

# 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 remain
  - Gridlock = status quo for the foreseeable future?
    - At least until after 2016 elections?
  - 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 \$9,275	10%	Up to \$18,550
Over \$9,275 and up to \$37,650	15%	Over \$18,550 and up to \$75,300
Over \$37,650 and up to \$91,150	25%	Over \$75,300 and up to \$151,900
Over \$91,150 and up to \$190,150	28%	Over \$151,900 and up to \$231,450
Over \$190,150 and up to \$413,350	33%	Over \$231,450 and up to \$413,350
Over \$413,350 and up to \$415,050	35%	Over \$413,350 and up to \$466,950
More than \$415,050	39.6%	More than \$466,950

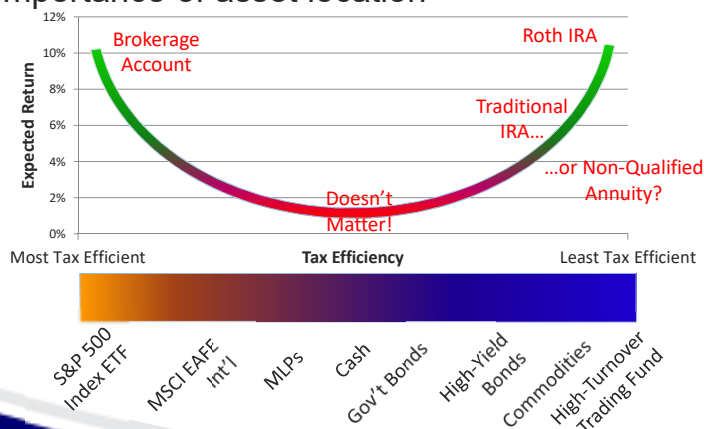
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## INDIVIDUAL INCOME TAXES – PLANNING IMPLICATIONS

- Importance of asset location



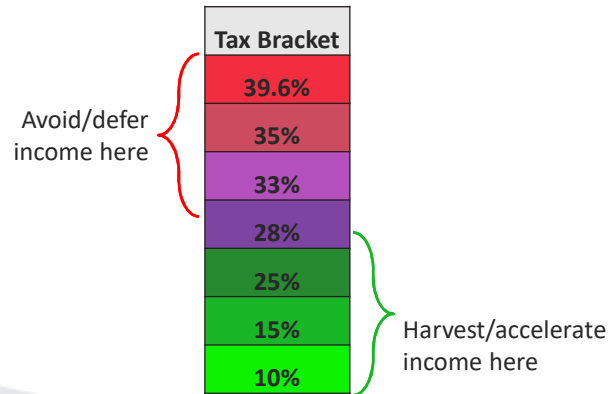
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## INDIVIDUAL INCOME TAXES – PLANNING IMPLICATIONS

- Tax Bracket Arbitrage



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## 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%

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## 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

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## 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: \$259,400 individuals, 311,300 MFJ
  - PEP ends at \$381,901 and \$433,801 respectively
  - Thresholds indexed for inflation going forward

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## 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](http://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

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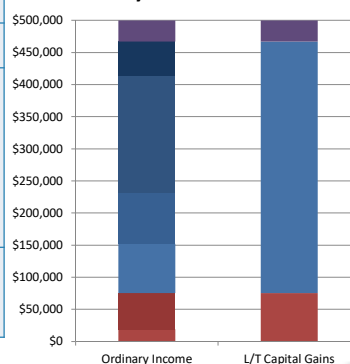
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## LONG-TERM CAPITAL GAINS

- Rates are graduated, just like ordinary income

Tax Bracket	Taxable Income (Married Couple)	L/T Gains Bracket
39.6%	More than \$466,950	20%
35%	Over \$413,350 and up to \$466,950	15%
33%	Over \$231,450 and up to \$413,350	
28%	Over \$151,900 and up to \$231,450	
25%	Over \$75,300 and up to \$151,900	
15%	Over \$18,550 and up to \$75,300	0%
10%	Up to \$18,550	

Ordinary vs Gains Brackets



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## 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 \$37,650	Up to \$75,300	0%
Up to \$200,000 AGI	Up to \$250,000 AGI	15%
Up to \$415,050	Up to \$466,950	18.8%
Over \$415,050	Over \$466,950	23.8%

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

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## 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!

