Considerations For Tax Planning Opportunities Prior to December 31, 2012

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This outline is not intended to be a comprehensive outline, but is intended to be a helpful resource summarizing the federal income tax and cited financial planning opportunities available before December 31, 2012 for individuals and trusts and estate and businesses. The information in this outline is for discussion purposes only and is not all-inclusive and should not be relied upon as, nor intends to provide, investment or tax or economic advice unless specifically stated herein.

A. Review and understand and implement appropriate tax planning opportunities this year, and that are scheduled to reset or expire on December 31, 2012 (and assuming no 2012, or 2013 retroactive, federal tax legislation modifies or extends the expiring provisions).

Take action in 2012 in order to take advantage of the following:

1. **The current $5.12 million (per individual, $10.24 million for a married couple) unified estate and GSTT and gift tax exemption resets at January 1, 2013 to $1 million (per individual) with a 55% top tax rate also effective in 2013.** Discuss utilization in 2012 of the $5.12 and $10.24 exemption amounts. Further, action should be carefully considered, to take advantage of existing estate and gift tax planning benefits, in light of the potential elimination of the long term tax advantages of defective grantor trusts, the present federal estate and gift tax treatment of family limited partnerships and entity valuation discounts, and more. However, <u>the remainder of 2012 presents opportunities for estate and gift tax planning, and where planning implementation is completed before December 31, 2012</u>. Note also the Treasury's 2012 Green Book proposed to limit the benefits of certain estate planning utilizing grantor trusts, and that since 1997 there have been recurring initiatives to eliminate family partnership discount regimes. Consider also that in 2010 there were also Congressional provisions to require a ten year minimum term for grantor retained annuity trusts. Any of the preceding tax planning opportunities could be repealed by current and future legislative agendas.

2. The August and September 2012 IRC Sec 7520 rate is 1%. The September IRC Sec 7872 annual 2012 rate is .21% (the short term rate, decreasing from .25% in August); the September Sec. 7872 mid term rate is .88% and the long-term rate is 2.18%. The Secs. 7520 and 7872 rates are presently at historic lows.

    a. <u>Generally, the benefit of these low rates can increase the amount (value) of assets that are transferred (or gifted) by a transferor (i.e., a senior family member) to a</u>

transferee (i.e., a junior family member, or a trust for their benefit), and without triggering a gift and/or estate tax liability on assets transferred.

b. For example, where the total investment return (yield and appreciation) on an asset transferred (gifted or sold) appreciates, in excess of the 1% Sec. 7520 and (or) the .88% Sec. 7872 mid term rate (in effect at the date of the asset transfer (gift)) and the payments to a transferor, the excess value is transferred free of gift tax.

3. The $5.12 and $10.24 transfer tax exemption can be utilized with the ideas cited in the following pages. These planning ideas can benefit funds managers and principals, investors, closely held business owners, corporate executives, and anyone desiring to transfer assets while minimizing or eliminating federal and state gift and estate tax.

4. The current 35% ordinary income tax rate increases to 39.6%, and the long term capital gain rate increases to 20% (a reset to the rates in effect under President Bush). The tax rate on qualified dividends increases to 39.6% in 2013. Observation: accelerate long term gains and qualified dividends (where available) income to 2012; consider deferring capital losses to 2013 (capital losses deferred to 2013 could offset a 2013 long term capital gain, which could be subject to the higher 2013 20% capital gain rate)

5. The current AMT patch expires this year, increasing amount of income subject to AMT post 2012. Observation: accelerate income to 2012 (considering the measurement of AMT in 2012 and 2013, to minimize total AMT for both or multiple years)

6. Effective January 1, 2013, a new and additional 3.8% Medicare tax will be imposed on unearned income (individuals), on top of ordinary and AMT tax liabilities; trusts are impacted as well. The surtax is subject to estimated tax payment rules. Numerous types of unearned income is subject to this tax, and a new .9% Hospital Insurance Tax

7. Considering 1. through 6. Consider investment asset allocations and strategies and after tax total return objectives. Qualified dividends remain beneficial due to the 15% 2012 tax rate and the scheduled 2013 20% tax rate, bond yields remain low, and corporate v. sovereign fixed income holdings should be considered, as should ETFs, Master Limited Partnerships and related taxation thereof, and more.

