Proactive Mitigation of High Net Worth Clients' Tax Liability in 2016

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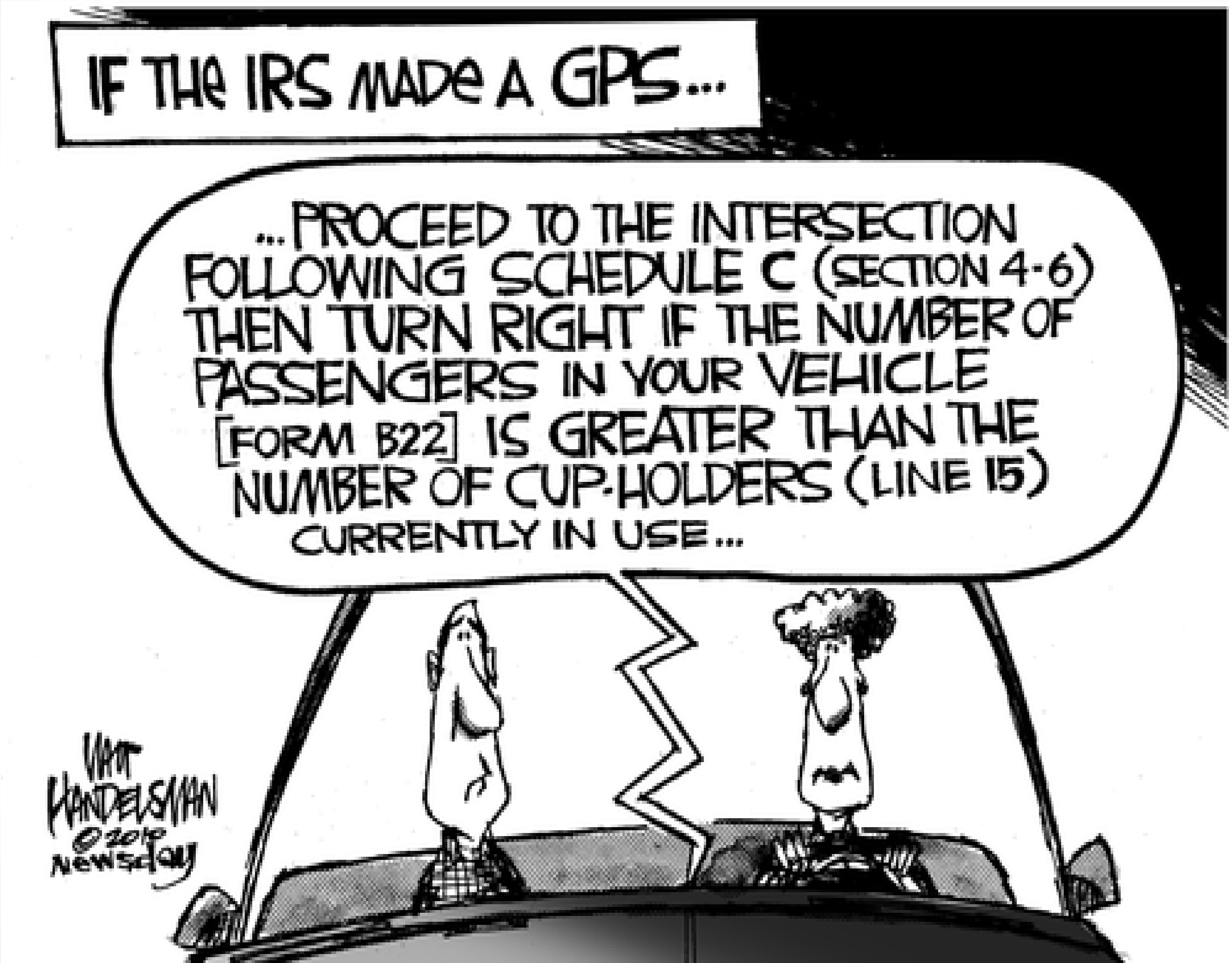

IF THE IRS MADE A GPS...
...PROCEED TO THE INTERSECTION FOLLOWING SCHEDULE C (SECTION 4-6) THEN TURN RIGHT IF THE NUMBER OF PASSENGERS IN YOUR VEHICLE [FORM B22] IS GREATER THAN THE NUMBER OF CUP-HOLDERS (LINE 15) CURRENTLY IN USE...

