
<th>Documentation of non-cash charitable deductions</th>
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Income tax: Planning is still important

Planning tip #5: Contribute to a donor-advised fund (DAF). A DAF is a fund that is managed under the tax umbrella of a public charity such as a community foundation. The donor makes an irrevocable gift of property (such as stock) to the host charity and receives a tax deduction equal to the fair market value of the property in the year of the gift. Assets are deposited into an investment account where they can grow tax free. The donor retains the right to advise (but not to direct) the host charity in administering the affairs of the DAF. Only one receipt (for the donation to the fund) is required instead of one receipt from each charity receiving a donation from the DAF, which can significantly simplify recordkeeping for tax purposes.

Depending on the policies of the host charity, advice may include naming the fund, managing investments, recommending grants, and selecting a replacement adviser at the death of the donor. DAFs cannot benefit the donor or any other private interest.

Planning tip #6: Consider the “related use” rules when donating personal property to a charity. Personal property refers to items such as art, jewelry, and household items. If the charity will not use the property in its exempt function, your charitable deduction is limited to the lesser of the value or your basis in the property. For example, art donated to a museum for its collection is deductible at the appraised value, but art donated to the same museum for its fundraising auction is deductible at the lesser of value or your cost.

In addition, if the charity does not use the property in its exempt function for three years, the benefit of the initial deduction may have to be recaptured. Exceptions may apply: consult your tax adviser if you think these limitations may apply to you.
Income tax: Planning is still important

Retirement savings and income

Sound retirement planning involves a range of economic and tax considerations. Most important, though, it involves consistent discipline to save. Taxpayers sometimes wonder whether they should skip making retirement plan contributions in light of uncertain market conditions. Keep in mind that you cannot make up missed retirement plan contributions in later years, and you will lose the potential for tax-favored earnings on those contributions. Regardless of your current and future tax situation and the market outlook, you should always consider contributing the maximum amount to your retirement plans annually.

Planning tip #1: Establish a Keogh plan. Sole proprietors or partnerships may establish a Keogh plan for themselves and their employees. Although you do not have to make contributions until the due date of the tax return (including extensions), you must establish the plan by the end of the year. For 2014, self-employed individuals may contribute the lesser of $52,000 or 100% of self-employment income to a defined contribution Keogh plan; however, any nondeductible amount (generally, any amount above the lesser of $52,000 or, in the case of plans for self-employed individuals with no employees, 20% of net self-employment income) is subject to a 10% excise tax. Self-employed individuals, therefore, generally contribute only the lesser of $52,000 or 20% of their net self-employment income. For purposes of the 20% limitation, net self-employment income includes a deduction for contributions to the plan. Older individuals should consider establishing a defined-benefit Keogh plan, which will likely allow a higher contribution amount.

Planning tip #2: Establish a defined-benefit plan. If you are an owner/employee of an S corporation without other employees, you may consider establishing a defined-benefit plan. Generally, an owner/employee may be able to contribute more to a defined-benefit plan than a defined-contribution plan. In addition, you may make contributions to the defined-benefit plan in a year in which you do not receive any compensation (or earned income if you are considered self-employed). In contrast, contributions to a defined-contribution plan are limited to the lesser of $52,000 or 100% of compensation (or earned income for persons considered self-employed); therefore, if you earn no compensation in a particular year, you may not make a contribution to a defined-contribution plan for that year. On the other hand, to avoid excise taxes, you may be required to make contributions that you would prefer not to make in a given year.

Planning tip #3: Establish solo 401(k) plans and SEP IRAs. In addition to contributing to Keogh plans, self-employed individuals are eligible to establish solo 401(k) plans and SEP Individual Retirement Accounts (IRAs). Solo 401(k) plans must be established prior to year-end of the year in which the deduction will be taken, whereas a SEP IRA may be established and funded at the time of filing the individual income tax return (including extensions). Each plan has its advantages and disadvantages; therefore, if you are self-employed, you should discuss retirement plan options with your financial adviser to determine which plan works best for you.
Income tax: Planning is still important

Planning tip #4: Board members can establish a Keogh or other self-employed retirement plan. Earning compensation for serving on a company’s board of directors may qualify as self-employment income and, therefore, be subject to self-employment taxes. If you earn self-employment income, you may qualify to sponsor a Keogh or other self-employed retirement plan. Qualification as self-employment income may be possible even if you are an employee of the company, as long as the self-employment earnings are sufficiently segregated from wage income. The rules in this area are complex; if you earn director fees, discuss this topic with your financial adviser.

Planning tip #5: Analyze contributions to employer-sponsored 401(k) plans. The maximum contribution to a 401(k) plan is $17,500 for 2014. Many investors have considered stopping contributions to their 401(k) plans in favor of investing in currently taxable accounts due to the lower capital gain and dividend rates. But, you should recall that amounts contributed to a 401(k) plan are pretax, which means they may lower your current tax bill and affect AMT planning. Also, if your employer offers matching contributions, you could be giving up “free” money. Talk to your investment adviser to determine whether it is better to invest funds in a currently taxable account or a tax-deferred account.

Planning tip #6: Make contributions to a Roth IRA or Roth 401(k). Consider making contributions to a Roth IRA or Roth 401(k) if you believe your tax rate will be higher in retirement. Although contributions to a Roth IRA or Roth 401(k) are never deductible, any income earned within the Roth IRA or Roth 401(k) may be free from federal income tax when you withdraw money from the account. The maximum annual contribution to a Roth IRA is generally $5,500 for 2014. The maximum permitted annual contribution begins to be phased out when AGI reaches $181,000 for joint filers and $114,000 for single filers. Unlike traditional IRAs, Roth IRAs permit contributions after reaching age 70½ and do not require minimum distributions starting at age 70½.

Planning tip #7: Make catch-up retirement plan contributions. If you are age 50 or older by year-end, you may make additional catch-up contributions to your retirement plans, including an additional contribution of $5,500 to your 401(k) plan in 2014. Check with your plan administrator for the proper procedure to make catch-up contributions to your 401(k) plan. For an IRA or Roth IRA, you may make additional contributions of $1,000 for 2014. Participants in SIMPLE plans may make additional contributions of $2,500 in 2014.

Planning tip #8: Establish a spousal IRA. A spouse who has little or no earned income and who is not an active participant in an employer-sponsored retirement plan can still have an individual retirement account. The maximum annual contribution to a spousal IRA is the lesser of $5,500 or the combined taxable compensation of both spouses. The deduction for such contribution begins to be phased out for married taxpayers filing jointly with 2014 AGI of $181,000. Although the contribution may not be deductible, the amounts contributed will still grow tax deferred; therefore, this may still be a good retirement planning option.
Planning tip #9: Make IRA contributions prior to the end of the year. You can do this even though the contributions are not due until the filing date, which is April 15th in 2015. Making contributions earlier increases the effect of compounding on retirement account earnings. As with the spousal IRA, even if the contribution is not deductible, it will grow tax deferred. If your contribution is deductible, your AGI will be lower, possibly allowing you to take advantage of certain credits and deductions that are limited by AGI levels. Take this into consideration when making year-end decisions. Taxpayers are allowed to contribute to both a 401(k) plan and an IRA in the same year; however, if you contribute to a 401(k) plan (or any other employer-sponsored retirement plan), your ability to deduct contributions to an IRA in the same year will be limited if your 2014 AGI exceeds $96,000 for joint filers ($60,000 for single filers).

Planning tip #10: Re-allocate tax-inefficient assets. Consider allocating tax-inefficient assets such as taxable bonds and TIPS to tax-deferred accounts such as IRAs and 401(k)s. If you have a Roth IRA, consider using this account for your higher-expected-return, tax-inefficient assets such as REITs and commodity-futures funds. If you do not have a Roth IRA, consider allocating these assets to your traditional IRA account. Consider allocating low-turnover long-term capital gain assets and municipal bonds to personal accounts.

Planning tip #11: Withdraw excess contributions before year-end to reduce excise tax. An excise tax is imposed on excess contributions to various savings vehicles. Generally, excess contributions to an IRA, medical savings account, health savings account, or Coverdell account (also known as an Education IRA) are subject to a 6% excise tax. Excess contributions to other qualified plans — such as 401(k) plans, Keogh, and pension plans — in excess of the deductible amount are subject to a 10% excise tax. To avoid potential excise taxes, withdraw excess contributions before year end.
Income tax: Planning is still important

Planning tip #12: Skip retirement distributions before age 70½. If a taxpayer is under age 70½ and does not need the funds, consider skipping distributions from qualified plans until required minimum distributions (RMDs) are mandatory. Choose beneficiaries with long life expectancies to delay distributions and make sure these beneficiary designations are always up to date.

Roth IRA conversions. All taxpayers have the opportunity to convert traditional IRAs into Roth IRAs without limitations based on their income level. If you currently have retirement accounts, you and your tax adviser should discuss the possibility of converting to a Roth IRA. While income taxes would be due currently, you and your heirs may have more after-tax wealth as a result of the conversion because qualified distributions from a Roth IRA are tax free, including the income and appreciation components of such distributions. In order for a distribution to be a qualified distribution, a five-year holding period must be satisfied, and one of the following four requirements must be met:

1. The distribution is made on or after the date on which the individual attains age 59½.
2. The distribution is made to a beneficiary or the individual’s estate after the individual’s death.
3. The distribution is attributable to the individual’s being disabled.
4. The distribution is to pay for certain qualified first-time homebuyer expenses (up to $10,000).

A nonqualified distribution may be subject to a 10% early withdrawal penalty. There are several other advantages to Roth IRAs. Contributions are permitted after the individual reaches age 70½ and the mandatory distribution rules applicable to traditional IRAs during the lifetime of the owner do not apply. There are also income tax benefits to heirs who inherit a Roth IRA. Unlike distributions from a traditional deductible IRA, the distributions are not subject to income tax when withdrawn by a designated beneficiary. (Distributions from a nondeductible IRA will be partially taxable, as the heirs recoup the decedent’s basis in the IRA.)

Additionally, as discussed above, taxpayers may also convert any portion of their balance in an employer-sponsored 401(k) account into a Roth 401(k) under that plan. The conversion option for retirement plans would only be available if the employer plan sponsors this feature.

Planning tip: Contribute to a nondeductible IRA that can be converted to Roth IRA later. If you are not eligible to contribute to a Roth IRA due to the income threshold, you should consider contributing to a regular nondeductible IRA so those amounts can be converted to a Roth IRA. Contributions to a nondeductible IRA build basis in the plan, which will be nontaxable when converted. The conversion can take place on the same day as the nondeductible contributions or later. Consult your tax adviser if you have other IRAs.

