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A monthly newsletter for Accounting, and Financial Professionals with a focusing on Estate Planning, Elder Law, and Special Needs Persons.

The Planner is a newsletter to inform and educate Accounting and Financial Professionals of the ever changing areas of estate taxes, and elder law to better service their clients.



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Top Income Tax Planning Ideas for 2011 and 2012

With the recent discussions about closing tax loopholes and increasing taxes for the “wealthy” incident to increasing the national debt limit, clients are beginning to fear that the taxes on their wealth will increase. Even without higher tax rates, wealthier Americans will pay more in taxes if allowable deductions (possibly charitable) and exemptions (probably estate tax) are lowered.

We need to be prepared to help our clients as they begin to draw down retirement savings and look for more tax-efficient investments for their stocks, bonds, real estate and savings.

In this issue of The Planner, we will examine some of the top income tax planning ideas to implement in 2011 and 2012.

Income Tax Overview

Anything can happen between now and January 1, 2013, but, based on current law, that will be the date the top

income tax rate increases from 36% to 39.6%, qualified dividends become subject to ordinary income tax rates, the tax on long-term capital gains jumps from 15% to 20%, and the 3.8% Medicare surtax kicks in (unless the Florida Federal District Court decision striking down the health care reform act is upheld). Let’s look more closely at how these taxes can impact your clients, and what you can do to help them.

Qualified Dividends

Under current law, in tax years beginning on or after January 1, 2013, qualified dividends will be subject to ordinary income tax rates. Therefore, C Corporations with accumulated earnings and profits and the cash to do so should consider making larger dividends in 2011 and 2012.

Example, Distribution of C Corp Dividends: Should the sole shareholder of a C Corp make a \$1 million dividend to himself in one lump payment in 2012 or in \$200,000

increments over five years (2012-2016)? Assuming he is in the highest marginal income tax bracket, 15% capital gains tax rate on dividends in 2012, and $39.6\% + 3.8\% = 43.4\%$ ordinary income tax rate on dividends for 2013 and beyond, he would pay \$150,000 in taxes on the lump sum distribution in 2012 and \$377,200 on the incremental distributions paid over five years. He would save \$ 227,200 by taking the lump sum in 2012.

Long-Term Capital Gains

Under current law, in tax years beginning on or after January 1, 2013, long-term capital gains will be taxed at a top rate of 20%. Taxpayers should consider selling (or otherwise disposing of) appreciated property and recognizing the taxable gain in 2011 and/or 2012. Taxpayers who have realized capital gains deferred on an installment note may want to consider accelerating the unrecognized gain in 2011 and/or 2012.

Example, Acceleration of Gains: In 2012, Judy sold her business for \$1 million in exchange for a nine-year installment note. At the time of the sale, she realized a \$900,000 gain. By electing out of the installment treatment, she would pay \$135,000 in capital gains tax on the lump sum in 2012 vs. \$175,500 on the installments in 2012-2021, and would save \$40,500 in taxes ($900,000 \times .15 = 135,000$ versus $900,000 \times .1 \times .15 = 13,500$ plus $900,000 \times .9 \times .2 = 162,000$).

Ordinary Income

Under current law, in tax years beginning on or after January 1, 2013, ordinary income tax rates will increase to their pre-2001 levels. Taxpayers should consider accelerating certain types of ordinary income (bond interest, annuity income, traditional IRA income, compensation income) into 2011 and 2012 if they expect to be in the same tax bracket or higher in future tax years. This is especially true for top bracket taxpayers who may pay the 3.8% Medicare surtax on their “net investment income.”

Example, Accelerating Bond Interest: Mike has \$100,000 of accrued bond interest that will be paid on January 3, 2013. Mike is in the 35% tax bracket for 2012 and $39.6\% + 3.8\%$ for 2013. If he sells his bonds (at par) before the end of 2012 and recognizes the accrued interest income, he will pay \$35,000 in taxes vs. \$43,400 if he waits and

collects the interest in 2013, and will save \$8,400 in taxes.

