Tax Planning Considerations

Executive summary

You may think of the period leading up to the April 15th tax-filing deadline as "tax season," but the reality for most of us is that the real tax season comes at the end of the calendar year. This is the time to carefully assess your personal financial situation to determine if you can take steps to reduce your tax burden when you file your 2013 tax return.

Conducting a tax review annually makes sense because tax laws are constantly changing, as are your own life circumstances. Strategies that may have worked last year might not be appropriate now. As far as the tax code is concerned, 2013 is a year where significant changes have taken effect.

Timing is especially important. If you do discover ways to reduce your tax burden this year, you'll most likely have to take action prior to year's end if the savings are to be reflected on your 2013 tax return.

Other strategies may not be specific to a single year's tax returns. They could have longer-term implications for you. A year-end tax review presents the perfect opportunity to assess and potentially incorporate other tax strategies that seem appropriate for your long-term wealth planning objectives.

This paper reviews strategies that may be specific to your 2013 tax situation, while also exploring potential tax-saving opportunities that may be beneficial to you over the long run.

Year-end tax planning opportunities—key issues to address

The most notable changes to the tax code this year include new tax rates that affect higher income individuals and families. Some laws are set to expire at the end of the year, giving you one last opportunity to capitalize on them. Others relate to long-standing elements of the tax code that are still worth your consideration. Here is a rundown of a number of issues that are time-sensitive as the clock winds down on 2013.

The return of a higher tax bracket plus a new surtax for wage earners

Income over $400,000 for single tax filers and above $450,000 for married couples filing a joint return is subject to the 39.6 percent tax bracket (compared to the previous top rate of 35 percent). This means income that exceeds those thresholds will be subject to $46 more of federal income tax on every $1,000 earned above these income levels.
In short, this means taxpayers at the highest levels could pay federal tax of 23.8 percent on assets sold for a gain that are held for at least one year and on qualified dividend income received. This compares to a 15 percent tax rate in 2012. It represents $88 more in tax on every $1,000 of investment earnings above the threshold amount in 2013 compared to 2012.

It is important to carefully assess the tax impact of any investment strategies you consider as the year comes to a close. If you decide to sell an asset, will the additional tax make any realized gains less valuable? Would it be worth it to delay selling the asset until a future date when you may not be subject to such a significant tax rate? Do you hold positions that would generate a capital loss if sold that could offset any gains? There is no single right answer, and investment considerations need to be the primary factor in your decision. Still, tax implications are more important to consider this year than in prior years given the new tax environment.

**Restored limitation on itemized deductions**

Another factor could result in higher taxes beginning in 2013. Married couples with adjusted gross income (AGI) of more than $300,000 and single tax filers with AGI above $250,000 will be subject to a limitation on itemized deductions. The limitation is the lesser of:

- 3 percent of AGI above the threshold amount
- 80 percent of total itemized deductions

This can reduce the benefit of deductions, but it does not eliminate the value of deductions such as mortgage interest, property taxes, state income taxes or charitable contributions. Again, managing income carefully if you are close to threshold amounts is critical.

**Defer income if you can**

To avoid or delay paying higher tax rates, there are steps you can take to defer income in 2013:

- Make pre-tax contributions to workplace savings plans (401(k)s, 403(b)s, etc.)
- Invest in municipal bonds to generate income that is not subject to income tax or the new 3.8 percent Medicare surtax
- Make maximum contributions to your Health Savings Account if you have such a health insurance plan
- Manage asset sales and harvest losses if possible to limit the amount of income or gain that must be recognized in a single year

**New taxes and tax rates on investment income**

Higher income individuals also need to be aware that they may pay more for taxable investment income in 2013 than was the case previously. This occurs in two forms:

- An increase in the tax on long-term capital gains and qualifying dividends from 15 percent to 20 percent for those that are in the 39.6 percent tax bracket.
- A new 3.8 percent Medicare surtax on net investment income (NII) for individuals with Modified Adjusted Gross Income (MAGI) above $200,000 or married couples with MAGI above $250,000.