5 Recent Tax Developments for Wealthy Taxpayers

- 39.6% top tax rate
- 20% capital gains tax rate
- 3.8% Medicare surtax
- 0.9% Medicare payroll tax
- Reduction of itemized deductions and personal exemptions

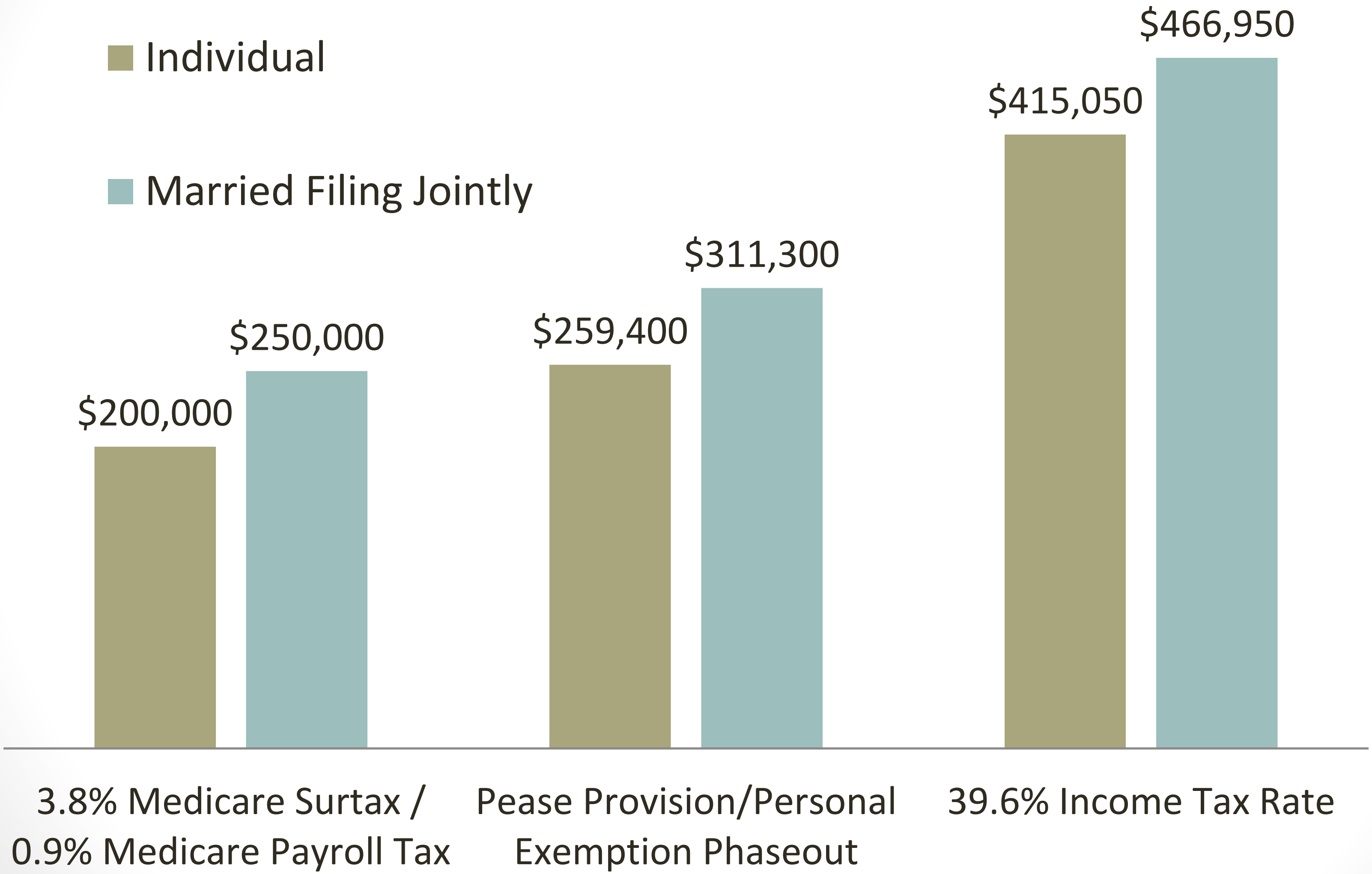
Planning After American Taxpayer Relief Act (ATRA)

- Higher income taxpayers face a possible 39.6% marginal tax on their wages, if 2016 earnings are greater than $415,050 for single filers and $466,950 for married couples filing jointly.

