Spring 2013 Tax, Retirement & Estate Planning Overview & Strategies

As we rang in 2013, we welcomed a new tax package. We highlighted the majority of these in a January commentary. However, now the sequester is front and center and we are having to deal with the outcomes of the tax package. Given this, we thought it might be helpful to review a few of the bigger points and offer up some strategic considerations.

MEDICARE SURTAX: The Medicare surtax isn't really new, as it was a part of Obamacare that was upheld by the Supreme Court last summer. Starting in 2013, there is an additional 3.8% tax on unearned net income for individuals making more than $200,000 or married couples with joint incomes of more than $250,000. In its simplest form, unearned income will be capital gains, rental income, property sales, etc.—any income that does not produce a W-2.

Strategy: If you are above the income thresholds, minimize unearned income to the extent possible. Also, consider when to realize gains, focusing on years when earned income falls below the threshold (the year of a job loss or in retirement).

PAYROLL WITHHOLDING: High income earners will also incur an additional 0.9% Medicare payroll tax, taking the Medicare tax to 2.35% from 1.45%. This tax is also applied to incomes of more than $200,000 for individuals and more than $250,000 for married couples filing jointly.

Strategy: Some high earners may be taxed even if they don't reach the cutoff. Payroll departments have been advised to add the additional 0.9% for married employees making more than $200,000 because there's no way for employers to know how much the spouse makes -even if, ultimately, that employee is not subject to the tax. Given this, review withholdings on your W-4 forms to determine if they fall in the gap.

EVALUATE DEDUCTION PHASEOUTS: Many itemized deductions have been phased out for those with higher income levels. The phase-out limits taxpayers' ability to fully deduct things like charitable contributions, starting at $300,000 adjusted gross income for married filing jointly and $250,000 for single filers. Both thresholds are less than where the highest tax bracket starts.

Strategy: Bundle as many deductions into the current year as the value of those deductions is greater at the higher tax rate. For taxpayers whose adjusted gross income exceeds the upper limits, the itemized deductions (not including medical expenses, investment interest, casualty or theft losses or allowable gambling losses) will be reduced by the lesser of 3% of adjusted gross income in excess of the threshold amount, or 80% of the itemized deduction otherwise allowable for the tax year.

MEDICAL DEDUCTIONS: The threshold at which you can deduct medical expenses is now 10% of adjusted gross income, up from 7.5%.

Strategy: If possible, load up on controllable expenses in one year and then delay as many expenses as possible the next year. In the third year, attempt to bunch up your deductions again. As with many things that sound good in theory—you may not be able to wait if you need medical attention. Placing emphasis on your health will most likely be more important than a tax deduction.

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<u>MAXIMIZING DEDUCTIONS</u>: Given that the top marginal rate for the highest earners increased from 35% to 39.6%, it is important to focus on adjusted gross income and identify "above-the-line" deductions.

Strategy: Contributions to a 401(k) or 403(b) plan will reduce adjusted gross income. Other items in this category are moving expenses, health savings accounts and expenses listed on Schedule C forms for self-employed clients.

- For 2013, a person can fund up to $17,500 in either a 401(k) or 403(b) plan. If age 50 or older, the limit is $23,000.
- A SIMPLE can be funded with $12,000, or $14,500 if age 50 or older.
- A traditional IRA may be tax deductible—and can be funded with $5,500 or $6,500 if age 50 or older.
- A ROTH IRA has the same contribution limits as a traditional IRA.
- BACK DOOR TO A ROTH IRA: if you make too much to contribute directly to a ROTH—you can make a non-deductible contribution to a traditional IRA and then immediately convert that to a ROTH IRA.
- A Health Savings Account has a family limit of $6,450 and an individual limit of $3,250—both are increased $1,000 if age 50 or older.
- Annual contribution to flexible-spending accounts is limited to $2,500.

The benefits associated with 401(k), 403(b) and IRA's continue to provide the following benefits:

1. Tax deductions
2. Tax deferred growth
3. The ability to leave assets to heirs in a tax deferred manner
4. Creditor protection

We also recommend investing or converting assets into a ROTH IRA so that retirees will have "tax flexibility" once they need funds. Withdrawing funds from a 401(k) might work well in a year when your income is low and having assets in a ROTH may be quite beneficial if you need cash—but are already in a high tax bracket.

