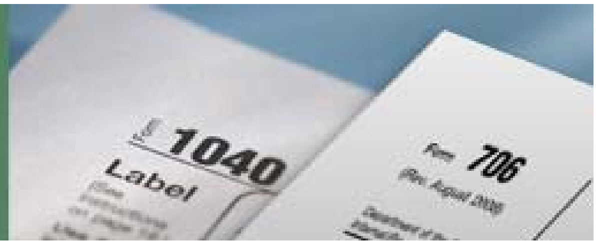

NAVIGATING THE 2012 TO 2013 TAX LANDSCAPE

An Advisory Services Publication

Authors,
R. Hugh Magill,
Chief Fiduciary Officer

Suzanne L. Shier,
Tax Strategist

April 16, 2012

"If man will begin with certainties, he shall end in doubts; but if he will be content to begin with doubts, he will end in certainties."

Francis Bacon, The Advancement of Learning

April is the traditional "tax season," but tax planning occurs year round. In this tax season we have some certainties regarding the 2012 and 2013 tax laws and related planning opportunities, but also many uncertainties. If we begin with the certainties, will we end with doubts? One would hope not. If we begin with uncertainties, will we end with certainties? Perhaps not certainties, but we can consider the current tax landscape and make informed income and wealth transfer tax planning decisions under the laws as presently in effect.

What do we know now about 2012 and 2013 individual income taxes?

Many of the "Bush era" tax cuts continue in effect in 2012. Most notable are:

- the 10% individual income tax bracket and the reduced income tax rates for individuals of 15%, 25%, 28%, 33% and 35%;
- reduced income tax rates on qualified dividends of 0% and 15%;
- the expanded 15% individual income tax bracket for married couples, providing "marriage penalty" relief; and
- reduced income tax rates on long-term capital gain income of 0% and 15%.

In addition, in 2012, high-income taxpayers are not subject to phase-out of their itemized deductions or personal exemptions and generally may exclude interest on state and local bonds from federal income.

However, as of the date this update is published, the 2012 allowable exemption for the alternative minimum tax (AMT), which imposes a minimum tax rate of at least 26%, has fallen back to the 2001 levels – just $45,000 on a joint married return and $33,750 on a single return in 2012, compared to $74,450 and $48,450, respectively, in 2011. Thus, absent a retroactive AMT "patch" for 2012, it is expected that the base of taxpayers subject to the alternative minimum tax will broaden in 2012.

In addition, the popular "charitable IRA rollover" which allowed an IRA owner's required minimum distribution to be reduced up to $100,000 by a direct transfer from the IRA to a qualified charity from 2006 through 2011, has not yet been extended to 2012.

Looking ahead to 2013, absent changes in the income tax laws that currently have been enacted, the following will occur for 2013:

- The lowest 10% individual income tax bracket will be eliminated and the 33% and 35% tax brackets in effect for 2012 will increase to 36% and 39.6%, respectively.

- The "marriage penalty" relief will expire and the 15% tax bracket for single individuals will again exceed one-half the 15% tax bracket for married persons filing jointly.

- Qualified dividends will be taxed at ordinary income tax rates.

- Capital gain tax rates will increase to 20% (18% for assets purchased after December 31, 2000 and held longer than 5 years).

- Certain itemized deductions for high-income taxpayers will be subject to phase-out of up to 80%.

- Personal exemptions for high-income taxpayers will be subject to phase-out of up to 100%.

- The new 3.8% Medicare contribution tax will be imposed on the excess net investment income of individuals, estates and trusts.

- The combined marginal income tax rate and the Medicare contribution tax will be 43.4%.

The net investment income potentially subject to the Medicare contribution tax includes interest, dividends, annuities, royalties, rents, net gains from investments, passive activity income and other non-business income. The Medicare contribution tax will apply to the lesser of (i) net investment income for the taxable year, or (ii) the excess (if any) of the taxpayer's modified adjusted gross income, over a statutory threshold amount. The threshold amounts for individuals in 2013 will be $250,000 for married taxpayers filing jointly, $125,000 for married taxpayers filing separately, and $200,000 for other individual taxpayers. We are awaiting further guidance from the Treasury regarding the details of the determination of net investment income for purposes of the Medicare contribution tax.

