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STRATEGIES TO SURVIVE THE EVER-CHANGING TAX ENVIRONMENT

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Since the beginning of 2010 the tax landscape has undergone significant changes for the highest tax brackets. Earlier this year, the headlines were dominated by monumental healthcare reform and the debate surrounding it, today we have a piece of legislation that transforms the financing of U.S. healthcare with the revenue generated through a new 3.8 percent Medicare surtax on unearned income of high-earning families and individuals. Moreover, lawmakers, preoccupied by healthcare reform, failed to act on the federal estate tax and generation skipping tax, which were officially repealed on January 1, 2010. Although this might at first appear to be a tax break, in reality the absence of estate tax has created numerous unintended consequences.

Nonetheless, the taxpayer is not without recourse, and in this paper we will explore the implications of no estate tax and the new Medicare surtax along with the strategies available to help survive the tumultuous tax environment.

2010: The Year of No Estate Taxes

Although the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) was scheduled to repeal the federal estate tax and the generation skipping transfer tax (GSTT) this year, few tax professionals and planners thought it would actually come to fruition—most expected Congress to act before the end of 2009 to reform the federal transfer tax system.

Now that the repeal has come to pass, there is ongoing speculation that Congress will act “quickly” to reinstate the federal estate tax at 2009 levels. At the same time, some observers believe legislators will act to reinstate the tax in 2010 and make the new law retroactive to January 1. More believe Congress will proceed “cautiously” in an attempt to enact more sweeping reforms. However, based on the congressional calendar and the midterm elections, it is unlikely Congress will take action until late 2010 or early 2011.

Has the Federal Estate Tax Gone Away?

Not likely. Estate taxes have been with us off and on throughout most of our country’s history. Beginning in the 1790s, estate taxes of some kind have been periodically imposed and later repealed. Most recently, the estate tax was reinstated in 1916 to help pay for the costs of World War I, and it has remained with us ever since.

Currently, the estate tax is slated to return on January 1, 2011, to unfavorable levels. If it remains unchanged, the estate tax will impact an even larger cross-section of the population, and the tax burden will be significantly heavier.



What About 2010?

Barring retroactive legislation, here's a snapshot of the current landscape:

- Both the estate tax and the GSTT (on assets given to grandchildren) are repealed for 2010.
- Both taxes are scheduled to return in 2011 at the unfavorable rates that applied 10 years ago, specifically a \$1 million exemption and an estate tax rate of 55 percent. In 2009, the exemption was \$3.5 million and the top rate was 45 percent.
- The federal gift tax remains in effect with a \$1 million lifetime exemption; however, the tax rate has dropped to 35 percent in 2010 from 45 percent in 2009. The gift tax rate is supposed to jump to 55 percent in 2011.

This table compares current rates and exemptions with those from 2009 and those scheduled to take effect next year:

Year	Estate Tax	Generation Skipping Tax	Gift Tax
2009	\$3.5 Million Exemption; 45% Rate	\$3.5 Million Exemption; 45% Rate	\$13,000 / year; \$1 Million Lifetime Exemption; 45% Rate
2010	Unlimited	Unlimited	\$13,000 / year; \$1 Million Lifetime Exemption; 35% Rate
2011	\$1 Million Exemption; 55% Rate 60% at \$10-17 million	\$1 Million Exemption; 55% Rate	Indexed with Inflation; \$1 Million Lifetime Exemption; 55% Rate

While there is no way of knowing what Congress will or will not do going forward, we do know that now is the time for everyone to review their estate plan. The people with the highest priority are the elderly and the ill. Keep in mind that even when the tax climate is not clouded by such uncertainty, we recommend you review your wealth plan annually or when there is a major life event, like a new child or grandchild or a significant change in net worth.

There Are Opportunities...

Amid the changes, several advantageous opportunities have emerged from all the confusion:

- **Gifting:** If you can afford to make lifetime gifts, it may be beneficial to do so now, when the gift tax is considerably lower than in previous years and possible future rates. Because the generation skipping transfer tax has been repealed, gifts to children and grandchildren may be a powerful planning strategy as it will enable you to transfer the money out of your estate, avoiding the tax burden of future appreciation. An important caveat—if Congress enacts retroactive legislation, these lifetime gifts, if made outright to children or grandchildren, may be negatively impacted. If, however, these lifetime gifts are made into certain kinds of trusts, you should be able to preserve the lower gift tax rate.



- **Charities:** Since charities do not pay any capital gains taxes, it makes sense to use a charitable vehicle to accomplish numerous philanthropic goals in 2010.
- **Low Interest Rates:** The applicable federal interest rates on promissory notes are very low right now, making repayment more manageable. Your children, or trusts for your children, can purchase interests in assets from you and repay you over time.
- **Life Insurance:** For many, Trust Owned Life Insurance is an ideal way to protect wealth, tax free. Insurance should be considered its own asset class and can be used to "hedge" an estate plan.
- **Roth IRAs and 401(k)s:** Beginning January 1, 2010, taxpayers at all income levels can convert regular IRAs and 401(k)s to Roth IRAs.
- **Qualified Personal Residence Trusts (QPRTs), Grantor Retained Annuity Trusts (GRATs), and sales to Intentionally Defective Grantor Trusts (IDGTs)** are all strategies for transferring wealth in a tax-efficient manner.

