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DECEMBER 2013 NEWSLETTER

Happy Holidays!

As we approach year-end our clients' focus will be shifting to the higher income tax they are likely to pay for 2013 as they look ahead to making 4th quarter estimated tax payments by January 15th and to filing tax returns by April 15th or later by extension.

We thought it appropriate to warn you of the nature of these income tax increases so you will not be unpleasantly surprised and may consider and implement year-end tax planning if appropriate.

Below we have reproduced some material on these income tax changes from our March 2013 Newsletter.

PERSONAL INCOME TAX CHANGES FOR 2013

Overview: General Income Tax Rates

Under the American Taxpayer Relief Act of 2012 ("ATRA") the Bush-era tax rates are permanently extended for most taxpayers. In general, and subject to the new health care tax discussed below, individuals with taxable income under \$400,000 (\$450,000 for joint filers) will continue to receive the benefit of the Bush tax cuts. However, a top rate of 39.6% – the highest rate under President Clinton and President George H. W. Bush – will be effective for individuals with taxable incomes above these amounts.

Capital Gains/Qualified Dividend Tax Rates

A top rate of 20% for long term capital gains and qualified dividends applies to individuals with taxable incomes above \$400,000, and joint filers with taxable income above \$450,000.

Long term capital gains and qualified dividends will continue to be taxed at 15% permanently for taxpayers with taxable incomes below these amounts.

Trusts and Estates

Trusts and estates are subject to the 39.6% rate on ordinary income and the 20% rate for long term capital gains and qualified dividends at just \$11,950 of taxable income. The 3.8% medicare surtax is imposed on certain taxes of investment income of trusts and estates with modified adjusted gross income above \$11,950.

Personal Exemption Phase-Out

The personal exemption phase-out has been reinstated beginning in 2013 for single filers with adjusted gross income above \$250,000 (\$300,000 for joint filers).

“Pease” Limitation on Itemized Deductions

The “Pease” provision phases out itemized deductions by the lesser of 3% of adjusted gross income or 80% of otherwise allowable deductions. Not all deductions are phased out. Home mortgage interest, taxes and charitable deductions ARE subject to the phase-out, but not medical and dental and some others. This limitation does NOT apply to trusts and estates.

The following chart demonstrates the cumulative impact in 2013 of the tax increases for taxable incomes above \$400,000 single/\$450,000 joint:

	Wage Income	Interest Income	Dividends	Long Term Capital Gains
Top Rate	41.05% *	39.6%	20%	20%
Phase-out of itemized deductions **	1.2%	1.2%	1.2%	1.2%
Medicare Tax	.9%	3.8%	3.8%	3.8%
Combined top rate	43.15%	44.6%	25%	25%

* includes 1.45% employee share of Medicare tax (an additional 1.45% applies to self-employed)

** estimated by Price Waterhouse Coopers

Individual Retirement Accounts

For 2013 only (for now) individuals may make tax-free gifts to charity of up to \$100,000 from traditional or Roth IRAs.

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We now want to focus a little more closely on the three important income tax changes:

1. Higher tax rates
2. Limits on itemized deductions
3. New Medicare tax on net investment income

These three new changes apply at varying income thresholds and on different measures of income.

Ordinary Income

The new top bracket of 39.5% applies to taxable net income above \$400,000 for individuals, above \$450,000 for married couples.

“Pease” Limitation on Itemized Dedications

This provision may be described as a “Stealth Tax.” In 2013 the adjusted gross income threshold at which the limit kicks in is \$250,000 for individual taxpayers, \$300,000 for married couples filing jointly.

Net Investment Income Tax

An additional 3.8% Medicare Tax (to fund The Affordable Care Act) applies to the net investment income of individuals with adjusted gross income above \$200,000 and married couples with income above \$250,000.

The calculation of net investment income is very complicated.

FIRST - - Calculate gross investment income by adding:

- A. Interest, dividends, annuities, royalties and rents (other than rent earned in the ordinary course of a trade or business in which the taxpayer “materially participates”)
- B. Passive income from a trade or business
- C. Net gain from the disposition of property other than property held in a trade or business in which the taxpayer materially participates.

- SECOND - - Calculate the permitted deductions by adding:
- A. Deductions attributable to rent and royalty income
 - B. Investment interest
 - C. Investment expenses
 - D. State income taxes

Gross investment income less permitted deductions is net investment income.