- These same wealthy taxpayers pay 20% on their long-term capital gains. Short-term capital gains continue to be taxed at ordinary income tax rates.

- ATRA made the gift and estate tax exemption ($5.45 million in 2016) permanent and inflation-adjusted. Gifts and estates above the exemption are taxed at 40% rate.

Different Income Thresholds for Top Taxes



Importance of Medicare Surtax

- The 3.8 % Medicare surtax , a pivotal provision of the 2010 Patient Protection and Affordable Care Act, took effect on January 1st, 2013.

- New surtax will raise the marginal income tax rate for affected taxpayers. Thus, tax-conscious investment management is pivotal for fiduciaries and higher-income taxpayers.
  - Higher income and investment taxes for top wage earners
  - Compressed income tax threshold for estates and trusts

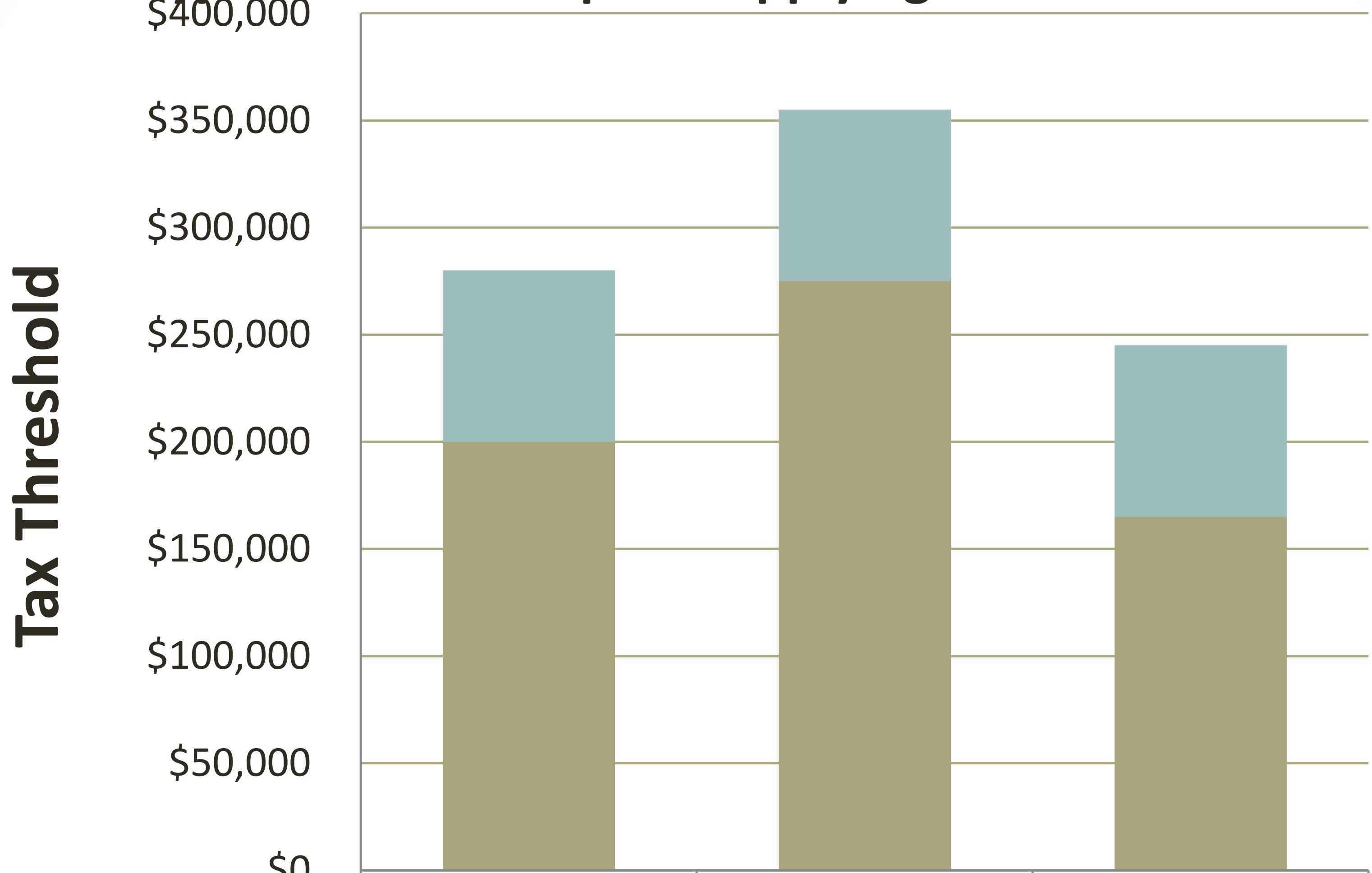
Personal Income Subject to Surtax

- The amount subject to 3.8% Medicare surtax varies depending on whether the taxpayer is an individual or a trust or estate.

- For **individuals**, the amount is the **lesser** of
  1. Net investment income OR the
  2. Excess of a taxpayer's modified adjusted gross income (MAGI) over an applicable threshold amount based on the taxpayer's filing status.

- A taxpayer in the 39.6% tax bracket – the highest marginal income tax rate in 2015 and 2016 – could have a marginal rate of 43.4% on net investment income.

Hypothetical Examples - Applying Medicare Surtax



	Regis & Kathy	Donald & Maria	Dwayne & Gaby
Net Investment Income	$80,000	$80,000	$80,000
Other Income	$200,000	$275,000	$165,000

Solutions to How to Apply Medicare Surtax

- **Regis & Kathy** – They will pay the 3.8% Medicare tax on $30,000. This is the lesser of NII ($30,000) or the AGI in excess of the threshold amount ($280,000 - $250,000 or $30,000). Thus, only $30,000 of investment income is subject to the Medicare surtax. <u>They pay $1,140 Medicare contribution tax (3.8% X $30,000</u>).
- **Donald & Maria** – They will pay the lesser of the NII ($80,000) or the AGI in excess of the threshold amount ($355,000 - $250,000, or $105,000). In this case, all $80,000 of the NII is subject to the tax. <u>Thus, they pay $3,040 Medicare contribution tax (3.8% X $80,000).</u>