But There Are Important Challenges...

Stepped-up basis repeal

Along with the 2010 repeal of the estate tax and the GSTT come new rules for determining the federal income tax basis of inherited assets. Previously, heirs inherited assets that were subject to a stepped-up basis using the fair market value on the date of the decedent's death. When the heir sold the asset, the capital gain for income tax purposes was measured by the difference between the selling price and the stepped-up basis of the asset. As a result, there was no income tax liability on the appreciation of the asset's value during the decedent's lifetime.

Today, however, and for the remainder of 2010, absent Congressional action to the contrary, heirs may adjust the basis on only \$1.3 million dollars in assets, and spouses may apply it to \$3 million in appreciated assets. All other assets are to be valued at their original value (with adjustments for capital improvements) using the carryover basis. As a result, when an heir sells the asset, the heir must pay capital gains on the appreciation of the asset above its original cost.

In the end, the return of the carryover basis may impose capital gains taxes on more people than have ever been subject to estate taxes previously.

The modified stepped-up basis and additional carryover basis will also likely lead to issues for estate administrators. Executors or trustees of estates larger than \$1.3 million, for example, will have to figure out which assets should receive the basis adjustment. This is especially important for heirs and beneficiaries other than a surviving spouse.

No more exclusion

Many wills and trusts were drafted with the expectation that estate taxes were permanent fixtures. As a result, the will often directs the assets up to the applicable exclusion amount to children, with the remaining assets directed to the spouse. In this no-estate-tax environment, however, this could create a situation where all of the assets pass to the children, with nothing going to the surviving spouse. It all depends on the wording of the formula clause found in the vast majority of estate planning documents.

Typically, formula clauses put the maximum amount that can be passed estate-tax-free into a family trust, with the balance going to a marital trust. Such clauses could be construed to leave a spouse with far less than the decedent intended, and in some cases, even nothing. The reverse may just as easily be true, where the formula clause directs 100 percent of the assets to the marital trust and nothing to the family trust.



To illustrate, an individual with a \$6.5 million estate intends to leave the “exempt amount” to his children from his first marriage and the balance to his current spouse. Had he died in 2009, the children would have received \$3.5 million and his spouse would have received \$3 million. The marital deduction coupled with exemption equivalent would have prevented any estate tax from being owed. But if he dies in 2010, the formula clause could be interpreted as giving everything to the children and nothing to his spouse.

The key to avoiding the current problems is amending your estate planning documents to provide for maximum flexibility. Your estate plan should include language to address different situations. If your estate is not subject to estate taxes, which it isn't at this time, then you have one set of strategies. If, on the other hand, your estate is subject to estate taxes, there would be another set of strategies listed. Thus, your intent is clearly represented and executed regardless of the tax environment.

As a principle, flexibility should also be incorporated into other aspects of your estate plan. This may mean giving your personal representative some additional powers to make what are called “Qualified Terminable Interest Property” elections. QTIPs allow more of your low-cost-basis assets to qualify for an increase in basis for assets that flow into a marital trust with the goal being to reduce income tax liability on inherited assets.

So what should *you* be doing? We urge everyone to review estate planning documents with a financial advisor or attorney to ensure that the documents still accomplish their plans and goals under the current law. The importance of immediately assessing your estate planning documents cannot be overstated.

The New Medicare Surtax

Although the new Medicare surtax, enacted on March 10, 2010, is less than 60 days old, it is already creating quite a stir. The Patient Protection and Affordable Care Act imposes several new taxes, including a 3.8 percent surtax on the lesser of net investment income (also known as unearned income) or the excess of modified adjusted gross income (MAGI). The MAGI is the sum of adjusted gross income plus the net foreign income exclusion amount. While this new surtax does not take effect until 2013, it is important to begin planning now in order to minimize its impact on your tax bill.

Whom Will It Affect?

The people who will bear the burden of this new tax will be individuals with unearned income contributing to a total income that exceeds \$200,000 annually, couples filing jointly who make more than \$250,000, and married people filing separately who make more than \$125,000. Trusts are also subject to the tax if they have investment income above \$11,200. The application of this tax is further nuanced by the types of investments that are subject to the tax. They include dividends, capital gains, interest, annuities, rents, royalties, and passive activity income. The taxable investment income does not include active trade of business income or income derived from an active business, distributions from IRAs or other qualified plans, income taken into account for self-employment tax purposes, or the gain on the sale of an active interest in a partnership or S corporation.



