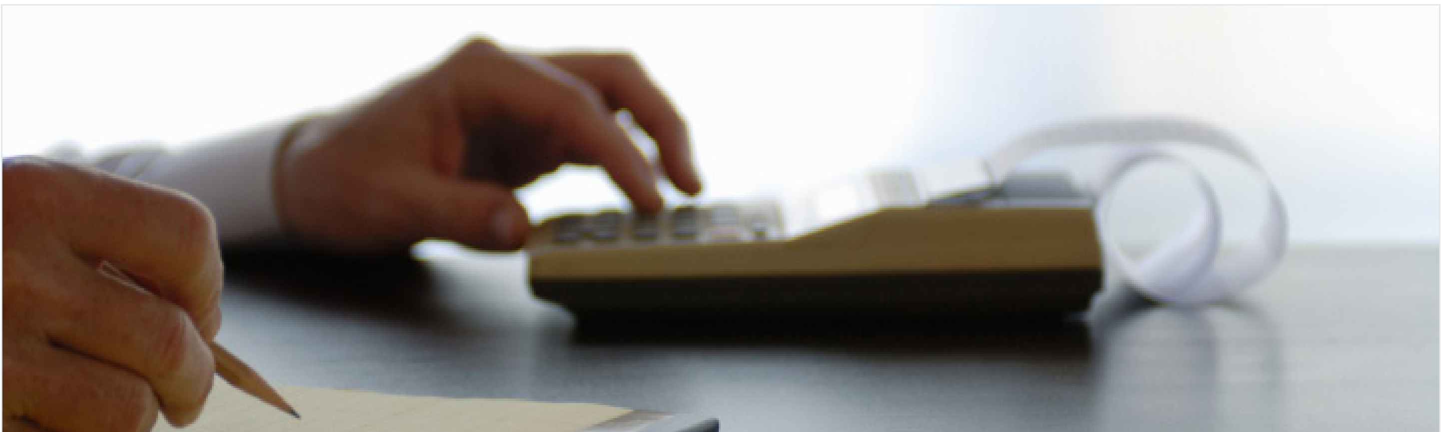
ASPIRIANT

Insight

February 2013 Wealth Management Commentary Achieve more.

Breathing a Sigh of Tax Relief



Baby New Year aided Congress and the President in averting the fiscal cliff and ushered in 2013 with the passage of the American Taxpayer Relief Act of 2012. While it's true that the Act raises income taxes on the highest income Americans, we should breathe a sigh of relief. Had all of the revenue proposals originally presented by the White House been adopted, the resulting tax liability for most Aspiriant clients would have been much more onerous than under the law that ultimately went into effect.

Taxes on Gifts and Estates

Let's start with the really good news for Aspiriant clients.

The President had called for a top estate and gift tax rate of 45%, with a per-person estate tax exemption of $3.5 million and gift tax exemption of $1 million. Ultimately, the Act leaves the transfer tax regime largely unchanged from the 2012 rules. As of January 2013, a 40% tax rate applies to estates and gifts in excess of a $5.25 million per-person lifetime estate and gift tax exemption (an amount that will increase with inflation over time). The Act also makes permanent the ability for a spouse to transfer any unused lifetime exemption at death to the surviving spouse.

These changes continue (for now, at least) a very favorable environment for multigenerational wealth transfer planning. Since none of these provisions "sunset" in the future, we now have more certainty in the area of estate planning than any time in the last decade. Moreover, we're pleased that the Act does not retire or otherwise limit some of the more popular asset transfer techniques, which are usually at risk whenever a new tax law is passed.

Planning Opportunities. With the transfer tax regime largely unchanged and interest rates governing intra-family loans near all-time lows, now continues to be an excellent time for intergenerational wealth transfer planning. Here are some transfer techniques that are popular among our clients.

Outright gifts. The least complicated way to transfer wealth to children, grandchildren and others is via outright gifts. With a lifetime allowance of up to $5.25 million per donor, a couple can continue to transfer substantial wealth (and all of the appreciation on that wealth) under the new law. The maximum "annual exclusion" gift, which doesn't use any of one's lifetime exemption, increased to $14,000 in 2013.

