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McNEES INSIGHTS

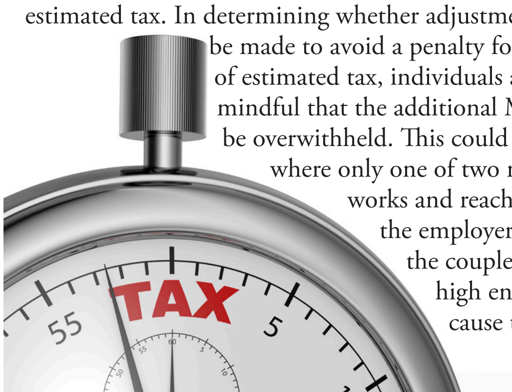
Asset Planning and Federal Taxation

TIMELY YEAR-END TAX PLANNING CAN REDUCE TAXES *by David M. Watts, Jr.*

Year-end tax planning could be especially productive this year because timely action could nail down tax breaks that won't be around next year unless Congress acts to extend them, which at the present time, looks doubtful. These include, for individuals: 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 ½ or older from IRAs for charitable purposes. High-income-earners have other factors to keep in mind when mapping out year-end plans. For the first time, they have to take into account the 3.8% tax surtax on unearned income and the additional 0.9% Medicare (hospital insurance, or HI) tax that applies to individuals receiving wages with respect to employment in excess of $200,000 ($250,000 for married couples filing jointly and $125,000 for married couples filing separately).

The surtax is 3.8% of the lesser of: (1) net investment income (NII), or (2) the excess of modified adjusted gross income (MAGI) over an unindexed threshold amount ($250,000 for joint filers or surviving spouses, $125,000 for a married individual filing a separate return, and $200,000 in any other case). As year-end nears, a taxpayer's approach to minimizing or eliminating the 3.8% surtax will depend on his estimated MAGI and NII for the year. Some taxpayers should consider ways to minimize (e.g., through deferral) additional NII for the balance of the year, others should try to see if they can reduce MAGI other than unearned income, and others should consider ways to minimize both NII and other types of MAGI.

The additional Medicare tax may require year-end actions. Employers must withhold the additional Medicare tax from wages in excess of $200,000 regardless of filing status or other income. Self-employed persons must take it into account in figuring estimated tax. In determining whether adjustments may need to be made to avoid a penalty for underpayment of estimated tax, individuals also should be mindful that the additional Medicare tax may be overwithheld. This could occur, for example, where only one of two married spouses works and reaches the threshold for the employer to withhold, but the couple's income won't be high enough to actually cause the tax to be owed.



We have compiled a checklist of additional actions based on current tax rules that may help you save tax dollars if you act before year-end. Not all actions will apply in your particular situation, but you will likely benefit from one or more.

Year-End Tax Planning Moves for Individuals:

- Increase the amount you set aside for next year in your employer's health flexible spending account (FSA) if you set aside too little for this year.

- If you become eligible to make health savings account (HSA) contributions in December of this year, you can make a full year's worth of deductible HSA contributions for 2013.

- Postpone income until 2014 and accelerate deductions into 2013 to lower your 2013 tax bill. This strategy may enable you to claim larger deductions, credits, and other tax breaks for 2013 that are phased out over varying levels of adjusted gross income (AGI). 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 also is 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 2013. 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 or where lower income in 2014 will result in a higher tax credit for an individual who plans to purchase health insurance on a health exchange and is eligible for a premium assistance credit.

- 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.

- It may be advantageous to try to arrange with your employer to defer a bonus that may be coming your way until 2014.

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

continued on page 2

TIMELY YEAR-END TAX PLANNING CAN REDUCE TAXES *continued from page 1*

- 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 2013 if doing so won't create an alternative minimum tax (AMT) problem.

- Take an eligible rollover distribution from a qualified retirement plan before the end of 2013 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 2013. 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 2013, but the withheld tax will be applied pro rata over the full 2013 tax year to reduce previous underpayments of estimated tax.

- Estimate the effect of any year-end planning moves on the alternative minimum tax (AMT) for 2013, 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 in the case of a taxpayer who is over age 65 or whose spouse is over age 65 as of the close of the tax year. As a result, in some cases, deductions should not be accelerated.

- Accelerate big ticket purchases into 2013 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 2013.

- 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 2014.