Net Result of Three Changes

Taxpayers with very high incomes will be subject to all three of these new tax changes. Many more will be subject only to the "Pease" provisions and net investment income tax.

Bessemer Trust calculated the income tax on identical scenarios in 2012 and 2013 and found an astonishing tax increase.

The scenario for a married couple filing jointly –

<u>Income</u>		<u>Itemized Deductions</u>	
Wages	\$450,000	Taxes	\$30,000
Qualified Dividends	\$300,000	Mortgage Interest	\$15,000
Long Term Capital Gains	<u>\$1,000,000</u>	Charitable	<u>\$75,000</u>
Total Income	\$1,750,000	Total Deductions	\$120,000

Total Tax 2012 \$293,000

Total Tax 2013 \$407,400

Increase by Percentage: 39%
 Increase by Dollars: \$114,400

Year End Income Tax Planning

What can be done to soften the new tax bite?

- Maximize deductible contributions to tax qualified retirement plans, establish a SEP-IRA or another plan if you have not
- Charitable contributions of appreciated long term capital gain property are more attractive because of the higher taxes rates offset, and avoided, by donation rather than sale
- Charitable remainder trust gifts of low basis, highly appreciated stock provide a current deduction to offset higher taxes and a future income stream
- Tax-loss harvesting, particularly to generate losses to offset short-term capital gain

CHANCE OF IRS AUDIT INCREASES WITH INCOME LEVEL

According to the latest figures released by the IRS, for tax year 2011, the more an individual makes, the greater her chances are of being audited.

<u>Adjusted Gross Income</u>	<u>Likelihood of Income Tax Audit</u>
\$50,000-\$100,000	.64%
\$100,000-\$200,000	.85%
\$200,000-\$500,000	1.96%
\$500,000-\$1,000,000	3.57%
\$1,000,000-\$5,000,000	8.9%
\$5,000,000-\$10,000,000	17.94%
More than \$10,000,000	27.37%

INTERNATIONAL TAX ADJUSTMENTS FOR 2014

The first \$145,000 of gifts made in 2014 to a spouse who is not a U.S. citizen will not be includible in taxable gifts, up \$2,000 from \$143,000 in 2013.

A U.S. person receiving aggregate foreign gifts exceeding \$15,358 in 2014 will be required to file an informational return.

The amount of the 2014 foreign income exclusion under Code Section 911 will be \$99,200, up from \$97,600 in 2013. The maximum foreign earned income housing deduction for 2014 will be \$29,760.

YEAR END TRANSFER TAX PLANNING

Recall that each U.S. citizen and permanent resident alien has a lifetime transfer tax exemption of \$5,250,000 in 2013. You may use this exemption during life if you choose, on gifts in excess of the annual exclusion discussed below, but such gifts must be disclosed to the IRS on a gift tax return due by April 15 of the year following the making of the gift. In 2014 this exemption will increase by \$90,000, to \$5,340,000. If you have previously given away and "used up" the entire current exemption, next year you may give away another \$90,000 tax free.

Annual Gift Tax Exclusion

In each calendar year, every individual may give to as many individuals as she likes (it does not matter if the donees are related) an annual amount which is \$14,000 in 2013 and will remain \$14,000 in 2014.

Direct Transfers Outright

Such gifts may be made by check cashed before year-end or wire transfer or by transfer of publicly-traded securities at the market value on the date of transfer. Gifts of fractional interests in real estate or closely-held business or investment entities pose very complex valuation issues. The donee of appreciated assets takes a "carryover" income tax basis from the donor – that is, the donee receives the same basis as the donor.

Example: Husband and wife with three married children and six grandchildren may each transfer \$14,000 to each, and if they choose, \$14,000 to each son and daughter-in-law. So in this example each parent would have 12 potential donees, so the couple could transfer $24 \times \$14,000 = \$336,000$ under this exemption every calendar year. The children do not pay income tax on the gifts. The parents do not even have to report such gifts to the IRS.

Other Transfer Vehicles

If the donor desires to delay the donee's access to the gifted property to a later date or until the donee attains a greater age, there are several alternatives.