Leveraged gifts. Families that want to leverage their lifetime exemption can combine a gift with a low-cost family loan to potentially transfer even more wealth than an outright gift alone.

Residence transfer. Families with a valuable residence, especially one that is likely to remain in the family through successive generations, may benefit from some specific techniques for transferring homes between generations.

Gifts of pre-IPO stock. Pre-IPO stock, venture capital partnerships and other high-growth-potential assets make ideal assets for gifts, as the future appreciation on those gifts will occur outside of the donor's estate.

Taxes on Ordinary Income

After much wrangling, the Act makes permanent for 2013 and beyond the lower Bush-era income tax rates for all taxpayers except those with taxable income above $450,000 ($400,000 for single filers). For these taxpayers, the Clinton-era top marginal tax rate of 39.6% applies to ordinary income (e.g., wages, stock option proceeds, IRA distributions). This will impact many Aspiriant clients, especially those who are not retired.

2013 FEDERAL INCOME TAX BRACKETS		ORDINARY INCOME		LONG TERM CAPITAL GAINS*		QUALIFIED DIVIDENDS*	
MFJ	SINGLE	2012	2013	2012	2013	2012	2013
< $17,850	< $8,925	10.0%	10.0%	0.0%	0.0%	0.0%	0.0%
< $75,500	< $36,250	15.0%	15.0%	0.0%	0.0%	0.0%	0.0%
< $146,400	< $87,850	25.0%	25.0%	15.0%	15.0%	15.0%	15.0%
< $223,050	< $183,250	28.0%	28.0%	15.0%	15.0%	15.0%	15.0%
< $250,000	< $200,000	33.0%	33.0%	15.0%	15.0%	15.0%	15.0%
< $398,350	< $398,350	33.0%	33.0%	15.0%	18.8%	15.0%	18.8%
< $450,000	< $400,000	35.0%	35.0%	15.0%	18.8%	15.0%	18.8%
> $450,000	> $400,000	35.0%	39.6%	15.0%	23.8%	15.0%	23.8%

* Includes Medicare contribution tax on income over $250,000.

Of course, many Aspiriant clients, especially those in relatively high tax states like New York and California, are usually subject to the alternative minimum tax (AMT), an alternative tax system that features a maximum 28% tax rate, but with fewer deductions. The AMT will continue to ensnare many clients, although the Act permanently fixes a provision of the AMT that threatened to subject millions of lower-income households to the tax, bringing welcome relief from the annual congressional ritual of passing short term fixes to the AMT each December.

Finally, as expected, the new law does not extend the temporary reduction in payroll taxes that was in effect in 2011 and 2012 as an economic stimulus measure. As such, the Social Security payroll tax on employment income will increase by 2% to its regular rate of 6.2%. Moreover, Medicare Part A taxes increase in 2013 from 1.45% to 2.35% (2.9% to 3.8% for self-employed taxpayers) on employment income greater than $250,000 ($200,000 for single) as part of the Affordable Care Act passed in 2010.

While the "headline" tax increases are being borne by those making over $450,000, the Act contains a number of "stealth" tax increases that apply to taxpayers with income above $300,000 ($250,000 for single filers). These increases are in the form of limitations on itemized deductions and personal exemptions. Most itemized deductions, such as property taxes, state taxes, mortgage interest and charitable gifts, are reduced by 3% of the amount by which income exceeds $300,000. Through this process, taxpayers can lose up to 80% of their itemized deductions. Personal exemptions ($3,900 per person in the household) decline by 2% for each $2,500 by which the taxpayer's income exceeds $300,000 and are fully phased out for a couple once income exceeds $425,000. The combined impact of these phase-outs is that the top marginal tax rate on ordinary income is actually as high as 41%.

Planning Opportunities. This increase in the tax burden on ordinary income makes income tax planning more important. Some increases are unavoidable (for example, the 0.9% increase in the Medicare tax); however, there are many other opportunities for deferring tax liability and optimizing the timing of income and deductions.

Deferred compensation. Higher tax rates make participation in employer-sponsored deferred compensation plans somewhat more attractive.