Roth IRA recharacterizations and reconversions. If your account balance falls after you convert your traditional IRA to a Roth IRA, you may be able to recharacterize your Roth IRA back to a traditional IRA and reconvert at the lower value. This technique effectively gives you the benefit of hindsight when making Roth IRA conversion decisions. Timing restrictions and other limitations apply, so you should consult your tax or financial adviser for details.
Roth 401(k) contribution program. Employees who elect to contribute to a 401(k) plan may designate some or all of these contributions as Roth IRA contributions (designated Roth contributions) if their particular 401(k) plan permits such treatment. Designated Roth contributions are included in taxable income in the contribution year; however, distributions from the designated Roth portion of the 401(k) plan after the employee reaches age 59½ will be tax free. Designated Roth contributions must be accounted for separately within the 401(k) plan. The maximum amount an employee may contribute to all 401(k) plans, including designated Roth contributions, is $17,500 in 2014. In addition to these amounts, taxpayers over age 50 by the end of the year can make additional contributions of $5,500, for a total maximum contribution of $23,000.

Nonspousal inherited retirement assets. An individual receiving an inherited qualified retirement plan from a decedent other than a spouse may roll over the inherited account into an IRA. The rollover must be executed by a trustee-to-trustee transfer. The inherited amounts transferred to the IRA will be treated as an inherited IRA subject to the IRA minimum distribution rules; thus, beneficiaries will be able to continue taking minimum distributions based on the life expectancy of the decedent.

Distributions from tax-preferred retirement savings. In general, a 10% early withdrawal penalty applies to distributions from qualified plans and IRAs for participants who have not yet reached age 59½. There are numerous exceptions to this general rule; therefore, if you need to withdraw funds prior to age 59½ you should consult your financial adviser. Generally, taxpayers who have reached age 70½ by December 31st must start receiving required minimum distributions from qualified plans or be subject to severe penalties. Generally, minimum distributions must begin for the calendar year in which the taxpayer reaches age 70½ (or when the taxpayer retires, if later) and must be paid no later than April 1st of the following year. For every year thereafter, distributions must be made by the end of the year. The rules differ between self-employed individuals and non-self-employed individuals, so check with your financial adviser to determine whether you are subject to special rules.

An excess accumulation is any amount of a required minimum distribution that is not distributed in a timely manner. A hefty 50% excise tax is imposed for each year the excess is not distributed. Although penalties may be waived under certain circumstances, taxpayers should make every effort to comply with the required minimum distribution rules.

Planning tip #1: Know the rules for withdrawing funds before age 59½. In general, a penalty is imposed on withdrawals from a qualified plan or IRA prior to age 59½. Ideally, you will not need plan funds prior to age 59½; however, where funds are withdrawn from a qualified plan or IRA prior to age 59½, the withdrawal may take place without penalty if the participant died or suffered a qualified disability. In addition, depending on the type of plan, it may be possible to withdraw funds without penalty under one or more of the following circumstances:

1. The payments are made following separation from service after attaining age 55 (not applicable to IRAs)
2. The payments are made in a series of substantially equal payments over the life of the participant (or joint lives of the participant and beneficiary)
3. Distributions are used to pay qualified medical expenses that exceed 10% of AGI

The 2015 essential tax and wealth planning guide 50
Income tax: Planning is still important

4. Distributions are made to a nonparticipant under a qualified domestic relations order
5. Distributions are used to pay qualified higher education expenses
6. Up to $10,000 is used for first-time homebuyer expenses
7. Certain distributions of dividends on employer securities are made by employee stock option plans (ESOPs)

Exceptions vary depending on the type of plan; therefore, you should discuss your options with a qualified financial adviser

Planning tip #2: Consider timing of initial required minimum distribution.
Although the first required minimum distribution does not need to be paid until April 1st of the year following the year the taxpayer reaches age 70½, postponement of the initial payment will result in doubling up on payments in the following year. For example, if you reach age 70½ in 2014, the first required minimum distribution does not need to be paid out until April 1, 2015; however, the required minimum distribution for 2015 also must be received by December 31, 2015, resulting in two payments in 2015. This will increase your AGI and may push you into a higher tax bracket in 2015 and potentially bring into play other limitations discussed above.

Planning tip #3: Roth IRAs do not require distributions at age 70½. The required minimum distribution rules do not apply to Roth IRAs during the lifetime of the owner. Distributions from Roth IRAs are required after the death of the participant if the spouse is not the sole beneficiary. When the spouse is the sole beneficiary of a Roth IRA, the Roth IRA may be treated as owned by the surviving spouse after the death of the first spouse.
Income tax: Planning is still important

Planning tip #4: Consider impact of timing on distribution of employer securities. In certain situations, an individual may receive a distribution of employer securities out of a qualified retirement plan while deferring taxation on unrealized gain until the securities are subsequently sold. At that point, realized long-term capital gains will be eligible for the lower rates and can be offset by capital losses from other investments. Check with your financial adviser if you currently own employer securities inside of a qualified plan and anticipate a distribution, in order to create a favorable tax outcome.

State income tax planning

Most tax planning focuses on saving federal taxes; however, state tax planning — especially for individuals living, working, or holding property in states with high tax rates — is equally important. Some individuals work and earn income in more than one state, requiring an analysis of the tax laws of several states as well as the possibility of having to file several different state income tax returns.

State laws vary widely, and the interaction between laws can be complicated. This guide cannot possibly cover all aspects of state tax planning; therefore, we encourage you to consult your local tax adviser for more detailed state tax planning techniques.

In addition to a separate income tax, many states have their own gift, estate, and inheritance taxes. In other words, you may be liable for not only federal taxes in these areas, but also state taxes. Consideration of state taxes must be part of any taxpayer’s overall financial planning, especially individuals who are considering moving to another state upon retirement. Although the taxpayer may save income taxes by the move, total taxes in the new locale may create an unexpected tax burden.

Planning tip #1: Use incentives. Many states offer special business incentives to those who work in or operate a business in that state. For example, multiple states offer an enterprise zone credit that may offset sales tax or provide significant hiring credits.

Planning tip #2: Consider early tax payment discounts. Certain states may allow a discount for early payment of taxes. For example, some Florida counties provide a discount of up to 4% for early payment of property taxes. It is important to consider these discounts in conjunction with AMT planning.
Income tax: Planning is still important

Planning tip #3: Consider nexus and filing requirements. Taxpayers (including trusts) who have a sufficient nexus with more than one state may owe taxes and have reporting requirements in multiple states. Nexus may be created through a variety of contacts; however, the most common are working in another state, owning property in another state, or engaging in a business activity in another state. Trusts may have nexus due to the residency of the beneficiary, the trustee, or the person who funded the trust (even if he or she died many years earlier). To complicate matters, each state may have its own definition of nexus, residence, and domicile. Credits may be available in your resident state to offset taxes paid to other states; therefore, you should check with your local tax adviser to determine where taxes may be due, what credits may be available, and whether you must file a return in more than one state.

Business tax changes: While the focus of this publication is primarily individuals and their estates, certain business changes that have been implemented over the last year or so could adversely impact individuals who own businesses that use pass-through entities. Owners and their businesses should observe the legislative process closely and evaluate risks resulting from increased rates. Examples of specific issues that you may want to explore include changing accounting methods to accelerate expenses or defer income, analyzing depreciation methods, evaluating transactions with related parties, considering a change in entity status, and analyzing opportunities surrounding investments in private enterprises with NOLs.

Year-round tax planning

Evaluate your tax position for 2014 and beyond annually to determine the potential impact of increased tax rates. Planning for higher tax burdens requires careful analysis and should be done with the assistance of a trusted tax adviser. A long-term commitment to a thoughtful tax planning process can help mitigate the risks of a dramatically higher tax landscape. To that end, you should:

• Adopt a multiyear perspective in reviewing your tax situation, evaluating the tax implications of shifting income or deductions.
• Consider the effect of the AMT. The expected outcome of deferring or accelerating income and deductions may be different after determining the AMT consequences. The result may not necessarily be intuitive.
• View transactions with regard to both their economic and tax implications.
• Stay engaged with understanding the tax changes debated or adopted by Congress.
• Review your tax situation with a trusted adviser regularly.

“A long-term commitment to a thoughtful tax planning process can help mitigate the risks of a dramatically higher tax landscape.”
Wealth transfer taxes: Thinking ahead with some predictability

Key wealth transfer tax facts: By the numbers

- **Estimates of 2013 decedents that will be required to file a federal estate tax return**: 8,700

- **The applicable exclusion amount for 2014**: $5.34 million

- **Amount that can be transferred to a non-US citizen spouse free of gift tax in 2014**: $145,000

- **The average annual inflation rate since 1980**: 3.6%

- **The annual gift tax exclusion for 2014**: $14,000

- **The limit of the duration of a trust in many states**: 80-110 years

- **The GST tax rate**: 40%

- **The number of states with a gift tax**: 1

  - (Connecticut)

- **States that have inheritance taxes**: 6

- **States that have estate taxes**: 16
Wealth transfer taxes: Thinking ahead with some predictability

The American Taxpayer Relief Act of 2012 (ATRA) fundamentally changed the wealth transfer landscape. ATRA answered those who thought we would go back to pre-2000 rates and it set a course for the future. Now that the public debates have died down, we also can also be reasonably certain that the estate tax will not be repealed. All this means we have the ability to think ahead with some predictability (subject to some tweaking, like President Obama’s green book proposals), and chances are that this will continue in the near term.

Anticipating that many readers will have used most of their $5 million exclusion in large transactions in 2012 (discussed later in this section), we will address planning when little applicable exclusion remains, as well as continuing our discussion of how best to use the $5 million exclusion for those just beginning to plan.

While this section of the Annual Wealth Guide provides some helpful insights, you should contact your advisers to align your plan to your particular situation.
Wealth transfer taxes: Thinking ahead with some predictability

Are you ready for estate taxes as they stand now?

Since we’ve had a couple years with ATRA, it’s time to turn to matters that are increasingly relevant in this “new world order” — the time for waiting is over. It’s time to pay attention on an inflation-adjusted basis.

As a result of ATRA, it was projected that in 2013 only about 8,700 estates (less than 0.2% of decedents) would be required to file a federal estate tax return. The 0.2% ratio is expected to continue for the next decade. This implies that aggressive wealth transfer for many may no longer be required. Prior to 2000, the highest estate tax rate was 55% (of which up to 16% of the 55% was shared with the states) and the exclusion amount was $1 million. Today, the highest maximum rate is 40% (none of which is shared with the states) and the exclusion amount is $5 million, inflation adjusted since 2011.

“Aggressive wealth transfer for many may no longer be required.”

In addition, because ATRA left intact the step-up in basis rule for assets inherited from decedents, for those no longer likely at risk of the estate tax, the face of wealth transfer planning will take the form of defensive income tax planning. Both themes will be discussed below.

Under ATRA, the states have now been made painfully aware that the old sharing of estate tax revenue with the federal government is well and truly history. Since last year’s Annual Wealth Guide, almost all legislative activity in the transfer tax arena has been at the state level.

