McNees Wallace & Nurick LLC

DECEMBER 2011

Harrisburg, PA • Lancaster, PA • State College, PA • Columbus, OH • Washington, DC

McNEES INSIGHTS
Asset Planning and Federal Taxation

# YEAR-END TAX PLANNING 2011

*by David M. Watts, Jr.*

Year-end tax planning is especially challenging this year because of uncertainty over whether Congress will enact sweeping tax reform that could have a major impact in 2012 and beyond. Even if there is no major tax legislation in the immediate future, Congress still will have to grapple with a host of thorny issues next year, such as whether to once again "patch" the alternative minimum tax (e.g., to avoid a drastic drop in post-2011 exemption amounts), and what to do about the post-2012 expiration of the Bush-era income tax cuts (including the current rate schedules, and low tax rates for long-term capital gains and qualified dividends), and the expiration of favorable estate and gift rules for estates of decedents dying, gifts made, or generation-skipping transfers made after Dec. 31, 2012.

Regardless of what Congress does late this year or early the next, there are solid tax savings to be realized by taking advantage of tax breaks that are on the books for 2011, but may be gone next year unless they are extended by Congress. These include the option to deduct state and local sales and use taxes instead of state and local income taxes, the above-the-line deduction for qualified higher education expenses, and tax-free distributions by those age 70 1/2 or older from IRAs for charitable purposes. Some of the actions listed below based on current tax rules may help you save tax dollars if you act before year-end:

- Increase the amount you set aside for next year in your employer's health flexible spending account if you set aside too little for this year. Don't forget that you can no longer set aside amounts to get tax-free reimbursements for over-the-counter drugs, such as aspirin and antacids.

- Realize losses on stock while substantially preserving your investment position. There are several ways this can be done. For example, you can sell the original holding, then buy back the same securities at least 31 days later.

- Postpone income until 2012 and accelerate deductions into 2011 to lower your 2011 tax bill. This strategy may enable you to claim larger deductions, credits, and other tax breaks for 2011 that are phased out over varying levels of adjusted gross income. These include child tax credits, higher education tax credits, the above-the-line deduction for higher-education expenses, and deductions for student loan interest. Postponing income is also desirable for those taxpayers who anticipate being in a lower tax bracket next year due to changed financial circumstances. Note, however, that in some cases, it may pay to actually accelerate income into 2011. For example, this may be the case where a person's marginal tax rate is much lower this year than it will be next year.

- But first, estimate the effect of any year-end planning moves on the alternative minimum tax for 2011, keeping in mind that many tax breaks allowed for purposes of calculating regular taxes are disallowed for AMT purposes. These include the deduction for state property taxes on your residence, state income taxes (or state sales tax if you elect this deduction option), miscellaneous itemized deductions, and personal exemption deductions. Other deductions, such as for medical expenses, are calculated in a more restrictive way for AMT purposes than for regular tax purposes. As a result, in some cases, deductions should not be accelerated.

- If you believe a Roth IRA is better than a traditional IRA, and want to remain in the market for the long term, consider converting traditional-IRA money invested in beaten-down stocks (or mutual funds) into a Roth IRA if eligible to do so. Keep in mind, however, that such a conversion will increase your adjusted gross income for 2011.

- If you converted assets in a traditional IRA to a Roth IRA earlier in the year, the assets in the Roth IRA account may have declined in value, and if you leave things as-is, you will wind up paying a higher tax than is necessary. You can back out of the transaction by recharacterizing the rollover or conversion, that is, by transferring the converted amount (plus earnings, or minus losses) from the Roth IRA back to a traditional IRA via a trustee-to-trustee transfer. You can later reconvert to a Roth IRA.

- Consider using a credit card to prepay expenses that can generate deductions for this year.

- If you expect to owe state and local income taxes when you file your return next year, consider asking your employer to increase withholding of state and local taxes (or pay estimated tax payments of state and local taxes) before year-end to pull the deduction of those taxes into 2011 if doing so won't create an alternative minimum tax (AMT) problem.

