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RECENT TAX LAW CHANGES MAKE INCOME TAX PLANNING MORE IMPORTANT THAN EVER

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One universal and challenging objective in wealth preservation planning is reducing taxes. Recent tax law changes have in many cases shifted the focus of such planning from estate and gift tax reduction to income tax reduction.

On January 1, 2013, Congress passed the American Taxpayer Relief Act of 2012 (ATRA) which, among other things, increased certain income tax rates. ATRA established a new top rate for ordinary income of 39.6% (up from 35%) for taxpayers with taxable income in excess of $400,000 for single individuals, $450,000 for married couples filing jointly, and only $12,150 for estates and trusts in 2014. In addition, the top long term capital gain and qualified dividend tax rate was increased from 15% to 20% for taxpayers in the above mentioned highest ordinary income tax bracket.

The Patient Protection and Affordable Care Act ("PPACA"), which was originally enacted in 2010, established a new 3.8% surtax on investment income which first became effective in 2013. For purposes of this tax, investment income includes interest, dividends, rent, royalties, capital gain and passive activity income. This additional tax applies to taxpayers with an adjusted gross income in excess of $200,000 for single individuals, and $250,000 for married couples filing jointly. For estates and trusts, this tax applies to the lesser of (i) undistributed net investment income or (ii) the excess of adjusted gross income over the amount at which the top income tax bracket for trusts and estates begins (only $12,150 in 2014). Considering this additional 3.8% tax, for taxpayers in the highest bracket, their effective ordinary federal income tax rate (not considering state income tax rates) can be as high as 43.4%, and the top long term capital gain and qualified dividend tax rate is now effectively almost 24%.

While income taxes have increased, particularly for estates and trusts, the imposition of federal estate and gift taxes on individuals has been significantly reduced. ATRA made permanent the $5 million estate and gift tax exemption that was first introduced in 2011. The exemption is indexed for inflation, and in 2014, an individual can shield up to a total amount of $5.34 million of assets either transferred during lifetime or at death from federal estate and gift taxes. ATRA also made permanent the portability feature, which now allows a surviving spouse to use his or her deceased spouse's unused exemption. This gives a married couple the ability to protect up to $10.68 million in 2014 from estate and gift taxes. The use of all or a portion of the exemption for gifts made during each person's lifetime will correspondingly reduce the amount that is available to shelter assets from estate tax after that person's death. ATRA increased the top marginal estate and gift tax rate from 35% to 40% to the extent the total value of assets gifted and passed upon death exceeds the available estate and gift tax exemption.

As a result of the recent changes to the estate and gift tax law, planning for these taxes is no longer relevant for most people. Less than one percent of estates are now subject to these taxes. However, this does not alleviate the need for proper and careful estate planning for everyone to assure that property is preserved and passes to the appropriate beneficiaries in the appropriate manner.

Income tax planning, however, is now more important than ever for many more people, including those with modest estates. In many cases, this planning focuses on the adjusted basis of a person's assets.

The adjusted basis is the original cost of an asset which is then adjusted for various tax-related items. Such adjustments include increases for the cost of improvements to property, increases for purchase and selling costs, and decreases for depreciation and amortization, where applicable. In addition, the basis in stock, partnership interests and other ownership interests in certain closely held businesses is adjusted up and down annually based on the amount of any distributions made from the business to the owners, taxable income or losses of the business passed through from the business to the owners, and certain other tax events occurring in the business during the year.

Under the tax law, the amount realized from a sale of an asset is generally an amount equal to the total consideration given for that asset, less the seller's adjusted basis in the asset. If the difference is positive, then the amount realized is a gain. If the difference is negative, the amount realized is a loss. Therefore, taxable gain upon the sale of an asset can be reduced if that asset has a high adjusted basis at the time of sale.

For lifetime gifting of an asset, the general rule is that the adjusted basis of the person making the gift (the "donor") carries over to the person receiving the gift (the "donee"), subject to certain exceptions. One exception to the general rule is that if the basis is greater than the fair market value of the asset at the time of the gift, then for the purpose of determining loss on the future sale of the asset, the basis must be adjusted to the fair market value at the time of the gift. The effect of these rules is that any unrealized gain in the gifted asset will be taxed to the donee when the asset is sold, but unrealized losses are lost to both the donor and donee. The donor's accumulated depreciation, where applicable, on a gifted asset carries over to the donee.

Upon death, the general rule for basis is different. The basis of property which is inherited gets "stepped up" to the then current fair market value of such property on the date of death (subject to certain exceptions). This increase in basis can reduce or eliminate capital gain tax liability on subsequent sale transactions by heirs, and can also provide heirs with a larger basis for depreciation and amortization deductions going forward.

For example, assume that a father who is seriously ill owns rental real estate worth $500,000 which has an adjusted basis of zero as a result of depreciation of the property over the years. He is thinking about gifting the property to his son. This plan would not be a good idea. If he follows through with the gift, the father's zero basis in the property will carry over to his son. On the other hand, if the father holds on to the property until his death, and passes the property to his son under his will, the son will receive a new "stepped up" basis in the property equal to the fair market value at the time of father's death. A stepped up basis will give the son the ability to receive valuable depreciation deductions against his income if he holds on to the property, or will allow the son to sell the property after father's death with little or no capital gain tax liability.

It is important to obtain detailed documentation of the basis of assets, to store this information in a safe place and to provide the information to family members and advisors. The sale of any asset can occur many years after the asset was received by gift or by inheritance. Without proper records, the tax consequences of the sale cannot be properly be determined or reported.

For many years the focus in planning has often been to minimize asset values to reduce estate and gift taxes. Now, many taxpayers will instead focus on maximizing the value of their assets to reduce future income taxes by keeping the adjusted basis of assets as high as possible. The recent income tax law changes will likely make professional appraisals more important for documenting basis, particularly for closely held business interests which do not have an easily determinable fair market value.

Individuals who are no longer subject to estate and gift taxes may have current estate plans that are focused on saving estate and gift taxes, and are not designed to obtain a stepped up basis to save income taxes. Existing plans should be reviewed and updated as soon as possible to be consistent with the new tax law.

We can work with you to review and update your current estate plan and to assure that proper provisions are in place to meet your needs and goals. Wealth preservation planning can involve a number of areas of law, including, estate planning, taxation, business law, litigation, asset protection planning, real estate law and divorce law. HRMML takes a multi-disciplinary approach to wealth preservation planning involving attorneys with expertise in a number of different areas of law. Please contact our office if you have any questions or want to learn more about our capabilities in this area.