CERTAINTY IN AN UNCERTAIN SEA OF TAXES

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WEALTH MANAGEMENT

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INTRODUCTION

"NOTHING IS CERTAIN BUT DEATH AND TAXES!"

It seems as though the only subject on the agenda of tax advisors is the uncertainty of taxes. The same goes for the financial press, which is replete with dark statements about higher taxes on the horizon. In reality, as that old homily says, there is a lot of certainty about taxes – even now. What is certain this year, compared to what is uncertain in the future, makes 2012 a planning opportunity window you don't want to miss.

SO WHAT IS CERTAIN?

The existence of ***some*** taxes is a certainty. The income tax, as we know it now, or in some other form, is unlikely to disappear. Nor will the social security tax, although the rates and amount of income subject to the tax could change. In addition, the recent Supreme Court ruling[1] ensures that, beginning in 2013, the new taxes created by President Obama's Health Care Acts[2] will take effect and result in higher taxes for some of us. These include:

- An additional 0.9% Medicare payroll tax, and
- A new 3.8% net investment income tax.

Given the size of the deficit and the appetite of some political and opinion leaders to target taxation to those who are or seem wealthy, transfer taxes (like estate and gift taxes) are also likely to stick around.

WHAT IS UNCERTAIN?

The most frequent questions regarding future taxes center around income taxation rates for capital gains, dividends and ordinary income; and who will pay – everyone, the rich, the ultra-rich? Most of these questions focus on the 2013 tax year, when the built-in reversion to tax rules and rates that were last in effect during 2001 and 2003 kicks in. The so-called "sunset provisions" of the 2001 and 2003 Tax Acts[3] (which were extended through 2012 by the 2010 Tax Act[4]) provide that individual income and capital gains tax rates, in addition to estate, gift and generation skipping tax rates, exemptions and credits all revert to their 2001 levels on January 1, 2013.

1. On June 28, 2012, the Supreme Court upheld the Patient Protection and Affordable Care Act. This means that the taxes imposed by the Health Care and Education Reconciliation Act will take effect on January 1, 2013.

2. The Patient Protection and Affordable Care Act, PL 111-148, March 23, 2010 and the Health Care and Education Reconciliation Act, PL 111-152, March 30, 2010.

3. The Economic Growth and Tax Relief Reconciliation Act of 2001, PL 107-116, June 7, 2001 and The Jobs and Growth Tax Relief Reconciliation Act of 2003 §301, PL 108-27, May 28, 2003.

4. Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, PL 111-312, December 17, 2010.

For 2012, there is uncertainty about tax provisions that technically expired on December 31, 2011. There are a bunch of these – 73 different provisions to be exact, which have typically been temporarily extended on a one or two-year basis. Two of these provisions are especially important to most Laird Norton Wealth Management clients:

- Tax-free distributions from IRAs to charities; and
- Increased alternative minimum tax exemptions.

As of today, no one is sure what will happen, either with regard to expired tax provisions or the soon-to-be expired lower income tax rates and transfer tax rules. Despite these tax uncertainties, there are still opportunities to plan.

2012 PLANNING SUGGESTIONS

INCOME TAX

Starting with income taxes, we know what the tax rates are for this year and we know that some taxes will definitely be higher next year for those likely to be paying the new Health Care Act taxes. For investors, this raises the question of whether to sell appreciated assets now before the tax increase hits or hold. Back in 2010, investors were faced with this same dilemma when future capital gains tax rates were uncertain. At the time, we wrote about this tax uncertainty and provided some planning solutions in a white paper called *"Sell before probable tax increases – or hold? Planning for a change in the capital gains tax rates."* Two years later, the planning solutions we provided in the white paper still apply. If an individual has unrealized gains, the decision about whether to sell now or hold on to their appreciated assets is determined by their expected holding period.[5] That is, by how long the person intends to keep those securities. For those who intend to sell within the next three years who are likely to pay the new net investment income tax, selling this year is advisable because they will be dollars ahead by selling and paying tax now rather than selling during the next three years and paying that additional 3.8% net investment income tax. It's also important to note that this new tax will hit all the investment income of most trusts and estates, as well as individuals with total income of over $200,000 if single or $250,000 if married and filing jointly. If one expects capital gains tax rates to be increased for 2013 to the pre-2003 levels, selling in 2012 is advisable even if

5. David M. Stein, "Do You anticipate an Increase in Tax Rates? Deferring Capital Gains is Not Always the Best Strategy," Parametric Portfolio Associates commentary, July 2004 and Paul Bouchey, "Pay Now or Later? Making Investment Decisions in a Changing Tax Environment," Parametric White Paper, Spring 2008.