- **Dwayne & Gaby** – None, this is because zero is the lesser of the NII ($80,000) or the AGI in excess of the threshold amount. The AGI of $245,000 is below the $250,000 Married Filing Jointly threshold. <u>Thus, they pay $0 Medicare surtax</u>.

Types of Net Investment Income Subject to Surtax

- Taxable interest and Dividends
- Long- and short-term capital gains
- Rents & Royalties
- Taxable income from investment annuities
- Taxable income from passive activities in trade or business
- Certain income from trading commodities

Types of Net Investment Income Not Subject to Surtax

- Salary, wages, and bonuses. Includes self-employment income
- Business Income from an active trade or business
- Gain on sale of active interest in a partnership or S corporation
- IRA, Roth IRA, and qualified plan distributions
- Social Security income
- Life insurance proceeds
- Items otherwise excluded or exempt from income under tax law, such as interest from municipal bonds and capital gains excluded (IRC 121)

Reducing Exposure to Surtax for Individuals

- Tax-exempt bonds
- Tax-deferred annuities
- Life Insurance
- Low NII investments (i.e. buy and hold investment strategies)
- Above-the-line deductions
- Capital loss harvesting
- Timing of Qualified Plan and IRA Distributions
- Creating material participation in passive activities

Case for Tax-Free Municipal Bonds to Reduce Surtax

- Interest on corporate bonds is NII. Interest on tax-exempt bonds is not NII.

- Switching from corporate bonds to tax-exempt bonds reduces both MAGI and NII and may decrease surtax payable.

- **Example** – Brittany, a married taxpayer in the 39.6% marginal income tax bracket, owns $1,200,000 of corporate bonds producing 6 percent interest. Her annual income from the bonds is $72,000 before tax. Brittany could switch to tax-free municipal bonds paying 4% interest and avoid both income tax and the surtax. *Should she make the switch?*

Solution to Case for Tax-Free Municipals

- Strategy is prudent if the switch produces a higher after-tax return and overall economic result.

- Brittany's after-tax return on the taxable corporate bonds would be **\$72,000 – (.436 X \$72,000) = \$72,000 - \$31,392 = \$40,608.** Her after-tax **\$48,000 (.04 X \$1,200,000)** return on the tax exempt bonds would be. Thus, switching to tax-exempt bonds would produce a better economic result.