*continued on back page*

## PLANNING AND PAYING FOR LONG-TERM CARE (PART 3 IN A SERIES: LONG-TERM CARE INSURANCE) *by Scott Alan Mitchell*

As the name implies, long-term care insurance (LTCI) is an insurance policy that individuals can purchase to pay for some or all of the costs of long-term care. LTCI often covers not only skilled nursing care but also assisted living, personal care, in-home care, respite care, etc. LTCI is relatively new compared to other types of insurance, having been around for 30-35 years, and it has increased in popularity over recent years. Although the annual premium for LTCI can be significant, the policy could pay hundreds of thousands of dollars towards long-term care, so it can be an extremely valuable tool in protecting a family's assets from depletion by long-term care costs. Recall from Part 1 that the Department of Health and Human Services estimates that at least 70% of people over age 65 will need long-term care services at some point in their lives – and over 40% will need care in a nursing home for some period of time. So, in the end, LTCI can be much less expensive than paying for long-term care out-of-pocket.

The annual premiums and benefits paid under LTCI policies vary widely, depending upon factors such as the following: (1) age and health of the policy holder when the policy is first purchased/issued; (2) types of long-term care to be covered by policy (in-home care, personal care, skilled nursing, etc.); (3) any elimination period (the number of days before the LTCI policy will begin to pay benefits after an individual needs long-term care, such as 60 or 90 days); (4) daily benefit to be paid (such as $100 or $150 or $200 per day); (5) the maximum dollar benefits or years of coverage under the policy; (6) inflation riders (allowing for the purchased daily benefit to increase with inflation until the time benefits would be paid under the policy); (7) waiver of premiums after an individual needs long-term care and benefits begin to be paid under the policy; and (8) the insurance company offering the policy.

To provide a very general illustration of premium costs, one well-known LTCI carrier's website offers a premium estimate calculator by entering the age of the individual, daily benefit sought, and years of coverage. For a 50-year old Pennsylvania resident seeking 3 years of coverage for $200 per day (in other words, up to $219,000 in benefits apart from an inflation rider), the calculator estimates an annual premium of $1,700. For a 60-year old seeking the same benefits, the calculator estimates an annual premium of $2,600. For a 70-year old, the estimated premium is $5,180. So, for a 50-year old paying for LTCI for 25 years and entering skilled nursing care at age 75, the individual would have paid total premiums of $42,500, and the LTCI policy would pay out up to $219,000 (assuming no inflation rider).

Over the past few years, some companies throughout the country have begun to seek approval from various states' insurance departments to raise their annual premiums by anywhere from 10% to as much as 40%. In the early years of long-term care insurance, without the benefit of a history of claims to compare to premiums, many companies highly underestimated both the costs of long-term care, the increased length of time that individuals are living, and the number of claims that would be made under LTCI policies. As a result, now with the benefit of hindsight from the last 30-35 years, many companies have been forced to seek an increase in premiums

## GIFTING AND MARCELLUS SHALE *by J. Corey Reeder*

When estate planning lawyers discuss gifting as an estate planning strategy with clients, there are a few very important components to this discussion that must be reviewed in order to most effectively leverage gifting as an estate planning strategy. Pursuant to the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the "Act") that President Obama signed into law last December, each person has a five million dollar exemption for lifetime gifting over the thirteen thousand dollar per person annual exclusion. What this means is that under the Act a person may make gifts over the annual exclusion of up to five million dollars without incurring gift tax. That being said, the Act is only in effect for 2011 and 2012 and with 2011 almost over, there is not a lot of time for a person to take advantage of this exemption.

The most important part of the gifting discussion centers on what type of asset is most suitable for gifting. In many situations, this discussion will focus on assets that are expected to appreciate in value after the gift is made such that the growth of the asset gifted will be outside of the person's estate who made the gift. In the case of a gas lease, an interest in natural gas may be a very attractive asset to consider gifting. This analysis focuses on the timeline of the gas lease because the value of a natural gas interest is usually lower the earlier one is in the timeline.

This makes sense because determining the value of a natural gas interest will take into account (among other factors) the "bonus payment" that the owner of the interest would receive for the right of a gas company to drill for natural gas and as well as the "royalty" payment once the well is put into production and natural gas is being extracted. Consequently, if a gift of a natural gas interest is made prior to these two factors (in addition to many others) the value of the natural gas interest will not be realized until after the gift is made and or adjust the terms of existing policies – and further increases could be sought in future years. However, although a 10% to 40% increase in premiums is significant, in the above example, assuming a 40% premium increase, the 50-year old would have paid $59,500 in premiums to receive benefits of up to $219,000. So, even with a premium increase, an LTCI policy still offers a substantial benefit for those needing long-term care.

