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2014 TAX UPDATE

Although delayed because of last fall's government shutdown, tax filing season is officially upon us! Several important changes to the U.S. tax code went into effect during 2013, and you will likely notice the effects of some of those changes when you complete and file your 2013 federal income tax return. In particular, you may discover that you owe more to the IRS for the 2013 tax year than you did in prior years, even if your income has not increased.

Additionally, due to recent changes to the federal income tax regime, income tax planning has become a more important component of estate planning. In particular, because of increased capital gains rates, the new Net Investment Income Tax, and higher federal estate and gift tax exemptions, some taxpayers should consider revising their estate plans and gift-giving strategies to make maximum use of the basis step-up that occurs upon death and to reduce the capital gains that their beneficiaries will realize upon the eventual sale of appreciated assets.

The following summarizes important income tax changes that you may notice when you prepare and file your 2013 income tax return, and outlines how changes to the income tax laws relate to your estate planning.

Income Tax Changes

In general, high-income taxpayers will see an increase in taxes owed for the 2013 tax year as compared with 2012. The term "high-income" does not have the same meaning for all of the provisions described below, although these tax increases generally begin to apply to single taxpayers earning $200,000 and above and to married taxpayers with a combined income of $250,000 or more.

Higher Tax Rates on Earned Income. In 2013, the highest marginal individual income tax rate increased from 35% to 39.6%. This new 39.6% tax rate applies to income above $450,000 for married couples filing jointly ($400,000 for single filers). Also, in January 2013, the 2% reduction in payroll and self-employment tax expired, meaning that taxpayers have been paying more in payroll and self-employment taxes throughout 2013 than they did in 2012. Taxpayers also now pay an additional Medicare Wage tax of 0.9% on wages and self-employed earnings that exceed $250,000 for married taxpayers filing jointly ($200,000 for single taxpayers).

Higher Long-Term Capital Gains and Qualified Dividends Tax Rate. At the beginning of 2013, the top long-term capital gains and qualified dividends tax rate was increased from 15% to 20%. This top rate applies to married taxpayers, filing jointly, with income above $450,000 ($400,000 for single filers).

Net Investment Income Tax. In 2013, the new Net Investment Income Tax (also referred to as the Medicare Contribution Tax) went into effect. This 3.8% tax is assessed on qualified dividends and investment income (which includes interest, dividends, and capital gains) of married taxpayers with a modified adjusted gross income over $250,000 ($200,000 for single filers). This tax is assessed on the smaller of the taxpayer's net investment income or the excess of modified adjusted gross income over the noted dollar thresholds.

Limitations on Itemized Deductions and Exemptions. In addition to raising tax rates and adding new taxes, for the 2013 tax year Congress has also limited the itemized deductions and personal exemptions that previously may have benefited high-income taxpayers. Specifically, for 2013, itemized deductions are reduced by 3% of the excess of adjusted gross income above $300,000 for married filers ($250,000 for single filers), although the total reduction may not exceed 80% of affected deductions, and certain categories of deductions are exempt from the cutback. Additionally, personal exemptions are reduced by 2% for every $2,500 that a taxpayer's adjusted gross income exceeds the same dollar thresholds. This means that many high-income taxpayers will have a higher adjusted gross income than they did in 2012, even if their income and deductions remained the same.

Expiration of the Charitable IRA Rollover Deduction. Beginning in 2014, taxpayers will no longer be able to claim a deduction for qualified charitable distributions (QCDs) made from Individual Retirement Accounts (IRAs). Previously, taxpayers who were at least age 70 ½ could transfer up to $100,000 from their retirement accounts to a qualified charity. This was useful for taxpayers who had to take out required minimum distributions but did not need the money to live on, because it permitted those taxpayers to avoid paying income tax on the distributions.

What This Means for You in 2013

If you are a high-income taxpayer—meaning generally that your household income exceeds the various dollar thresholds noted above—you will likely owe more in taxes this year than last year. The chart below illustrates how the 2013 tax increases set forth above will result in an increased tax bill for a hypothetical married couple with two dependent children and having the same income and deductions in 2012 as 2013.

Item	2012	2013	Explanation
Income			
Wages	$475,000	$475,000	
Interest Income	$20,000	$20,000	
Qualified Dividends	$30,000	$30,000	
Short-Term Capital Gains	$25,000	$25,000	
Long-Term Capital Gains	$100,000	$100,000	
Adjusted Gross Income	$650,000	$650,000	Income in 2012 and 2013 is exactly the same.
Deductions			
Itemized Deductions	$75,000	$64,500	Certain itemized deductions are reduced in 2013 for high-income taxpayers.
Exemptions	$15,200	$0	Personal exemptions are now phased out for high-income taxpayers.
Total Taxable Income	$559,800	$585,500	*Even with the same income and deductions, this couple's taxable income is over $25,000 higher in 2013.*
Federal Taxes			
Tax on Ordinary Income	$119,570	$128,024	Highest marginal rate on ordinary income is now 39.6% (previously 35%).
Tax on Qualified Dividends	$4,500	$6,000	Top tax rate on qualified dividends is now 20% (previously 15%).
Tax on Long-Term Capital Gains	$15,000	$20,000	Top tax rate on long-term capital gains is now 20% (previously 15%).