- Alternatively, if the tax-exempt bonds instead produced an ordinary 3 percent return, she may be better off staying with the taxable bonds. Note that any transaction costs would have to be factored in.

Surtax Planning with Tax-Deferred Annuities

- Tax-deferred annuities can lower the surtax exposure by making favorable changes in timing of NII and MAGI.

- NII and MAGI can be shifted to years when earnings are reduced (i.e. after retirement) so they don't exceed threshold.

Shielding Surtax Exposure with Life Insurance

- Life insurance can similarly be employed to produce a smoothing effect on income.

- Taxpayers can reduce MAGI and perhaps NII in high earning years by utilizing income-producing assets to pay premiums.

- Earnings could be withdrawn from the policy in lower income years when no surtax is payable.

- **Example** – Trustee Jim recently paid a $300,000 single premium to buy a $2,500,000 second-to-die whole-life insurance policy. At the end of Year 10, Jim withdrew $70,000 from the policy's cash value when it was worth $500,000. *What earnings are subject to the 3.8% Medicare surtax?*

Solution to Surtax Exposure with Life Insurance

- None of the $200,000 of earnings-to-date ($500,000 – current cash value - $300,000 initial premium), or any future earnings within the life insurance policy, are subject to the 3.8% surtax until the trustee withdraws more than his initial single premium amount.

- No tax on withdrawals or loans up to basis in policy.

Minimizing Surtax with Low NII Investments

- Investors concerned about surtax should consider passive management (i.e. buy-and-hold strategy or index investing).
- Many investors will still prefer an actively-managed stock portfolio that produces significant amounts of annual capital gains and dividend income. Emphasis should be on after-tax return.
- Leverage prudent asset location strategies to reduce tax liabilities.

Maximizing Above-the-Line Deductions

- Exclusions and above-the-line deductions can lower MAGI and potentially reduce the Medicare surtax.

- Maximize these above-the-line deductions to lower MAGI:
  1. Contributions to qualified retirement plans
  2. Individual Retirement Account (IRA) deductions
  3. Health Savings Account (HSA) deductions
  4. The deductible portion of the self-employment tax
  5. Student loan interest deduction
  6. Educator expenses

Impact of Capital Loss Harvesting

- Capital loss harvesting has been a favorable strategy for netting out capital gains at the end of a tax year. Excess losses can be carried over for use in the future.
- Increased capital gains rate of up to 23.8% for high-income taxpayers has made year-end loss harvesting to offset capital gains even more significant.

Planning with Retirement Income Distributions

- Taxable payments from Social Security, traditional IRAs, and qualified retirement plans are not subject to the Medicare surtax, but retirement income can raise AGI in a way that subsequently exposes other investment income to this tax.

- Hypothetically, required minimum distributions from a traditional IRA can create as much as a 43.4% effective tax on IRA distributions (39.6% income tax + 3.8% surtax on investment income created by distributions).

- **Example** – Jack and Jill have $295,000 of taxable income from IRAs and Social Security but do not owe any 3.8% tax. *If $105,000 of their income came instead from dividends, income, and capital gains, how much surtax do they owe?*

Solution to Planning with Retirement Distributions

- $45,000 would be subject to 3.8% Medicare surtax, because Jack & Jill have $45,000 in investment income above $250,000. <u>Thus, Jack and Jill owe NII of $1,710 (3.8 X $45,000).</u>

Timing Qualified Plan and IRA Distributions

- Shifting some or all of traditional IRA or qualified plan assets to Roth accounts over time could control the taxable income clients recognize in any one year.
- This strategy can be worthwhile for clients who expect that income will rise above MAGI thresholds later in retirement when they are taking Social Security and qualified plan withdrawals.
- Roth IRA conversion income will count toward MAGI.
- Roth IRA distributions are not included in net investment income and the surtax.

NII Tax on Gain of Personal Residence Sale

- The NII tax will not apply to any amount of gain that is excluded from gross income for regular income tax purposes.

- IRC section 121 statutory exclusion exempts the first $250,000 ($500,000 for married couples) of gain recognized on the sale of a principal residence from gross income and NII tax.