As a result of the passage of the federal Deficit Reduction Act in early 2006, states have been permitted to allow for what are generically known as "partnership" LTCI policies. Pennsylvania first approved these policies in late 2007, and approximately 15 companies currently offer partnership policies. As will be discussed in subsequent parts of this series, individuals can apply for Medicaid/Medical Assistance benefits for skilled nursing care when their "countable" assets have been spent down below a certain amount (approximately $120,000 for married couples). By purchasing a partnership policy, an individual may keep assets over and above the Medical Assistance eligibility - up to the amount of the total LTCI benefits paid out - and still be eligible for Medical Assistance benefits. For example, if a married couple otherwise must spend their assets down to $120,000 to qualify for Medical Assistance benefits, and if the spouse in the nursing home has a partnership policy that pays total benefits of $150,000, the couple can protect a total of $270,000 while becoming eligible for Medical Assistance benefits.

Another recent variety of LTCI is a "hybrid" policy. Some consumers are hesitant to purchase traditional LTCI because it might never be used. As a result, some companies now are offering policies that combine whole-life or universal-life coverage with long-term care benefits. By way of example, under such a hybrid policy, a 60-year old individual might make a single premium payment of $70,000 for a policy with a $150,000 death benefit. In addition to the death benefit, the policy might also offer a LTCI benefit of $200 per day for 4 years.

As can be seen above, LTCI can be an extremely valuable tool for protecting assets from depletion by long-term care costs. However, the options and costs for LTCI vary widely, and so it is important for individuals and couples to discuss LTCI with a knowledgeable insurance agent and elder law attorney to ensure that they purchase a policy that is right for them. ■

*In Part 4, I will begin to discuss Medicaid/Medical Assistance.*

Scott Alan Mitchell practices in the McNees Asset Planning and Federal Taxation and Business Counseling groups.
717.581.3713 / smitchell@mwn.com

thus may be removed from the estate of the person making the gift.

Another important factor to consider is if there are any "discounts" that can be taken against the value of the asset being gifted so as to reduce its value and the ultimate amount of annual or lifetime gift exclusion that a person must utilize. In the case of a natural gas interest, there are many discounts that can be applied to the value of the asset, however, these discounts are based on many factors and many of those factors are time sensitive. A few examples of discounts related to natural gas interests would be the percentage ownership of the natural gas interest; the classification of the natural gas reserve pursuant to IRS regulations; location of the property to active producing wells; location of the property to mid-stream pipelines; and how many wells can the acreage support. Clearly the aforementioned list is not exhaustive and is very generic in nature, but it should highlight that there are many factors that should be considered when doing a valuation, and given that the valuation will have to pass IRS scrutiny, it is imperative that a client engage a valuation firm that utilizes techniques and methods that are in line with the IRS regulations and Tax Court holdings.

Further, it should be noted that a valuation is a time sensitive study which means that one should not engage a firm to do a valuation unless the client is prepared to make gifts of the natural gas interest so as to not spend funds for the valuation only to have it become worthless because of the passage of time.

In conclusion, with the current gift tax environment, the gift of a natural gas interest at the proper time could allow a client to pass significant wealth to the next generations free of any estate or gift tax provided an appropriate and well documented valuation is obtained. ■

Corey Reeder practices in the McNees Asset Planning and Federal Taxation, Business Counseling, Oil and Gas and Real Estate groups.
814.867.8500 / creeder@mwn.com

## YEAR-END TAX PLANNING 2011 *continued from front*

- Take an eligible rollover distribution from a qualified retirement plan before the end of 2011 if you are facing a penalty for underpayment of estimated tax and the increased withholding option is unavailable or won't sufficiently address the problem. Income tax will be withheld from the distribution and will be applied toward the taxes owed for 2011. You can then timely roll over the gross amount of the distribution, as increased by the amount of withheld tax, to a traditional IRA. No part of the distribution will be includible in income for 2011, but the withheld tax will be applied pro rata over the full 2011 tax year to reduce previous underpayments of estimated tax.