a person's expected holding period is eight or nine years. The following chart will help you determine if it's a good time for you to sell, recognize gain or hold your appreciated assets this year:

Table for evaluating whether to sell, recognize gain and repurchase in 2012 to reset tax basis, or just hold the security:

Years the security is held	What is the expected growth in the security's value?*						
	1%	2%	4%	6%	8%	10%	12%
1	0.1%	0.3%	0.5%	0.8%	1.0%	1.3%	1.5%
2	0.3%	0.5%	1.0%	1.5%	2.1%	2.6%	3.1%
3	0.4%	0.8%	1.6%	2.4%	3.2%	4.0%	4.9%
4	0.5%	1.0%	2.1%	3.2%	4.4%	5.5%	6.7%
5	0.6%	1.3%	2.7%	4.1%	5.6%	7.1%	8.7%
6	0.8%	1.6%	3.3%	5.0%	6.9%	8.8%	10.8%
7	0.9%	1.9%	3.8%	6.0%	8.2%	10.6%	13.1%
8	1.0%	2.1%	4.5%	7.0%	9.6%	12.4%	15.4%
9	1.2%	2.4%	5.1%	8.0%	11.1%	14.4%	17.9%
10	1.3%	2.7%	5.7%	9.0%	12.6%	16.4%	20.4%
11	1.4%	3.0%	6.4%	10.1%	14.2%	18.5%	23.0%
12	1.6%	3.3%	7.0%	11.2%	15.8%	20.6%	25.7%
13	1.7%	3.6%	7.7%	12.3%	17.4%	22.9%	28.5%
14	1.9%	3.9%	8.4%	13.5%	19.1%	25.1%	31.3%
15	2.0%	4.2%	9.1%	14.7%	20.9%	27.4%	34.1%
20	2.7%	5.8%	12.9%	21.1%	30.1%	39.3%	48.0%
30	4.2%	9.2%	21.4%	35.3%	49.0%	60.5%	69.1%

*Based on 2012 long-term capital gain tax rate of 15%.

All the boxes in the table above show the break-even increase in tax rate (over 15%). For example, if the expected growth is 8% for 4 years, you have indentical after-tax outcomes from selling and re-purchasing in 2012 as from holding when the expected tax rate is 19.4% (15+4.4). If the expected tax rate is equal to 19.4% or less, sell. The orange-shaded boxes above indicate the holding periods and expected growth rates if the expected increase to the tax rate is 3.8%, in which case selling in 2012 is recommended. The light blue boxes expand the holding periods and growth rates if the expected increase to the tax rate is 8.8%, in which case selling in 2012 is recommended. Further, 8.8% is what tax rates on capital gains could increase to with the new net investment income tax of 3.8% plus a return of the capital gain rate to the pre-2001 rate of 20%.

But what about income other than capital gains? In 2013, any investment income (interest, dividends, capital gains, rental income and income from businesses that are investments rather than occupations) is subject to that new 3.8% tax for those that meet the income thresholds outlined on the previous page. In general, if you expect tax rates to increase next year, the recommended strategy is to accelerate income into the current year and defer deductions to the year with higher tax rates.

IRA DISTRIBUTIONS

Although the law allowing tax-free treatment of IRA distributions for charitable donations (up to $100,000) has been very popular with both donors and charities, it was allowed to expire at the end of last year. This provision has had wide appeal because it allows a current tax benefit from a charitable contribution to all taxpayers, even for taxpayers who do not itemize deductions (and therefore get no tax benefit from their charitable contributions) and for those who give so much to charity that their tax benefits are deferred. For many taxpayers, however, the tax-free nature of the distribution to a charity doesn't have a very significant tax effect because they normally do deduct their charitable contributions and those contributions are not limited based on the person's income.

A strategy for those individuals who were hoping to use this now-expired provision is to have up to $100,000 of their 2012 IRA distribution paid directly to charity – just as they would have if the tax-free distribution provision still existed. That way, if the provision is retroactively extended for 2012, the distribution should qualify for tax-free treatment. On the other hand, if the provision isn't extended, since the distribution will have been paid to charity, a charitable deduction could be claimed to offset the taxable income from the distribution. It's important to mention that this strategy won't work for those who would not normally itemize deductions or for those whose charitable giving exceeds the percentage of income limitations on current charitable donations. For this latter group, waiting to see if the law is extended is the wisest strategy.