Net Investment Income Tax	--	$6,650	The new 3.8% Net Investment Income Tax applies to certain unearned income.
New Medicare Wage Tax	--	$2,025	Employees pay the 0.9% Medicare surtax once household income exceeds $250,000 (for married taxpayers).
Increased Medicare Wage Tax	--	$2,202	Additional 2% in payroll taxes.
Total Federal Tax Liability	$139,070	$164,901	***Despite the same income and deductions in both years, this family's tax bill is almost 20% higher for the 2013 tax year than it was for 2012.***

Steps You Can Take to Reduce Future Income Taxes

Most of the income tax rules for the 2013 tax year will also apply in 2014. However, you may be able to reduce your 2014 taxes by implementing one or more of the following tax deferral and avoidance strategies throughout this year:

- One very simple way to reduce your income tax liability is to maximize your retirement account contributions. The current (2014) contribution limits are as follows:
  - Traditional/Roth IRA: $5,500 if under age 50; $6,500 if age 50 or older
  - 401(k)/403(b)/457(b)/SAR-SEP: $17,500 if under age 50; $23,000 if age 50 or older
  - SIMPLE: $12,000 if under age 50; $14,500 if age 50 or older
- If you anticipate that you will realize significant capital gains in 2014, you may wish to harvest some of your portfolio losses to offset those gains.
- Certain types of gifts—such as charitable donations—offer tax advantages. In particular, taxpayers who make gifts of certain appreciated stock or other illiquid assets may claim an income tax deduction for the full market value of those gifts, even if their tax basis is much lower.
- Depending on your anticipated future income stream, you may consider converting your traditional IRA to a Roth IRA. Although this would increase your 2014 taxes (because it would require you to pay taxes on the amount converted), future qualified withdrawals in retirement will be tax free.
- You may wish to supplement your investment portfolio with municipal bonds. Generally, interest income earned on municipal bonds is not subject to federal income taxes.
- If you are in the higher marginal brackets for ordinary income, consider investments that will generate long-term capital gains or qualified dividends, which are taxed at lower rates.

However, you should consider these steps only to the extent that they make financial sense for you. Reducing your income tax bill should not come at the expense of your overall financial goals.

Estate and Gift Tax Changes

Federal Estate and Gift Tax. For 2014, the estate and gift tax exemption is $5,340,000. The Generation Skipping Transfer tax exemption is also $5,340,000. The top marginal estate tax rate is 40%. Additionally, "portability" was made permanent beginning in 2013, meaning that a surviving spouse may utilize his or her deceased spouse's unused exemption in addition to his or her own exemption, provided that the proper election is made following the first spouse's death.

State Estate Tax. On the state level, the 2014 estate tax exemption amounts for several states are as follows:

State	Estate Tax Exemption Amount	Top Estate Tax Rate
Massachusetts	$1,000,000	16%
Rhode Island	$921,655	16%
Connecticut	$2,000,000	12%
New Hampshire	No estate tax	--
New York*	$1,000,000	16%
Florida	No estate tax	--

**A recent proposal by the New York State Tax Relief Commission would increase the exemption amount to match the federal estate tax exemption and would lower the top estate tax rate to 10%.*

Integrating Income Tax Planning with Estate Tax Planning

Income Tax Considerations in Estate Planning and Administration. Given the high federal estate tax exemption and the permanence of portability, as well as changes to the income tax regime that increase taxes on capital gains and investment income, it is becoming increasingly important to consider income tax ramifications when creating an estate plan and settling an estate. One reason for this is the basis step-up that occurs upon death: most of the taxpayer's assets that are includible in his or her estate receive a step-up in basis to the value as of date of death, which reduces or eliminates the gain that the ultimate recipients of that property will realize if they eventually sell those assets. Depending on the taxpayer's tax basis in certain assets as well as projected state and federal estate taxes, it may be advantageous to the ultimate recipients of the property to receive certain appreciated assets through the taxpayer's estate rather than as a lifetime gift.

Use of "Free" Lifetime Gifts. For taxpayers who anticipate estate tax liability, making "free" gifts during their lifetime is still an excellent way to reduce the size of the taxable estate. "Free" gifts are those that can be made without using any of the taxpayer's lifetime gift exemption. These include:

- **Annual Exclusion Gifts.** The 2014 annual gift tax exclusion is $14,000 for individuals, or $28,000 for married couples.
- **Tuition and Medical Gifts.** These include payments for someone else's qualified tuition costs or qualified medical expenses, provided that the payment is made directly to the institution or provider.
- **Grantor Retained Annuity Trusts (GRATs).** A GRAT is a trust into which the taxpayer transfers property, and from which the taxpayer retains a right to receive a fixed annuity for a term of years. At the end of the term, any property remaining in the trust will pass to the beneficiaries (often the next generation), usually free of any transfer tax.

Tax Planning for Same-Sex Couples

Last year was a watershed year for same-sex marriage. As a result of the U.S. Supreme Court decision in US v. Windsor, same-sex marriages are recognized under federal law, which means that at the federal level, several tax and benefits provisions apply to same-sex married couples for the first time in 2013. Although the Windsor case dealt with estate tax, the decision in that case also applies to income tax and other federal benefits.

Beginning with the 2013 tax year, same-sex couples who married in jurisdictions that recognize same-sex marriage must file as married taxpayers (jointly or separately). Additionally, married same-sex couples may elect to file amended returns using married status for prior tax years, provided that the statute of limitations for amending the returns has not expired.

Finally, estate and gift tax benefits once available only to opposite-sex married couples (such as the unlimited marital deduction) are now also available to same-sex married couples. Same-sex married couples who developed estate plans prior to this change should consider revising their plans to take advantage of newly available tax benefits.

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