What are some of the implications of the scheduled changes in the individual income tax rates and other individual income tax provisions from 2012 to 2013?

First and foremost, it is important to be aware of the many changes in the individual income tax laws between 2012 and 2013 so that informed income tax planning can be considered well in advance of year-end. However, tax laws change and 2012 is an election year; it is highly probable that the laws presently in effect for 2013, and even possibly 2012, may change. Nonetheless, there are many income tax planning alternatives to consider for 2012 and 2013, including:

- ***Capital gains and losses***
  If you expect to recognize long-term capital gains in the near future, consider timing the recognition in 2012 instead of 2013. If you have assets with differing bases, consider sales of *lower* basis assets in 2012. If you have losses, consider deferring them to 2013 instead of recognizing them in 2012. If capital gain tax rates increase as scheduled in 2013, the tax on gains of lower basis assets in 2012 will be lower than the tax in 2013 and losses will be of greater tax benefit in 2013 than 2012. In short, consider harvesting 2012 year-end gains, rather than focusing exclusively on harvesting year-end losses.

- ***Dividends***
  To the extent that dividends can be timed, consider dividend payments in 2012 rather than 2013 to obtain the 0% or 15% qualified dividend tax rate and to avoid shareholder Medicare contribution tax on the dividend income for high-income taxpayers.

- ***Other types of income***
  Marginal bracket taxpayers may consider timing other types of income, such as commissions and bonus payments, in 2012 rather than 2013 in order to obtain the benefit of the lower marginal income tax rates in 2012. Accelerating income is not generally a tax planning strategy, but it may be beneficial in the current environment.

- ***Required IRA minimum distributions***
  If you are planning to make charitable contributions and are required to take a minimum distribution from your IRA, consider waiting until later in the year to take your required minimum distribution. If Congress extends the permitted $100,000 charitable IRA rollover for 2012 later this year and you have taken your required minimum distribution prior to the change in the law, it is likely that you will not be able to take advantage of the change retroactively as the contribution is required to be made *directly* to the charity to qualify. You will still be able to make your charitable contribution, but not with the benefit of the charitable IRA rollover treatment.

- ***Deductible expenditures***
  If you have recurring deductible expenditures, such as charitable contributions, consider accelerating 2013 expenditures to 2012 to avoid possible deduction phase-outs in 2013, but be mindful of any alternative minimum tax implications. Deductions that are *not* expected to be affected by the phase-outs in 2013 include medical expenses, investment interest and certain casualty losses, so there is no need to address timing of these deductions (if they even could be timed given their nature).

- ***Roth IRA conversion***
  If you are considering converting a traditional IRA to a Roth IRA, the income tax cost of the conversion at the 2012 tax rates likely will be less than the tax cost of the conversion at higher 2013 tax rates. If you convert in 2012 and chose to, you may unwind ("re-characterize") your 2012 conversion prior to the filing of your 2012 income tax return in 2013, as late as October 15, 2013 with extensions.

What developments do we anticipate for the remainder of 2012 and for 2013 regarding income taxes?

- ***Tax extenders***
  There are innumerable provisions of the Internal Revenue Code that have been enacted on a temporary basis, but have historically been extended, thus the moniker "tax extenders." Some of the more commonly recognized tax extenders affecting individual taxpayers include the state and local sales tax deduction, the higher education tuition deduction, the increased AMT exemption and the charitable IRA rollover. The Tax Relief, Unemployment Insurance Reauthorization and Jobs Creation Act of 2010 extended many of these temporary tax incentives through December 31, 2011, but no extender legislation is currently in effect for 2012. It is anticipated that the House Ways and Means Committee will begin reviewing extenders after Congress' April recess.