Example, Sale/Repurchase of Bond: James purchased \$1 million of corporate bonds in 1993 at par value; they mature December 31, 2011. On December 31, 2012, he sold them for \$1,050,000. On January 3, 2013, he repurchased the same bonds for \$1,050,000. Under tax law, this \$50,000 premium can be used to offset his interest income over the remaining life of the bond (one year). By selling the bonds in 2012 and repurchasing them in 2013, he realizes a net income tax savings of \$14,200 ($\$21,700$ in income tax savings on the bond premium, less $\$7,500$ in capital gains tax on the sale of the bonds = $\$14,200$).

Additional Income Tax Planning Ideas

Oil and Gas Investments: Intangible drilling costs (IDCs) provide a large immediate income tax deduction (up to 85% of the initial investment). Losses, if any, created as a result of IDCs will be ordinary and will lower the taxpayer’s Adjusted Gross Income. Depletion and other depreciation provide for additional deductions during the term of the investment. Additional tax credits may be available for certain oil and gas ventures.

Planning Tip: Be careful with oil and gas investment where the client may be subject to the alternative minimum tax (AMT). The AMT may limit the amount of deductions allowed.

Gold Investments

Generally, gold held as coins or bullion is treated as “collectibles,” for which the long-term capital gain rate is 28%. All short-term capital gains are treated as ordinary income. Therefore, a taxpayer in a lower tax bracket would be better off triggering short-term rather than long-term capital gain on gold coins or bullion. On the plus side, the “wash sale rule” (explained below) does not apply to “collectible” losses.

Planning Tip: The “collectibles” tax rate does not generally apply to gold held in mutual funds or to non-exchange-traded options on gold. Gold futures must be “marked to market” and the unrealized gain/loss must be recognized each tax year. Moreover, gold futures gains are subject to special tax treatment (60% long-term capital gain or 40% short-term capital gain).

Foreign Currency Transactions

Gains and losses in foreign exchange transactions are ordinary income/loss rather than capital gain/loss. Generally, taxpayers will want to recognize ordinary income in 2011 and 2012 and push ordinary losses to 2013 and later years.

Index Options

These have special gains treatment on certain broad-based listed options (60% long-term and 40% short-term). For taxpayers in the highest marginal income tax bracket in 2013, this would result in a blended capital gains tax rate of 29.36% $((.6 \times .2) + (.4 \times .434))$.

Loss Harvesting

Loss harvesting can apply to individuals, trusts/estates, and charitable lead and remainder trusts. Considerations include:

Wash Sale Rule:

Capital losses are denied to the extent that a taxpayer has acquired (or has entered into a contract or option to acquire) a “substantially identical” stock or security within a period beginning 30 days before the sale and ending 30 days after the sale of a stock that was sold at a loss (“loss stock”). The disallowed loss on the loss stock is added to the cost basis of the new stock, and the holding period of the loss stock is carried over to the new stock. This rule also applies to ETFs, index funds, IRAs and taxable investment accounts. It does not apply to “collectibles.”

Diminishing Real Value of Capital Losses: Because of the cost of capital, the sooner a capital loss is used the better.

Efficiency of Capital Loss Offsetting:

In general, capital losses are more tax effective if they can be used to offset income taxed at higher tax rates (short-term capital gains and ordinary income). Long-term losses used against short-term gains are tax-efficient. Short-term losses used against long-term capital gains are tax inefficient.

Income Shifting to Junior Generations

Income taxes can be saved by shifting income-producing assets from parents or grandparents who are in a high income tax bracket to their children and grandchildren who are in lower tax brackets. Planning considerations include asset protection (accomplished through the use of trusts)

and the “kiddie tax” for beneficiaries under age 24.

What makes this most attractive in 2011 and 2012 is the \$5 million per person gift tax exemption: a married couple can gift up to \$10 million and no gift tax will be incurred on the gift. The gift can be made in trust and then used to invest and/or purchase life insurance on the donors.

