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TAX UPDATE

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This past year was interesting for many reasons, not the least of which were extensive changes to the tax laws and a government shutdown that will again delay the IRS' acceptance of 2013 returns that will be filed by taxpayers. As the year draws to a close, it is the perfect time to consider potential planning opportunities and pitfalls before waving goodbye to 2013.

Highlights of 2013 Income Tax Changes

- For single taxpayers with taxable income greater than $400,000 ($450,000 for married filing jointly taxpayers and $225,000 if married filing separately), the top marginal income tax rate is 39.6%. Note that the tax brackets are adjusted annually for inflation. For taxpayers with taxable income below these thresholds, the income tax rates remain the same as the rates in effect for 2012.
- The top tax rate on long-term capital gains and qualified dividends increases from 15% to 20% for single taxpayers with taxable income in excess of $400,000 ($450,000 for married filing jointly taxpayers and $225,000 if married filing separately). The additional 5% tax is only levied on taxable income in excess of the threshold amounts; for long-term capital gains and qualified dividend income below these thresholds, the capital gains tax rates remain the same as the 2012 rates.
- Single taxpayers are subject to a payroll tax of 0.9% on wages and self employment income 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).
- A surtax of 3.8% is imposed on net investment income (i.e., interest, dividends, rents, royalties, capital gains and gross income from passive business activities) for single taxpayers with AGI in excess of $200,000 ($250,000 for married filing jointly taxpayers and $125,000 for married filing separately taxpayers). 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 additional 5% capital gains tax are based on taxable income.
- The Personal Exemption Phase-out ("PEP") applies to individual taxpayers with AGI of greater than $250,000, and for married filing jointly taxpayers with AGI of greater than $300,000 ($150,000 for married filing separately taxpayers). The PEP reduces the total amount a taxpayer may claim in personal exemptions by 2% for each $2,500 ($1,250 if married filing separately), or a fraction thereof, by which the taxpayer's AGI exceeds the threshold amounts.

- Individual taxpayers with AGI of greater than $250,000 and married filing jointly taxpayers with AGI of greater than $300,000 ($150,000 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.
- The provision allowing for the deduction of state and local general sales taxes was extended for 2013 and 2014.
- Taxpayers who receive mortgage debt relief (whether the mortgage is canceled or forgiven) may exclude up to $2 million from income in 2013. This provision, however, has not yet been extended to 2014.
- The above-the-line deduction for qualified tuition and related expenses is still available in 2013, but not 2014.
- 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.
- Taxpayers who are at least 70-1/2 years of age may distribute up to $100,000 from a traditional IRA directly to a charity without triggering federal tax. Keep in mind that since there is no tax on the distribution, the taxpayer does not get a charitable deduction for the direct transfer. This provision is scheduled to expire at the end of 2013.

Estate and Gift Tax Highlights

- The estate and gift tax exemption amount has been indexed annually for inflation; the 2013 exemption amount is $5,250,000 and the 2014 exemption amount is $5,340,000.
- 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 is $14,000 for gifts made in 2013 and 2014. 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 $143,000 in 2013 to a non-citizen spouse without generating a gift tax. This will increase to $145,000 in 2014.

Other Tax Issues

- The 3.8% surtax on net investment income applies to trusts as well, which 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 ($11,950 in 2013, rising to $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.

Planning Opportunities

- If AGI or taxable income is expected to be higher in 2013 than in 2014, or if you anticipate being in the same or a higher tax bracket in 2013, you may benefit by deferring income into 2014 or accelerating deductions into 2013. The converse would apply if income is expected to be higher in 2014 than 2013.
- 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 greater than $250, 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. 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 condition.
- As the estate and gift tax exemption amount continues to increase and the income tax rate becomes more costly, taxpayers should consider shifting their focus to the income tax consequences of their current estate plans and modify where necessary.
- With the relatively generous federal estate and gift tax provisions currently enacted, it is important to remember that federal taxation is often only one tax regime to consider. Currently, several states impose their own separate state-level death taxes, with most of them topping out at rates of 16%.
- For clients with existing irrevocable trusts where a trustee has the discretionary power to make distributions of income and/or principal, 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.
- 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.
- Taxpayers should continue to consider dynasty planning because the current estate, gift and generation skipping transfer tax exemption amounts allow the ability to pass significant wealth to future generations.
- 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.

Tax year 2013 has brought significant increases to ordinary and investment income tax rates, while also providing more generous estate and gift tax laws. There are a number of planning opportunities available to high income taxpayers through the remainder of this year. 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.