- ***Tax expenditures***
  "Tax expenditures" are provisions of the Internal Revenue Code that provide special tax benefits for certain taxpayers or activities and result in lost tax revenue. There were more than 170 tax expenditures identified in the 2012 federal budget. Reducing tax expenditures has attracted significant attention as a means of simplifying the Internal Revenue Code, broadening the tax base and increasing tax revenues. Of particular significance for many high-income taxpayers are the exclusion of interest on state and local bonds from federal income and the charitable contribution deduction**.**

- ***The Administration's Green Book and related pending legislation***
  Each year the Administration proposes its budget and Treasury publishes what is commonly referred to as the "Green Book," which provides us with guidance as to the types of tax legislation of which the Administration would be supportive. The fiscal year 2013 Green Book (General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals) includes numerous income tax provisions affecting "upper-

income" taxpayers with adjusted gross income above certain threshold amounts. The proposed thresholds (each indexed for inflation) are $250,000 for married taxpayers filing joint returns, $225,000 for head-of household taxpayers, $200,000 for single taxpayers, and $125,000 for married taxpayers filing separately.

Reinstate the phase-out of itemized deductions and personal exemptions for upper-income taxpayers. The Administration proposes to allow the scheduled reinstatement of the phase-out of itemized deductions (up to 80%) and personal exemptions (up to 100%) to take effect for 2013. Itemized deductions (other than medical expenses, investment interest, theft and casualty losses, and gambling losses) would be reduced by 3% of the amount by which AGI exceeds statutory thresholds, but not by more than 80% of the otherwise allowable deductions. The amount of each personal exemption would be reduced (but not below zero) by 2% of the exemption amount for that year for each $2,500 ($1,250 if married filing separately) or fraction thereof by which AGI exceeded the threshold.

Reinstate the 36% and 39.6% tax rates for upper-income taxpayers. The December 31, 2012 sunset of the 33% rate and 35% rate with reversion to 36% and 39.6% for high-income taxpayers would be allowed to occur without further extension of the lower rates for these tax brackets.

Tax qualified dividends as ordinary income for upper-income taxpayers. The Administration's proposal would allow the current reduced tax rates on qualified dividends to expire at year-end as scheduled for income that would be taxable in the 36% or 39.6% brackets, but would extend the lower qualified dividend tax rates for taxpayers in lower brackets.

Tax net long-term capital gains at a 20% rate for upper-income taxpayers. The Administration's proposal would allow the current reduced tax rates on long-term capital gains to expire as scheduled for capital gain income that, in the absence of any preferential treatment of long-term capital gains, would be taxable in the 36% or 39.6% brackets. It would also repeal the special reduced rate on gains from assets held over 5 years. Thus, the maximum long-term capital gains tax rate for upper-income taxpayers would be 20%.

Tax carried (profits) interest as ordinary income. The Administration's proposal would tax as ordinary income a partner's share of income on an "investment services partnership interest" (ISPI) in an investment partnership, regardless of the character of the income at the partnership level. Accordingly, such income would not be eligible for the reduced rates that apply to long-term capital gains. In addition, the proposal would require the partner to pay self-employment taxes on the income.

- The Carried Interest Fairness Act" (H.R. 4016), which is aligned with the Administration's proposal, was introduced on February 14, 2012, and has been referred to the House Ways and Means Committee. The proposed Act would tax carried interest compensation for services which investment fund managers make from taking a portion of profits from an investment fund at ordinary income tax rates. The proposed Act would also treat this compensation as wage income subject to employment taxes, rather than taxing the interest at the lower capital gains rate, not subject to employment taxes. Allocations of partnership capital gain income representing a return on invested capital would still be taxed as capital gains.