Example: Husband and wife, who are taxed at the current top (35%) rate, own \$16,000,000 in S Corporation stock. They gift \$10 million of it to their four adult children (15 5/8% of the S Corporation stock to each child). The S Corporation income is \$2 million per year. After the gift, 37.5% is attributed to the parents and taxed at their rate and 62.5% is attributed to the children and taxed at their lower rates (assume 25%). Annual income tax savings: $\$10,000,000 \times 10\% = \$100,000$.

Planning Tip: Income can also be shifted upwards. For example, a high-earning professional can make the gift to his/her elderly parents who are in a lower tax bracket. The additional income can be used to help pay for medical and/or assisted living expenses. After the parents die, the assets can go to the original donor’s children (if the “kiddie tax” does not apply) for additional income shifting.

Roth IRA Conversions

Benefits of converting include a lowering overall of taxable income long-term; tax-free compounding; no required minimum distributions (RMDs) during the owner’s life; tax-free withdrawals for beneficiaries; and more effective funding of the bypass trust. For most people, converting to a Roth IRA is highly beneficial over the long term.

Planning Tip: When exploring a Roth IRA conversion, consider the tax rate in the year of conversion vs. the tax rate in years of withdrawals; the owner’s ability to use outside assets to pay the income tax on the conversion; and the need for the IRA to meet annual living expenses.

Net Unrealized Appreciation (NUA) Planning

If an employee has employer securities in his/her qualified retirement plan, he/she may be able to convert a portion of the total distribution from the plan from ordinary income into capital gain income. The distribution must be made as a lump-sum distribution due to the employee's death, attaining age 59 1/2, separation from service, or becoming disabled within the meaning of Code section 72(m)(7).

Taxation of Lump-Sum Distribution

Ordinary income is recognized on the cost basis of the employer securities distributed (a 10% early withdrawal penalty is due if the employee is under age 55 at the time of distribution). The difference between the fair market value at distribution and the cost basis is Net Unrealized Appreciation (NUA). NUA is not taxed at the time of distribution, but at a later time when the stock is sold, and is taxed then at long-term capital gain tax rates. (Ten-year averaging is available to those born before 1/2/1936; 20% capital gain applies to pre-1974 contributions only.)

Planning Tip: NUA does not receive a step-up in basis at death, although subsequent gain above the value at distribution should. Also, if an estate or trust contains NUA stock, a fractional funding clause must be used; otherwise, the NUA will be subject to immediate taxation.

Charitable Planning

If the capital gains tax rate increases to 20% and the 3.8% Medicare surtax applies, charitable remainder trusts (CRTs) could become very attractive again. That's because appreciated assets that are transferred to a CRT are not taxed, so the full value of these assets is available to provide income to the donor, generating much more income than if the donor had sold the asset, paid the capital gains tax, and re-invested the proceeds.

Planning Tip: With the current historically low 7520 rates, charitable lead trusts can be used now by charitably inclined clients to shift significant wealth while using only an insignificant amount of their estate/gift tax exemption.

Inherited IRAs

An IRA is treated as inherited if the individual for whose benefit the IRA is maintained acquired the IRA upon the death of the original owner. Under the tax law, the IRA assets can be distributed based upon the life expectancy of the beneficiary if the beneficiary is a living person or a trust that meets certain requirements, such as that it is irrevocable, all beneficiaries are natural persons, and the oldest possible beneficiary can be determined.

Spouse as Beneficiary

A surviving spouse named as beneficiary of the deceased spouse's IRA may roll it over into a new or existing IRA in the spouse's own name. The spouse is then treated as the owner and may delay taking required minimum distributions (RMDs) until he/she turns age 70 1/2 and then take distributions based on his/her life, often allowing for a greater stretch-out period.

Planning Tip: If the surviving spouse is under 59 1/2, rolling over can expose him/her to the early withdrawal penalty if the IRA funds are needed before the surviving spouse reaches 59 1/2. Safer strategy is to wait until then to roll over and use the inherited IRA withdrawal rules before then.

Non-Spouse as Beneficiary

Naming a non-spouse beneficiary avoids having the IRA assets being subject to estate tax in the surviving spouse's estate. Required minimum distributions (RMDs) occur over the life expectancy of the designated beneficiary.