Code Section 529 Savings Program for Minors

Qualified Tuition Programs (529 Plans) are a good alternative for donors who want to specifically set aside funds for higher education. All fifty states offer these programs. You may sign up directly or create the account through your stockbroker, mutual fund company or other investment advisor. You may use any state's program regardless of where you live or where the beneficiary will attend school. Gifts to your home state's program may afford a state income tax benefit. You may survey the state programs at www.savingforcollege.com. Income earned on funds in such a program are not subject to tax as they accumulate or when they are withdrawn for expenses of higher education, i.e., college, post graduate, professional education. The donor or a designated party may control the account. If the intended beneficiary does not need these funds, the controlling party may shift the account to another beneficiary. Funds withdrawn other than for higher education are subject to income tax and a penalty. An interesting feature of these accounts is that a donor may give five years of gift in advance by aggregating this year's and the next four years' gifts to make a one-time gift, e.g., $\$14,000 \times 5 = \$70,000$ at one time by an individual; \$140,000 at one time by a couple. No legal work is involved to establish a 529 plan. The plans offered by Maryland and Virginia are particularly highly rated by Morningstar.

UTMA/UGMA accounts

Uniform Transfers to Minor Act or Uniform Gifts to Minors Act accounts may be established at any financial institution or with any investment manager. A custodian – the donor or another party – controls and invests the account and may distribute assets to or for the benefit of the child at his/her discretion until the child's 21st birthday, at which time the child is entitled to any balance. The accounts should be designated "Hold to Age 21" or else in some states the child

could claim the account at age 18, before the funds can be used to pay for college. The child's own social security number is on the account. The "Kiddie tax" which causes children to age 21 to be taxed at the parents' top tax bracket above a nominal amount of passive income – \$2,000 in 2013 – can deter use of such accounts. But these accounts are simple to establish. No legal work is involved to establish a UTMA/UGMA account.

Custom Trusts

Custom trusts are prepared by a lawyer and provide the greatest level of flexibility and greatest level of control for the donor. The donor dictates when and if income and/or principal are distributed, perhaps in stages at particular ages or upon the occurrence of certain events. A trustee or trustees manage the funds and distribute the assets according to the trust's terms. The trust is subject to income tax on income retained, at the top bracket of 39.5% at only \$11,950 of income in 2013. The beneficiary is taxed on income distributed. If income is not going to be distributed, it is frequently desirable to invest such a trust in non-income producing growth equities to minimize the income tax the trust must pay.

Two Types of Gifts Not Subject to Gift Tax At All

Tuition paid directly to the school and medical expenses paid directly to the service provider are subject to an unlimited exemption from gift tax. So all over America grandparents are paying the tuition of grandchildren at private elementary and secondary schools as well as to colleges and universities for undergraduate, graduate and professional school. These gifts can be made in addition to the annual exclusion gifts described above. No tax reporting is required.

GENERAL OVERVIEW OF ESTATE PLANNING

Fred spoke at an alumni seminar at Georgetown University offered to reunion classes. The very useful outline of this program is on our website, or, if you prefer, we can mail it to you. It is titled Critical Issues in Planning Your Estate After the December 2012 The Law Changes.

ASSET PROTECTION PLANNING

Fred spoke at a legal conference on International Estate Planning in Boston in October. His topic was Offshore (and Domestic) Asset Protection Trusts. This very comprehensive outline is on our website, along with a more general overview of domestic asset protection techniques delivered in 2010 at a legal conference in Madison, Wisconsin. It is titled Protecting Family Assets from Creditors. If you have any concerns about present or potential future creditors, please review this outline and/or contact us. Fred has an expertise in asset protection planning that is frankly unique in the D.C. Metro area.

PRE-AND POST-NUPTIAL AGREEMENTS

We have a great deal of experience negotiating marital agreements for newlyweds or couples with children from a previous marriage. Such agreements can determine the rights of each party in each other's property and income before and after marriage and in joint property in the event of death or divorce.

OTHER NEWS

Brooke recently took and passed the Virginia Bar exam. She just finished her 4th Marine Corps Marathon, and her 6th marathon overall. Cindy's daughter Kate started at UVA, where she is majoring in chemistry with an eye on medical school. Nivin's daughter Rhonda just got married. Fred's other daughter Charlotte is living in Dubai working for Ogilvy & Mather where she focuses on social media and digital communications. Our Firm was selected by US News and World Report as one of the Best Law Firms in the Washington Metro Area in 2013. Fred was named recently in Northern Virginia Magazine and in the December 2013 Washingtonian Magazine as one of the best Trust and Estate lawyers in the area. He was also named in 2013 as a Super Lawyer in Washington and Virginia and in Best Lawyers in America.

REVIEW OF YOUR SITUATION

If you would like us to review the desirability of any changes or additions to your estate plan or to discuss anything in this Newsletter, please contact us to set up an appointment.

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