Proving that transfer taxes have yet to lose their political heat, Minnesota repealed its gift tax, less than a year after enacting it. Additionally, New York State enacted tax reform that included changes to the estate tax. The New York estate tax exemption will be increased gradually until it matches the federal exemption amount in 2019. After 2019, the New York estate tax exemption will be indexed for inflation to mirror the federal exemption amount. However, there will now be a phase-out “cliff” of the entire state exemption when a taxpayer’s estate exceeds 105% of the exemption amount in the year of death. In other words, estates valued at 105% or more of the exemption amount for the applicable year will be fully subject to the state estate tax, with no offsetting exemption amount.

At the date of publication, six states have inheritance taxes, 16 have estate taxes (including the District of Columbia), two have both estate and inheritance taxes, but only Connecticut has a gift tax. Of note, only two states with an estate tax (Delaware and Hawaii) have an exclusion equal to the federal exclusion amount and index the exclusion for inflation.
Wealth transfer taxes: Thinking ahead with some predictability

The outcome is now a situation where effective transfer tax planning is driven even more fundamentally by one’s state of legal domicile. In states that have estate and/or inheritance taxes, transfer tax planning is paramount, whereas in states without transfer taxes but with high income taxes, planning has become much more demanding and very fact-specific.

“Effective transfer tax planning is driven even more fundamentally by one’s state of legal domicile.”

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Wealth transfer taxes: Thinking ahead with some predictability

Gift tax

As a quick overview, most uncompensated transfers of property during life are subject to the Federal gift tax. The gift tax is computed based on the fair market value of the property transferred. Some types of transfers are excluded in determining the total amount of gifts that are subject to tax.

Gift tax annual exclusion

In 2014, gifts of 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. Given that the exemption just climbed from $13,000 in 2012 to $14,000 in 2013, the next incremental increase is not expected for several years.

Gift tax annual exclusion quick facts:
The annual gift tax exclusion for 2014 is $14,000
Gifts must be of a present interest
Gifts to Section 529 educational savings plans generally qualify
Gifts in trust without special trust provisions generally do not qualify
Transfers of interests in certain family investment entities may not qualify

To qualify for the gift tax annual exclusion, gifts must be of a present interest. A present interest implies that the beneficiary has a substantial present economic benefit arising from the gift property. Such a benefit implies that the assets received can be readily converted to cash or that the assets received are income producing from the outset. As such, many outright transfers — including gifts of cash, marketable securities, and income-producing real estate — qualify for the annual exclusion.

Consequently, not all gifts will qualify for the gift tax annual exclusion.

Transfers under the Uniform Transfer to Minors Act and funds contributed to Section 529 educational savings plans will generally qualify for the annual exclusion. Certain gifts in trust also qualify if the trust vests an income interest in the beneficiary or allows the beneficiary a choice between withdrawing some or all of the value of the gifted property or leaving it in the trust. Otherwise, gifts in trust generally do not qualify for the annual exclusion. In addition, the IRS has been successful in arguing that transfers of interests in certain family investment entities that do not consistently distribute earnings to their owners do not qualify for the annual exclusion.
Wealth transfer taxes: Thinking ahead with some predictability

What if my spouse is not a U.S. citizen?

Transfers to a spouse who is a U.S. citizen are covered by the unlimited gift tax marital deduction; therefore, such transfers may be made totally free from gift tax. If a spouse is not a U.S. citizen, the amount that can be transferred to the spouse free of gift tax in 2014 is $145,000. If either you or your spouse is not a U.S. citizen, it is imperative that you make your estate planning adviser aware of this fact. At the time this Annual Wealth Guide went to press, the 2015 annual exclusion amount for noncitizen spouses had not yet been announced.

The lifetime gift tax exclusion

In addition to the $14,000 annual exclusion (and the $145,000 annual exclusion for a noncitizen spouse), every individual taxpayer can transfer a certain amount of property during his or her lifetime without paying gift tax. The amount of property that can pass tax-free is referred to as the applicable exclusion amount. The applicable exclusion amount is used to calculate the credit available to offset the gift tax calculated for current-year transfers. The applicable exclusion amount for 2014 is $5.34 million. For 2014, the top marginal gift tax rate is 40%, which is applicable to gifts in excess of $1,000,000. Taking into account the applicable exclusion amount and the current rate structure, the applicable credit amount for 2014 is $2,081,800.

For those who have already made some gifts, determining the additional amount that can yet be given before a gift tax liability is incurred requires a two-step calculation:

1. First, the tax on the current year’s gifts is determined by computing the difference between the tax on the aggregate of all current and prior gifts and the tax due on all prior gifts
2. Second, the unused applicable credit amount against this initial liability is subtracted

The unused applicable credit amount is the current applicable credit amount ($2,081,800), less the amount of the credit that would have been used taking into account the historical applicable exclusion amount in effect in any given year, but assuming the current rate structure had always been in place. Stated differently, your entire gift history is recalculated with only one change - that the current rate structure had always existed.

In working through the math, one quickly observes that the maximum amount of applicable credit “used” can never exceed the largest applicable exclusion amount in the past ($1 million in place from 2002 through 2009) taxed at the current rate structure, which is $345,800. Thus, full use of the $4.34 million incremental increase in the applicable exclusion amount is assured, regardless of large gift transfers in the past because there will, in every event, be $1,736,000 ($2,081,800 minus $345,800) available to offset the computed tax for the gifts made since 2010 when the applicable exclusion amount has been $5 million or higher.

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Wealth transfer taxes: Thinking ahead with some predictability

A second outcome of this calculation, which we will revisit when we discuss the estate tax, is the recomputation of the gift tax liability that would have been due under the current rate structure in each year that the taxable gifts made in any one year exceeded the available exclusion amount set for that year. The total of these hypothetical gift tax liabilities are allowed as a credit against the estate tax.

“Beyond the exclusion — what to do after you’ve used the $5 million applicable exclusion amount.”

If you have already put the $5 million applicable exclusion to work, the range of continuing planning that remains available to you is still quite broad. We have organized transfer considerations around four broad themes:

1. Doubling down on prior planning
2. Outright gifts and the inflation adjustment
3. Structured nongift transfers
4. Blocking and tackling through using the annual index increases

Doubling down on prior planning

While much of the planning undertaken since the American Taxpayer Relief Act of 2012 (ATRA) involved large outright gifts to individuals, many donors opted to use trusts. Many of these trusts, for reasons discussed in the “Blocking and tackling” section below, were structured as grantor trusts. Grantor trusts are trusts in which the grantor has retained either an economic interest or powers over trust property that are significant enough to require the income of the trust to be taxed to the grantor, thus making the trust a disregarded entity for income tax purposes.
Wealth transfer taxes: Thinking ahead with some predictability

As described in the “Leveraged gift transfers” section later, such trusts are permitted to transact with the grantor without income tax consequence. Thus, periodically selling assets to such a trust in exchange for cash and/or a note provides a continuing vehicle to transfer appreciating assets to the trust beneficiaries. Assets are generally sold to the trust in exchange for a note having a face amount equal to the fair market value of the assets acquired and bears a safe-harbor interest rate to avoid being considered a below-market rate loan. This safe-harbor rate, because of how it is determined, is always less than prevailing commercial interest rates. Additional subsequent sales to the same trust can be contemplated as the economic circumstances of the trust permit. Remember, it is imperative when dealing with debt that the borrower/buyer be able to perform the necessary debt service. Thus, net equity and anticipated cash flow considerations must support every asset sale. In general, this is regarded as no more than 90% debt and 10% equity.

Outright gifts and the inflation adjustment
There are different ways to make gifts. It is important to understand how each type of gift works and how it interacts with the applicable exclusion amount ($5.34 million for 2014).

Considering when to pay gift tax after ATRA. Family wealth is preserved when it is taxed at the lowest possible effective tax rate. The gift tax is assessed only on the value of the property transferred whereas the estate tax is assessed on the aggregate value of all of the decedent’s wealth including the funds with which the estate tax will be paid. Thus, the effective tax rate for gifts is always lower than for bequests.

Although perhaps counterintuitive, taxpayers might consider making gifts large enough to pay gift tax. Because lifetime transfers are currently subject to a 40% gift tax rate, a taxpayer has the opportunity to transfer assets at an effective tax rate of 28.57% (i.e., the tax divided by the sum of the gift and the tax). This conclusion remains true even taking into account the time value of money. Thus, the “tax exclusive” nature of the gift tax makes taxable gifts a generally more efficient method of transferring wealth. Federal and state governments, aware of this advantage, generally require the gift taxes paid with respect to any gifts made within three years of death be added back to the gross estate. Doing so recaptures the “tax exclusion” benefit and thereby discourages so-called “death bed transfers.”

It is important to plan one’s current gift tax liability so that the estate’s value at the date of death, under any reasonable circumstance, will be less than a projected indexed exclusion amount (or for a married couple, an aggregate estate of two times the indexed exclusion amount). Although we don’t know what the applicable exclusion amount will be in any future year, one can still make reasonable assumptions. For example, using the Consumer Price Index (CPI), the average annual inflation rate since 1980 has been around 3.6% (since 1990 around 2.8%). Using the post-1980 average, a reasonable estimate of the potential applicable exclusion amount per person would be $6,600,000 in 2020, $9,400,000 in 2030, and $13,400,000 in 2040.
Wealth transfer taxes: Thinking ahead with some predictability

EXAMPLE: Give now or later?

A couple, each with a joint actuarial life expectancy of 16 years, who has never before made a taxable gift, determines that they can afford to transfer up to $20 million of their $30 million estate and pay the resulting tax. They are deciding whether to do so now or to wait. They believe that at the end of their life expectancies in 2030, their estate will have tripled in value. Since they intend to transfer the assets to a long-established trust, they expect the transferred $20 million will also have tripled in value by 2030 (e.g., a compound growth rate of 7.1%). That being said, they feel inflation will not exceed its post-1980 average of 3.6%. Projecting forward, that implies that the applicable exclusion amount in 2030 will be $9,400,000 for each of them. If they make the $20 million gift today, they will, after gift splitting, pay combined federal gift taxes of $3,728,000 (after reflecting the current applicable credit amounts). As a result, their estate has decreased by $23,728,000 leaving them with $6,272,000, which, for ease of calculation, we will assume passes to charity to the extent not consumed during their joint lives.

Under these assumptions, if the couple does not make the gift, the value of their estate will be $71,184,000 greater in 2030 (3 x $23,728 million). Using the current rate schedule, the computed aggregate tax on this amount would be $28,419,400. As discussed above, the projected applicable exclusion amount in 2030 will be approximately $9,400,000 and the applicable credit amount will be $3,705,800 for each of them. The net estate tax liability on the $71,184,000 would then be $21,007,800 leaving an after-tax legacy of $50,176,200. By contrast, the trust receiving the $20 million gift would hold assets of $60,000,000 in 2030. Thus, all other things being equal, paying gift tax now will act to preserve after-tax family wealth — in this example by $9,823,800 an increase of 19.6% and total tax expenditures will have decreased by $17,279,800.