- Unless Congress extends it, the up-to-$4,000 above-the-line deduction for qualified higher education expenses will not be available after 2013. 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 2013 in connection with enrollment at an institution of higher education during 2013 or for an academic period beginning in 2013 or in the first 3 months of 2014.

- Purchase qualified small business stock (QSBS) before the end of this year. There is no tax on gain from the sale of such stock if it is (1) purchased after September 27, 2010 and before January 1, 2014, and (2) held for more than five years. In addition, such sales won't cause AMT preference problems. To qualify for these breaks, the stock must be issued by a regular (C) corporation with total gross assets of $50 million or less, and a number of other technical requirements must be met.

- 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 70-1/2. 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 2013, you can delay the first required distribution to 2014, but if you do, you will have to take a double distribution in 2014, including the amount required for 2013 plus the amount required for 2014. Think twice before delaying 2013 distributions to 2014 bunching income into 2014 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 2014 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 $14,000 in 2013 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. ■

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INCOME TAX COST BASIS PLANNING *by Vance E. Antonacci*

Prior to the recent and significant increases in the federal estate tax exemption amount, many clients engaged in planning the purpose of which was to ensure the use of both spouses' exemption amount through the use of a "bypass" or "credit shelter" trust at the first death and/or excluding assets from one's taxable estate through the use of irrevocable trusts. A byproduct of this planning, however, was the loss of a basis step up for income tax purposes when a surviving spouse died. That is, the general rule that basis of an asset is stepped up to its fair market value at the date of death is not the case for assets held in bypass, credit shelter and irrevocable trusts because such assets are not part of the surviving spouse's estate.

For example, if one spouse owns real estate worth $500,000 at that spouse's date of death, and the real estate ends up in a bypass trust in order to keep it out of the surviving spouse's estate, and at the second death the real estate is worth $2,000,000, then there will be a $1,500,000 capital gain that would be taxed when the real estate is sold. Assuming a federal income tax rate of 20%, the 3.8% Medicare surtax on investment earnings, and a Pennsylvania income tax of 3.07%, the tax would be approximately $403,050 (this example does not account for any depreciation recapture, which would increase the tax liability).

Among other things, the American Taxpayer Relief Act of 2012 established the estate tax exemption amount at $5,000,000 per person, with this amount increasing annually based on inflation. For 2013, the exemption amount is $5,250,000 per person. The significant increase in the estate tax exemption amount is illustrated by the fact that the exemption amount was as low as $600,000 in 1997. Consequently, there are clients who no longer have exposure to the federal estate tax even with the inclusion of the value of assets previously gifted or which funded a trust when the first spouse dies. However, these clients – given the structure of their estate plan – cannot achieve a basis step up at death.

With respect to existing bypass, credit shelter and irrevocable trusts, some clients would like to "unring the bell" with regard to prior planning, but this is not always possible. Although an irrevocable trust can be terminated in certain circumstances, the termination of the trust will require the consent of all beneficiaries and the fiduciary obligations of the trustee may make termination difficult if not impossible. In addition, the termination of a trust will eliminate the creditor protection offered by the trust, which may be ill-advised if the surviving spouse anticipates long-term care expenses. Likewise, a family limited partnership may be unwound, but the distribution of the property owned by the partnership may have adverse tax consequences and, like a trust, the creditor protection afforded by the limited partnership will be lost. Many clients think of creditors in the context of lawsuits, but potential creditors would include long-term care providers and, in certain circumstances, the Pennsylvania Department of Public Welfare.

What can be done to amend an estate plan to provide for a basis step up? There are several options that can be considered depending on your situation.

- For clients that have established a family limited partnership, the client could take the position that an implied agreement existed among the partners so that the partnership was, for estate tax purposes, a sham. Therefore the partnership assets are part of the decedent's estate. The risk of this strategy is that creditors may be able to disregard the partnership as well.
- For clients who have established a "qualified personal residence trust," the client could argue that an implied agreement exists whereby the clients would continue to use and enjoy the residence after the trust terminates (for example, by staying at the property without paying rent). This strategy can be particularly attractive for shore properties in New Jersey and Delaware since New Jersey's inheritance tax does not apply to transfers to children and Delaware's estate tax provides for an exemption equal to the federal estate tax exemption.
- For clients who established irrevocable trusts during their lifetimes, the trust agreement could be amended to give a third party, such as the trustee, the discretion to grant the client a "limited power of appointment." The limited power of appointment provides the client with the right to shift the benefits of the trust among the beneficiaries, and results in the inclusion of the trust's assets in the client's taxable estate, even if not exercised. The risk with this strategy is that the third party must actually grant the client the limited power of appointment prior to the client's death.
- A trust agreement may be amended to grant the beneficiary (such as a surviving spouse) a "general power of appointment." A general power of appointment allows the beneficiary upon his or her death to direct the trust assets to any person or entity and therefore results in the inclusion of the trust assets in the beneficiary's estate. This strategy presents the problem that the beneficiary may direct the trust assets outside the family and also presents creditor protection issues. The trust agreement could also be amended to give the third party the discretion to grant the general power of appointment to the beneficiary (although this presents the same timing issues as the limited power of appointment strategy outlined above).