<u>KNOW WHERE TO OWN SPECIFIC ASSETS</u>: Due to increases in taxes, certain types of investments may make more sense to hold in one type of account verses another.

Strategy: If you own assets that spin off lots of income that is taxable at your marginal bracket (real estate, bonds)—it might be best to own those in a retirement (tax-deferred) account.

Conversely, assets that produce lower taxation (like qualified dividends) or no taxation (just lots of deferred growth) may be better held in a taxable investment account. Remember, what matters most is not what you make—but rather what you make net of taxes.

<u>EVALUATE ROTH CONVERSIONS</u>: ROTH IRA conversions may not be as attractive as they once were due to higher income tax associated with the conversion itself. However, this higher upfront tax hurdle may still be worthwhile to consider.

Strategy: The longer you have between now and when you might retire and/or withdraw funds, the more attractive a ROTH conversion may be. If you have at least ten to twenty years to leave the funds invested in the ROTH, the better the odds are that the move will be beneficial.

Additionally, no one said you had to do a ROTH conversion all at once. Many clients will sit down in the fourth quarter of the year when they have a good idea as to their anticipated tax bracket for the year. They will then choose to convert a specific amount, knowing they can pay the associated income tax out of their pocket.

Or, they will determine how much room they have left in a given tax bracket and convert enough to use up the remainder of those lower rates. Another strategy may be to convert in a year in which you have very low income (maybe due to a new venture startup) or you lost your job.

Finally, the IRS allows taxpayers with a Roth conversion to recharacterize the conversion within 18 months—in effect giving you the benefit of hindsight. If you do a conversion and it goes down, you can always change your mind and recharacterize regardless of tax rates.

RETIREMENT PLAN BENEFICIARY DESIGNATIONS: Whether a 401(k), 403(b), IRA or ROTH IRA, all allow the owner to name a beneficiary.

Strategy: If you name your estate, or fail to name a beneficiary, and then you pass away—most likely your heirs will pay income tax on the funds within the account before they get control of it.

By properly naming beneficiaries, after you pass away, your heirs will not have to pay full income tax immediately. Instead, the required distribution will be based upon the heirs expected lifespan. In the case of a child or grandchild, required distributions—and the associated income tax burden—can be delayed for many decades.

If your heirs inherit a ROTH, they still don't have to pay income taxes—but they do still have required distributions based upon their expected lifespan.

ESTATE & GIFT PLANNING: In 2013 the estate, gift and generation skipping taxes all have a $5.25 million exemption per person. Furthermore, they are now indexed to inflation meaning that they will climb over time.

Strategy: A husband and wife, with properly drafted bypass trusts can leave their heirs $10.5 million in 2013 before estate taxes start taking a chunk.

If you add in a generation skipping transfer trust, you can leave multiple generations of heirs $10.5 million.

These trusts are exempt from estate taxes, creditors, and ex-spouses. Even if you are well below the current $5.25 million limits, these trusts are very effective vehicles by which to manage assets.

Additionally, there are other asset transfer strategies that can be utilized.

- In addition to the $5.25 million, an individual can also gift $14,000 in any one year without any estate or gift taxes. Spread across many children or grandchildren, this can pass a pretty large amount of value each year.
- Consider funding education for kids or grandkids. Transfers can be made to either Education Savings Accounts or 529 plans. Additionally, an individual can make gifts for educational needs. These transfers can also be in addition to the stated annual or lifetime limits on gifting.
- Unlimited gifts can be made for someone's healthcare. The only catch is that the gift must be given directly to the care provider—not your heir.

OTHER CHARITABLE GIVING: Charitably inclined people can front-load charitable donations all at once without deciding where to direct those gifts.

Strategy: Contributing to a donor-advised fund can be written off this year, even if donations are not made until subsequent years.

Depending on your income, those gifts may be subject to the new phase-out. That doesn't mean they're not worth doing, though. If the gift is large relative to your income, the deduction might be worth more in the new higher tax bracket than previously.

Sincerely,

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