Self-employment pensions. Self-employed clients have a number of retirement plan opportunities, including defined benefit plans which in some situations allow for very large (over $200,000/yr) contributions.

Pre-IPO planning. Clients with pre-IPO stock and options now have more incentive to engage in pre-IPO tax planning, for example, exercising pre-IPO stock options before they vest.

Year-end tax planning. Traditional year-end planning around the recognition of income and deductions continues to be important. For high-income taxpayers there's probably no avoiding some increase in taxes under the new law, but smart planning can mitigate some of the biggest impacts.

Roth 401(k). The Act now allows employees with 401(k) plans to convert those assets to a Roth 401(k) while still working (previously one had to rollover the 401(k) to an IRA before doing a Roth conversion). Similar to Roth IRAs, Roth 401(k) accounts grow tax-free and qualified distributions are neither taxable nor subject to minimum distribution requirements at the owner's age 70 ½, making a Roth 401(k) conversion an attractive wealth planning strategy for many clients who have already converted their IRAs to Roth IRAs.

Charitable Distributions from Traditional IRAs. Taxpayers over 70 ½ who intend on making gifts to charity can distribute up to $100,000 per year from an IRA to a public charity and avoid including the IRA charitable distribution in income.

Taxes on Investment Income

In addition to higher ordinary income tax rates, taxes on capital gains and qualified dividends increase to 20% for joint taxpayers with income over $450,000 ($400,000 for single), up from the current 15%. Municipal bond income remains tax-free.

Less publicized, but almost as important for Aspiriant clients, is the fact that an entirely new tax on investment income began on January 1. Part of the Affordable Care Act passed in 2010, this new 3.8% tax applies to the lesser of net investment income (capital gains, dividends and interest) or adjusted gross income over $250,000 ($200,000 for single filers). In other words, taxpayers with total income less than these thresholds aren't exposed to this additional tax at all, but once total income reaches these thresholds the new Medicare tax applies to any investment income above the threshold. This is a potentially very significant tax for those with high income from their investment portfolios.

Planning Opportunities. The vast majority of Aspiriant's clients are individuals and families who, unlike entities such as private foundations and pension plans, are subject to tax on investment income. Consequently, we have always managed portfolios with an eye toward reducing the tax burden, something that's even more important in the face of higher tax rates on investment income.

Portfolio implementation. Aspiriant routinely implements investment portfolios using tax-managed strategies, which actively attempt to reduce capital gains and dividends. We also pay close attention to holding the least "tax efficient" assets (e.g., real estate) in IRA accounts, and actively taking advantage of equity market volatility by "harvesting" capital losses.

Charitable gifts. Clients with significant charitable intent should generally make all large gifts using appreciated investments held longer than 12 months. Many Aspiriant clients use a donor-advised fund or private foundation to separate the charitable gift from the ultimate gift to charity. These approaches allow clients to match the timing of their charitable gifts with their highest income years (when the tax deduction is most valuable) and then spread the distributions to charities over many years or even multiple generations.

Capital gain transfer. Capital gain rates remain at 15% (and in some cases, 0%) for taxpayers with income under $450,000. This opens up an opportunity for clients to make gifts of appreciated assets to their adult children, who could then subsequently sell the stock at a lower tax rate.

The Road Ahead

In our December ***Insight: Fiscal Cliff Notes***, we wrote that we hope to eventually see broad based reform that:

- makes the tax system more efficient and growth-oriented,
- addresses the long-term fiscal issues with Social Security, Medicare and Medicaid,
- makes clear progress toward reducing and ultimately eliminating the large structural deficit, and
- lifts the cloud of uncertainty that currently exists over tax and fiscal policy, which has hurt consumer and business confidence and delayed investment, thus hindering economic growth.

The recent tax act does remove much of the uncertainty that has been looming over personal tax policy for the last decade; however, this represents only a first, small step in addressing the country's fiscal issues. As we wrote in our recent ***Insight: Fourth Quarter Market Snapshot***, we view the political challenges associated with resolving these issues to be one of the key risks for the economy and investment markets over the medium-term.

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