Under current law, there are two caveats to securing the gift tax benefit described above. First, as has always been the case, each taxpayer must live at least three years from the date of the gift. Otherwise, the gift tax paid of $1,864,000 by each spouse is added back to each respective gross estate, thus eliminating the gift tax benefit. Second, because the exclusion amount is indexed, there will now always be a break-even point at which retaining the assets, undiminished by the gift tax, and paying the estate tax will result in greater retained family wealth.
Wealth transfer taxes: Thinking ahead with some predictability

Determining the break-even point is a function of four variables:

1. The size of the anticipated transfer
2. The assumed indexed value of the applicable exclusion amount at death
3. Life expectancy
4. Asset performance

Of course, it also helps to assume that the assets at issue perform equally whether transferred or not. Returning to the couple in our example, with a combined $20 million transfer, a constant index value of 3.6%, a joint life expectancy of 16 years, the trust assets must yield just less than 1.69% to reach the breakeven point. Otherwise, paying the estate tax, instead of the gift tax, will result in greater retained family wealth. If the combined gift were $31 million, all other things being equal, the trust assets would simply need to avoid declining in value. If the combined gift were $50 million, all other things being equal, the trust assets could lose a compounding 2.09% before paying the estate tax would prove the better option.

**Net gifts and bargain sales.** A net gift is a gift conditioned on the donee reimbursing the donor for the related gift tax. It is called a net gift because the amount subject to tax is the net of the value of the property transferred less the amount that the donee will reimburse the donor. In the example above, under a net gift scenario, the donors would agree to transfer assets to the trust with a value of $23,728,000 on condition that the trust reimburses them $1,864,000 each for the resulting gift tax. By virtue of this agreement, the trust would expend $3,728,000 and the trust’s equity will have grown by the net amount of $20 million. The reimbursement of the gift tax of $3,728,000 is treated as consideration for the transfer and thus, one has a bargain sale — a sale of property having a value of $23,728,000 for $3,728,000, resulting in a taxable “net gift” of $20,000,000.

A net gift can be useful when:

1. You want to make a significant transfer, but either lack the liquidity to pay the resulting tax or are unwilling to bear the tax burden, or
2. In situations where the asset being transferred is illiquid and the donee is better positioned to shoulder the burden of paying the related gift tax.

Thus, net gifts are generally transacted with individuals or long-established trusts. There is, again, a caveat. Because consideration is being received, the donor must consider whether there will be any income tax consequences arising from the transaction. To experience a taxable gain, the consideration must exceed the property’s basis.
Wealth transfer taxes: Thinking ahead with some predictability

The consideration in a net gift transaction need not be paid at any set point in time. If the donor is in a position to pay the tax with available liquid assets, the donee can agree to pay the bargain sales price through an installment note. Although beyond the scope of this discussion, the interest expense may be income tax deductible as investment interest. The value of using a note is that it will limit the growth of the donor’s estate to the consideration, plus the after tax amount of the interest income received. In any event, even if the donor does not have the liquid assets necessary to pay the gift tax, the donee is not required to remit the cash any earlier than the following April 15. Thus, the donee would be free to enjoy the earnings on the reimbursement amount until the following April 15.

The reimbursement required of the donee does not make the donee the primary obligor for the gift tax. Consequently, as is the case with all taxable gifts, the donor’s death within three years of the net gift will result in the gift tax being added back to the gross estate. Should this occur, all other things being equal, a premature death cannot give rise to a tax outcome worse than if the parties had never entered into the transaction in the first place.

Structured nongift transfers
Wealth transfers that result in no taxable gift are called for when:

1. One has already utilized the indexed $5 million exclusion amount, and
2. The payment of gift tax is not reasonably possible

The possible transfers under this scenario generally employ a trust that limits or eliminates the taxable gift by employing one or more of three techniques:

1. The grantor retains an interest in the trust, thus limiting the size of the gift transfer (e.g., the classic zeroed-out Grantor Retained Annuity Trust (GRAT))
2. An interest in the trust is transferred only for full and adequate consideration (i.e., an asset “exchange” of equal value is not a gift since the grantor’s estate has not been diminished)
3. A transfer of an interest in the trust qualifies for a gift tax deduction (e.g., the marital or charitable deduction).

Because charitable transactions are addressed under separate sections in this Annual Wealth Guide, this section will concentrate on the first two variations. The discussion that follows is representative of the planning that occurs in this area, but it is by no means a comprehensive discussion.
Wealth transfer taxes: Thinking ahead with some predictability

Grantor Retained Annuity Trusts (GRATs). A GRAT is an irrevocable trust that names the grantor as its sole beneficiary during a set period of years during which the trust is required to make an annuity payment to the grantor. The annuity amount, as a function of prevailing interest rates, is set at a level where the net present value of the aggregate annuity payments is nearly 100% of the value of the property contributed by the grantor to the trust. If the assets consistently outperform the prevailing interest rate, then the remainderman of the GRAT, whether an individual or a continuing trust, will succeed to that excess. Because the grantor only parts with the value of the trust remainder, the gift tax cost of a GRAT is nominal. However, because the trust is established fundamentally for the grantor’s benefit, should death occur during the annuity period, the full value of the trust, as a general rule, will be included in the grantor’s gross estate as if no prior planning had ever been undertaken. To diminish this estate inclusion risk, most GRATs have short two-year terms and make large annuity payments.

Ideal assets for funding a GRAT include publicly traded stock that has reasonable prospects of near term appreciation; stock in a company planning an IPO, sale, or other merger or acquisition in the near future; or, any other asset that is expected to rise in value and/or produce income at a rate greater than the applicable federal rate set for these purposes under section 7520 of the Internal Revenue Code.

Planning tip: Use an escalating GRAT. The escalating feature increases the annuity amount 20% each consecutive year. In general, assuming assets will generally appreciate over time, increasing annuity payments can produce more value for the beneficiaries at the end of a term than would constant annuity payments simply because more of the GRAT’s assets remain in the GRAT for a longer period of time. For example, an individual funds a GRAT with $2 million of stock which the grantor feels is on the cusp of a rally with appreciation of 8% this year and 30% in the second year. The GRAT has a term of two years. Assume the current Section 7520 rate is 2%, and the annuity payments are made at each anniversary. The first-year annuity is 46.864% of the GRAT’s initial fair market value, resulting in a required payment on the first anniversary date of $937,295. The trust provides for a 20% increase in the annuity payment, so the annuity rate for year two is 56.237% of the GRAT’s initial fair market value, and the corresponding payment on the second anniversary date is $1,124,754. At the end of the two years, the remainder of $464,763 passes on to the beneficiaries free of gift tax. If the grantor had selected a level-payment GRAT, the remainder would be $438,821. The escalation feature resulted in a transfer 5.91% greater.

“A GRAT is a relatively high-maintenance transaction and should be reserved to those who need to engage in higher-complexity planning.”
Wealth transfer taxes: Thinking ahead with some predictability

A GRAT is a relatively high-maintenance transaction and should be reserved to those who need to engage in higher-complexity planning, and/or those who need to “zero out” the immediate gift tax consequences of a current transfer (e.g., those who have used their applicable exclusion amount). That being said, the appeal of GRATs to all donors will remain high so long as:

- Prevailing interest rates remain low (note that the prevailing rate required to be used in GRAT gift tax calculations in October 2014, while up from its all-time low in September 2012 of 1%, is still only 2.2%)
- The likely gift candidate assets are value-stressed
- Short-term GRATs continue to be legislatively permitted

Remainder purchase marital trusts. The Remainder Purchase Marital Trust (RPM), in many ways resembles a GRAT; however, it is the donor’s spouse who is given an annuity interest (or an income interest) for a specified term (or life). However, unlike a GRAT, the spouse’s interest cannot be for the shorter of term or life. Generally, in times like these when interest rates are low, structuring the transaction is easier when an annuity interest is transferred. The opposite is true when interest rates are high; then an income interest may prove more advantageous.

It is important that the spouse receive only a straight income or annuity interest. Any discretionary rights to trust principal make the interest he or she receives incapable of valuation which, in turn, makes the sales price of the remainder interest unascertainable thus precluding an effective sale. For the same reason, a termination on divorce clause is also not possible. What is required is a benefit structure that results in a readily ascertainable purchase price of the remainder interest in the trust, which is only possible if the income or annuity interest also has a readily ascertainable value.
Wealth transfer taxes: Thinking ahead with some predictability

The remainder interest, simultaneously with the creation of the trust, is sold (ideally for cash), to a long-established trust (ideally a generation-skipping trust not also created by the donor) for its actuarial value. Unlike with a GRAT, the object here is not to “zero out” the value of the remainder. The value of the remainder interest must be substantial. While such a determination is subjective, the value should be sufficiently large that the fiduciary of the purchasing trust is interested in protecting its interest.

Funding an RPM does not give rise to a taxable gift because the spouse’s income or annuity interest in the RPM qualifies for the gift tax marital deduction, and the trust remainderman acquired its interest from the donor for full and adequate consideration when the RPM was created. However, the transfer to the spouse will be a taxable gift if the remainder interest is not sold for full and adequate consideration. This requirement may limit the types of assets contributed to the RPM. Ideally, the value of the contributed asset should also be readily ascertainable; otherwise, a valuation contest may lead to the outcome that the remainder interest was not transferred for full and adequate consideration thus potentially resulting in a loss of the gift tax marital deduction and a large taxable gift. Alternatively, a formula valuation clause, discussed more fully below, should be considered.

The assets of the RPM, unlike those of a GRAT, are not includable in the donor’s estate because the donor retained no interest in the trust. Additionally, even though the spouse’s interest qualified for the gift tax marital deduction, the RPM assets are not included in the spouse’s estate. This is because the spouse’s interest terminates before or at death, is not subject to an election that would require estate inclusion of the trust assets, and the spouse has no powers over the disposition of trust assets significant enough to give rise to estate inclusion.

As is the case with all estate planning, the success of the transaction is ultimately a function of the performance of the assets involved. If the purchase price of the remainder interest might have been more profitably employed elsewhere, then the purchase of the remainder interest will not have helped preserve family wealth.

**Blocking and tackling — Using the annual index increases**

The indexing feature applied to the $5 million exclusion amount, while complicating a determination to pay gift tax, provides a significant amplification to the annual giving plan discussed more fully below in “Basic blocking and tackling.” While the amount of any annual increase can’t be known before it is announced, it is reasonable to expect that the increase will be not less than 2% annually. Since 1970, there have only been two years with inflation less than 2% (1986 and 2010) and only one year with no inflation at all (2009). At 2%, the annual increase should be approximately $100,000 in any given year.