Common Inherited IRA Mistakes to Avoid

For non-spouse beneficiaries, it is critical to keep the inherited IRA in the name of the deceased IRA owner. Correct wording for an individual: "John Smith, deceased, IRA for the benefit of James Smith." Correct wording for a trust: "John Smith, deceased, IRA for the benefit of James Smith as Trustee of the Smith Family Trust dated 1/1/2010."

Other mistakes include not taking required minimum distributions, not using disclaimers when appropriate, not analyzing contingent beneficiaries, and taking a lump-sum distribution at the death of the IRA owner.

Life Insurance Planning for Inherited IRA

If the IRA owner's taxable estate does not have sufficient other assets, it could be necessary to use a portion of the IRA to pay estate taxes. Because this use triggers additional income taxes, between 60-80% of the IRA could be lost to taxes.

A solution is to establish an Irrevocable Trust that holds a life insurance policy on the IRA owner's life. Upon his/her death, the death benefit proceeds can be used to provide liquidity to the IRA owner's estate and preserve the inherited IRA. To the extent that the grantor does not hold any "incidents of ownership," none of the trust assets will be included in his/her taxable estate. Another alternative is to annuitize the IRA and contribute the annuity payments to the Irrevocable Trust where they are used to pay premiums for life insurance on the IRA owner.

Conclusion

The current income tax laws and the tax increases that will happen in just 16 months (unless the Congress and President agree otherwise) provide some unique opportunities for estate planning professionals to work together as a team to help our mutual clients. Take advantage of this limited time to meet with your clients, ask the right questions, and make a positive difference for them and their families.

The Future of Medicaid and Medicare

In our March issue, we reported about the federal government's efforts to decrease spending in 2011 by making sweeping cuts to numerous federally funded programs to avoid a government shutdown. Four months later, the focus on cutting Medicaid and Medicare benefits has gained momentum, despite documented evidence of the many benefits of Medicaid, as well as the huge detrimental impact cutting either program can have on individual states.

Proposed Cuts

As has been widely reported, the Obama Administration is offering to cut tens of billions of dollars from Medicare and Medicaid as part of the negotiations to reduce the federal budget deficit. The depth of the cuts depends on whether Republicans will accept any increases in tax revenues.

It appears that hospitals and nursing homes will be the unwilling recipients of some of the cuts, as Administration officials and those involved in the negotiations say that the cuts can come from health care providers like hospitals and nursing homes without directly imposing new costs on needy beneficiaries or overhauling either program. Some of the proposals being considered are:

- Gradually eliminating Medicare payments to hospitals for uncollectible patient debt. Medicare currently reimburses hospitals for 70% of debt resulting in patients failing to pay deductibles and co-payments and the hospitals have made reasonable efforts to collect.
- Reducing Medicare payments to teaching hospitals for the cost of training doctors, caring for sicker patients and providing specialized services such as trauma care and organ transplants.
- Reducing the federal share of payments to health care providers treating low-income people under Medicaid and the Children's Health Insurance Program.

Lawmakers opposed to the cuts say it would impair access to care for the poor and shift costs to the states that are already facing a huge expansion in Medicaid eligibility and enrollment beginning in 2014 under the terms of the health care reform legislation passed last year. Hospital executives say that additional cuts (besides the reduction in Medicare payments already part of the health care reform legislation) will result in hospitals discontinuing services and increasing charges to patients with private insurance.

Proposed Cuts Will Limit Access to Health Care

CBS News recently reported on the impact of the potential health industry cuts. Doctors are among the many who are very concerned about any additional health industry cuts. Dr. David Ansell, Chief Medical Officer of Chicago's Rush University Medical Center told CBS News, "People are dying because they don't have simple access."

Ansell explained that he is seeing a growing number of patients with Medicaid or Medicare who can't find doctors willing to treat them, and the problem is the government's low reimbursement rates. One study

by the Colorado State Task Force found that a doctor earning \$100 through private insurance would be paid about \$71 through Medicare, and about \$50 through Medicaid.