To better illustrate whom this tax affects, let us examine several possible scenarios:

- Scenario 1:* Chris, a single taxpayer, has \$100,000 of salary and \$75,000 of net investment income. His MAGI is \$175,000 and less than the \$200,000 threshold. Therefore, the 3.8 percent Medicare surtax does not apply.
- Scenario 2:* Miriam, another single taxpayer, has \$250,000 of net investment income and no other source of income. The 3.8 percent surtax would apply to \$50,000 of income (the lesser of investment income of \$250,000 or the excess of \$250,000 MAGI over the \$200,000 threshold amount).
- Scenario 3:* Scott and Alison, married and filing jointly, have \$300,000 of salaries and no net investment income. The 3.8 percent surtax will not apply because they have no investment income.
- Scenario 4:* Frank and Lindsey, married and filing jointly, have \$400,000 of salaries and \$100,000 of net investment income. They will pay the 3.8 percent surtax on \$100,000.
- Scenario 5:* Jack and Samantha, married and filing jointly, have \$200,000 of salaries and \$150,000 of net investment income for a total MAGI of \$350,000. The 3.8 percent surtax would apply to \$100,000 of income (excess of \$350,000 MAGI over \$250,000 threshold amount).
- Scenario 6:* Luke, a single taxpayer, age 69, has investment income of \$200,000 and is not subject to the surtax. In the following year, Luke has a required minimum distribution from his IRA of \$125,000. In this case, \$325,000 of MAGI exceeds the \$200,000 threshold, and \$125,000 is subject to the 3.8 percent surtax. This is called the surtax “bubble.”
- Scenario 7:* The Jackie Phillips Trust has investment income of \$50,000 and no distributions. The amount over the threshold (\$11,200) will be subject to the 3.8 percent surtax.

The nonpartisan staff of the congressional Joint Committee on Taxation estimates that the Medicare surtax on investments will generate more than \$30 billion annually, or \$210.2 billion from 2013 through 2019. It is the biggest tax increase in the law and accounts for half of the \$409 billion in total revenue. As the preceding examples demonstrate, it will weigh heavily on high-earning taxpayers.

Reducing the Impact: Two Main Strategies

While the pundits debate the possible negative consequences of the Medicare surtax reducing the demand for investment, and others tout the importance of funding the expansion of Medicare services and the healthcare overhaul, individuals have two strategies to reduce the impact on their tax bills. First, there are several steps you can take to reduce your earned income to below the threshold:

- You can reduce your MAGI by making contributions to qualified retirement plans such as 401(k)s, 403(b)s, 457 plans, and IRAs.
- You can create “alternative” qualified retirement plans like defined benefit plans.
- You should reconsider a Roth conversion. Although converting your traditional Roth IRA increases your taxable income and therefore your income taxes when you convert, the top tax rate today—35 percent—is significantly lower than future rates. In 2013 the top rate will be 43.4 percent, creating an arbitrage of 8.4 percent for those who convert to a Roth now as opposed to waiting. Moreover, any distributions from the Roth IRA will not be subject to the surtax.



The second strategy is to reduce/re-characterize your taxable investment income with one or a combination of the following strategies:

- You can invest in municipal bonds that remain tax exempt, the caveat being that municipal bonds are only as good as the creditworthiness of the underlying municipalities. A carefully managed municipal bond portfolio weighs the credit risks, effective durations, and state allocations.
- You can accelerate bond interest income into 2012, timing the interest payments to occur in December 2012 and selling “ripe” bonds in late December 2012, then repurchasing different bonds in January 2013.
- A similar concept applies to security sales, in which you can accelerate gains to 2012 while merging shorts to generate capital losses, collar the gains, and slowly sell the stocks.
- Tax-deferred non-qualified annuities allow you to defer income, enabling you to “leapfrog” over high-income years while you are in the workforce. In retirement, the annuity payments become part of your MAGI and investment income; however, your earned income at this point will likely be below the threshold.
- Another powerful strategy is the use of life insurance for retirement income. The income generated in retirement is not part of the MAGI and therefore not subject to the 3.8 percent surtax.
- Finally, charitable remainder trusts and charitable lead trusts, or a combination of the two, offer an opportunity to reduce your MAGI and benefit the organizations and causes that are important to you. These trusts allow taxpayers to defer income and stay under the threshold amount, allowing investment income to be offset by the “above the line” charitable deduction. When given the choice between leaving one’s money to the IRS or to charity, few pick the IRS.

There are a breadth of strategies to minimize the Medicare surtax and the potentially negative effects of the absence of estate taxes. More importantly, the nuances and complexities of the new tax law can be overwhelming, and we encourage you to contact your First Western Advisor to guide you through the ever-changing tax environment.

Disclosures

First Western Trust Bank cannot provide tax advice. Please consult your tax advisor for guidance on how this information may apply to your specific situation.

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