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2013 Year-End Tax and Estate Planning Opportunities

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The 2013 year-end lacks the high drama of the 2012 year-end, which had tax and estate planning advisors scrambling through December 31st in light of the impending fiscal cliff and its December 31, 2012 expiration date to favorable exclusion amounts and tax rates. The 2012 year-end fiscal cliff was not rectified until January 2, 2013, when President Obama signed into law The American Taxpayer Relief Act of 2012 ("ATRA").

Looking back at last December, a year-end without high drama may not be such a bad thing. Nevertheless, although the 2013 year-end may lack dramatic flair, it makes up for it through solid tax and estate planning opportunities that can save clients significant amounts of money both in the short term and in the long run. This article explores some of the top year-end tax and estate planning opportunities before the clock strikes midnight on January 1, 2014.

1. Taking Advantage of Expected Differences in Taxpayer Income and Deductions in 2013 vis-à-vis 2014

ATRA significantly impacted individual income tax planning by reviving the 39.6 percent tax bracket for higher income individuals, reviving the personal exemption phaseout ("PEP") and limitation on itemized deductions ("Pease limitation"), and increasing the maximum tax rate on qualified dividends and capital gains. In addition, the Affordable Care Act introduced two additional considerations that should be factored into the year-end planning mix for higher income taxpayers: the 3.8 percent net investment income ("NII") surtax and the new "Additional Medicare Tax."

Under ATRA, the individual income tax rates for 2013 and subsequent years are 10, 15, 25, 28, 33, 35 and 39.6 percent. (The 3.8 percent surtax on net investment income under the Affordable Care Act effectively pushes the top rate up to 43.4 percent.) The taxable income starting points for the 39.6 percent bracket in 2013 and 2014 are:

Filing Status	2013	2014
Married filing jointly and surviving spouse	$ 450,000	$ 457,600
Head of household	$ 425,000	$ 432,200
Single	$ 400,000	$ 406,750
Married filing separately	$ 225,000	$ 228,800
Estates and Trusts	$ 11,950	$ 12,150

The extremely low taxable income threshold for reaching the top tax bracket for estates and trusts is especially noteworthy, and will be discussed in more detail in the following section of this article.

Starting in 2013, ATRA raised the top rates for capital gains and qualified dividends to 20 percent, up from 15 percent. The top rate of 20 percent for capital gains and qualified dividends is generally reached at the same taxable income levels at which the 39.6 percent income tax bracket starts.

The traditional year-end planning tax strategies for cash basis taxpayers of deferring (or accelerating) the collection of income, and accelerating (or deferring) the payment of deductible expenses, should be considered. Thus, year-end planning should attempt as much as is feasible to avoid spikes in income, whether capital gains or other income, which may push income into either the 39.6 percent bracket or the 20 percent capital gains bracket. Spreading the recognition of certain income (or accelerating deductions) between 2013 and 2014, rather than recognizing it all in either 2013 or 2014, may accomplish this objective.

This is no easy task, however, because the following additional tax thresholds simultaneously apply:

A. *The 3.8 percent surtax on net investment income ("NII") under the Affordable Care Act.* The NII surtax on individuals equals 3.8 percent of the *lesser of*:

(1) Net investment income for the year, *or*

(2) The excess, if any of:

a. The individual's modified adjusted gross income ("MAGI") for the tax year, over

b. The threshold amount.

For 2013, this threshold amount is:

- $ 250,000 in the case of joint returns or a surviving spouse;
- $ 125,000 in the case of a married taxpayer filing a separate return;
- $ 200,000 in any other case involving individuals; and
- $ 11,950 in the case of estates and nongrantor trusts.

B. *The Additional Medicare Tax*, which for years beginning after December 31, 2012 increases the employee share of Medicare tax by an additional 0.9 percent of covered wages in excess of certain threshold amounts. The Additional Medicare Tax similarly imposes an additional 0.9 percent tax on self-employment income in excess of certain threshold amounts. The threshold amounts for 2013 are:

- $ 200,000 for single individuals and heads of households;
- $ 250,000 for married couples filing a joint return; and
- $ 125,000 for married individuals filing separate returns.

C. *The Alternative Minimum Tax*, which has the following exemption amounts for 2013:

- $ 51,900 for single

individuals and heads of households;

- $ 80,800 for married couples filing joint returns; and
- $ 40,400 for married individuals filing separate returns.

D. *The "Pease limitation" (named for the member of Congress who sponsored the original legislation) on itemized deductions for higher income taxpayers.* The Pease limitation reduces the total amount of a higher-income taxpayer's otherwise allowable itemized deductions by three percent of the amount by which the taxpayer's adjusted gross income exceeds an applicable threshold. However, the amount of itemized deductions cannot be reduced by more than 80 percent in total. Certain items, such as medical expenses, investment interest, and casualty, theft or wagering losses are excluded from this limitation. The "Pease limitation" applicable threshold levels for 2013 are:

- $ 300,000 for married couples and surviving spouses;
- $ 275,000 for heads of households;
- $ 250,000 for unmarried taxpayers; and
- $ 150,000 for married taxpayers filing separately.