Those clients that desire estate inclusion will have to pay the Pennsylvania inheritance tax if it applies. The tax rate is 4.5% for transfers to children and other descendants. Using the example above, the tax on $2,000,000 transferred to children is $90,000 (a tax savings of $313,050).

continued on back page

INCOME TAX COST BASIS PLANNING *continued from page 3*

Each client's situation is unique, and caution should be exercised in employing any strategy to gain a basis step up. Generally speaking, implementing a basis step up strategy could upset a decedent's estate plan or create an opportunity for a creditor to recover assets that were otherwise creditor protected. Nonetheless, the trading of an inheritance tax for the basis step up may be worth the potential risks. ■

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MARRIAGE AND TAXES IN 2013 *by Elizabeth P. Mullaugh*

Two significant events in 2013 underscored the nexus of marriage and taxes that make it possible for many couples to radically simplify their estate planning.

First, on January 2, 2013, Congress enacted a permanent (inasmuch as any tax law is ever permanent) estate and gift tax regime that included the concept of 'portability,' which has important and wide-ranging implications for federal estate tax planning. Coupled with the new larger lifetime exemption from estate and gift tax ($5,340,000 in 2014 and indexed for inflation), portability will allow the vast majority of married taxpayers to simplify their estate planning.

Second, on June 26, 2013, in *U.S. v. Windsor,* the United States Supreme Court struck down Section 3 of the Defense of Marriage Act (DOMA), which set the stage for the Internal Revenue Service to rule that henceforth, legally married same sex couples would be considered married for all federal tax purposes. The federal tax benefits (and burdens) of marriage are now available to same sex couples, who may now view the option of legal marriage in a new light even if their state of residence, like Pennsylvania, does not recognize it.

Portability

Though the word 'portability' is not included in any federal tax statute or regulation, it has become shorthand for the concept first introduced into law in 2011 that a surviving spouse can utilize any unused exemption from her last deceased spouse. Conceptually, portability remedies the problem posed by jointly held marital assets and individual estate tax exemptions. Traditionally, this was addressed by using a credit shelter trust, also known as a 'family' trust or A/B trust planning, to allow the first spouse to shelter an amount up to his allowable exemption but give the benefit of that sheltered amount to his surviving spouse. In this manner, assuming each spouse had sufficient individually owned assets to fund the credit shelter amount, the full amount of both exemptions could be used.

For many couples, however, this was an ill-suited fix at best. A typical couple owns a home jointly, joint financial accounts and retirement plan assets. For numerous reasons, it was difficult or undesirable to use any of those assets to fund a credit shelter trust and the resulting estate plan relied on future disclaimers by the surviving spouse. Portability now allows most couples with less than $10 million in combined assets to eliminate the credit shelter trusts in their plans without losing the benefit of the combined exemptions.

Windsor and Marriage Equality

Thea Spyer died in 2009. The assets passing to her surviving spouse, Edith Windsor, generated federal estate tax because the federal government did not recognize their Canadian marriage. Faced with a tax bill of more than $300,000, Edith filed suit for a refund and eventually won the case, leading to a major policy shift in the recognition of marriage by federal authorities. The IRS announcement, made at the end of August, that it would henceforth recognize any marriage legal in the jurisdiction in which the marriage took place, regardless of the domicile of the taxpayers, has fundamentally altered the tax calculus for same sex couples. Those who had been married in a domestic or foreign jurisdiction recognizing same sex marriage will now be treated as spouses for all federal tax purposes. Estate planning for married same sex couples now takes into account the availability of the marital deduction and the new portability regime addressed above. ■

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