

With Higher Taxes Looming, Are Your Clients Ready?

by Ed McCarthy, CFP®
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If some of your wealthier clients are worried about the prospect of tax increases, they're not being paranoid. Consider the recent "please tax me more" requests from rich taxpayers in the United States and Europe. Warren Buffett launched the movement with an August 14 op-ed piece in the *New York Times*, "Stop Coddling the Super-Rich." His advice: "Raise rates immediately on taxable income in excess of \$1 million, including, of course, dividends and capital gains. And for those who make \$10 million or more—there were 8,274 in 2009—I would suggest an additional increase in rate."

It's not just a few of the wealthy seeking higher taxes on themselves and their peers, though. A CNN/ORC International Poll conducted in early August found that most Americans feel the same way. Sixty-three percent of the respondents believe the newly appointed Joint Select Committee on Deficit Reduction should raise taxes on higher-income Americans and businesses. Only one-third believe taxes on the wealthy should be kept low because rich Americans help create jobs.

Wealthier clients also must consider estate-tax hikes. The current federal estate - and gift-tax exemptions and rates expire at the end of 2012, and the current law calls for higher taxes in 2013. Given the spiraling U.S. federal deficit and popular support for taxing the wealthy, it's easier to imagine both income - and estate-tax rates for wealthy taxpayers going higher rather than lower.

Educated Guesses

Tax increases are not a certainty, however. A review of congressional legislation over the past several years illustrates the political dimension. During the first two years of the Obama administration, Democrats controlled both the Senate and House. Nonetheless, they didn't push through any major tax increases.

The recently appointed deficit reduction committee adds to the uncertainty. The committee is charged with developing a deficit reduction plan for achieving \$1.2 to \$1.5 trillion in savings from 2013 to 2021. Some appointees are staking out anti-tax-increase positions already, but the committee's eventual direction is still undetermined. If the committee can issue a report by its November 23 due date, Congress will pass or reject the proposals by a simple up-or-down vote December 23.

One course of action in this uncertain tax-policy environment is to wait and see what Congress does and then advise clients on appropriate responses. That's a cautious strategy, but it's not risk free, says estate-planning attorney Martin Shenkman, CPA/PFS, J.D., in Paramus, New Jersey. Shenkman says it's impossible to predict effective dates for any changes the committee might propose because some recent tax proposals have included effective dates set at the date of the proposal, not the later date of enactment. If the committee takes that approach, advisers planning to use the window between proposal and enactment will be caught short. Nonetheless, he believes advisers shouldn't shy away from the uncertainty. "We as advisers can have at least an informed discussion with a client about the possibility [of tax increases], even if we can't pin anything down," he says. "I think that type of discussion will give some sense of comfort to the clients because at least it gives them some parameters of where we may go."

The risk of higher taxes isn't the only factor to consider, though; Shenkman sees planning opportunities that will work regardless of congressional actions. He believes any client who is concerned about liability claims or whose estate is potentially taxable can benefit in the current environment. "They really should take advantage of the opportunity that we have today—discounts, low interest-rate environment—which makes some of these planning techniques more viable, easier to implement, and have more leverage and a very high gift exemption of \$5 million. Those benefits can be used to leverage significant wealth outside of a client's estate and grow that wealth in a very tax-advantaged, asset-protected manner."

Scheduled Tax Increases

Some tax increases are already scheduled for 2013 unless Congress acts in the interim to change them.

