Cutting Edge Tax Planning Developments & Opportunities

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A New Era Of Tax Stability?

- American Taxpayer Relief Act of 2012 (ATRA)
  - "Permanently" ended the fiscal cliff sunsets
- Budget deficits & debt ceiling challenges remain
  - Gridlock = status quo for the foreseeable future?
    - At least until 2016 elections?
  - Corporate tax reform vs individual tax reform vs "loophole closing"

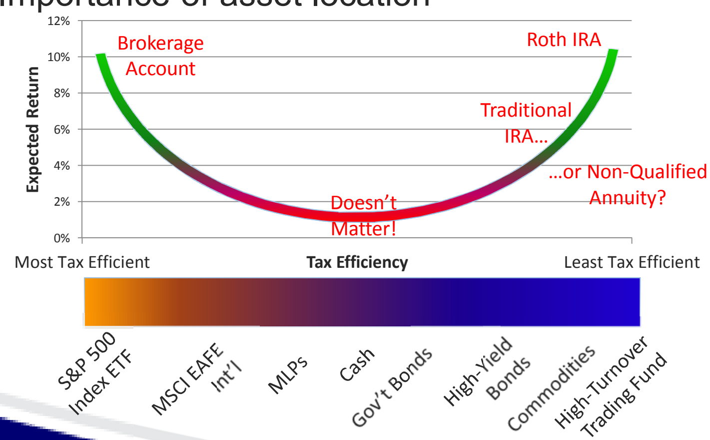
Individual Income Taxes

- ATRA created "new" 7-bracket tax system
  - Compressed 35% tax bracket, more progressive system

Individuals		Married Couples
Taxable Income	Tax Bracket	Taxable Income
Up to $9,225	10%	Up to $18,450
Over $9,225 and up to $37,450	15%	Over $18,450 and up to $74,900
Over $37,450 and up to $90,750	25%	Over $74,900 and up to $151,200
Over $90,750 and up to $189,300	28%	Over $151,200 and up to $230,450
Over $189,300 and up to $411,500	33%	Over $230,450 and up to $411,500
Over $411,500 and up to $413,200	35%	Over $411,500 and up to $464,850
More than $413,200	39.6%	More than $464,850

Individual Income Taxes – Planning Implications

- Importance of asset location



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Individual Income Taxes – Planning Implications

- Tax Bracket Arbitrage

Avoid/defer income here

Tax Bracket
39.6%
35%
33%
28%
25%
15%
10%

Harvest/accelerate income here

Individual Income Taxes – Planning Implications

- Tax Bracket Arbitrage – smoothing income over time
  - Roth conversions
  - Capital gains harvesting

Deferring Income

Age 65	Age 66	Age 67	Age 68	Age 69	Age 70	Age 71
39.6%	39.6%	39.6%	39.6%	39.6%	39.6%	39.6%
35%	35%	35%	35%	35%	35%	35%
33%	33%	33%	33%	33%	33%	33%
28%	28%	28%	28%	28%	28%	28%
25%	25%	25%	25%	25%	25%	25%
15%	15%	15%	15%	15%	15%	15%
10%	10%	10%	10%	10%	10%	10%

Harvesting Income

Age 65	Age 66	Age 67	Age 68	Age 69	Age 70	Age 71
39.6%	39.6%	39.6%	39.6%	39.6%	39.6%	39.6%
35%	35%	35%	35%	35%	35%	35%
33%	33%	33%	33%	33%	33%	33%
28%	28%	28%	28%	28%	28%	28%
25%	25%	25%	25%	25%	25%	25%
15%	15%	15%	15%	15%	15%	15%
10%	10%	10%	10%	10%	10%	10%

Phaseout of Exemptions & Deductions

- Prior law included phaseout of personal exemptions and itemized deductions for high-income taxpayers
  - Phased out 2006-2009
  - Eliminated 2010-2012
  - (Permanently) returned in 2013

Phaseout of Exemptions & Deductions

- "Pease limitation" on itemized deductions
  - Itemized deductions phased out by 3% of income over threshold, up to 80% of total deductions
- Personal Exemption Phaseout (PEP)
  - Personal exemptions phased out by 2% per $2,500 over threshold, up to 100% of exemptions
- AGI thresholds: $258,250 individuals, $309,900 MFJ
  - PEP ends at $380,751 and $432,401 respectively
  - Thresholds indexed for inflation going forward

Pease & PEP – Planning Implications

- Effective result is to increase marginal tax rates
  - **Pease**: losing 3% of deductions at 33% rate = 1% increase in tax rate
  - **PEP**: marginal impact also approximately = 1% increase in *per exemption*
    - Impact greater as number of exemptions increases

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Pease & PEP – Planning Implications

- Pease + PEP push up top tax brackets
  - PEP impacts 33% + 35% tax brackets
  - Pease impacts 33%, 35%, & 39.6%
    - Cap rarely reached in practice
- Proper planning accounts for higher tax rates…
  - …*not* by avoiding deductions (e.g., charitable)!
    - Unless 80% cap has been reached
    - www.kitces.com/PeaseCharitable