Note the impact on a married couple filing a joint return in 2013 with taxable income of $550,000 compared to that same couple with the same income in 2012:

<table>
<thead>
<tr>
<th>Year</th>
<th>Income tax due on last $100,000 of taxable income</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>$35,000</td>
</tr>
<tr>
<td>2013</td>
<td>$39,600</td>
</tr>
</tbody>
</table>

Another impact for those earning higher incomes is the new 0.9 percent Medicare surtax on earned income. This applies for income above $200,000 for single tax filers and $250,000 for married couples filing a joint return. In this case, for each $1,000 you earn above those threshold amounts, an additional $9 in FICA taxes will apply, raising the individual portion of the Medicare tax to 2.35 percent (from the standard 1.45 percent). Again, note the impact of the Medicare surtax on a married couple filing a joint return in 2013 with taxable earned income of $550,000 compared to that same couple with the same income in 2012:

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Medicare portion of FICA tax due (on $550,000 of earned income)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>$7,975</td>
</tr>
<tr>
<td>2013</td>
<td>$10,675</td>
</tr>
</tbody>
</table>

Based on wages alone, this couple would owe an additional $7,300 in 2013 compared to the previous year (this assumes earnings were comparable from an inflation-adjusted standpoint in 2012 and 2013) through a combination of higher income taxes and the new Medicare surtax based on comparable earned income.

This is an example of where the concept of “bracket management” can come into play. To the extent you can manage your income, you may want to try to delay receiving some income in 2013 if it will help you avoid either the Medicare surtax or the new, highest income tax bracket.
Make charitable contributions before the end of the year
Most of us recognize the importance of timeliness when it comes to charitable contributions. Generally, they need to be made by the end of the year in order to claim them as a deduction on our taxes in that year. There are some specific strategies to consider that may be particularly applicable in 2013:

- Consider contributing appreciated stock to qualified charities in 2013. This creates a healthy tax deduction for you, and it also helps you avoid having to pay taxes on the appreciated stock. If you are near the threshold level that would make you subject to the 20 percent capital gains tax rate (instead of 15 percent), this move can be particularly beneficial.

- Take advantage of the Charitable IRA Rollover provision in the tax code that is set to expire at the end of 2013. If you are age 70 and a half or older, you can direct a distribution to a qualified charity or charities, with the total distribution not to exceed $100,000. This distribution is excluded as part of your taxable income. This can be particularly useful if you must take required minimum distributions from your Traditional IRA, as the charitable rollover can satisfy those requirements.

Group deductions in the same year when possible
To help manage your income level (and perhaps keep you in a lower tax bracket), consider grouping deductible expenses in the same year. For example, if you can make your 2014 property tax payment prior to the end of this year, you may want to do so to claim a higher deduction this year (however, you will not be able to claim that deduction in 2014). Also make sure mortgage payments due in January are paid in December so you can deduct the interest in 2013.

Make big ticket purchases if claiming a sales tax deduction
As current law stands, 2013 will be the last year you can elect to deduct state and local sales taxes rather than deducting state and local income taxes. If you plan to claim the sales tax deduction, you may want to accelerate big-ticket purchases in 2013 to take advantage of what may well be the final year of the sales tax deduction election.

Capture education tax credits
The American Opportunity Tax Credit, which provides up to a $2,500 tax credit (a dollar-for-dollar reduction of your taxes) has been extended. If you have upcoming tuition payments coming due, even in 2014, but can pay them by 2013, try to do so. The full credit can be claimed if qualified education expenses in a year total $4,000. Individuals with MAGI of $80,000 or less or married couples filing a joint return with MAGI of $160,000 or less qualify for a full credit.

Manage gifts and trusts
Individuals can claim an annual exclusion of up to $14,000 per donee for gifts in 2013. That means a couple could gift up to $28,000 of their assets to each desired donee this year without having gift taxes apply.