- Accelerate big ticket purchases into 2011 in order to assure a deduction for sales taxes on the purchases if you will elect to claim a state and local general sales tax deduction instead of a state and local income tax deduction. Unless Congress acts, this election won't be available after 2011.

- You may be able to save taxes this year and next by applying a bunching strategy to "miscellaneous" itemized deductions, medical expenses and other itemized deductions.

- If you are a homeowner, make energy saving improvements to the residence, such as putting in extra insulation or installing energy saving windows, or an energy efficient heater or air conditioner. You may qualify for a tax credit if the assets are installed in your home before 2012.

- Unless Congress extends it, the up-to-$4,000 above-the-line deduction for qualified higher education expenses will not be available after 2011. Thus, consider prepaying eligible expenses if doing so will increase your deduction for qualified higher education expenses. Generally, the deduction is allowed for qualified education expenses paid in 2011 in connection with enrollment at an institution of higher education during 2011 or for an academic period beginning in 2011 or in the first 3 months of 2012.

- If you are age 70-1/2 or older, own IRAs and are thinking of making a charitable gift, consider arranging for the gift to be made directly by the IRA trustee. Such a transfer, if made before year-end, can achieve important tax savings.

- Take required minimum distributions (RMDs) from your IRA or 401(k) plan (or other employer-sponsored retired plan) if you have reached age 70-½. Failure to take a required withdrawal can result in a penalty of 50% of the amount of the RMD not withdrawn. If you turned age 70-1/2 in 2011, you can delay the first required distribution to 2012, but if you do, you will have to take a double distribution in 2012—the amount required for 2011 plus the amount required for 2012. Think twice before delaying 2011 distributions to 2012—bunching income into 2012 might push you into a higher tax bracket or have a detrimental impact on various income tax deductions that are reduced at higher income levels. However, it could be beneficial to take both distributions in 2012 if you will be in a substantially lower bracket that year, for example, because you plan to retire late this year.

- Make gifts sheltered by the annual gift tax exclusion before the end of the year and thereby save gift and estate taxes. You can give $13,000 in 2011 to each of an unlimited number of individuals but you can't carry over unused exclusions from one year to the next. The transfers also may save family income taxes where income-earning property is given to family members in lower income tax brackets who are not subject to the kiddie tax. ■

David M. Watts, Jr. is chair of the McNees Asset Planning and Federal Taxation group.
717.237.5344 / dwatts@mwn.com

**McNees Asset Planning & Federal Taxation Group**

| | | | |
|---|---|---|---|
| David M. Watts, Jr., Chair<br>717.237.5344/dwatts@mwn.com | Bradley J. Gunnison<br>717.237.5479/bgunnison@mwn.com | Scott Alan Mitchell<br>717.581.3713/smitchell@mwn.com | Richard W. Stevenson<br>717.237.5208/rstevenson@mwn.com |
| Vance E. Antonacci<br>717.581.3701/vantonacci@mwn.com | Veronica R. Johnson<br>717.237.5417/vjohnson@mwn.com | Elizabeth P. Mullaugh<br>717.237.5243/emullaugh@mwn.com | M. Yvonne Crouse, Paralegal<br>717.581.3732/ycrouse@mwn.com |
| Salvatore J. Bauccio<br>717.237.5238/sbauccio@mwn.com | Donald B. Kaufman<br>717.237.5373/dkaufman@mwn.com | James K. Noel, IV<br>717.581.3709/jnoel@mwn.com | Linda M. Eshelman, Paralegal<br>717.237.5210/leshelman@mwn.com |
| Frank C. Chesters<br>717.581.3702/fchesters@mwn.com | Peter F. Kriete<br>717.237.5486/fkriete@mwn.com | J. Corey Reeder<br>814.867.8500/creeder@mwn.com | David E. Gruver, Paralegal<br>717.237.5362/dgruver@mwn.com |
| Timothy M. Finnerty<br>717.237.5394/tfinnerty@mwn.com | Kendra D. McGuire<br>717.581.3734/kmcguire@mwn.com | Bruce R. Spicer<br>717.237.5331/bspicer@mwn.com | Dianna L. McSherry, Paralegal<br>717.581.3707/dmcsherry@mwn.com |