- **Example** – Bill and Mallory, a married couple, sell their principal residence that they have owned and resided in the last 7 years for $1.4 million. Bill and Mallory's cost basis in the home is $800,000. Bill and Mallory's realized gain on the sale is $600,000. They collectively earn $75,000 in wages and have $125,000 of NII. *How much NII tax do Bill and Mallory owe?*

Solution to NII Tax on Personal Residence Sale

- Bill & Mallory's realized gain on sale is $600,000. Recognized gain subject to regular income taxes is $100,000 ($600,000 realized gain less the $500,000 Section 121 exclusion).

- Bill and Mallory have total NII of $225,000 ($100,000 recognized gain + $125,000 NII).

- Their Modified Gross Income is $300,000 ($225,000 total NII + $75,000 wages) and exceeds the threshold amount of $250,000 by $50,000. Bill & Mallory are subject to NII on the lesser of $225,000 or $50,000. They owe NII of $1,900, which is $50,000 X 3.8% Medicare Surtax.

Creating Material Participation in Passive Activities

- The automatic inclusion of rental property in passive activities does not apply to real estate professionals.

- NII is investment income reduced by properly allocable deductions, and investment income includes trade or business income that is a passive activity with respect to the taxpayer.

- Passive income is subject to the surtax. Losses are disallowed for passive activities and carried forward to future years.

- Avoid the characterization of an activity as passive to minimize the 3.8 percent Medicare surtax. An activity is not passive if the taxpayer materially participates.

Viable Wealth Transfer Planning

- High earners can gift ordinary income or net income producing property by outright transfer of assets to family members in a lower marginal income tax bracket.

- Gifting to a Section 529 plan can also defer taxable income.

- Family Limited Partnerships can be applied by parents to shelter a portion of their NII from the Medicare surtax, as well as to gift partnership interests to younger generations in lower tax brackets.

Charitable Planning for Surtax

- Gifting income-producing property outright to a charity can remove such asset from the taxpayer's estate and help keep MAGI below threshold limits.
- Consider gifting highly appreciated stock or property to charity, rather than selling assets and incurring as high as a 23.8% long-term capital gains tax (20% plus 3.8% surtax).
- For clients who have substantial wealth and specific large assets, you may employ conventional techniques, such as charitable remainder trusts (CRTs), charitable lead trusts (CLTs), and installment sales to defer income and save taxes.

CRTs to Mitigate Surtax

- CRTs are very useful to spread out large current capital gains. Taxpayer can spread out MAGI over annual CRT payments to avoid exceeding threshold amount in any tax year.
- Transferring property to a CRT provides your donor client with an immediate charitable income tax deduction for the present value of the remainder interest that can offset NII.
- Trust is a tax-exempt entity, and can sell the asset with no immediate gain recognition.
- Via income recognition timing, family members can benefit by receiving a level income stream during the CRT term with distributions passing later to a preferred charity.

Charitable Lead Trusts (CLTs) and Installment Sale Opportunities

- Ultra high net worth clients should consider non-grantor CLTs with current low interest rates. The CLT receives a deduction (IRC 642©) when it makes its annual distributions to the charitable lead beneficiary.

- This deduction is allocated between the NII and excluded portions of a distribution. In essence, the strategy offsets NII against charitable deductions.

- An installment sale is another technique that can spread a prodigious taxable gain over a period of time to keep MAGI below the applicable threshold amounts in the year of sale and all later years.

What Trust and Estate Income is Subject to Tax?

- Trusts and estates are separate taxable entities that receive income and pay expenses.

- For **trusts** and **estates**, the 3.8% surtax is imposed on the **lesser** of
  1. Undistributed net investment income OR the
  2. Excess of the trust/estate's adjusted gross income (AGI) over the dollar amount at which the highest estate or trust income tax bracket begins.

- Income distributed to the beneficiary of a trust or estate is generally deductible by the trust or estate and taxable to the beneficiary under the distributable net income rules.