If you have created a trust where the trustee has discretion about distributing income to beneficiaries (or you are the trustee of such a trust), be mindful of the dramatic differential between the highest tax rates that apply to the trust versus those that apply to individual beneficiaries. While the highest individual tax rates don’t come into play until income reaches $400,000 for an individual or $450,000 for a couple, for a trust, the highest rate applies to income above $11,950. From a tax standpoint, paying out trust income above that level each year may be more efficient than holding that income in the trust and losing a large percentage of the income the trust earns to taxes.

Watch the calendar, and plan ahead
Tax planning for 2013 should not be done in a vacuum. To the extent possible, assess your income expectations and deductions for 2014 as well as 2013, and determine how best to manage the timing of income and deductions to generate the greatest tax benefit. For example, you might have a need to find more deductions in 2014 to stay below important thresholds that would result in higher tax rates. In that case, it makes sense to delay some deductions until next year.

Whatever decisions you make related to your income and taxes, they generally need to occur by December 31 of this year in order to be reflected on your 2013 tax return. The only exception for most individuals is the flexibility to delay 2013 contributions to IRAs or some other retirement plan until April 15, 2014.
Long-term tax planning issues to put on your agenda now

As you conduct a year-end review of your tax situation, there are longer-range planning issues that should be addressed as well. In some cases, this has to do with building strategies related to existing tax laws, and in other situations, it involves maintaining a position that is flexible to respond to inevitable alterations to the tax code down the road.

Prepare for potential future tax rate changes

Nobody knows exactly how tax policy might change in the future, but there is speculation that today’s currently low tax rates (ranging from 0 percent to 20 percent, depending on your tax bracket) for long-term capital gains and qualifying dividends will rise. If you are considering selling an asset (stocks, property, business, etc.) that you have held for more than a year, this is an issue to watch carefully. Tax rates may be more favorable now than in the future as the government tries to structure a tax policy that helps deal with its deficit issues.

Plan ahead for new laws that will persist

The Medicare surtax (3.8 percent on net investment income and 0.9 percent on earned income) that applies to individuals at higher income levels will most likely be around for some time. Individuals and families who meet the threshold level, both while working and in retirement, need to adjust their income expectations accordingly and, where possible, take steps to manage income from year-to-year to minimize the impact of this new tax.

One strategy to consider is to begin converting retirement assets (from workplace plans or Traditional IRAs) to Roth IRAs. If you think you might be subject to the 3.8 percent Medicare surtax on net investment income in retirement, this could work to your advantage, as Roth IRA distributions are excluded from the calculation of income and not subject to this new tax. Remember, however, that when you convert dollars to a Roth IRA, any earnings and pre-tax contributions being converted are subject to current income tax. Given the elevated tax rates that apply for higher income individuals, you may want to consider doing a Roth conversion in stages to keep your income below the highest tax thresholds.

The same strategy applies to selling large assets, such as a business or property. To avoid having the sale push you into the highest tax brackets, consider using installment sales—for example, having payments made to you over a period of years. Even though the buyer is contractually obligated to make all future payments, gains are prorated and taxed as you collect the payments.

Another way to manage your tax liability is to create a Charitable Remainder Trust (CRT). Transferring property to a CRT provides the donor with an immediate charitable income tax deduction equal to the present value of the remainder interest passing to a qualified charity. Investment income generated inside a CRT is exempt from the surtax. In a typical CRT, the owner receives annual income over its term, spreading out the tax liability and exposure to the surtax. The ability to contribute and sell highly appreciated assets inside a CRT helps the owner delay and even potentially eliminate the Medicare surtax liability. This can be an attractive tool for those with charitable intentions to efficiently structure a long-term income stream.

Build strategies to capitalize on new estate tax rates

After years of constant change, estate tax rates now in place have no expiration date. This gives you the ability to map out strategies more effectively for the long term with a reasonable expectation that tax rates and exemption amounts will remain consistent for several years.

In 2013, the first $5.25 million of an individual’s estate is exempt from estate taxes. In effect, this amount reaches $10.5 million for a couple, because when one spouse dies, the value of the unused exemption is portable and can be added to the exemption of the surviving spouse. This eliminates estate tax concerns for a large percentage of households. Still, there are techniques and strategies that can allow for the more efficient transfer of assets during your lifetime and after.

