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TAX UPDATE

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Although taxpayers have been spared a government shutdown this year, extensive changes to the tax laws will again delay the IRS's acceptance of income tax returns that will be filed. Before looking too far ahead, however, taxpayers would be remiss to not consider potential planning opportunities and pitfalls before ringing in the new year.

Highlights of 2014 Income Tax Changes

- The tax brackets continue to be adjusted annually for inflation. For single taxpayers with 2014 taxable income greater than $406,750 ($457,600 for married filing jointly taxpayers and $228,800 if married filing separately), the top marginal income tax rate is 39.6%. For taxpayers with taxable income below these thresholds, the income tax rates remain the same as the rates in effect for 2013.
- The top tax rate on long-term capital gains and qualified dividends is 20% for single taxpayers with taxable income in excess of $406,750 ($457,600 for married filing jointly taxpayers and $228,800 if married filing separately). For long-term capital gains and qualified dividend income below these thresholds, the capital gains tax rates remain the same as the 2013 rates.
- Single taxpayers with adjusted gross income ("AGI") in excess of $200,000 ($250,000 for married filing jointly taxpayers and $125,000 for married filing separately taxpayers) are subject to a payroll tax of 0.9% on wages and self-employment income and a surtax of 3.8% on net investment income (i.e., interest, dividends, rents, royalties, capital gains and gross income from passive business activities). Please note that the payroll tax and net investment income surtax are based on AGI, whereas the top marginal income tax rate increase and the capital gains tax are based on taxable income.
- The standard deduction for 2014 is $6,200 for single taxpayers ($12,400 for married filing jointly taxpayers and $6,200 for married filing separately).
- The 2014 personal exemption is $3,950, but is subject to a phase-out that, for single taxpayers, begins with adjusted gross incomes of $254,200 ($305,050 for married couples filing jointly and $152,525 for married filing separately taxpayers). The phase out reduces the total amount a taxpayer may claim in personal exemptions by 2% for each $2,500, or a fraction thereof, by which the taxpayer's AGI exceeds the threshold amounts. The personal

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exemption phases out completely at $376,700 ($427,550 for married couples filing jointly $213,775 for married filing separately taxpayers).

- Individual taxpayers with AGI of greater than $254,200 ($305,050 for married filing jointly taxpayers and $152,525 for married filing separately taxpayers) are subject to the itemized deduction limitation (known as the Pease limitation). Under the Pease limitation, the total amount of itemized allowable deductions is reduced by 3% for each dollar of AGI in excess of the threshold amounts. The Pease limitation does not impact deductions for deductible medical expenses, casualty losses, investment interest expenses and/or gambling losses.
- Medical expenses paid in a calendar year must exceed 10% of AGI before the expenses are deductible, with one exception. Taxpayers over age 65 are still eligible to deduct medical expenses that exceed 7.5% of AGI.
- A Report of Foreign Bank and Financial Accounts ("FBAR") is required to be filed by any U.S. person who has a financial interest in or signature authority over at least one financial account located outside of the United States with an aggregate balance exceeding $10,000 at any time during the year.
- Form 8938, Statement of Specified Foreign Financial Assets, must be filed by any U.S. person who has foreign financial assets valued at more than $50,000 on the last day of the tax year or more than $75,000 at any time during the tax year (more than $100,000 on the last day of the tax year or more than $150,000 at any time during the tax year for married filing jointly taxpayers).
- The foreign earned income exclusion amount increases to $99,200 for 2014.
- Taxpayers should be aware that the House of Representatives passed a bill (H.R. 5771) on December 3, 2014 to extend various tax provisions for the 2014 tax year, including the deduction of state and local general sales taxes in lieu of state income tax, exclusion of gain from sale of qualified small business stock, IRA rollovers to public charities, mortgage debt relief (whether the mortgage is canceled or forgiven), and the above-the-line deduction for qualified tuition and related expenses. As of this writing, the Senate has not set a date to consider the measure, although a vote is expected by year end.