CBS called 40 primary care physicians at random to test whether doctors are limiting the patients they will see based on their method of insurance. 95% of the physicians polled said they accept new patients with private insurance, 78% still accept Medicare patients, but only 13% see patients who are on Medicaid.

With additional cuts to Medicare and Medicaid, it is clear that access to health care will be severely limited to those on Medicare, and more so for those who receive Medicaid.

Governors Speak Out Against Medicaid Cuts

The National Governors Association wrote the President and congressional leaders involved in the budget negotiations urging them not to cut Medicaid funding. Responding to reports that the target for 10-year total Medicaid reduction is in the neighborhood of \$100 billion or \$10 billion a year, the Chair of the National Governors Association wrote, "Make no mistake: these reductions are significant and cannot be absorbed into state budgets or simply passed on to providers of health services for our Medicaid populations."

The Benefits of Medicaid Access

In the first ever study of its kind, the National Bureau of Economic Research, a private, not-for-profit, nonpartisan research organization, released a working paper with results of a study conducted in Oregon to determine the effects of Medicaid on recipients. The study began in 2008 when Oregon opened a waiting list in its Medicaid program to low income adults who had previously been ineligible for enrollment and then drew names by lottery from the 90,000 who signed up.

What the study found in part was that Medicaid could lead to better self-reported physical health and lower medical debt. "We find that in this first year, the treatment group had substantively and statistically significantly higher healthcare utilization (including primary and preventive care as well as hospitalizations), lower out-of-pocket medical expenditures and medical debt (including fewer bills sent to collection), and better

self-reported physical and mental health than the control group," the study said.

The authors of the study, including researchers from Harvard, MIT and the Oregon Health Study Group, caution against generalizing these estimates to other contexts, like the planned Medicaid expansion as part of the health care reform legislation passed last year. The study covered approximately 10,000 low-income uninsured adults, relative to a total Oregon population of about 3.8 million, with 650,000 uninsured and around 200,000 low-income adult uninsured. "Our estimates are therefore difficult to extrapolate to the likely effects of much larger health insurance expansions, in which there may well be supply-side responses from the healthcare sector," the study noted.

The working paper for "The Oregon Health Insurance Experiment: Evidence from the First Year" can be ordered from the National Bureau of Economic Research website, <http://www.nber.org/papers/w17190>.

Why Everyday Americans Need Medicaid

The Center for American Progress recently published the top 10 reasons why everyday Americans should pay close attention to the House Republican proposal to cut Medicaid and completely restructure it into a block-grant program. A few of the reasons are noted below, with the full text of the article available at http://www.americanprogress.org/issues/2011/07/medicaid_middle_class.html.

The current proposal for a Medicaid block-grant leaves the states holding the bag on Medicaid. If a block-grant program were implemented, states would be forced to spend \$266 billion more on Medicaid from state revenues just to maintain current eligibility and services.

Block-granting Medicaid would threaten the safety net for middle-class families whose family members have suffered a serious illness or face extended long term care due to old age or disability. The Center notes that many disabled and elderly Medicaid enrollees come from middle-class households and include individuals with physical and mental disabilities, victims of catastrophic accidents and nursing home residents. While these individuals make up 25% of Medicaid enrollees, they account for approximately 2/3 of Medicaid spending.

Block-granting Medicaid could impoverish the spouses of many nursing home residents. If a block-grant program were implemented as proposed, the spousal impoverishment provisions that currently exist to protect the spouse at home will be repealed.

Block-granting Medicaid could affect the economic security of millions of middle-class families with parents needing nursing home care. Without Medicaid, families would have to face huge nursing home bills once the resources of the family member are exhausted, care for the loved one at home, or leave their loved one without care. These limited choices will have great implications on family finances including home ownership and the ability to send children to college.

Conclusion

Despite numerous documented benefits of Medicaid and Medicare, these programs face severe financial cuts and restructuring. Now more than ever it is important for seniors and their loved ones to work with trusted legal counsel to come up with a comprehensive plan that will cover how they will access health care and how it will be paid for.

Please contact us if you would like additional information on any of the topics addressed in this newsletter or if you would like to discuss a specific issue.

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