These include:

- *Ordinary Income*: Ordinary income-tax rates will increase to their pre-2001 levels with a top rate of 39.6 percent.
- *Qualified Dividends*: Tax rate reverts to taxpayer's ordinary income-tax bracket.
- *Long-Term Capital Gains*: The top rate on long-term capital gains will be 20 percent.
- Medicare Tax:
 - There will be an additional Medicare payroll tax of 0.9 percent (without a cap) on wages and self-employment income over \$200,000 for single taxpayers and \$250,000 for married couples.
 - A new 3.8 percent Medicare contribution tax will be imposed on the unearned income of high income taxpayers (\$200,000 single/\$250,000 married), estates, and trusts (with some modifications). The tax is equal to 3.8 percent of the lesser of: (1) net investment income: this can include interest, dividends, annuities, royalties and rents, capital gains, income from a business considered a passive activity or from a business that trades financial instruments or commodities, or (2) modified adjusted gross income, which is defined as adjusted gross income increased by any foreign earned income exclusion that exceeds \$200,000/\$250,000 or \$125,000 if married filing a separate return.
 - Some income sources, such as municipal bonds, veterans' benefits, gains from the sale of a principal residence excluded from gross income, and retirement plan distributions, are not subject to the additional Medicare tax.
- *Itemized Medical Deductions*: The deduction floor increases to 10 percent of adjusted gross income; the floor remains at 7.5 percent until 2016 for taxpayers age 65 and older.
- *Federal Estate Taxes*: In 2013 the federal estate-tax rate is scheduled to revert to the pre-2001 level of a 55 percent top rate with a \$1 million applicable exclusion amount for estates and gifts.

Potential Tax Increases

Predicting tax-law changes is risky, but it is possible to identify potential changes based on previous legislative efforts. Those potential changes fall into several major categories.

Overall Limits on Deductions: This approach limits high-income taxpayers' ability to fully utilize their itemized deductions for expenses such as home-mortgage interest, state and local property taxes, and charitable contributions. Instead of allowing these taxpayers to claim the deduction based on their marginal tax bracket, they would be limited to 28 percent. A variation on this approach would eliminate deductibility on specific items, such as mortgage interest on loan balances over \$500,000.

Higher Marginal Rates for Wealthiest Taxpayers: This tax could resemble the Buffett proposal and impose a high marginal rate on income above a specified amount. On September 19 President Obama unveiled his proposals to fund his American Jobs Act. These include:

- Allowing the 2001 and 2003 tax cuts for upper income earners to expire
- Limiting deductions and exclusions for those making more than \$250,000 a year
- Closing loopholes and eliminating special-interest tax breaks

Estate-Planning Restrictions: Shenkman notes that several popular estate-planning techniques could also face restrictions at some point, such as:

- Requiring grantor retained annuity trusts (GRATs) to use a 10-year minimum term. This would substantially increase the mortality risk of having the trust's full value be pulled back into the grantor's estate.
- Eliminating valuation discounts on family-controlled entities: discontinuing or significantly limiting discounts for lack of control and marketability that allow asset transfers at reduced values.
- Restricting dynasty trusts' favorable treatment. A proposal in President Obama's 2012 budget would have limited dynasty trusts' federal tax exemption to a term of 90 years.

Planning Opportunities

It's a conundrum: clients who do nothing risk missing effective dates for legislation, but if you advise clients to take irrevocable measures and the estate tax is radically cut or eliminated, for example, clients might regret the changes they make. There's also the old maxim about not putting the tax cart before the economics horse. Drew Tignanelli, CFP®, CPA, president of Financial Consulate in Hunt Valley, Maryland, says he can recite a litany of "the trash bin of bad tax decisions that were made that weren't thought out economically."

An ideal tax-planning strategy provides sound economic benefits that help clients achieve their financial goals in addition to potential tax savings. Such strategies are available for both ultra-wealthy and affluent clients, according to the sources for this article. Some strategies involve timing the receipt of income to minimize taxes, and others take advantage of depressed asset prices and low interest rates. Another group offers both asset protection and estate savings.

Take Advantage of Timing Opportunities: Classic tax-planning advice is to recognize income in lower-rate years and take deductions in higher-rate years. For instance, clients who know they will face a higher tax rate in 2013 will want to accelerate income into 2012 if they can. Options could include taking amounts above the required minimum distributions for retirement plans, making withdrawals from deferred annuities, and so on. It's good advice, but the timing decision must be balanced with the economics.