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Long-Term Capital Gains

- ATRA created new top rate for long-term capital gains

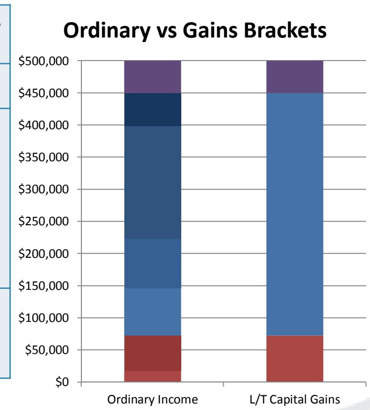
Ordinary Income Bracket	L/T Capital Gains Rate
10% or 15%	0%
25%, 28%, 33%, or 35%	15%
39.6%	20%

- Rates are graduated, just like ordinary income

Long-Term Capital Gains

- Rates are graduated, just like ordinary income

Tax Bracket	Taxable Income (Married Couple)	L/T Gains Bracket
39.6%	More than $464,850	20%
35%	Over $411,500 and up to $464,850	15%
33%	Over $230,450 and up to $411,500	
28%	Over $151,200 and up to $230,450	
25%	Over $74,900 and up to $151,200	
15%	Over $18,450 and up to $74,900	0%
10%	Up to $18,450	



Long-Term Capital Gains

- 3 brackets become 4 brackets w/ 3.8% Medicare tax

Income		
Individual	Married Couple	L/T Capital Gains Rate
Up to $37,450	Up to $74,900	0%
Up to $200,000 AGI	Up to $250,000 AGI	15%
Up to $413,200	Up to $464,850	18.8%
Over $413,200	Over $464,850	23.8%

  - Further adjusted for Pease & PEP!
- Ordinary brackets indexed, Medicare threshold *not*!

Long-Term Capital Gains – Planning Implications

- Managing the timing of capital gains
  - Deferring *or accelerating* can permanently avoid higher rates
  - Harvesting losses vs harvesting *gains*
    - Harvesting gains much easier – no wash sale rules
    - Harvest losses when income is high, gains when it's low
    - Especially appealing at 0% rates – "free" step-up in basis!

Qualified Dividends

- ATRA made qualified dividends *permanent*
  - But still tied to L/T capital gains rates
    - Including the new 3.8% Medicare tax!
- Likely little impact for most investors
  - Limited impact on after-tax yield
  - Cannot control timing of dividends anyway
- Planning opportunities for closely-held C corps
  - *Can* control the timing of dividends
  - Strategic profit distributions to manage family tax brackets?

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Lapsed Tax Extenders

- Currently lapsed *again*, may be reinstated *again*?
  - $250 schoolteacher expense deduction
  - Exclusion of discharged mortgage debt
  - Deduction for state and local sales taxes
  - Above-the-line education deduction
  - Section 179 expensing + bonus depreciation
  - Qualified Charitable Distributions from IRAs
    - Do it anyway, and see how it turns out?

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Marginal Tax Rates: Moving Target

- Tax rates exposed to numerous factors
  - Tax brackets
  - Phaseout of exemptions & deductions
  - Long-term capital gains & qualified dividends
  - AMT tax rates
  - AMT exemption phaseout
  - 3.8% Medicare tax
  - Income-related Medicare adjustments to Part B & Part D
  - Taxability of Social Security benefits

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Marginal Tax Rates: Moving Target