Reduce value of certain tax expenditures. The Administration's proposal is to limit the tax value of certain income exclusions, deferrals and deductions that would otherwise be subject to the 36% or 39.6% tax brackets to 28%. Included in the affected tax

expenditures would be tax-exempt state and local bond interest, employer-sponsored health insurance paid for by employers or with before-tax employee dollars, health insurance costs of self-employed individuals, employee contributions to defined contribution retirement plans and IRAs, the deduction for income attributable to domestic production activities, certain trade and business deductions of employees, moving expenses, contributions to health savings accounts and Archer MSAs, interest on education loans and certain higher education expenses. Similar limitations would apply under the AMT.

• The "Paying a Fair Share Act of 2012" introduced to the Senate March 22, 2012 is loosely aligned with the Administration's tax expenditures proposal. This proposed Act would impose a minimum effective tax rate of 30%, with a carve-out for charitable contributions, on individual taxpayers with adjusted gross income in excess of $1,000,000, adjusted for inflation, effective in 2013. Debate on the bill and related bills is expected to commence following Congress' April recess.

What have the candidates proposed regarding income taxes?

Presidential candidate Romney has set forth individual income tax proposals that differ in many respects from those of the Administration and the related proposed legislation. Included among Romney's proposals are permanent, across-the-board 20% cuts in marginal income tax rates, continuation of the current rates on interest, dividends and capital gains, and elimination of income taxes on interest, dividends and capital gains for taxpayers with adjusted gross income below $200,000. Additional income tax proposals include repeal of the Medicare contribution tax and the AMT. As the election season progresses, the details of the income tax proposals will be clarified. Because individual income tax rate *reductions*, rather than increases, are proposed, it will be important to monitor developments and defer execution of rate sensitive income tax planning until later in the year.

What do we know and what can we plan for regarding transfer taxes?

In 2012 the exclusions and exemptions from the gift, estate and generation-skipping transfer (GST) taxes are all $5,120,000 and the rate for the taxation of transfers above the $5,120,000 level is 35%. This is the first time we have ever had an across the board unification of the exemption amounts and the tax rates. The 35% rate is the lowest estate tax rate since 1931 and the lowest GST rate ever. In addition, the surviving spouse of a person who passes away in 2011 or 2012, may be eligible to increase the surviving spouse's estate tax exclusion amount by the portion of the predeceased spouse's exclusion that remained unused at the predeceased spouse's death (in other words, the exclusion is "portable").

However, the current exclusion and exemption levels and tax rates are scheduled to expire at year-end and revert to revert to 2001 levels. Absent changes in the law as currently enacted, in 2013 the gift and estate tax exclusion will drop to $1,000,000 and the GST exemption will decrease to somewhere around $1,400,000 (this exemption is inflation adjusted and we do not yet know the exact level where it will be in 2013). The marginal gift and estate tax rates and the GST tax rate will each increase to 55% and there will again be an additional 5% surtax on estates between $10,000,000 and $17,184,000. Although there has been much discussion of modifications of the gift, estate and GST tax provisions that will come into effect in 2013, it is not expected that we will have definitive guidance in this regard prior to year end.

The fiscal year 2013 Green Book provides us with guidance as to the current Administration's proposals regarding transfer taxes.

- ***Exclusions, exemption and rates***
  The Administration's gift, estate and GST tax proposal would make permanent the gift, estate and GST tax rates, exclusions and exemptions as they applied during 2009. The top tax rate would be 45% and the exclusion/exemption amount would be $3.5

million for estate and GST taxes and $1 million for gift taxes. In addition, the "portability" of unused gift and estate tax exclusion between spouses in effect in 2011 and 2012 would be made permanent.

- ***Grantor retained annuity trusts***
  The Administration has again proposed a minimum 10 year term for grantor retained annuity trusts but has also proposed a maximum term of the life expectancy of the annuitant plus 10 years. The proposal also would include a requirement that the remainder interest have a value greater than zero at the time the interest is created and would prohibit any decrease in the annuity during the GRAT term. Longer term GRATs will continue to present estate planning opportunities, but they will work best for assets with long term appreciation potential, and they will continue to require careful coordination of tax and investment planning.