Another important point to remember is that estate tax laws at the state level are not necessarily aligned with federal estate tax laws. Exemption amounts at the state level may be lower, and an estate that is not subject to federal estate tax may still be taxed by the state of residence.
Be sure to consult with your tax and legal advisors to determine the best solutions for your personal circumstances. Some strategies that may be appropriate for you include:

**Grantor Remained Annuity Trusts (GRATs)** – This has become an extremely attractive way to pass on assets in a trust free of estate taxes, because of today’s low interest rate environment. The Internal Revenue Service sets a threshold interest rate during the term of the GRAT. Earnings on assets put into a GRAT to the extent that they outperform the threshold interest rate, accumulate free of gift tax. With the threshold rates so low today, the likelihood of earning a higher return in the trust is increased. Many choose to set GRATs for a limited term, such as two years, and then roll assets into a new GRAT after each expires. You must survive the term of the GRAT in order to achieve the gift tax savings.

**Asset Protection Trusts** – These are trusts that are most beneficial for professionals who want to protect against possible future liabilities. Medical professionals, for example, who may be subject to lawsuits in the future, often use these. Assets set aside in the trust are protected from future liabilities, helping to preserve the estate.

**Intentionally Defective Grantor Trusts (IDGTs)** – These are trusts that are purposely created with a flaw. You place assets in the trust, which reduces the value of your estate. However, you continue to pay income taxes on earnings generated by those assets. When you pay income taxes, you are, in effect, transferring wealth with no gift tax consequences. This is particularly attractive for assets with the potential to appreciate considerably over time.

**Spousal Access Trusts** – The gift tax annual exclusion ($14,000 per donee in 2013) and lifetime exemption ($5.25 million in 2013) can be used to fund an irrevocable trust for the benefit of your spouse. The assets gifted are removed from your estate, but your spouse retains access to the cash flow from the gifted assets during your spouse’s lifetime.

**Qualified Personal Residence Trusts (QPRTs)** – This allows you to transfer a primary or second home to a trust while retaining the right to live in the home rent-free during the term of the trust. A taxable gift is made at the time of the transfer, but the value of the gift is less than the actual property value as you retain the right to live in the home. You can apply a portion of your $5.25 million exemption to avoid paying gift tax. If you survive the expiration of the trust’s term, the home passes to your beneficiaries free of estate and gift tax.

**Conclusion**
Tax planning is always challenging due to the complexity and ever-changing nature of our tax laws. Because of the constant shifting of tax policy, the need for planning becomes even more imperative if you are serious about minimizing your tax liability today and over time. Smart decisions and appropriate implementation of strategies suited to your circumstances and fully leveraging the opportunities that exist in the tax code can result in significant tax savings. Be certain that any decisions you make from a tax perspective are also in the interests of your overall wealth plan.

As always, the expertise of your tax and financial advisors, and in some cases, legal professionals, is vital in any decisions you make on important tax matters. U.S. Bank is ready to work with you and other advisors on your team to make sure your tax plan is consistent with the wealth planning objectives you’ve identified.
Tax rates are a moving target

Tax rates have varied widely over the past century, since the income tax was permanently instituted. As the chart indicates, the tax burden for those who reach the highest marginal tax bracket has been much higher at times than is the case today. Still, today’s highest marginal tax rate, 39.6% (the rate that applies to income above $400,000 for individuals and $450,000 for married couples filing a joint return) is higher today than was the case from 2001 to 2012. Today’s 39.6% marginal tax rate is also higher than the rates that applied to those in the top tax bracket in the late 1980s and early 1990s (note that the income level that applies to the highest marginal tax rate is not consistent year-after-year).

Since the factors that impact tax decisions can vary from year-to-year, tax planning needs to be an annual event. Income tax rates are only one consideration. Other factors that will impact your tax liability include rules around deductions and personal exemptions, FICA taxes (Social Security and Medicare), surtaxes, and state and local taxes. Working with qualified professionals who can help you understand the impact of higher tax rates and strategies to limit your liability should be part of your annual wealth planning agenda.