8. The federal payroll tax rate cuts expire in 2012. Discuss with employers to ensure proper 2013 payroll reporting and withholdings controls will be in place.

9. Deductions expire for student loan interest, employer education assistance programs, the 15% tax bracket for married couples, and after 2012 there will be increased limitations on dependent care tax credits - these are significant foregone benefits for a majority of U.S. taxpayers.

10. Under the American Recovery and Reinvestment Act (“ARRA”), more parents and students will qualify for the American Opportunity Tax Credit, to pay for college

expenses. However, the credit expires at the end of 2012. The credit is available to a broader range of taxpayers, including many with higher incomes and those who owe no tax. It also adds required course materials to the list of qualifying expenses and allows the credit to be claimed for four post-secondary education years instead of two. Many of those eligible will qualify for the maximum annual credit of $2,500 per student. The full credit is available to individuals whose modified adjusted gross income is $80,000 or less, or $160,000 or less for married couples filing a joint return.

11. Discuss additional matters, such as the future uncertainty of taxation of carried interests in investment funds, taxation of insurance, more. Discuss what could be done in 2012 to mitigate tax exposures. Trusts can be structured to acquire and own life insurance, and to receive business and investment interests, thus avoiding estate inclusion and gift tax and achieving certain income tax savings based on income allocations.

12. Review tax basis of interests in pass through entities, and limitations on loss deductions, and active v. passive rules. Review wash sale compliance before year end for investment clients and hedge/investment funds.

13. Financial planning and risk management matters. Discuss the design of a personal (or a family's) Capital Accumulation model, to measure the ability of assets and income to fund cash flow needs through life expectancy. Include balance sheet reviews and refinancing opportunities, cash inflow and outflow models through life expectancy with inflation, and current and proposed investment allocation models matched to desired investment returns and risk tolerance.

14. Risk management reviews and the effective use of insurance to mitigate risk (e.g., health, life, disability, long term care, property and casualty; asset protection techniques).

15. State and local tax opportunities in New York, New Jersey, Pennsylvania, California, Connecticut

16. There are many observations for international taxpayers; offshore investment reporting obligations remains a very high profile Treasury initiative

B. Specific 2012 Gift and Estate Asset Transfer Planning Ideas

The August and September 2012 IRC Sec 7520 rate is 1%. The September IRC Sec 7872 annual 2012 rate is .21% (the short term rate, decreasing from .25% in August); the September Sec. 7872 mid term rate is .88% and the long-term rate is 2.18%. The Secs. 7520 and 7872 rates are presently at historic lows. Generally, the benefit of these low rates can increase the amount (value) of assets that are transferred (or gifted) by a transferor (i.e. a senior family member) to a transferee (i.e. a junior family member, or a trust for their benefit). For example, where the total investment return (yield and appreciation) on an asset transferred (gifted or sold) appreciates, in excess of the 1% Sec. 7520 and (or) the .88% Sec. 7872 mid term rate (in effect at the date of the asset transfer (gift)) and the payments to a transferors, the excess value is transferred free of gift tax.

With proper structuring, income tax liabilities can be retained by the transferor (a grantor, a seller) further increasing the value of assets that are transferred free of gift tax.

Observation: The current Sec. 7520 interest rate of 1% would be utilized for a 10 Year September 2012 Grantor Retained Annuity Trust (GRAT).

- A non-voting interest in a business is transferred (with no gift tax applicable) by a senior family member to the GRAT (the GRAT is designed so no gift tax results at the time of the transfer). An independent valuation/appraisal of the business is obtained; it is possible a valuation discount can be properly obtained with respect to the business interest transferred.
- The GRAT remainder beneficiary is a junior family member (the GRAT terminates in September 2022). There is no gift tax when the GRAT terminates, nor an estate tax to the senior family member if he/she is living when the GRAT terminates.
- The senior family member receives a ten year annuity from the GRAT based on the business interest value (the discounted value) at the transfer date, and a 1% annual interest rate (the Sec. 7520 rate).
- Where the total investment return (the cumulative 10 year total of annual income and asset value appreciation) on the business interest transferred appreciates, in excess of the 1% Sec. 7520 rate in effect at the date of the asset transfer (gift) and the total annuity payments, the excess value is transferred free of gift tax.
- The transferor pays income tax annually on taxable income generated by the GRAT. The income tax paid is not subject to a gift tax; therefore the asset to be transferred to remainder beneficiary is not reduced by the income tax costs; this in essence results in a second tax free gift .
- Assets transferred to a GRAT could decrease in value during the trust term, and the asset transferred to the GRAT is includable in the transferor's (grantor's) estate if the transferor dies prior the expiration of the GRAT (the 10 year term) - as these are undesirable scenarios, different and effective asset transfer techniques can be designed and implemented.