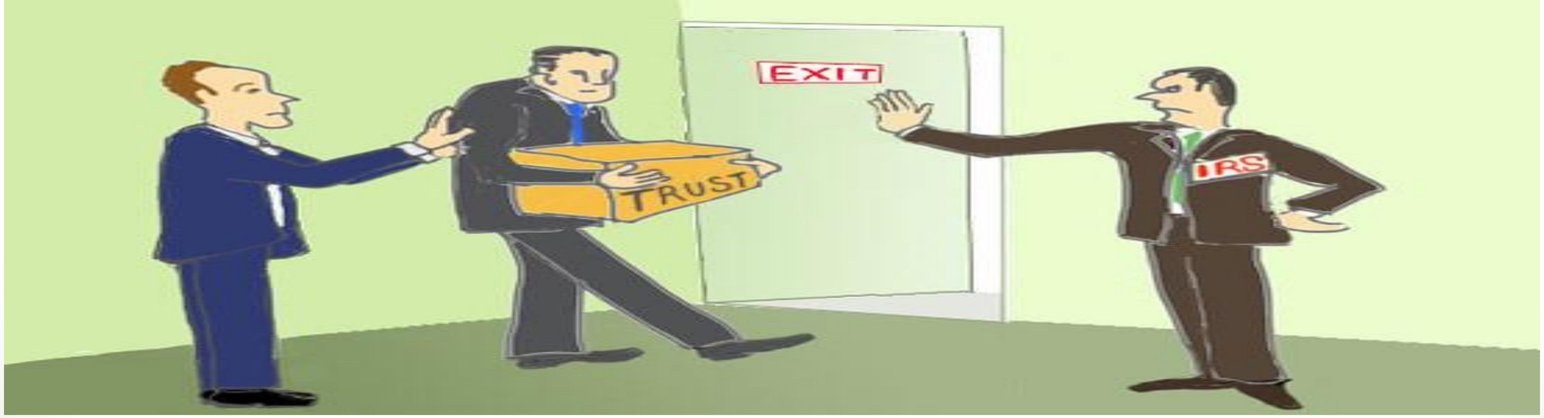
Specific Trusts Not Subject to Surtax

- A trust, all the unexpired interests of which are devoted to a charitable purpose
- A trust exempt from tax under IRC Section 501 (c)
- A charitable remainder trust
- A grantor trust
- Most foreign trusts, business trusts, and common fund trusts
- Any other trust statutorily exempt from Subtitle A taxes, such as health savings accounts and qualified tuition programs.

Calculation of the Amount of Surtax Payable for Trusts

- **Example 1** – A trust subject to the surtax received $26,000 of dividends in 2016 and made no distributions. *How much surtax is payable?*

- ***Example 2*** – Assume the same facts as in Example 1, except that $13,600 of the trust income was distributed to beneficiaries. *How much surtax is payable?*



Solutions to Surtax Payable for Trusts Examples

- **Example 1** – For 2016, the threshold amount is $12,400. $13,600 is subject to the Medicare surtax ($26,000 - $12,400). 3.8% surtax applies to $13,600, which means that the surtax payable is <u>$516.80 (3.8% X $13,600)</u>.

- **Example 2** – <u>The trust will pay no surtax because its undistributed income does not exceed $12,400</u>. The beneficiaries will add the $13,600 to their own NII and MAGI. They may be subject to the surtax depending on NII and MAGI amounts on their income tax returns.

Limiting the Surtax with Trust and Estate Distributions

- Educate clients who are trustees or beneficiaries of an estate or trust on strategies that will be effective in limiting the new Medicare surtax. The surtax applies **only** to the undistributed NII of a trust or estate.

- Generally, if income is accumulated, then the income is taxed to the trust/estate. If income is distributed, then the trust/estate gets an income tax deduction and beneficiaries report taxable income.

- Advise trustees to increase NII distributions to beneficiaries who are in low income tax brackets, to be taxed at their lower rates, rather than at the trust/estate rate (39.6% after the $12,400 threshold is reached).

Caveats for Managing Trust and Estate Distributions

- Factor in low federal trust and estate tax threshold for income distributions from trusts.

- Distributions must be consistent with governing instrument and fiduciary duties.