Estate and Gift Tax Highlights

- The estate and gift tax exemption amount has been indexed annually for inflation; the 2014 exemption amount is $5,340,000 and the 2015 exemption amount is $5,430,000.
- The estate, gift, and generation-skipping transfer tax rate for transfers exceeding the estate and gift tax exemption amount is 40%.

- The annual gift tax exclusion amount remains at $14,000 for gifts made in 2014 and 2015. Qualifying tuition payments and medical payments do not count against this limit when paid directly to the educational or medical institution.
- A taxpayer may gift up to $145,000 in 2014 to a non-citizen spouse without the gift reducing their federal exemption amount or generating a gift tax.

Other Tax Issues

- The 3.8% surtax on net investment income applies to trusts, too. Trusts will be taxed on the lesser of the undistributed net investment income for the tax year or the excess (if any) of the trust's adjusted gross income over the dollar amount at which the highest tax bracket for trusts begins ($12,150 in 2014).
- In addition to the increased income tax rates, taxpayers must continue to remain aware of the Alternative Minimum Tax ("AMT"), even though it is now indexed for inflation. The AMT exemption amount for 2014 increases to $52,800.

Planning Opportunities

- If AGI or taxable income is expected to be higher in 2014 than in 2015, a taxpayer may benefit by deferring income into 2015 or accelerating deductions into 2014. The converse would apply if income is expected to be higher in 2015 than 2014.
- Charitable contributions of money will be disallowed unless the donor maintains a cancelled check, bank record, or receipt from the donee organization showing the name of the donee organization, and the date and amount of the contribution. For deductions of $250 or more, a letter from the organization, dated on or before April 15 of the following year, is required as well to be eligible for the deduction. For non-cash contributions greater than $500, the donor will need to provide records showing how the donor acquired the property, the date the property was acquired, and the basis in the property. For non-cash contributions over $5,000, a qualified appraisal prepared by a qualified appraiser must be obtained. A contribution of appreciated publicly traded marketable securities held more than one year yields a charitable contribution deduction equal to the fair market value of the security, and the unrealized gain is not taxed to the donor. When making non-cash charitable contributions, keep in mind that no deduction is allowed for charitable contributions of clothing and household items if such items are not in good used condition or better.
- As the relatively generous federal estate and gift tax exemption amount continues to increase, taxpayers should shift their focus to the income tax and state estate tax consequences of their current

estate plans and modify where necessary. Currently, several states impose their own separate death taxes, with most of them topping out at rates of 16%.

- Clients with existing irrevocable trusts where the trustee has the discretionary power to make distributions of income and/or principal should consider making a distribution of the net income of the trust in order to take advantage of potentially lower income tax rates at the individual beneficiary level. This is because trusts are taxed less favorably than individuals and pay tax at the highest marginal rate of 39.6% when taxable income is $12,150 or greater.
- Grantor Retained Annuity Trusts (GRATs), Intentionally Defective Grantor Trusts (IDGTs), and Spousal Lifetime Access Trusts (SLATs) continue to be viable options for those looking to minimize their exposure to the federal estate and gift tax.
- Because the current estate, gift and generation-skipping transfer tax exemption amounts allow for the ability to pass significant wealth to future generations, taxpayers should continue to consider dynasty planning as a viable method of reducing exposure to estate taxes.
- Trust decanting, where the assets of an old trust are "poured over" into a new trust with more favorable terms, is becoming a popular option for those taxpayers who have irrevocable trusts but now wish to extend the trust term or alter the fiduciary powers. Not every state permits decanting, however, so it may be necessary to first change the location, or situs, of the trust.

The year 2014 has continued to build upon the significant tax changes enacted in 2013, resulting in further increases to ordinary and investment income tax rates, but more generous estate and gift tax exemptions. Given that these conditions are slated to continue for the foreseeable future, there are a number of long-term planning opportunities available to high income taxpayers through the remainder of this year and into 2015. For any questions with regard to your specific income tax and estate planning alternatives, or any questions relating to the content of this article, please feel free to contact us at any time.