**Planning tip: Transfer the annual index increase in January.** For those in a position to do so, consideration should be given to instituting a program of transferring the annual index increase at the beginning of each calendar year. Recall that a principal benefit of gift transfers is to remove the future appreciation and income of the transferred assets from the donor’s estate. The compounding effect of moving the annual index amounts across time will be profound. For a discussion of how to choose assets that are likely to have greater wealth transfer effect, see the “Simple outright gifts” section below.
Wealth transfer taxes: Thinking ahead with some predictability

Utilizing the now $5.34 million applicable exclusion amount

With the applicable exclusion amount at $5.34 million in 2014, a greater range of planning possibilities is available now, assuming you have not fully utilized your exclusion. We’ve organized transfer considerations around four broad themes:

1. Leveraging gift transfers
2. Tuning up prior planning
3. Simple outright gifts
4. Basic blocking and tackling

Leveraging gift transfers

It is an option to move assets in excess of the $5.34 million exclusion amount ($10.68 million per couple) by using the increased exclusion amount as seed capital to engage in leveraged transactions with the grantor (i.e., sales for notes). This strategy remains appealing and should be strongly considered. It is important to note that, to be respected, the debt obligation must be serviced pursuant to its terms.

Planning tip: Evaluate leveraged gift transfers. Compare the projected wealth transfer over time between an outright gift using the $5.34 million exclusion amount and a leveraged gift transfer using the same amount as seed money.

To illustrate the comparison in this planning tip, consider the following scenario: in 2014, an individual with an actuarial life expectancy of 20 years funds a trust with a $5.34 million interest in the wholly-owned family business – an S corporation. The trust is to terminate in favor of the grantor’s children at his or her death. The taxpayer has made no prior taxable gifts. For purposes of this example, assume annual distributions from the acquired S stock are $370,000 per year, and that the stock appreciates, on average, 3% per year. Furthermore, there will be no trust distributions until the trust terminates. Instead, earnings on the invested cash are used to pay trust expenses. Under these assumptions, the trust will have received $7.4 million in cash distributions, and the business interest will be worth $9.48 million at the end of the 20th year for a total value in this illustration of $16.88 million.

Why Rainy Day Trusts are a thing of the past

Earlier versions of the Annual Wealth Guides included a section on so called Rainy Day Trusts (also commonly referred to as Spousal Limited Access Trusts or SLATS). While Rainy Day Trusts take different forms, the defining aspect of a Rainy Day Trust is indirect access by the grantor to the income and value of the transferred assets. While a “back-door” to transferred wealth is always appealing, it is also the source of the complexity, difficult governance, and risk of challenge that characterizes these types of trusts. With the $5 million exclusion made both permanent and indexed, for most persons, the prior motivation to use these trusts (to soak up the $5 million exclusion before it lapsed) is no longer present. Therefore, they do not appear in this Guide simply because there are better alternatives. That being said, we recognize that they will still appeal to those where the risk of “donor’s remorse” is so great that no other transfer vehicle is appealing. For those few, we will be happy to provide a copy of the 2012 Annual Wealth Guides on request.
Wealth transfer taxes: Thinking ahead with some predictability

By comparison, assume the taxpayer funds the trust with $5.34 million in cash and then engages in a purchase of $48.06 million of additional S corporation stock — a debt to equity ratio of 9 to 1. Distribution and growth rates remain the same. The note has a 20-year term and bears interest at 2.97% — the lowest rate permitted for such a note in September 2014 (date of the acquisition). Given these assumptions, by the end of the 20th year, the trust would have received distributions of $66.6 million, enough to satisfy the note leaving $2.2 million in cash behind, plus the original $5.34 million and the business interest would be worth $86.8 million for a total value in this illustration of $94 million.

In comparing and contrasting the two scenarios, we can make the following observations.

• All other things being equal, the successful use of leverage increased family wealth by $77.12 million in our example.

• No gift tax would be due in either scenario, since each involves a $5.34 million gift of either S corporation stock or cash. The gift simply utilizes the grantor’s available applicable exclusion amount.

• In the stock gift scenario, the grantor would have retained $48.06 million in S corporation stock that would have a value of approximately $86.8 million at the date of death and would be subject to estate tax. In the purchase scenario, that S corporation stock resides in the trust and would not be included in the gross estate.

• In the purchase scenario, the grantor receives $64.4 million in note payments. Assuming most of the S corporation distributions are required to pay income taxes that the grantor owes on the trust’s income, the aggregate note payments would be substantially dissipated and would not substantially increase the grantor’s gross estate.

• By the same token, in the gift scenario, the grantor would be paying income taxes on the trust’s income from his or her other available resources, thus the estate would also be reduced somewhat more than by the value accumulated in the trust.

• While it is unlikely that a trust would accumulate for its entire 20-year term, this example points out the wealth accumulation possibilities inherent in a trust where the undistributed wealth is not subject to income taxes payable by the trust.

On a cautionary note, one cannot enter into a leveraged transaction without appreciating the inherent economic risk associated with extreme leverage. The example assumed cash distributions sufficient to satisfy the purchase money debt. If the S corporation does not make sufficient distributions and the note must ultimately be paid in kind, not only is the efficacy of the transaction reduced, but there is a risk of having the sale disregarded and the purchased property treated as an indirect gift.
Wealth transfer taxes: Thinking ahead with some predictability

Tuning up prior planning
“Tuning up” in this regard is not just addressing prior wealth transfer transactions that may not have developed as modeled (e.g., those that might have been adversely affected by the Great Recession); it also means effectively addressing risks that arise as tax laws change and develop.

Planning tip #1: Dispose of interests in family investment entities. Consider disposing by sale or gift any interest you might have in a family investment entity you obtained as an initial contributing owner; or, alternatively, consider terminating the entity. Since 2004, the IRS has waged a profoundly successful campaign against family investment entities, including family-controlled investment partnerships and LLCs.

Prior to 2004, taxpayers had won the majority of the tax controversies regarding these types of entities. It is now common in estate tax examinations for the IRS to audit, in depth, the circumstances behind the creation and the business and investment activities of any family controlled investment partnership or LLC in which the decedent was an initial contributing owner and in which the decedent owned an interest at death.

Where the IRS detects anomalies in the creation and funding of the entity or where the economic behavior of the entity over time exhibits events that suggest that there had been an “indirect” agreement among the parties to permit the now deceased owner to continue to exercise dominion and control over the contributed assets, then the entity will be ignored for estate tax purposes and the entity assets attributable to the decedent’s capital contributions to the entity will be included in the gross estate at full fair market value.

That the deceased owner might have disposed of some of his or her ownership interest by gift or sale prior to his or her death does not change this outcome. Should this occur, the result is almost always a significant increase in the value of the gross estate, and therefore, the ultimate estate tax paid. This can be particularly troubling when the decedent’s estate plan relied on the estate tax marital or charitable deduction to avoid tax, which it can no longer do in the situation described above.
Planning tip #2: Make debt service payments. As discussed previously, highly leveraged sales of interests in family-controlled entities are not uncommon wealth transfer transactions. When circumstances have conspired to disrupt debt service or the note is in default for any reason, failure to act raises issues regarding the propriety of the original sale transaction. In situations where the trust’s cash flow is not likely to recover enough to permit the original terms of the note to be met, accelerating the notes and foreclosing against the trust’s assets (e.g., the purchased entity interest) is often the better course of action.

In situations where the trust’s fortunes are likely to recover but not in a fashion that permits the original terms of the note to be met, consider renegotiating the formal terms of the note (e.g., extending the term of the note, reducing the interest rate, etc.) or, perhaps, forgive the note in whole or in part. Alternatively, you might consider gifts of assets to the purchasing party that may in turn promote the satisfaction of the note. Be aware, however, that there are gift and income tax considerations to be addressed in refinancing or otherwise modifying any existing note.

Planning tip #3: Act promptly when a loan is in default. It is quite common for parents to extend credit either directly to children and trusts for descendants or indirectly to businesses or investment entities owned by descendants or trusts for descendants. It is also common for such loans to become nonperforming. As noted previously, the failure to act when a note is in default raises transfer tax concerns. In these situations, you may want to consider forgiving some or all of any nonperforming notes. If the loan was bona fide at the outset and it became troubled only later, the tax consequences of the later forgiveness of the debt may not be dictated by the gift tax rules; instead, the income tax rules governing bad debts and cancellation of indebtedness may apply. As a result, the debtor may have income to the extent of solvency. Where the transaction is between a grantor and his or her grantor trust, however, there can be no income tax consequences, since the loan transaction is disregarded for income tax purposes.

It is important to exercise greater caution when forgiving a note to an entity since it is quite likely that doing so will be considered a gift to each entity owner equal to the face amount of the note properly apportioned among the owners. Perhaps a better use of the applicable exclusion amount would be to subscribe for a new or increased interest in the entity for cash (a transaction that will dilute the ownership of the other owners but will not be treated as a gift), and then use the new working capital to promote the satisfaction of the debt. Thereafter, you can consider transferring the newly acquired equity interest by gift or sale.

Planning tip #4: Grant life interest in QPRTs. For a Qualified Personal Residence Trust (QPRT) to qualify for its statutory valuation safe harbor, the trust document must preclude the sale of the residence back to the donor. The result is that the grantor is required to rent the home from the new owners of the residence (e.g., often the grantor’s children or a trust for the children) in order to avoid the inclusion of the residence in the grantor’s gross estate. These rental arrangements often are uncomfortable for all concerned. With the increased exclusion amount, the children could consider a gift back to the parent(s) of the life interest in the residence. Such a transfer would negate the need for rent payments. Under the current, low prevailing interest rates, such a life interest could be quite modestly valued, depending on the parents’ life expectancies.
Wealth transfer taxes: Thinking ahead with some predictability

Simple outright gifts
For a great many taxpayers, the $5.34 million exclusion ($10.68 million per couple) for gifts made in 2014 is more than enough to cover their wealth transfer goals — thus reducing the need for more complicated wealth transfer transactions. When this is true, minority interests in closely held businesses, fractional interests in real estate, interests in private equity funds, or other investment entities (perhaps even interests in family-owned investment entities like family limited investment partnerships or family investment LLCs), may prove more effective candidates for gift transfers by virtue of how they are valued.

A minority interest in a closely held enterprise is generally valued at less than its proportionate share of going-concern value (for a business enterprise) or net asset value (for an investment entity) because of lack of control and/or lack of marketability discounts. This valuation outcome has been the government’s primary motivation in attacking the veracity of family-owned investment entities. Thus, successful valuation outcomes depend on the determination that any closely held entity is demonstrably motivated by reasons other than tax efficiency and that the entity is operated in a business-like manner. Still, even if the taxpayer prevails with respect to discount valuation determinations, such discounts simply lower the threshold required for a wealth transfer to be successful or, in the alternative, reduce the tax cost of the transfer if the enterprise is not ultimately successful. Although it might seem compelling to transfer a property that can be discounted, one must remember that the success of a gift transfer is fundamentally a function of an asset’s post-transfer growth and earnings prospects — not its current value.