Observation: intra-family loans are effective when selling a non-voting business interest (an LLC interest) from a senior family member to a junior family member using a grantor trust.

- The current Sec. 7872 mid term interest rate of .88% can be utilized (the loan term is nine years).
- The senior family member is the seller (transferor, grantor).
- The sale would be structured as a non-taxable transfer, and distributions from the LLC to the grantor trust could potentially fund the loan principal and interest payments due to the seller from the trust.
- An independent valuation/appraisal of the business is obtained; it is possible a valuation discount can be properly obtained with respect to the business interest sold.
- Where the total investment return on the business interest sold appreciates (the cumulative 9 year total of annual income and asset value increases) in excess of the

asset value and .88% Sec. 7872 rate in effect at the date of the asset transfer (gift), the excess value is transferred gift tax free.

- The transferor pays income tax annually on taxable income generated by the grantor trust (in essence, the pro rata taxable income of the business (as owned by the trust)). The income tax paid is not subject to a gift tax; therefore the asset to be transferred to remainder beneficiary is not reduced by the income tax costs; this in essence results in a second tax free gift .
- Assets sold the trust could decrease in value during the trust term.
- If the transferor (seller) dies prior to the payoff of the note, the note value at the time of death is includable in the transferor's (grantor's) estate.
- If the transferor (seller) dies prior to the payoff of the note, asset value in the trust (the value of the asset at time of death) is not includable in the transferor's (grantor's) estate.

The Affordable Healthcare Act – Federal Unearned Income Surtax Effective in 2013

The Patient Protection and Affordable Care Act ("Act") was signed into law by President Obama on March 23, 2010. While certain elements of the legislation have already begun to take effect, the federal unearned income surtax won't begin until January 1, 2013. This outline is not intended to be a comprehensive write-up about the Act, but is a summary of the federal unearned income surtax provision. The information in this outline should not be relied upon as, nor intends to provide, investment or tax or economic advice unless specifically stated herein.

Summary of the Law

A) <u>Unearned Income Surtax- "Higher" Income Taxpayers</u>

Beginning 2013, an unearned income Medicare Contribution Tax is imposed on Individuals, Estates and Trusts.

For Individuals the tax is 3.8% on the lesser of:

A. Net investment income (NII), or
B. The excess of modified AGI over $250,000 if married, $125,000 if married filing separately, or $200,000 for all others.

For trusts and estates, the 3.8% surtax is imposed on the lesser of:

A. Undistributed NII, or
B. The excess of adjusted gross income over a threshold (approximately $12,000 in 2013).

FAQs: Higher Income Surtax

Q1. What types of unearned income is subject to the tax surtax ?

A1.
1. Interest
2. Dividends
3. Capital Gains
4. Annuities
5. Royalties
6. Rents
7. Income from a trade or business involving passive activities
8. Income from a trade or business involving trading in financial instruments and commodities.

Q2. What types of income are exempt from the surtax?

A2.
1. Disposition of certain active Partnerships and S Corporations
2. Distributions from Qualified Plans
3. Tax Exempt Interest
4. The "non-taxable" portion of gains from sale of residences, but it does apply to the capital gains in excess of the tax exempted portion (i.e., over $500K of gain from sale of principal residence for joint filing taxpayers)
5. The disposition of property held in a trade or business.

Q3. Does the surtax apply to capital gains from sales that closed prior to 2013?

A3. Yes, therefore consideration should be given to electing out of installment sale treatment for pre 2013 sales or try to have the sale close prior to December 31, 2012.

Q4. Why is income subject to the surtax called "Net Investment Income"?