Kristi Mathisen, CPA/PFS, J.D., director of tax and financial planning at Laird Norton Tyee in Seattle, Washington, points out that the current 15 percent tax rate on long-term capital gains is scheduled to expire at the end of 2012. Clients who know they will be selling an asset should do the math to determine whether it makes sense to sell at the lower tax rate. "If you know you're going to sell within a certain time frame, maybe you should sell in a year when you have a 15 percent capital gains rate instead of waiting to see if you're going to get a 20 or 28 percent capital gains rate," she says. "So you do strategies: is my client likely to recognize a capital gain on a specific security in the next five years or in the next three years or in the next two years? Then you can mathematically determine whether they should sell now or sell later. It's algebra. The big unknown in that is what price I am going to get for my stock when I sell it because the market is so volatile."

Combine Depressed Asset Prices and Valuation Discounts: A basic principle of asset valuation is that a minority ownership interest is worth less than its prorated share of the asset's value because of lack of control. For example, the 51 percent owner can outvote an owner with a 49 percent interest in an asset, which reduces the minority interest's value. Accordingly, a discount can be applied to the minority interest for estate-valuation purposes. The discount percentage will vary, but 20 percent to 25 percent is not uncommon.

Combine Depressed Asset Prices and Valuation Discounts (continued): The liquidity or marketability discount is another recognized valuation technique. If two businesses—one publicly traded and one privately held—are of similar size and produce similar financial results, an interest in the privately held business will be less marketable and will trade at a discount to the public company.

Combining valuation discounts with depressed market prices can allow clients to transfer wealth favorably. Real estate that had a fair market value of \$1 million five years ago, for example, might be worth \$700,000 today, depending on its location. Transferring the property while its price is depressed to an entity that can apply additional valuation discounts creates wealth-transfer leverage. “You could take discounted real estate, put it into an entity, give it another discount because it’s now in an entity, and really get some leverage on either selling or giving it to your children using the favorable intra-family rates,” says Mathisen. “We’ve got an expanded gift-tax exemption for the rest of this year and all of next year, plus a significant generation-skipping tax exemption if gifting to the grandchildren is on the client’s horizon.”

Consider Dynasty Trusts for Asset Protection and Multigenerational Benefits: “Dynasty trust” is a generic term for trusts intended to preserve wealth for multiple generations, and usually involves an allocation of the client’s generation-skipping tax to the trust. Shenkman suggests advisers consider two types of dynasty trusts for their clients: domestic asset protection trusts and beneficiary defective irrevocable trusts. “Even though the Republicans continue to say ‘no new taxes, no tax increases,’ it may very well be that things that we call tax benefits or tax planning opportunities may be re-characterized as loopholes,” Shenkman says. “It may become politically correct to close those loopholes without that becoming an increase in taxes.” Targeted loopholes could include the valuation discounts on family-controlled entities frequently used to shift assets into these types of dynasty trusts. A loss of those discounts would hinder the amounts that could be moved to the trusts. Another potential target: the gift-tax and estate-tax exemption. Shenkman believes that wealthy clients should act now. “If you have anybody that is concerned about liability, anybody with an estate that’s large enough to potentially be subject to tax, they really should take advantage of the opportunity that we have today,” he says.

Take Advantage of Low Discount Rates: Low interest rates can generate substantial tax savings in the right circumstances. Mathisen points to the charitable lead annuity trust (CLAT) as an example. A CLAT’s charitable beneficiary receives the trust’s distributions for a specified number of years. After that period, the trust’s remaining principal is distributed to a charitable or non-charitable beneficiary. Lower interest rates result in lower discount rates being applied to the distributions. This increases the distributions’ discounted present value and the potential tax benefit to the donor. “The interest rate that is used to value the CLAT transaction for income - and gift-tax purposes is driven off of the Applicable Federal Rate (AFR), and the rate for September [2011] is 2 percent,” says Mathisen. “So the valuation of your charitable gift uses 2 percent as your discount rate, and it also assumes that the trust will grow at 2 percent. Even in today’s stock market, most people expect to do better than 2 percent on their investment. You get to take a charitable deduction, and the appreciation in the assets in excess of 2 percent either comes back to you, the grantor, if you’ve retained that interest, or can go to your children because you could use this as a vehicle to make a gift.”