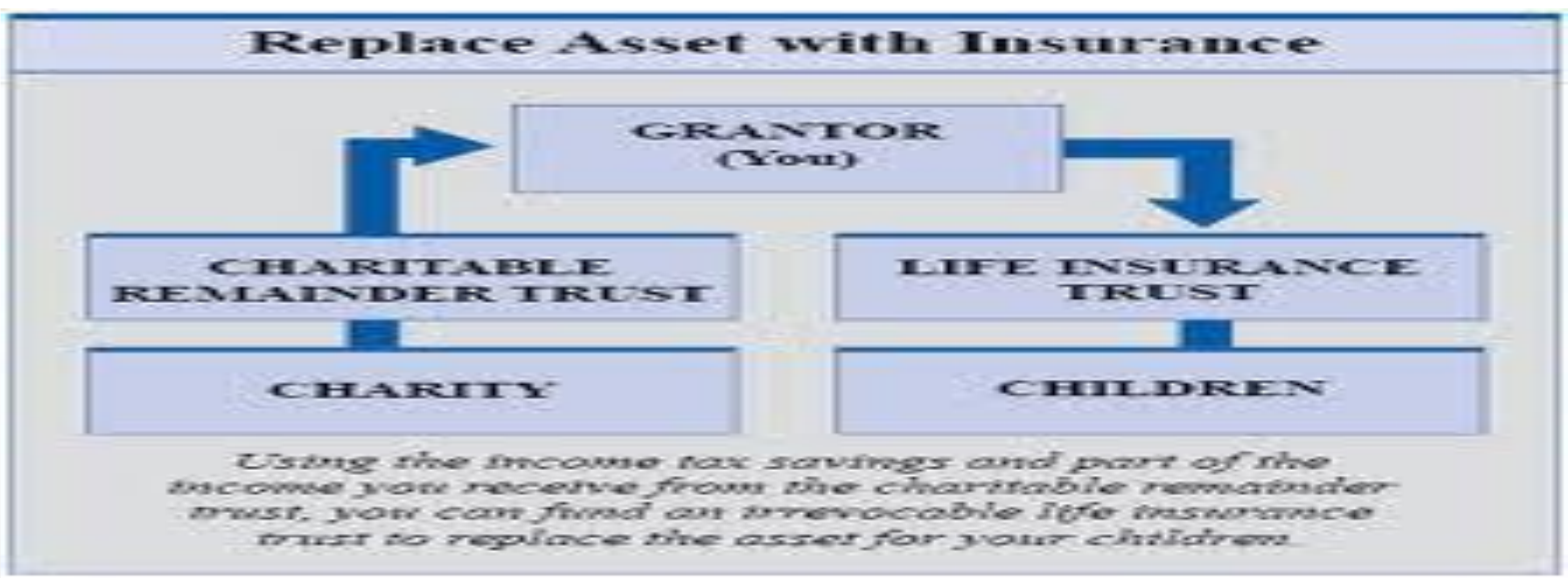
- Check with fiduciaries for other implications, such as the possible disadvantages of exposing the allocated assets to a divorcing spouse or creditor.

- Account for the effects of shifting income on high income beneficiaries already subject to the surtax.

Suitable Trust and Estate Investments to Mitigate Surtax

- Reduce capital gains via low turn-over funds and decrease taxable interest income by utilizing tax-exempt bonds.

- Consider the tax-deferred growth and tax-free death benefit of life insurance in trusts and estates.



Devising Strategies for 0.9% Medicare Payroll Tax

- There is a separate 0.9 percent Medicare payroll tax on earned income (including wages and net self-employment income) above MAGI thresholds.

- High earning pre-retirees, self-employed individuals, and employees with substantial company stock benefits should plan for this additional Medicare tax.
  - Make projections related to expected income payments
  - Time cash flows accordingly over the next several years

- Collaborate with clients’ employers and tax professionals when exercising stock options or accelerating income payments to lessen the impact of high MAGI in subsequent years when investment income may be high.

Planning for Itemized Deductions

- Medical expenses, investment interest expense, and casualty or theft losses are itemized deductions *protected* from application of the phase-out.

- Home mortgage interest, charitable contributions, and state and local taxes are *unprotected* itemized deductions considered in calculating the phase-out.

- Ultra-wealthy taxpayers are likely to receive the full benefit of any increase in itemized deductions. The Pease limitation does not necessarily affect the tax deductibility of charitable giving.

Bottom Line on Mitigating Top Income Taxes

- Evaluate proactive income tax minimization techniques in tandem with the other elements of clients' overall plans to determine if they fulfill their immediate and future goals.

- Careful tax projections should be prepared to determine the potential benefit prior to engaging planning strategies.

- Efficient coordination with estate and tax specialists is essential to facilitate a continuous strategic plan.

- Initiate meetings as a team to present timely wealth planning solutions to your clients in the top tax bracket.

Questions? Please Contact Me. Thank You.

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