E. *The Personal Exemption Phaseout ("PEP").* Under this phaseout, the total amount of personal exemptions that may be claimed by a taxpayer is reduced by two percent for each $ 2,500, or portion thereof (and two percent for each $ 1,250 for married couples filing separate returns) by which the taxpayer's adjusted gross income exceeds the applicable threshold level. The threshold adjusted gross income levels for the PEP for 2013 mirror those of the Pease limitation:

- $ 300,000 for married couples and surviving spouses;
- $ 275,000 for heads of households;
- $ 250,000 for unmarried taxpayers; and
- $ 150,000 for married taxpayers filing separately.

It should be noted that, beginning in 2013, the 7.5 percent of adjusted gross income threshold for the deduction of medical expenses generally increases to 10 percent. However, taxpayers (or their spouses) who are age 65 or older before the close of the tax year may continue to apply the 7.5 percent threshold for tax years through 2016.

2. Income Tax Planning for Estates and Trusts

Estates and trusts warrant special attention in year-end planning because the top tax bracket for estates and trusts of 39.6 percent (43.4 percent taking into account the 3.8 percent surcharge under the Affordable Care Act) is reached at an extremely low level ($ 11,950 for 2013 and $ 12,150 for 2014). Executors and trustees should therefore consider making distributions to beneficiaries before the year-end, which generally will pass that amount of taxable income through to the individual beneficiaries whose tax brackets are not nearly as compressed as they are for estates and trusts.

Estates and trusts have flexibility even after December 31, 2013 to engage in tax planning for 2013. Section 663(b) of the Internal Revenue Code confers an election upon executors and trustees to treat distributions to beneficiaries that occur in the first 65 days of 2014 (*i.e.*, until March 6, 2014 in the case of calendar year estates and trusts) as having been made for income tax purposes on December 31, 2013. Thus, for estates and trusts, 2013 year-end tax planning opportunities truly do not end until March 6, 2014.

3. Code Section 179 Expensing for Businesses

An enhanced Code Section 179 expense deduction is available through December 31, 2013 to taxpayers (other than estates, trusts or certain noncorporate lessors) that elect to treat the cost of qualifying property as an expense rather than as a capital expenditure. The annual dollar limitation on Code Section 179 expensing for 2013 is $ 500,000. For 2013, an annual $ 2 million overall investment limitation applies before the maximum $ 500,000 deduction gets reduced dollar-for-dollar if the taxpayer places more than $ 2 million of qualifying property in service.

In stark contrast, beginning in 2014, the maximum Code Section 179 deduction is scheduled to plummet to $ 25,000. In addition, the dollar-for-dollar phase-out ceiling is scheduled to drop to $ 200,000 in 2014.

The Section 179 deduction is also limited to the taxpayer's taxable income derived from the active conduct of any trade or business during the tax year, computed without taking into account any Section 179 deduction, deduction for self-employment taxes, net operating loss carryback or carryover, or deductions suspended under any provision. Any amount disallowed by this limitation may be carried forward and deducted in subsequent tax years, subject to the maximum dollar and investment limitations, or, if lower, the taxable income limitation in effect for the carryover year. Accordingly, the ability to take advantage of the enhanced Section 179 deduction in 2013 may be limited depending upon the client's circumstances.

4. Bonus Depreciation for Businesses

ATRA generally allows for 50 percent "bonus depreciation" during 2012 and 2013. After 2013, bonus depreciation is scheduled to expire (except for certain noncommercial aircraft and longer production period property which may be eligible for 50 percent bonus depreciation through 2014).

Qualified property for bonus depreciation purposes must be depreciable under the Modified Accelerated Cost Recovery System (MACRS) and have a recovery period of 20 years or less. These requirements encompass a wide variety of assets. In addition, the property must be *new* and placed in service (as well as acquired) before January 1, 2014 (with a corresponding date of January 1, 2015 to apply for certain noncommercial aircraft and longer production period property).

Unlike regular depreciation, under which half-year or quarter-year conventions may be required, a taxpayer is entitled to the full 50 percent bonus depreciation deduction irrespective of when during the year the asset is purchased. Therefore, advising one's client to place new property in service in December 2013 can produce immediate tax savings.

5. Recognition Period for S Corporation Built-in Gains

In the case of an S corporation that used to be a C corporation, a corporate-level tax, at the highest marginal tax rate applicable to C corporations, is imposed on an S corporation's net recognized built-in gain. This would include gains that arose prior to the conversion of a C corporation to an S corporation that is recognized by the S corporation during the recognition period. Under Section 1374 of the Internal Revenue Code, that recognition period is generally the 10-year period beginning with the first day of the first taxable year for which the corporation becomes an S corporation.