Grantor retained annuity trusts (GRATs) use the same concept for intra-family giving. The trust grantor—a parent, typically—puts assets in a trust for a period of years. The trust pays the grantor an annuity payment. At the expiration of the trust’s term—assuming the grantor is still alive—the remaining principal goes to the children or any other named beneficiary and is removed from the grantor’s estate. Low discount rates create considerable planning flexibility with GRATs. “You can structure them under current law to produce a taxable gift of zero in the year of the gift, or now with our larger gift-tax exemption, you could actually have it be a taxable gift and get a lot of leverage on your gift,” says Mathisen. “That’s a strategy that works well because we have very low applicable federal rates used to value the transactions for gift-tax purposes.”

Take Advantage of Low Discount Rates (continued): The same approach applies to qualified personal residence trusts (QPRTs), but those trusts have additional appeal because home values are down significantly from their peak in many areas. That means the homeowner can transfer the home to the trust at a lower valuation than would have been required a few years ago. Like a GRAT, the QPRT has two components: the retained interest, which is essentially the right to live in the home for a specified term, and the remainder interest, which is the home's transfer to the beneficiaries at the trust's expiration. The remainder's value is the difference between the property's market value and the retained interest. Market values are down, but retained interests are worth more because discount rates are low. As a result, the potential gift-tax liability on remainder interests is reduced and possibly eliminated. Although the trust grantor must outlive the trust's term for a QPRT to work, the potential payoff can justify the arrangement.

Consider Intra-Family Loans: As of September, the short-term (fewer than three years) annual AFR was 0.26 percent. The rate for mid-term loans of three to nine years was 1.63 percent, and for loans longer than nine years was 3.57 percent. These record-low rates create a unique opportunity for intra-family lending, says Mathisen. Clients who are currently earning practically nothing on their money market funds could lend to family members at 0.26 percent or more. For a longer-term option, parents could provide the mortgage funds for their children to buy a home or make other investments. Provided the loan is properly structured and the interest rate meets or exceeds the AFR, the loan won't be treated as a gift, although the parents can make gifts if they choose to forgive repayments. The technique also freezes the loaned amount's value in the parents' estates. Alternatively, the parents can collect the income from the loan, which is secured by the property and pays a higher rate than bank deposits.

Roth IRA Conversions: Roth IRA conversions also merit consideration. Diahann Lassus, CFP®, CPA/PFS, co-founder of Lassus Wherley and Associates in New Providence, New Jersey, notes that many assets have depreciated instead of appreciated. That means the clients would pay lower taxes by converting an IRA today than they would have paid had they converted when values were higher. "It's really about valuation," says Lassus. "If the market goes down even lower, then you come back and re-characterize it, wait a month, and convert it at a later point in time. There's a lot of flexibility in the Roth conversion that gives you some good opportunities for planning." Roth conversions can work with non-deductible IRAs as well, Tignanelli points out. He describes a hypothetical scenario of a 55-year-old client with a 401(k) plan whose income prevented him from opening a Roth IRA. Assuming the client and his spouse don't have traditional IRA money in their accounts, they can each invest \$6,000 in non-deductible IRAs and then convert those to Roth IRAs within a relatively short period. In a sense, says Tignanelli, it's a back door into a Roth IRA that can accumulate a significant amount over time.

It's likely that possible income - or estate-tax increases beyond those already on the books will hang over wealthy taxpayers at least through the 2012 elections. In the meantime, advising those clients on available tax-reduction strategies can help them weigh their options regardless of the political landscape.

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