<table>
<tr><th colspan="13">Determining The Marginal Tax Rate For Various Types Of Income In 2014</th></tr>
<tr><th>Individual income above…</th><th>Couple's income above…</th><th>Income "type"</th><th>Ordinary Income</th><th>AMT rate</th><th>L/T gains & qual. dividends</th><th>Wage earned income</th><th>Self-employed earned income</th><th>Net inv. income</th><th>Itemized deduction phaseout (Pease)</th><th>Personal exemption phaseout (PEP)*</th><th>AMT exemption phaseout</th></tr>
<tr><td>$0</td><td>$0</td><td>Taxable</td><td>10%</td><td rowspan="8">26%</td><td rowspan="2">0%</td><td rowspan="3">7.65%</td><td rowspan="3">15.30%</td><td rowspan="11">0%</td><td rowspan="12">0%</td><td rowspan="12">0%</td><td rowspan="6">0%</td></tr>
<tr><td>$9,075</td><td>$18,150</td><td>Taxable</td><td>15%</td></tr>
<tr><td>$36,900</td><td>$73,800</td><td>Taxable</td><td rowspan="2">25%</td><td rowspan="15">15%</td></tr>
<tr><td>N/A</td><td>$117,000</td><td>Earned</td><td rowspan="2">7.65% / 1.45%</td><td rowspan="2">15.30% / 2.9%</td></tr>
<tr><td>$89,350</td><td>$148,850</td><td>Taxable</td><td rowspan="5">28%</td></tr>
<tr><td>$117,000</td><td>N/A</td><td>Earned</td><td rowspan="5">1.45%</td><td rowspan="5">2.90%</td></tr>
<tr><td>$117,300</td><td>N/A</td><td>AMTI</td><td>6.5% / 0%</td></tr>
<tr><td>N/A</td><td>$156,500</td><td>AMTI</td><td>6.5%</td></tr>
<tr><td>$182,500</td><td>$182,500</td><td>AMTI</td><td rowspan="11">28%</td><td rowspan="5">7%</td></tr>
<tr><td>$186,350</td><td>$226,850</td><td>Taxable</td><td rowspan="6">33%</td></tr>
<tr><td>$200,000</td><td>$250,000</td><td>Earned</td><td rowspan="9">2.35%</td><td rowspan="9">3.80%</td></tr>
<tr><td>$200,000</td><td>$250,000</td><td>AGI</td><td rowspan="8">3.80%</td></tr>
<tr><td>$254,200</td><td>$305,050</td><td>AGI</td><td rowspan="3">1%</td><td rowspan="2">1%</td></tr>
<tr><td>$328,500</td><td>N/A</td><td>AMTI</td><td rowspan="5">0% / 7%</td></tr>
<tr><td>$376,700</td><td>N/A</td><td>AGI</td><td>0% / 1%</td></tr>
<tr><td>$405,100</td><td>$405,100</td><td>Taxable</td><td rowspan="2">35%</td><td rowspan="2">1.05%</td><td>0% / 1.1%</td></tr>
<tr><td>N/A</td><td>$427,550</td><td>AGI</td><td rowspan="3">0%</td></tr>
<tr><td>$406,750</td><td>$457,600</td><td>Taxable</td><td rowspan="2">39.6%</td><td rowspan="2">20%</td><td rowspan="2">1.2%</td></tr>
<tr><td>N/A</td><td>$487,700</td><td>AMTI</td><td>0%</td></tr>
</table>

Income thresholds based on estimated 2014 inflation adjustments (where applicable).
Where two rates are shown, the first applies to individuals, the second to married couples
* Phaseout *per exemption*

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Converting After-Tax 401(k) $$$

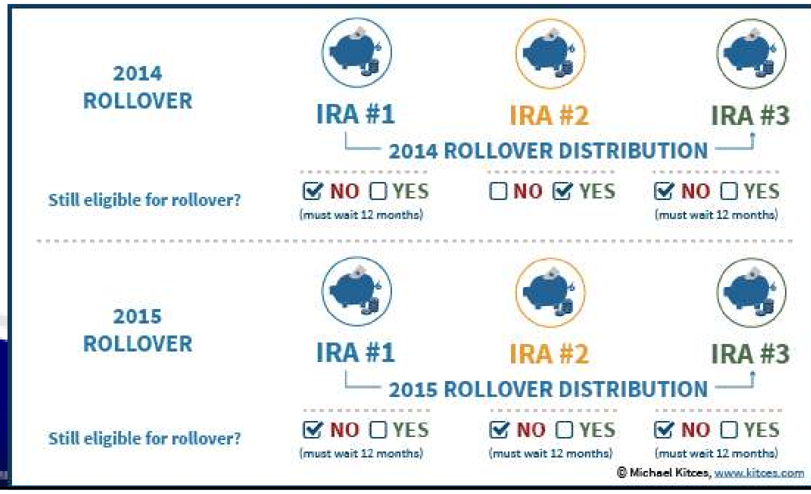
- "Splitting" after-tax 401(k) $$$ for Roth conversion
  - Plan administrators issuing "two checks"
    - Intended when only *one* check is rolled over!
  - IRS indicated pro-rata treatment in IRS Notice 2009-68
- IRS Notice 2014-54 *reverses position*
  - Allows after-tax portion of "two checks" distribution to be allocated *however the taxpayer wishes*
    - Applies going forward, "reasonable" retroactively

Converting After-Tax 401(k) $$$

- Individual has $250k in a 401(k) plan including $50k of after-tax contributions
  - Distributes $50k, deemed $10k of after-tax (pro-rata)
  - Receives two checks ($10k & $40k), sends $10k to Roth and $40k to rollover
  - Can choose to allocate all $10k of after-tax to the $10k Roth!
- Incentivizes after-tax 401(k) contributions?
  - But watch out for ACP test?

New IRA Rollover Rules

- *Bobrow v. Commissioner* (2014)
  - IRA aggregation rule applies *for once-per-year rollover rules*



"Backdoor" Roth Contributions

- Backdoor Roth IRA Contributions
  - For high-income clients to get money into a Roth
    - Contribute to a non-deductible, then convert

- Beware of:
  - IRA aggregation rule
  - Step transaction doctrine?
    - Allow a time lag between contribution & conversion?

New 529A(BLE) Accounts For Special Needs

- 2014 Tax Extenders legislation creates new 529A
  - 529-ABLE plans designed for special needs beneficiaries
    - Tax-free qualified distributions for education, housing, health, etc.
  - Specifically for disabled beneficiaries
  - Able to accumulate without disqualifying Federal/state aid
    - May require Medicaid payback
  - Run by states, *must use in-state plan*
    - Still subject to existing 529 plan maximum contribution limits
  - Potential alternative for “simple” special needs trusts?

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Questions?

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