Mitigating valuation risks in gift transfers. In the last two editions of the Annual Wealth Guide, we have discussed a case that may be the most significant gift tax development in 50 years, Wandry v. Commissioner.T.C. Memo 2012-88. In Wandry, the Tax Court for the first time endorsed the use of a formula clause to fix the amount of property transferred in a gift transaction to a specified value. The taxpayer was transferring units in a limited liability company. The transfer document was clear that the donor was relinquishing ownership of only that number of LLC units which had a value on the transaction date equal to the specified amount. The IRS, as it has consistently done in valuation cases, argued that the gift was of the number of units that must, of necessity, be reflected on the gift tax and subsequent income tax return. The Tax Court, however, found that this was not so, and declined to fix the tax liability based on the number of units transferred. Instead, the Tax Court determined that the amount of the gift was to be determined by the actual value of the LLC units on the date of the transfer. Consequently, the tax was based on that value, and not on the number of units that were transferred.

“The success of a gift transfer is fundamentally a function of an asset’s post-transfer growth and earnings prospects — not its current value.”
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returns. The IRS argued that to give the required adjustment clause credence would be to nullify their ability to enforce the law by “returning” property to the grantor in an amount sufficient to eliminate any gift tax liability; consequently, such clauses were against public policy. The court, however, was satisfied that property could not be returned if it was never transferred and that the parties, acting in their own best interests, would undertake the required “true up” of the economic consequences that might result from an adjustment to the property actually transferred.

Speculation continues to suggest that the IRS is searching for a case that would be appealable to the Fourth Circuit Court of Appeals (which covers Maryland, Virginia, West Virginia, North Carolina, and South Carolina), the Circuit that has the strongest extant authority regarding the inefficacy of formula clauses in a gift tax context. However, because a Tax Court opinion has national significance, it would appear that careful adherence to the Wandry model may continue to provide a mechanism to limit gift tax exposure when transferring property that is difficult to value. As we have noted earlier, reliance on Wandry may well be conditioned on the taxpayer’s acting in good faith. Specifically, we are of the opinion that to invoke Wandry affirmatively requires obtaining a contemporaneous appraisal of the transferred property by a qualified appraiser.

Planning tip #1: Use an annual gifting program. You may want to shift wealth down generational lines through an annual gifting program. There is even more benefit if the gifted asset:

• Can be valued on a discounted basis
• Is likely to appreciate and/or generate income that will be excluded from the donor’s estate
• Is given to a grantor trust that permits the trust assets to grow income-tax free while the grantor, who reports and pays tax on the trust’s income, further reduces his or her estate by the amount of any income tax paid, but without having to declare the indirect benefit to the trust as a taxable gift

To demonstrate the power of annual gifting, assume a couple has three children. In 2014, this couple can transfer up to $28,000 per child, or $84,000 to all three children. If each child has a spouse, the maximum amount that can be given to the children and their spouses is $168,000 without incurring a taxable gift. If the couple has grandchildren, the ability to further reduce their taxable estates through annual gifts expands.

Basic blocking and tackling
While the indexed $5 million applicable exclusion amount has greatly increased planning flexibility and opportunity, tried and true estate-planning techniques are still important.
Wealth transfer taxes: Thinking ahead with some predictability

As discussed earlier, the indexing feature applied to the $5 million exclusion amount provides a wonderful amplification to the annual giving plan. In the current economic environment, the annual increase should be not less than $90,000 in any given year. For those in a position to do so, consideration should be given to instituting a program of annual exclusion transfers in conjunction with full utilization of the annual index increase at the beginning of each calendar year. Doing so fully realizes the primary benefits of an annual gift program, removing the future appreciation and income from the transferred assets from the donor’s estate. The compounding effect of such a program across time will be profound.

Planning tip #2: Make a cash gift. If a child or grandchild has earned income, consider making a cash gift. The child or grandchild may use that gift to contribute $5,000 or the amount of the donee’s earned income, whichever is less, to a traditional IRA or Roth IRA. Funds contributed to a Roth IRA will grow tax deferred, and qualified distributions will be tax free for federal income tax purposes. Funds contributed to a traditional IRA may be deductible by the child or grandchild for income tax purposes.

Planning tip #3: Make direct payments to educational institutions or medical providers. Such direct payments are not taxable gifts. For example, a grandmother who wishes to help pay for a granddaughter’s education can write tuition checks directly to the school without making a taxable gift. If she writes the check to the granddaughter, however, she will have made a taxable gift to the extent the amount gifted exceeds the $14,000 annual exclusion. Tuition is not limited to college tuition; any qualified school’s tuition can be excluded. Medical expense does not just mean those for doctors and hospitals; any qualified medical expense, including health insurance premiums, can be paid under this exclusion.
Wealth transfer taxes: Thinking ahead with some predictability

Planning tip #4: Make future educational gifts through a Section 529 plan. Using a special election, a donor can fund up to five years of annual exclusions into these plans in one year. Specifically, in 2014, one can contribute $70,000 to one grandchild’s Section 529 plan without incurring a taxable gift or a GST transfer (discussed in more detail later). If other gifts are made by the donor to that grandchild during 2014-2018, however, those gifts would use some of the donor’s applicable exclusion amount, as well as some of the donor’s GST tax exemption. By funding these plans in advance, the growth in the fund occurs in an income tax-exempt environment.

Planning tip #5: Make transfers to grantor trusts. Grantor trusts are trusts in which the grantor has retained either an economic interest or powers over trust property that are significant enough to require the income of the trust to be taxed to the grantor, thus making the trust a disregarded entity. Interestingly, the retention of some powers over trust property will not also cause the trust to be disregarded for transfer tax purposes. Properly employed, these powers can cause the grantor to be legally liable for the income taxes arising from the trust’s tax attributes but not in a manner that causes estate tax inclusion. From an estate tax perspective, such trusts represent the gifts that keep on taking (from the grantor’s estate) — a situation that can be perpetuated for as long as the grantor is willing to pay the continuing income tax liability.

GST tax

The generation-skipping transfer tax (GST) is imposed on transfers during life and at death that are made to a “skip person” — a recipient who is at least two generations younger than the donor or decedent, such as a grandchild. If there were no GST tax, a transfer to a grandchild would be subject to the gift or estate tax once, while a gift to a child who then gifts or bequeaths those assets to a grandchild would be subject to transfer tax twice. The GST tax is intended to tax the gift to the grandchild twice at the time it is made (both the gift tax and GST tax), to compensate for the otherwise skipped level of tax. Furthermore, with respect to a taxable gift, the GST tax actually paid is, itself, subject to gift tax.

For GST tax purposes, when a gift or bequest is made within a family, the focus is on the relationship of the transferor and the transferee and not their age difference. For example, a donor may have siblings who are significantly younger than he or she and who, therefore, have children who are significantly younger than the donor and his or her children. A transfer to a nephew who is 40 years the donor’s junior is not subject to GST tax because the nephew is only one generation removed from the donor. Conversely, a transfer to a grandnephew who is only 30 years the donor’s junior is subject to GST tax because the grandnephew is two generations removed. Married individuals are considered to be in the same generation, regardless of the spouses’ age difference.
Leveraging the GST exemption — Dynasty trusts

A GST tax-exempt dynasty trust is used to transfer income and/or principal to multiple generations, including children (hence the title “dynasty trust”), while paying estate or gift tax only upon the initial transfer to the trust. This is accomplished by allocating all or part of the transferor’s $5.34 million GST tax exemption to the trust in an amount equal to the value of the transferred property on the date of the transfer. The wealth accumulated in the trust thereafter avoids both estate tax and GST tax at each subsequent generation until such time as the trust terminates. Because dynasty trusts are intended to skip multiple generations, they represent the most tax efficient use of a taxpayer’s GST exemption. Although gift tax annual exclusions may be available when funding a dynasty trust, transfers to dynasty trusts do not qualify for the GST tax annual exclusion, so the donor’s unused $5.34 million GST tax exemption will be allocated dollar for dollar when these trusts are funded.

Because dynasty trusts are intended to skip multiple generations, they represent the most tax efficient use of a taxpayer’s GST exemption.”
Wealth transfer taxes: Thinking ahead with some predictability

Dynasty trusts are permitted in all states, but laws in many states limit the duration of a trust to a term from 80 to 110 years. Many states allow the trust to continue until 21 years after the death of the last surviving descendant of the trust creator who was living at the time of the trust’s creation. This concept is known as a “rule against perpetuities.” Other states have recently amended their trust statutes to permit trusts to exist in perpetuity. An individual may create a trust in a state other than his or her state of residence; consequently, dynasty trust planning is open to everyone.

As discussed further below, while the tax attributes of a Dynasty Trust are compelling; the governance provisions of a trust intended to last centuries and to govern wealth access to increasing numbers of beneficiaries is relatively untested. Common sense, good judgment and competent counsel are a must if costly future judicial intervention is to be avoided or mitigated.

Planning tip: Use dynasty trusts to build wealth for future generations. Consider dynasty trusts as a tax-efficient tool for leveraging your GST exemption while building wealth for future generations. Consider this example: In 2014, a couple each funds a nongrantor irrevocable dynasty trust with $5.34 million. Neither spouse has previously made taxable gifts. No gift or GST tax will be due as a result of funding the trusts because each spouse utilizes his or her available gift tax applicable exclusion amount and his or her GST exemption. Assume the trusts have an after-tax growth rate of 4%, which is added to trust principal each year. After 110 years, the trusts, in the aggregate, will be worth approximately $798 million. Under present law, no transfer taxes are due on distributions during the duration of the trust or when the trust terminates.

The most leveraged form of GST transaction would have each spouse fund a dynasty trust, each in the form of a grantor trust, with $5.34 million. Thereafter, the trusts would engage in a purchase of property, at a reasonable multiple of the $5.34 million value of the trust, from the grantor. Returning to the previous example regarding the value of a leveraged transfer over 20 years, if the term is extended to 110 years, the stock value of the trust at the end of that term would have grown from $48.06 million to $1.24 billion appreciating 3% annually, even if we assume that all cash receipts were expended or distributed. Although...
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a trust leaving its corpus intact while also maintaining a 3% compounded growth for the entire 110-year term is highly unlikely, the example demonstrates the wealth accumulation possibilities inherent in a dynasty trust where the undistributed wealth is subject only to income taxes — not transfer taxes — and then only after the grantor’s death when grantor trust status terminates.

Tuning up prior GST planning
Given the greater GST exemption currently available, if you have existing GST trusts that have an inclusion ratio of between zero and one (that is, a trust where a distribution to a skip person would be partially subject to GST tax), you should consider allocating the increased exemption to those trusts. When a trust has an inclusion ratio of between zero and one, the amount of GST tax exemption required to obtain an inclusion ratio of zero (thus making the trust thereafter exempt from GST tax) is a function of the value of the trust’s assets at the time the additional GST tax exemption allocation is made. In an appreciating economic environment, time is of the essence.