A.4 Taxpayer is allowed to reduce the amount of gross investment income for expenses associated with earning that income. However losses in one category cannot offset income in another category (i.e., capital losses cannot offset interest income. Those losses can only be used to offset capital gains).

Q5. If tax rates on capital gains or dividends increase in 2013, is this tax in addition to the new rates ?

A5. Yes

Q6. Does the surtax apply to income from LLC's and S Corporations?

A6. It applies to income you receive from these entities only if you do not materially participate in the entities as defined in the Passive Rules under §469. Thus the distributive share of ordinary income from an S corporation to a shareholder who

materially participates in the trade or business of the S corporation (including rental income for real estate professionals) will not be subject to the 3.8% Medicare tax. However, this income will be taken into account for determining the $200,000 and $250,000 income thresholds.

Other types of investment income flowing through the S corporation such as interest, dividends and rents will retain their character and will be subject to the tax regardless of active participation.

Q7. Are the $200,000 and $250,000 thresholds indexed for inflation.

A7. No

Q7a. An Example.

A.7a. If AGI for a single individual is $275,000, then the excess over $200,000 would be $75,000 ($275,000 minus $200,000). Assume that this individual's net investment income is $60,000. The new 3.8% tax applies to the smaller amount. In this example, $60,000 of net investment income is less than the $75,000 excess over the threshold. Thus, in this example, the 3.8% tax is applied to the $60,000.

If this single individual had AGI if $275,000 and net investment income of $90,000, then the new tax would be imposed on the smaller amount: the $75,000 of excess over $200,000.

Q8. I earn all of my income from real estate investments that I own and operate myself. Will my rents and gains be subject to the new tax?

A8. No. If the ownership and operation of real estate you own is your sole occupation, then those activities are what's called your "trade or business." Income derived from a trade or business is not subject to the new 3.8% tax. If the owner of rental properties has a "day job," however, real estate investments are not considered as a trade or business, but are rather considered as investments, even if they are a major source of income.

Many Realtors engage in business activities are that are the "typical" selling, leasing and brokerage endeavors usually associated with the term "Realtor." If they also own rental real estate assets as part of their own personal investment portfolio, the net rents from that portfolio could become subject to the new 3.8% tax on net investment income, depending on AGI. (Per FAQ from National Association of Realtors)

B) <u>Changes in Threshold for Deducting Medical Expenses</u>

For tax year 2013, unreimbursed medical expenses will be deductible only to the extent they exceed 10% of AGI (up from 7.5% in prior years).

If a taxpayer or their spouse has reached age 65 before the close of the tax year, a 7.5% floor remains in effect through 2016 with an increase to 10% thereafter.

FAQ: Medical Expense Threshold

Q1. Does the additional medical expenses threshold impact HSA's?
A1. No HSA's are not affected and are deductible as in prior years.

C) <u>Medicare Wage Surtax</u>

Beginning in the tax Year 2013, an additional .9% Hospital Insurance Tax applies to wages and/or self-employment income in excess of $250k for married filing joint returns, $125k for married filing separate return and $200k for all other taxpayers.

FAQ: Medical Wage Surtax

Q1. Under current law a self-employed person deducts ½ of his/her self-employment tax. Is this additional tax deductible?

A1. No.

Q.2 What is earned income?

A.2 Income derived from an individual's labor, including wages, salaries, commissions or similar compensation

C. Businesses, and business owners and/or investors, can take advantage of tax benefits this year, that expire at December 31, 2012 (and assuming no 2012, or 2013 retroactive, federal tax legislation that modifies the provisions). Provisions apply to certain of real estate and energy and technology industries, and investors. Accordingly, action should be taken in 2012 so to take advantage of:

1. Business asset 50% expensing provision expires in 2012.

2. Cost recoveries for qualified leaseholds benefits reduce after 2012.

3. Research and experimentation tax credit expires in 2012.

4. Qualified biomass energy credit reduced to $25,000 after 2012 ($125,000 in 2012).

5. Wind energy credits and placed in service dates, and non business energy credits change after 2012.

6. Green building energy credits and related sustainable building and design bonds benefits curtailed after 2012.

7. Review pre-year end tax planning for businesses to undertake prior to 2013.