ALTERNATIVE MINIMUM TAX

Now for the issues surrounding the 2012 Alternative Minimum Tax (AMT). Unlike the Medicare tax discussed above, the AMT has broad applicability in its current form.

Approximately 31 million taxpayers will pay the AMT in 2012, 26 million or roughly 84% of them for the first time. This tax, originally designed to make sure that the very wealthy pay some tax, now reaches a large portion of the middle-class as well. More likely than not, this tax provision will be "patched," as it has been every year since 2004 when the expanded exemptions originally expired. The so-called "patch" means that Congress authorizes for 2012 the expanded exemptions that expired at the end of last year. As an example, the current AMT exemption for a married couple is $45,000. In 2011, when the expanded exemption was in effect, that amount was $74,450. The decrease in the exemption amount from 2011 to 2012 could increase a couple's tax by as much as $8,246. Unfortunately, we may not be able to plan around the uncertainty with the AMT. It is fairly difficult to plan to minimize the AMT without the expanded exemptions because the tax is based on recalculating taxable income with fewer deductions and other tax benefits. A huge cause of the broad applicability of the AMT is the fact that for the past nine years the regular income taxation rates have been very low, which by itself increases a taxpayer's likelihood of paying the AMT. For most taxpayers 'on the cusp' of paying the AMT, relief has come in the form of the above-mentioned patch. Sadly, in recent years, that relief hasn't become a reality until the very last month of the year.

TRANSFER TAXES

While the long-term status of estate, gift and generation skipping transfer taxes is uncertain, we do know what the rules are for 2012 – and they are very generous. Next year, however, we foresee something different. Although we do not believe that gift and estate taxes will be repealed, the tax rates are likely to increase and the exemptions could decrease. Without Congressional action, in 2013 the lifetime and at-death exemption amount will be capped at $1,000,000 and the top transfer tax rate will be 55%. Compare that to the exemption and top tax rates for 2012: $5,120,000 and 35%. For many individuals, these expiring provisions allow an additional $4,120,000 of lifetime giving – but, as far as we know, only until the end of 2012. If an individual can afford to give assets away, this is a great time to do so. For taxpayers with estates that are subject to Washington state estate tax, completed gifts also remove assets from the Washington estate tax base, possibly saving as much as 19% of state tax per dollar gifted.

Making taxable gifts of illiquid assets (such as real estate) allows donors to take advantage of the opportunity to save future estate tax while not altering the amount of liquid assets available to support their lifestyle. For example, transferring a residence to a qualified personal resident trust (QPRT) allows a donor to take a discount from the market value of an asset (that may already have a depressed market value) for gift tax purposes while still allowing the donor to retain the right to live in and use the residence for a period of time. Gifts to QPRTs are taxable gifts that the temporarily expanded gift tax exemption may make "tax-free." This year is also a great time to pre-fund irrevocable life insurance trusts with gifts that are tax free in 2012 because of the expanded exemptions. This strategy provides the trust with assets to help pay annual premiums, which will be especially helpful for those trusts with policies where increased annual premium payments are expected to exceed the amount the donor can gift to the trust using gift tax annual exclusions. This year's larger exemption also facilitates gifting to grandchildren on a completely tax free basis since the generation skipping transfer tax exemption is also $5,120,000.

Finally, it is important to recognize that wealth transfers can also occur by giving away opportunities to earn income. Intra-family loans are straightforward transactions that allow donors to provide family members and others with the opportunity to invest and build wealth from appreciating investments while freezing the values of their own estates by converting appreciating assets into fixed value loans. The required interest rates on intra-family loans for July 2012 are as low as an annual 0.24% (loans for three years or less) and as high as 2.30% (for loans of more than nine years).

The status of tax laws in the future is uncertain because we know that the tax rates and rules will change. We also know that it is reasonable to expect these forthcoming changes to result in higher tax rates and less generous rules. But, we are certain that thoughtful planning during 2012 to take advantage of the generous rules we currently have will be a good investment. If any of these ideas are interesting to you or you would like to explore other planning opportunities during 2012, please contact your Laird Norton Wealth Management advisor.

ABOUT THE AUTHOR

Kristi Mathisen serves as Laird Norton Wealth Management's in-house expert on tax and estate planning issues. She provides advice on philanthropic strategies to the firm's client service team and to clients directly. She is an attorney and CPA and has more than 20 years of finance-related experience, much of it in accounting.

Kristi has a bachelor's degree in business administration with an accounting concentration from the University of Washington and a Juris Doctor from the University of Washington School of Law. She is a member of the Washington State and King County Bar Associations, the Washington State Society CPA and the American Institute of CPAs.

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