LOOKING AHEAD TO 2014

Planning For What We Know and What We Don't Know

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When planning for the New Year it is important to consider the implications of what we know—tax rates, threshold levels, increasing state taxes and the Medicare related taxes—and dispassionately weigh that against what we don't know: the possibility of tax reform.

TAX RATES, THRESHOLD LEVELS AND RISING STATE TAXES

As we move into 2014, we have some certainty regarding tax rates that were set at the start of 2013 by the American Taxpayer Relief Act of 2012 (ATRA). In 2014 we will continue to operate in a higher-tax environment for high-income taxpayers. Therefore, it will be important to think about tax rates and evaluate decisions accordingly.

Income Tax

In 2014, the top marginal federal income tax rate continues to be 39.6% for high-income individuals, with a top marginal rate of 20% for long-term capital gains and qualified dividends. Additionally, the Medicare related taxes–the additional 0.9% on wages and self-employment income as well as the 3.8% tax on Net Investment Income (NII)–may increase federal taxes for high-income individuals to 43.4%, before taking state taxes into account.

State income taxes are on the rise in many states. California, for example, taxes any income over $1 million at a rate of 13.3%. So, with the 39.6% federal rate, the possibility of the 3.8% NII tax on long-term capital gains and the state income tax, the tax cost may be in excess of 50%. Also, to be noted, the 20% tax rate for long-term capital gains and qualified dividends applies to taxpayers in the 39.6% tax bracket.

The thresholds for these federal and state taxes vary. For individual income tax rates, the thresholds are annually adjusted for inflation. Thanks to ATRA the thresholds for the Alternative Minimum Tax are also permanently adjusted for inflation. But, the individual thresholds for the 3.8% Medicare Contribution tax on net investment income are set and not indexed for inflation. Therefore, when evaluating the timing of income it is important to keep in mind the applicable thresholds.

Taxpayer	Taxable Income to Which the 39.6% Rate Applies in 2014
Single Filers	Over $406,750
Heads of Households	Over $432,200
Married Filing Jointly and Surviving Spouses	Over $457,600
Married Filing Separately	Over $228,800
Estates and Trusts	Over $12,150

Ordinary Income Tax Rates	Long-term Capital Gain and Qualified Dividend Tax Rates
10%, 15%	0%
25%, 28%, 33%, 35%	15%
39.6%	20%

Taxpayer	Modified Adjusted Gross Income Above Which the NII Tax Applies
Married Filing Jointly and Surviving Spouses	$250,000
Married Filing Separately	$125,000
All Other Individuals	$200,000

Wealth Transfer Planning Considerations

Higher gift, estate and generation-skipping transfer tax exclusion and exemption levels allow for greater wealth transfer planning flexibility. The exclusion and exemption levels increase from $5,250,000 in 2013 to $5,340,000 in 2014. However, in the current higher rate environment, wealth transfer planning should take into account the relative tax rates and the tax cost of lifetime transfers versus transfers at death.

	2014 Exclusion/Exemption Adjusted for Inflation	Highest Marginal Tax Rate
Gift	$5,340,000	40%
Estate	$5,340,000 (with portability)	40%
GST	$5,340,000	40%

THE POSSIBILITY OF REFORM IN 2014

Looking ahead to 2014 it is impossible to say when or if comprehensive tax reform will take place. As 2013 closes, budget discussions persist and Democrats and Republicans are presenting their ideas for tax reform. In particular, Max Baucus, chairman of the Senate Finance Committee has begun to publicize a series of working papers meant to begin the dialogue regarding tax reform in 2014. Senator Baucus announced earlier this year that he will not seek reelection in the 2014 midterms. In December, President Obama announced his intention to nominate Senator Baucus to be the next U.S. ambassador to China. Senator Baucus continues to advance the tax reform debate before leaving office.

When and if comprehensive tax reform takes place, it will not necessarily reflect either party's initial proposals. Rather, comprehensive reform would entail agreement and compromise by both parties regarding the many elements of the Internal Revenue Code. There are numerous facets of the tax code which would need to be addressed for comprehensive reform to take place, including: corporate, individual, pass-through entities, international taxation, tax administration and the taxation of financial products.

The considerations and concerns underlying tax reform discussions include: the projected rising cost of health care, whether or not certain proposals are revenue raising or revenue neutral and how tax revenue will be spent in the short and long term.

Tax Expenditures

In light of the increasing costs of the federal government and benefits, tax expenditures continue to be a topic of discussion as a source of revenue. Tax expenditures are revenue losses attributable to provisions of the federal tax laws which either allows a special exclusion, exemption or deduction from gross income, or which provide a special credit, a preferential rate of tax or a deferral of tax liability. Currently in the Internal Revenue Code, more than 200 tax expenditures exist, and the ten main expenditures are estimated to account for more than $990 billion in "lost" revenue in 2013. The largest expenditure is the exclusion of employer provided health benefits. The preferred tax rate for capital gains and qualified dividends is a high level "lost" revenue item. The majority of tax expenditures relate to individuals.

The Administration's Fiscal Year 2014 Green Book Proposals

The Administration's Budget Proposals for Fiscal Year 2014, the so-called Green Book which was published in April, sheds light on some of the priorities of the Administration. *Proposed* areas of reform relevant to individuals as well as income and wealth transfer planning include:

- Limit the value of certain itemized deductions and exclusions to 28% (would apply after the current phase-out).
- "Buffett Rule" Fair Share Tax on high-income taxpayers–30% of adjusted gross income over $1 million, $500,000 married filing separately, with a credit for charitable contributions.
- Tax carried (profits) interest from an investment partnership as ordinary income, subject to self-employment tax.
- Multiple provisions affecting tax-preferred retirement accounts including automatic employee enrollment in IRAs, elimination of required distribution rules for small IRA balances, required inherited beneficiary distribution payments over no more than 5 years and a limit on the total accrual of tax-favored retirement benefits.
- In 2018, restore gift, estate and GST tax rates, exclusions and exemptions to 2009 levels.
- Proposed minimum (10 years) and maximum terms (life expectancy of the annuitant plus 10 years) for grantor retained annuity trusts.
- Limit the duration of GST tax exemption for "dynasty trusts" to 90 years.

Both the issue of addressing tax expenditures to help raise revenue and the Administration's proposed areas of reform set forth in their 2014 budget are only two of the specific proposals on the table. Should comprehensive reform take place in the future, more fundamental changes may come to light as the discussions continue.

STARTING OUT IN 2014

Although tax reform remains uncertain, a successful start to 2014 will entail making the most of what we know. With the higher tax rate environment, it will be important to consider the timing of income and deductions, accelerating deductible expenses and deferring income. However, it is important to keep in mind the tax brackets and evaluate how these thresholds may impact the tax bite in 2014. For individuals selling sizeable assets or interests, such as a sale of an interest in an investment partnership, one option to consider in 2014 would be the possibility of doing so as an installment sale, stretching the payments out over a period time to determine if the overall tax cost might be less.

Ultimately, no two taxpayers are alike, so it is important to work with trusted advisors when making decisions. As these and other developments unfold, we will continue to keep you informed.

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