- ***Dynasty trusts***
  For long-term GST exempt dynasty trusts the Administration's proposal provides that, on the 90th anniversary of the creation of a trust, the GST exclusion allocated to the trust would terminate. Specifically, this would be achieved by increasing the inclusion ratio of the trust to one, thereby rendering no part of the trust exempt from GST tax.

- ***Grantor trusts***
  A new proposal included in the Green Book that has surprised many estate planning professionals is a proposal to "coordinate" the grantor trust income tax rules and the estate taxation of grantor trusts. To state it very, very simply, trusts taxed as grantor trusts for income tax purposes would be included in the grantor's gross estate for estate tax purposes. If this proposal were to be enacted in its present form, which is thought to be highly unlikely, planning with intentionally defective grantor trusts would be severely limited or eliminated and planning with irrevocable insurance trusts also would be affected.

What are some wealth transfer tax planning solutions that may be considered in 2012?

In light of these unusual and short lived circumstances in 2012 there are a number of wealth transfer opportunities to consider. One is to use the 2012 gift tax exclusion and possibly the GST exemption to make gifts to address unique family circumstances or assets.

- ***Forgive family loans***
  If you have made loans to a family member, but repayment is either not feasible or no longer desired, this might be a good time to make a gift and forgive the loan. If there are other family members to whom you did not make a loan, but would like to treat equitably, this might also be a good time to make compensating gifts so that all members of the family can be treated similarly.

- ***Lifetime special needs trust***
  If you have a disabled member of the family, consider working with your counsel to establish what is commonly referred to as a special needs trust; a unique trust that is designed to provide supplemental benefits to the family member without endangering the availability of government benefits for that individual.

- ***Unique assets***
  If you have a unique asset within your family such as a closely held business, an unusual art object, a vacation home or a unique piece of real estate, 2012 is a good year to consider whether or not transferring the asset to other family members could be advantageous. Transfer of these types of assets requires careful planning and consideration of how the asset would be managed by the other family members. If the asset is, for example, income consuming rather than income producing, as the

case might be with a vacation home or an art object, consider how to endow the costs of ownership to make sure that the recipient can afford to continue to own the asset. Transfer of unique assets may be structured through entities such as limited liability companies to facilitate management, insurance and other day-to-day issues, with the possible additional consequence under current law of valuation discounts for lack of marketability or a minority interest with gifts of units among multiple family members.

- ***Modern and blended families***
  Many American families today do not necessarily fit into the traditional paradigm of a longstanding marriage and biological children from that marriage alone. A "traditional" estate plan to use the unlimited estate tax marital deduction and the exemption amount, providing first for the surviving spouse and then for children after the demise of both parents, may not be the right "fit" for some families. If your family differs from the traditional model you may want to consider a lifetime gift (either outright or in trust) in 2012 using the $5,120,000 gift tax exclusion to provide for a partner for whom a gift or estate tax marital deduction would not be available. If your family includes descendants of different lineage you might want to consider pre-funding inheritances (again, either outright or in trust) for children using the $5,120,000 gift tax exclusion. Gifts can be used to "equalize" and also to allow children and grandchildren the benefit of the gift without waiting until the death of a surviving spouse, particularly where there is a large disparity in the ages of spouses.

- ***Dynasty trusts***
  If you have very significant wealth consider establishing a long term trust (a "dynasty trust") for your family that benefits several generations of family members. Such a trust may be funded presently with a lifetime gift exempt from both gift tax and GST tax as long as it is not greater than the available $5,120,000 exemption levels. If both you and your spouse make gifts you can double that amount to $10,250,000. A trust of this type requires careful design in planning. It must be established in a state which allows perpetual trusts for family members, and it should be managed by a trustee with experience in serving multiple generations as well as managing complex trusts in frequently changing investment and tax environments.