ATRA extended a reduced recognition period of five years (as opposed to ten years) for built-in gains through 2013. Accordingly, the sale or other disposition of built-in gain property before the end of 2013 should be considered by an S corporation where such property has already been held for five years or more (but for less than ten years), because after December 31, 2013, that same property must be held for at least ten years to avoid the built-in gains tax.

6. Estate, Gift and Generation-Skipping Transfer Taxes

ATRA instilled stability into the estate, gift and generation-skipping transfer (GST) tax systems by eliminating the application of expiration dates to favorable exclusion amounts and tax rates. The transfer tax system under ATRA features a unified $5,000,000 exclusion amount subject to indexing (the indexed amount is $5,250,000 for 2013, to increase to $ 5,340,000 for 2014) for each of the estate, gift and GST tax regimes, with a 40% tax rate for taxable transfers that exceed the applicable exclusion amount. In addition, this exclusion is now permanently "portable" for estate and gift tax purposes (but not for GST tax purposes) between spouses following the first spouse's death.

But when it comes to taxes, nothing is truly "permanent," because Congress possesses the ability at moment's notice to revamp the system yet again the next time it needs a revenue raiser. Of particular concern to wealthy individuals and their advisors is the Obama Administration's Fiscal 2014 Greenbook proposals which, if adopted, would effect fundamental changes to the availability and effectiveness of commonly-employed estate planning strategies, including the use of grantor trusts and grantor retained annuity trusts (GRATs).

Among other things, the Obama Administration's Fiscal Year 2014 proposals would attempt to address the "disconnect" between the income tax rules and the estate tax rules that apply to "intentionally defective grantor trusts" ("IDGTs")[1] in the case of certain *transactions with grantor trusts* that constitute a "*sale, exchange or comparable transaction* that is disregarded for income tax purposes by reason of the person's treatment as a deemed owner of the trust." In the case of such transactions, the portion of the trust attributable to the property received by the trust in that transaction (including all retained income therefrom, appreciation thereon, and reinvestments of such property), net of the amount of the consideration received by the person in that transaction, (i) would be subject to estate tax as part of the gross estate of the deemed owner, (ii) would be subject to gift tax when grantor trust status ceases as to the deemed owner during such person's lifetime, and (iii) would be treated as a gift by the deemed owner to the extent any distribution is made to another person (except in discharge of the deemed owner's obligation to such other person) during the life of the deemed owner. The transfer tax imposed by this proposal would be payable from the trust. Certain exceptions would apply. This proposal would apply to transactions entered into on or after the date of enactment.

A recent New York development also warrants attention. In November 2013, the New York State Tax Reform and Fairness Commission, a body established by Governor

Cuomo in December 2012 to conduct a comprehensive and objective review of the State's tax structure, issued its final report. The Commission was charged with developing revenue neutral policy options to modernize the tax system with the objective of increasing simplicity, fairness, economic competitiveness and affordability. Its recommendations include the following:

- To reform the New York estate tax by raising the New York estate tax exemption from $ 1 million to $ 3 million;
- To eliminate the New York GST tax, which applies to taxable distributions and taxable terminations from a trust to a "skip person" for GST tax purposes;
- To reinstate the New York gift tax, which New York repealed back in 2000; and
- To subject to New York income tax nongrantor trusts (or perhaps New York beneficiaries of such nongrantor trusts) that are currently exempt from New York income tax under the "New York resident trust exception" which applies to nongrantor trusts for which (1) all of the trustees are domiciled outside of New York State; (2) all real and tangible trust property is located outside of New York State; and (3) all trust income and gains is derived from sources outside of New York State.

This proposal to reinstate the New York gift tax is of particular concern, because under current law making large gifts can save significant New York estate taxes when the donor later dies. So as we head into 2014, it is once again timely for wealthy New Yorkers to consider making large gifts to their grantor trusts.

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[1] An IDGT is an irrevocable trust for which one of the "grantor trust" provisions set forth in IRC §§ 671-679 is triggered. Transfers by the grantor to the IDGT will be complete for gift tax (and estate tax) purposes but incomplete for income tax purposes. Therefore, if the trust is drafted properly, the income and gains of the trust will be taxable to the grantor, but the assets transferred to the trust by the grantor will be excluded from the grantor's gross estate upon death. Further, the grantor's payment of income taxes attributable to the trust will not constitute a gift for Federal gift tax purposes because the grantor is discharging his own legal obligation. *See* Rev. Rul. 2004-64. In addition, transactions between the grantor and the grantor trust will not be taxable events. *See* Rev. Rul. 85-13. These tax benefits of IDGTs under current law are all on top of the wonderful asset protection and property management benefits that trusts can provide.

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