GST blocking and tackling
While the indexed $5.34 million GST exemption amount has increased the opportunity for larger scale GST tax planning, it need not — and should not — detract from the use of tried and true estate planning techniques that have GST implications.

Planning tip #1: Establish a minor’s trust. Grandparents wanting to make a substantial gift to a grandchild should consider establishing a minor’s trust, also known as a Section 2503(c) trust. Gifts to a minor’s trust qualify for both the gift and GST tax annual exclusions. For example, a married couple can currently transfer up to $28,000 per year to each grandchild without incurring gift or GST tax. The property and associated income must be available for distribution before the grandchild attains age 21 and, generally, any remaining balance must be distributed to the grandchild at age 21.

Planning tip #2: Use a Section 2503(b) trust. Another type of trust sometimes used for gifts to minors, known as a Section 2503(b) trust, requires all income from the trust to be distributed annually, but does not require the trust to terminate when the grandchild reaches age 21. Note, however, that a $14,000 gift to a Section 2503(b) trust may not be fully excludible by the gift tax and GST tax annual exclusions. These limitations may be overcome if the trust contains special additional provisions to fully qualify the gift for the gift tax and GST tax annual exclusions.
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Estate tax — a primer

In its simplest manifestation, the taxable estate is determined by taking the aggregate value of all includible assets, reduced by all allowable exclusions and deductions, and increased by the taxable gifts made by the decedent after 1976. A tentative tax is then computed on the taxable estate. Assuming no prior gift tax was actually paid, this tentative tax is then offset by the applicable credit amount. For 2014, that amount is the estate tax on the $5.34 million base exclusion amount, computed using the rate structure in effect on the date of death ($2,081,800 in 2014). Any estate where the tentative tax is less than the applicable credit amount avoids a federal estate tax liability (although state estate and/or state inheritance taxes may apply).

If gift tax has previously been paid, then an additional credit is allowed for some or all of the gift tax actually paid. As mentioned previously, this credit permits those that have made gifts in excess of past exclusion amounts to take advantage of the $4 million incremental increase in the indexed $5 million exclusion amount made permanent by ATRA. The credit is a hypothetical amount determined using the rate structure existing at the date of death, but taking into account the applicable credit amount in effect at the date of each gift. In 2014, with the top estate tax rate at 40%, the limitations on the credit amount will result in a credit less than the amount of gift tax actually paid when the top gift tax rates were greater than 40%. Similarly, for tax paid in 2010, when the top gift tax rate was 35%, the hypothetical credit will exceed the tax that was actually paid.

Portability

ATRA made permanent the portability to surviving spouses of the unused exclusion amount of decedents dying after 2010. Thus, a surviving spouse can use his or her own base exclusion amount of $5.34 million plus the unused exclusion amount of his or her most recent deceased spouse to offset the tax on subsequent gifts or to offset his or her estate tax. The deceased spouse’s unused exclusion amount (DSUE) will not be available to the surviving spouse unless the executor of the deceased spouse’s estate makes an election to convey it and computes the amount to which the surviving spouse is entitled. Relief will be extended only in extraordinary circumstances to an executor who fails to make a timely election. In enforcing the carryover, the IRS is permitted to review the deceased spouse’s prior filed gift tax returns and estate tax return to determine the proper DSUE amount, even after the statute of limitations with respect to those returns has closed.

Quick taxable estate calculation

Take the aggregate value of all includible assets
- allowable exclusions and deductions
+ taxable gifts made by the decedent after 1976
= taxable estate
Wealth transfer taxes: Thinking ahead with some predictability

EXAMPLE: Credit shelter trust vs. portability

Assume, for the sake of illustration, that the wife died in 2011, having made no taxable gifts and leaving a gross estate of $10 million. Assume she left her entire estate to her surviving husband outright, thus reducing her taxable estate to zero, leaving her basic exclusion amount of $5 million unused and causing full inclusion of the $10 million in her husband’s estate. Assume an election is made on her estate tax return and he succeeds to her deceased spouse’s unused exclusion amount (DSUE) of $5 million. The husband does not remarry and dies in 2018, having not made any taxable gifts. At death, his taxable estate is valued at $20 million. This includes the property he inherited from his wife, which has now appreciated to $15 million (i.e., 50% growth in the intervening seven years). His applicable exclusion amount is $11 million ($5 million of deceased spouse’s unused exclusion amount, plus his own base exclusion amount of $6 million – an assumed inflation-adjusted exclusion amount for individuals dying in 2018). The husband will pay an estate tax of $3,600,000 – 40% of the difference between the $20 million estate and the $11 million applicable exclusion amount. As a result, the family’s net worth, after estate taxes, would be $16.4 million.

Now assume that the wife had instead used her entire applicable exclusion to place $5 million of her estate in a trust for her husband that did not qualify for the marital deduction and left the remaining $5 million to her husband outright. On the husband’s subsequent death, the value of the trust is $7.5 million (reflecting the same 50% appreciation over the husband’s life), which is excluded from his taxable estate. Now, the amount of the husband’s taxable estate is not $20 million, but $12.5 million. His estate will pay an estate tax of $2,600,000 (40% of $6.5 million – $12.5 million less his applicable exclusion amount of $6 million). As a result, the family’s net worth, after estate taxes, would be $17.4 million or $1 million greater in this scenario (i.e., 40% of the trust’s $2.5 million of appreciation, which, because it is in the trust, is not taxed in the husband’s estate).
Wealth transfer taxes: Thinking ahead with some predictability

Portability could greatly simplify the tax planning that must occur before or upon the death of the first spouse to die. No longer will it be necessary to make sure that both spouses own property equal to the prevailing applicable exclusion amount. Even where each spouse individually controls assets in excess of the applicable exclusion amount, the need to affirmatively plan for its use in the testamentary plan of the first spouse to die is removed (unless that spouse desires to affirmatively use his or her GST tax exemption, which is not portable). In fact, (subject to the GST tax exception just noted and ignoring state estate/inheritance tax considerations), there would now appear to be no tax detriment to a classic “sweetheart” disposition — leaving one’s assets fully to one’s surviving spouse either outright or in trust.

Planning tip: Evaluate portability vs. credit shelter trusts. As favorable as the potential simplicity promised by portability is, it is no panacea. In fact, family wealth may likely be better preserved under the classic credit shelter trust arrangement — one in which both spouses have wealth equal to at least their base exclusion amount and affirmatively plan its use — that dominates current testamentary estate plans.

The example illustrates how waiting to use a spousal unused exclusion may be poor tax planning. The savings noted in the example would be replicated if the surviving spouse had made a $5 million gift in 2011, shortly after his wife’s passing. The problem, however, is a practical one — convincing the surviving spouse to do something the deceased spouse refused to do in his or her testamentary documents. Consequently, as a matter of planning, in those situations where each spouse has assets in excess of the applicable exclusion amount — continuing to use a credit shelter trust remains, as a general rule, the more prudent course of action.

One final note on this planning example: The greater the appreciation of the assets during the husband’s life, the greater the savings. Assume, for example, that the value of the trust’s assets had tripled in value to $15 million prior to the surviving husband’s death. In that case, the family’s wealth would be greater by $4 million (40% of the trust’s $10 million of appreciation, which, because it is in the trust, is not taxed in the husband’s estate).

State estate and inheritance tax considerations

On a cautionary note, many states do not now and will not hereafter conform to the federal estate tax rules. Consequently, in these states, an immediate state estate/inheritance tax may arise where the corresponding state applicable exclusion amount is less than the federal applicable exclusion amount and the testamentary plan is built upon the federal exclusion amount.

Thus, in a state that doesn’t provide for its “own” state-only marital deduction protocol, fully funding a bypass trust with the federal $5.34 million applicable exclusion amount would give rise to a state estate tax of $431,600 assuming that the state tax is equal to what the state death tax credit would have been in 2000 (a common approach employed by many states to avoid a reduction in state estate tax revenues).

“Many states do not now and will not hereafter conform to the federal estate tax rules.”
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An additional advantage of portability is that the problem noted above can be eliminated. Specifically, if all assets pass to the surviving spouse in a manner qualifying for the marital deduction except for enough to fund a credit shelter trust equal to the state's exemption amount and a corresponding DSUE election is made, there is no transfer subject to state estate taxation until the surviving spouse dies. However, the same analysis made above with respect to the greater family wealth preservation associated with having the first spouse to die fund a credit shelter trust with the federal exclusion amount remains true. By paying state estate tax at the first death, all future appreciation on a federal credit shelter trust’s assets escapes state estate taxation upon the death of the surviving spouse. Whether that future savings justifies a current state estate tax liability is ultimately a function of nontax factors.

Planning tip: Give gifts in states that do not levy gift tax. The better solution to the problem of a state’s estate tax is to utilize the other significant difference between federal and state estate/inheritance tax systems; specifically, other than Connecticut, states do not levy a gift tax. Thus, except in Connecticut and subject to one caveat, the state estate tax base does not include prior taxable gifts notwithstanding they are an element in the federal estate tax base. The caveat, of course, is that all transfers made within three years of death can be treated as “death bed” transfers and are added back to the state estate tax base.

A cautionary tale regarding income taxes and estate planning

As discussed in the introduction to this section, with ATRA having made the indexed $5 million exclusion amount permanent, an overwhelming majority of Americans will no longer be subject to estate taxes. What is also significant is what ATRA did not do. Unlike the Bush-era tax cuts, the estate tax benefits under ATRA did not also require the sacrifice of the step-up in asset basis at death.

As a result, for most Americans, “tax” planning for one’s estate has now taken a 180 degree turn. Specifically, if one finds him or herself with an estate less than the applicable exclusion amount (or for a surviving spouse, the sum of his or her individual base applicable exclusion amount, plus their deceased spouse’s unused credit amount), it becomes advantageous to pull assets into the taxable estate in order to secure a step-up in income tax basis for those assets.

Not unmindful of the issue, the Internal Revenue Code restricts the ability to get a basis step-up on assets given to the decedent within a year of death that return by bequest to the donor. Consequently, finding assets for estate inclusion is more profitably directed at trusts in which the decedent had an interest (for example, a credit shelter trust set up by a predeceasing spouse) or trusts, of which the decedent was the grantor where access to trust assets might be obtained through trust amendment.

Planning Tip: Retain the power to reclaim assets. In any event, any newly created trust should consider a provision, which allows the grantor a power to reclaim assets in the event a determination is made that his or her estate is valued beneath the exclusion amount in existence at the date of death. Care must be taken, though — if not structured properly, such a power can conflict with the ability to make gifts.