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## ALTERNATIVE MINIMUM TAX (AMT) RELIEF

- ATRA made numerous *permanent* AMT changes
  - Retroactively patched 2012 AMT exemption
    - \$Up to \$83,800 MFJ & \$53,900 for individuals in 2016
- Resolved “AMT creep” by adding *permanent* inflation-indexing for:
  - AMT exemption amount
  - Exemption phaseout threshold
  - 28% bracket threshold

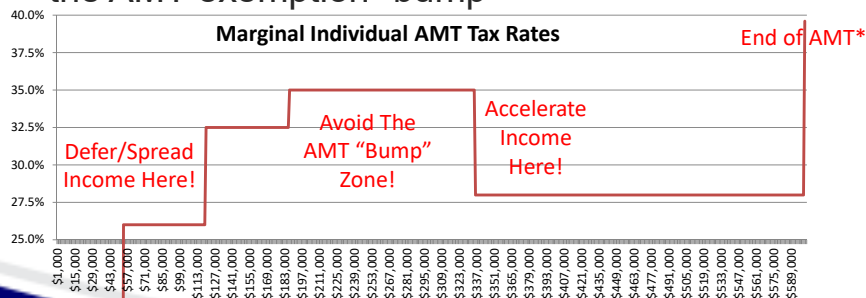
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## AMT RELIEF – PLANNING IMPLICATIONS

- AMT planning remains relevant
  - *Defer or accelerate* income to manage the AMT exemption “bump”



\* AMT endpoint depends on specific adjustments/preferences

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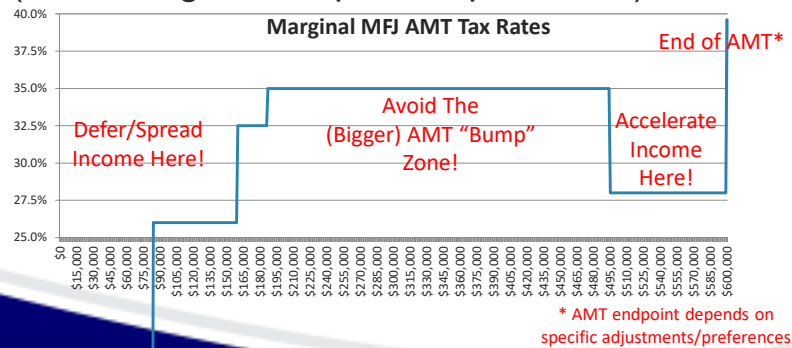
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## AMT RELIEF – PLANNING IMPLICATIONS

- AMT planning remains relevant
  - Bigger AMT “bump” zone for married couples (due to larger exemption to phase 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

Determining The Marginal Tax Rate For Various Types Of Income In 2016

Individual income above...	Couple's income above...	Income "type"	Ordinary Income	L/T gains & qual. dividends	Wage earned income	Self-employed earned income	Net inv. income	Itemized deduction phaseout (Pease)	Personal exemption phaseout (PEP)*	AMT rate	AMT exemption phaseout
\$0	\$0	Taxable	10%	0%							
\$9,275	\$18,550	Taxable	15%		7.65%	15.30%					
\$37,650	\$75,300	Taxable	25%							26%	0%
N/A	\$118,500	Earned			7.65% / 1.45%	15.3% / 2.9%					
\$91,150	\$151,900	Taxable	28%				0%	0%	0%		
\$118,500	N/A	Earned									6.5%
\$119,700	\$159,700	AMTI			1.45%	2.90%					
\$186,300	\$186,300	AMTI									
\$190,150	\$231,450	Taxable		15%							
\$200,000	\$250,000	Earned									7%
\$200,000	\$250,000	AGI									
\$259,400	\$311,300	AGI	33%								
\$335,300	N/A	AMTI									
\$381,900	N/A	AGI						1%	1%	28%	
\$413,350	\$413,350	Taxable							0% / 1%		
N/A	\$433,800	AGI	35%				3.80%	1.05%	0% / 1.1%		0% / 7%
\$415,050	\$466,950	Taxable									
N/A	\$494,900	AMTI	39.6%	20%				1.2%	0%		0%

Income thresholds based on estimated 2016 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

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## 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?

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## “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?

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## QCDs FROM IRAS

- Qualified Charitable Distributions made permanent
  - Must be at least age 70 ½ (but satisfies the RMD)
  - Up to \$100,000/year (per taxpayer)
  - Must go directly from the IRA to a (qualified) charity
  - A perfect “pre-tax” charitable contribution
- Superior to taking RMDs and ‘just’ donating cash...
  - But still not as good as donating appreciated securities?

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