Taxes are only one part of wealth transfer planning. It is wise to communicate with your family about your plans. Their lives will be affected by the way in which your wealth will be transferred and managed for them in the future. Also consider including in your will and trust a personal statement (a "statement of intent") which describes the values which have shaped your life and contributed to the formation of your wealth. This type of statement will serve both your family and your fiduciary by setting a context for the role that financial wealth is intended to play in your family's well being.

What is the current audit environment for high-income taxpayers?

The Administration's fiscal year 2013 budget seeks additional funding for the Internal Revenue Service (IRS) for administration and enforcement of the Internal Revenue Code. In testimony before the House Appropriations Subcommittee on Financial Services and General Government on March 28th, Treasury Secretary Timothy Geithner emphasized the need for additional funding for enforcement capabilities, stating that for every dollar spent by the IRS on enforcement it raises $4 in revenue.[i] One specific area where the IRS expects the proposed FY 2013 funding to enable it to strengthen enforcement efforts is in individual and business taxpayers' international compliance.

There has been little recent public comment regarding the activity of the Global High Wealth Industry Group (GHWIG) created by the IRS in the fall of 2009, specifically charged with examining "high net worth individuals." This is very resource intensive activity, for both the IRS and the affected taxpayers, and much of the increased activity of the IRS generally has been in the less resource intensive (for the IRS) correspondence audits. Correspondence audits are on the rise and have come under scrutiny in the tax professionals' community.

What is clear is the continued and increasing focus of IRS audit activity on high net worth individuals. The IRS published its FY 2011 Data Book in late March, again highlighting its heightened examination rates for high net worth individuals.[ii] In FY 2011 12.5% of individual returns with total positive income of $1,000,000 were examined, with recommended aggregate additional tax of $5,147,263,000, compared to 8.4% for FY 2010, with recommended aggregate additional tax of $5,121,162,000.[iii] The examination coverage level increases dramatically at the higher levels for individuals within the "over $1,000,000 adjusted gross income" category[iv]:

Adjusted Gross Income	Examination Coverage FY 2010	Examination Coverage FY 2011
$1,000,000 under $5,000,000	6.67%	11.80%
$5,000,000 under $10,000,000	11.55%	20.75%
$10,000,000 or more	18.38%	29.93%

It is expected that the heightened level of audit activity for high net worth individuals, both in field audits and correspondence audits, will continue.

In conclusion, 2012 and 2013 are more years of tax uncertainty. However, 2012 at least is also a year of tax opportunity, both for income tax planning and wealth transfer tax planning. In this tax season, it is beneficial to take stock, consider alternatives, and have a plan in place to implement as the year progresses and we gain a clearer picture of what is in store for the remainder of 2012 and 2013.

©2012, Northern Trust Corporation. All rights reserved.

LEGAL, INVESTMENT AND TAX NOTICE: This information is not intended to be and should not be treated as legal advice, investment advice or tax advice. Readers, including professionals, should under no circumstances rely upon this information as a substitute for their own research or for obtaining specific legal or tax advice from their own counsel.

IRS CIRCULAR 230 NOTICE: To the extent that this outline or any attachment concerns tax matters, it is not intended to be used and cannot be used by a taxpayer for the purpose of avoiding penalties that may be imposed by law. For more information about this notice, see http:// www.northerntrust.com/circular230.

[i] Treasury Secretary Geithner's Opening Statement, http://www.treasury.gov/press-center/press-releases/Pages/tg1508.aspx

[ii] Internal Revenue Service Data Book, 2011, Publication 55B, Washington DC, March 2012 (data for fiscal year 2011, October 1, 2010 through September 30, 2011)

[iii] IRS Data Book 2011 Table 9a; Internal Revenue Service Data Book, 2010, Publication 55B,Washington DC, March 2011 (data for fiscal year 2010, October 1, 2009 through September 30, 2010) Table 9a

[iv] IRS Data Book 2010 Table 9b; IRS Data Book 2011 Table 9b