“An overwhelming majority of Americans will no longer be subject to estate taxes.”
Wealth transfer taxes: Thinking ahead with some predictability

Example: Distributing assets before death

A surviving spouse is the beneficiary of a bypass trust established by a predeceased spouse. The trust has been in place for many years and holds real estate and securities with relatively low basis. The trustee has the power to distribute income or corpus to the spouse in the trustee’s discretion, which it has not yet done. Trust assets are to be distributed per stirpes to the decedent’s children upon the death of the surviving spouse. A combination of substantial extended care expenses and spendthrift children has depleted the surviving spouse’s personal estate to approximately $2 million. The surviving spouse’s estate plan leaves her assets directly to the decedent’s children at her death. Given the surviving spouse’s deteriorating condition, the trustee determines to distribute real estate and other assets that are likely to be sold following the surviving spouse’s death. The fair market value of the distributed assets is thought to be about $3 million. The basis of the assets distributed to the surviving spouse is $500,000. Assuming none of the $3 million is consumed by the surviving spouse, the outcome is that the family will take the $3 million of assets with a basis stepped up from $500,000 to $3 million. Assuming, conservatively, that the assets are all capital assets, the federal income tax savings arising from the trust distribution is at least $595,000 (23.80% [the 20% capital gains rate and the 3.8% net investment income surtax] of the step-up of $2.5 million). Additional savings arise if state income taxes apply or if the real property distributed was depreciable, and depreciation recapture is avoided.
Estate tax and the estate’s income tax return

Estate administration expenses may be deducted in computing the estate tax or the income tax but not both. In prior years, when federal estate tax rates were significantly higher than federal income tax rates, these expenses were always deducted in determining the estate tax liability. Now, with many states not assessing an estate tax, and the federal estate tax rate just slightly higher than the highest income tax rate (i.e., 40% compared to 39.6%), where to deduct estate administration expenses is now a matter of some analysis.

For estates subject to both federal and state estate or inheritance taxes, it still makes sense to deduct all administration expenses on the estate tax return. In estates that do not face a federal estate tax liability but only a state income tax liability or that are heavily subject to the net investment income tax of 3.8%, it may now be less expensive to deduct all administrative expenses on the estate’s income tax return. Depending on circumstances, this may be true even when the result is a higher federal estate tax.

This analysis is complicated by the fact that for income tax purposes, estate administration expenses can be deducted only in the year paid and then only to the extent of available income. Excess deductions are simply lost except in the year of the estate’s termination when they can be distributed out as a deduction to the estate’s beneficiaries.

As a consequence, coordination of income recognition and the payment of offsetting administration expenses are now required in order to avoid the loss of tax benefits. These determinations are complex, and in our experience, each case is unique. To avoid unfortunate consequences, it is necessary to plan the estate’s administration and to consult frequently with your professional tax adviser.

“The transfer tax landscape of the future — The President’s budget proposals.”

The public debate regarding the estate tax has quieted since ATRA. Notwithstanding, bills were introduced in both houses of Congress in 2013 with the intent to repeal the tax. Furthermore, as part of the budget process, it is customary for the Administration to suggest tax proposals that reinforce budget provisions and reflect the Administration’s view of tax policy. Over the past six years, the Obama administration’s budget proposals have begun to flesh out what the transfer tax landscape of the future might look like — one dramatically different from what we see today.

Future tax rates and exemption amounts

The Obama administration, in its most recent budget submission for 2015, indicated its continuing support of a return to the rules as they existed in 2009, namely, a gift tax exclusion amount of $1 million; an estate tax exclusion amount and a GST exemption amount of $3.5 million; with a top gift, estate, and GST tax rate of 45%.
Grantor retained annuity trust (GRAT) limitations

In each of the Obama administration’s six budgets, the administration has consistently stated its intention to seek a 10-year minimum term for GRATs. GRATs were discussed in detail on page 65. As a GRAT is established fundamentally for the grantor’s benefit, should death occur during the annuity period while the grantor is still collecting annuity payments, the full value of the trust, as a general rule, will be included in the grantor’s gross estate as if no prior planning had ever been undertaken. It is for this latter reason that a 10-year minimum term will dramatically affect the appeal of GRATs as estate planning vehicles.

Logic would suggest that GRATs will be used less frequently given the inflation-indexed $5 million applicable exclusion amount. Simply stated, a GRAT is a relatively high-maintenance transaction. There will be fewer individuals who need to engage in higher-complexity planning and/or need to “zero out” to avoid transfers that would otherwise result in a gift tax (excluding of course all of those who made large gift transfers in 2012). Notwithstanding, while GRATs are likely to become relatively less important to estate planning, their appeal will remain high so long as:

• Prevailing interest rates remain low (note that the prevailing rate required to be used in GRAT gift tax calculations in October 2014, while up from its all-time low in September 2012 of 1.0%, is still only 2.2%)
• The assets that are likely gift candidates are value-stressed
• Short-term GRATs are still possible

Requiring GRATs to have a minimum 10-year term has also been endorsed by certain lawmakers. For example, in addition to the GRAT change being included in the budgets, members of both houses of Congress introduced legislation in 2010 and 2011, which included similar provisions. Given the current political appetite for deficit reduction and balanced budgets, the prospects for such legislation in the future remain high. Also keep in mind the current condition favoring the use of GRATs — historically low interest rates — should change with an improved economy.

Planning Tip: Plan now for shorter-term GRATs. If shorter-term GRATs appeal to your specific situation, consideration should be given to current planning and implementation.
Wealth transfer taxes: Thinking ahead with some predictability

Limited duration of GST tax exempt status
In its last four budgets, the Obama administration has proposed a provision that would limit the benefit of GST dynasty trusts by requiring the trust’s inclusion ratio (the percentage of the trust that is subject to a GST tax upon certain events) to be increased to 100% upon the 90th anniversary of the creation of the trust. This proposal would apply to trusts created after enactment, and to the portion of any then existing trust attributable to additions to such trust made after the date of enactment.

The primary effect of any such legislation, if enacted, would be to preclude the effectiveness of any trust not subject to a rule against perpetuities by “forcing” such trust back into the tax base — in other words, the trust could continue, but its GST tax profile would change after 90 years. The administration of dynasty trusts subject to such a provision will become more difficult and costly since a GST tax may thereafter be due with every distribution and at the death of every beneficiary.

The estate tax treatment of grantor trusts
In the past three years, the Obama administration’s budget has included a proposal that would institute what many have called a “hard to complete” rule. The rule has three facets:

1. First, a transfer of an asset to a grantor trust (a trust of which an individual is treated as the owner of the trust’s assets for income tax purposes) would be considered incomplete for gift tax purposes.

2. Second, any transfer out of a grantor trust to a person other than the grantor would be considered a completed gift and the value of the entire trust would be considered a completed gift upon the date that grantor trust status lapsed.

3. Third, as a general rule, the value of the assets of any trust determined, at the date of death, to be a grantor trust relative to the decedent, would be included in the decedent’s gross estate.

In the Obama Administration’s fiscal year 2014 and 2015 budgets, the “hard to complete” rule was altered to better focus on negating the estate tax benefits of the transaction discussed above at “leveraged gift transfers.” The new proposal would only apply to the “portion” of a grantor trust, which engages in a sale, exchange, or other comparable transaction with the “deemed owner of the trust.” In most cases, the deemed owner of the trust is the trust’s grantor. The “portion” of the trust to which the rule would apply includes the acquired property (at its value when the transfer is ultimately complete under the hard to complete rule), the retained income produced by the acquired property, and reinvestments of any sales proceeds of the acquired property. The affected portion of the trust would not include the consideration given up by the trust to acquire the property, nor would it include any trust property that was acquired as a result of a taxable gift.

Under the current proposal any distributions (including distributions of income) out of that trust portion to someone other than the deemed owner of the trust portion would be treated as a completed gift by the deemed owner of the trust. Similarly, the termination of the affected portion’s grantor trust status prior to the deemed owner’s death would be considered a completed gift of the full value of that portion of the trust. Lastly, the undistributed assets of the affected trust portion would be includible in the deemed owner’s gross estate.

Complications always attend a trust which may in whole or in part be included in the grantor’s estate. For example, the GST exemption cannot be effectively allocated to any portion of the trust.
Wealth transfer taxes: Thinking ahead with some predictability

It remains clear that the means to avoid the unwelcome outcomes described above is to use only nongrantor trusts in one’s planning where a sale, exchange, or other comparable transaction is under consideration. Using a nongrantor trust to affect such a transaction will impose an income tax cost on several transactions that are currently quite popular, but otherwise would not inhibit the types of planning that occur today.

If the initial proposal was the first argument in the debate, the current proposal is a strong second voice that will, at a minimum, serve to continue to stir the issue of whether or not grantor trusts will have a reduced prominence in the transfer tax planning landscape of the future. Many issues remain unresolved, not the least of which is the treatment of trusts that, while not grantor trusts at inception, later become grantor trusts.

Simplifying the gift tax exclusion for annual gifts

In 2014, a donor may give $14,000 of gifts to an individual donee without being subject to tax. There is no limit on the number of donees to whom a donor may give such excluded gifts in any one year. However, each gift must be of a present interest rather than a future interest (e.g., many gifts in trust), in the donated property. However, in Crummey v. Comm’r, the Ninth Circuit held that a transfer to a trust can qualify as a present interest if the beneficiary has the unrestricted right to withdraw the value of the contribution from the trust, if even for a limited period of time.

The Administration argues that the Crummey rules are creating significant compliance and enforcement costs and that the IRS is increasingly concerned about the lack of a limit on the number of beneficiaries to whom Crummey powers are given. The fiscal year 2015 budget, for the first time, proposes to eliminate the present interest requirement for gifts that qualify for the gift tax annual exclusion, but it would impose an annual limit of $50,000 per donor on transfers of certain property.

The new category of transfers subject to the proposed annual $50,000 limit per donor would include:

- All transfers in trust with very limited exceptions;
- Transfers of interests in pass-through entities;
- Transfers of interests subject to a prohibition on sale; and
- Other transfers of property that, without regard to withdrawal, put, or other such rights in the donee, cannot immediately be liquidated by the donee

The proposal would not eliminate the unlimited number of donees who could receive up to the annual exclusion amount (currently $14,000) for gifts that do not fall in the above new category. This would include simple outright gifts of cash, outright gifts of marketable securities, and gifts to certain trusts, which, as a general rule, can benefit only one beneficiary or that beneficiary’s estate.
Wealth transfer taxes: Thinking ahead with some predictability

Beyond 2014

ATRA has led to a feeling of statutory stability for the first time in more than 12 years. With ATRA, tax planning, while made somewhat more complicated with the inflation indexed applicable exclusion and GST exemption amounts, is becoming more systematic. However, from the points above, you can see that the wealth transfer tax environment beyond ATRA may still be subject to significant change relative to the types of planning that have historically been very popular. If the targeted planning appeals to you, then you would be well advised to consider taking action currently. In any event, keeping informed of tax legislative developments will give you more effective opportunities to plan ahead and react quickly as changes transpire.

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