6/05/13
3:00 Session

Estate Tax Update
2013

- Karen L. Carmichael & Associates, P.C.

- Overview
- Overview of Rates
- Overview of 3.8% Surtax on Net Investment Income
- Overview of Fiduciary Tax Issues
- Income Shifting
- Charitable Remainder Trusts
- What's Changing
- Federal Estate Tax Exemption in 2013
  - $5,200,000
  - Inflation-Adjusted
- General Skipping Tax Exemption in 2013
  - $5,200,000
  - Inflation-Adjusted
- Annual Exemption
  - $14,000

(Obama Administration Proposal to
Reduce Both to $3,500,000)

- More changes
- State Estate Tax (Not Oklahoma)
  - Decoupling
  - Additional Tax Structures
- Income Taxes
  - Dividends
  - Step-up in Basis
- ObamaCare
- Medicaid
- Health Care Decision-Making
- Individual Tax Rates
- Individual Tax Rates of 10%, 15%, 25%, 28%, 33%, and 35% were permanently extended on income at or below $450,000 for joint filers and $400,000 for single filers.
  - The 39.6% rate applies above the income threshold amounts.
  - The threshold amounts are indexed for inflation after 2013.

- 2013 Ordinary Income Tax Rates
- 10%, 15%, 25% and 28% rates from Bush Administration tax cuts made permanent
- 33% and 35% rates made permanent up to certain threshold levels –
  - Single Taxpayers $400,000
  - Head of Household $425,000
  - Married Filing Jointly or Surviving Spouse $450,000
  - Married Filing Separately $225,000
- **Amounts of Income Above These Threshold Levels Taxed at 39.6%.**
- Threshold amounts adjusted for inflation

- 2013- Long-term capital gains & dividends
- Tax rate increases to 20% for taxpayers with income above the threshold amount listed on the previous slide
  - As these taxpayers will be above the threshold amounts for the 3.8% surtax, their capital gain rate will actually be 23.8%
- Maximum rate stays at 15% for taxpayers with lower incomes
- Qualified dividends treatment is made permanent
- 3.8% Medicare Surtax
  on **Investment** Income
- New Medicare surtax of 3.8% on investment income is added for AGI's in excess of $200,000 for single filers, $250,000 for joint filers, beginning in 2013.
- Itemized Deductions Phase Out
- If AGI is over $300,000 joint/$250,000 single, itemized deductions are phased out at a rate of 3% over the threshold level, up to a maximum of 80% of the deductions other than medical investment interest, and casualty and gambling losses.
- Over $450,000-NO Deductions
- Phase Out of Personal Exemptions
- Similar to itemized deductions, the $3,900 personal exemption deduction is phased out if AGI is over the $300,000 joint/$250,000 single thresholds.
- 0.9% Medicare Payroll Surtax
- The Medicare payroll surtax on employees is increased by 0.9% on earned incomes over $200,000 for single filers and $250,000 for joint filers, beginning in 2013.

- Healthcare surtax beginning Jan. 1, 2013

- 3.8% Medicare "Surtax" Overview
- Investment Income

- Beginning with the 2013 tax year, a new 3.8% Medicare "surtax" will apply to all taxpayers whose income exceeds a certain "threshold amount."
    - This new "surtax" will, in essence, raise the marginal income tax rate for affected taxpayers.
- Thus, a taxpayer in the 39.6% tax bracket (i.e. the highest marginal income tax rate in 2013) would have a marginal rate 43.4%!

- 3.8% MEDICARE "SURTAX" OVERVIEW
- Threshold amounts

Application of the NIIT to partners and S corporations shareholders

- UNDERSTANDING THE "SURTAX"

Application to C-Corp Dividends & Capital Gains:

- Both Dividends and Capital Gains from a C-Corp are included in Net Investment Income and are subject to the 3.8% Surtax
- UNDERSTANDING THE "SURTAX"

Application to S- Corp Earnings:

- K-1 profits for S-Corp owners who ***materially participate*** appear *not* to be subject to either the 0.9% tax on earned income OR the 3.8% surtax on net investment income.
- Distinguish portfolio income which is separately stated
- Passive owners would still be subject to the 3.8% surtax
- UNDERSTANDING THE "SURTAX"

Application to sale of S-Corp shares:

- For material participants, only net gain or loss attributable to property held by the entity which is *not* "property attributable to an active trade or business" is taken into account (e.g. stocks, bonds, other investment property) for the 3.8% surtax
- For passive investors, any and all gain or loss will be included in calculating Net Investment Income
- UNDERSTANDING THE "SURTAX"

Application to Sub-K (partnership) Earnings:

- Earnings for Sub-K owners who ***materially participate*** appear *not* to be subject to the 3.8% tax on net investment income BUT will be subject to the 0.9% tax on earned income.
- Passive owners are just the opposite. They would be subject to the 3.8% surtax on NII, but not the 0.9% tax on earned income.
- UNDERSTANDING THE "SURTAX"
- Application to sale of Sub-K (partnership) interest:
- For material participants, only net gain or loss attributable to property held by the entity which is *not* "property attributable to an active trade or business" is taken into account (e.g. stocks, bonds, other investment property) for the 3.8% surtax
- For passive investors, any and all gain or loss will be included in calculating Net Investment Income
- UNDERSTANDING THE "SURTAX"

- Catch - 22
- Shifting active income may save income tax but increase the 3.8% Surtax
- "Endangered Strategies" – Obama Budget

"Endangered Strategies"
(Under Obama Proposals)

- Grantor trusts still avoid estate tax, including Intentionally Defective Grantor Trusts (**IDGTs**) and Irrevocable Life Insurance Trusts (**ILITs**).
- Discounts are still allowed on non-business interest or for transfers to minority interests.
- The ten-year minimum term for Grantor Retained Annuity Trusts (**GRATs**) was not enacted – two-year rolling GRATs remain available.
- No **90-year limit on the GST** tax exemption was adopted. Dynasty Trusts are still possible.
- What's NOT Changing
- Fundamentals
  - Avoiding Living and Death Probate
  - Protection of Surviving Spouse
  - Philanthropic Objectives
  - Planning for Heirs
    - Youth
    - Responsibility & Skill
    - Divorce Protection
    - Preventing "Affluenza"
- What's NOT Changing
- Business Planning
  - Entrance
  - Growth
  - Maintenance
  - Mergers/Acquisitions
  - Exit
- What's NOT Changing (?)
- Retirement Planning***– [May 17, 2013]
  - Roth IRA Conversions
  - IRA Planning Via Trusts
  - Stretch
  - Annuitization & Replacement
  - Reengineering Closely-Held Businesses

***Friday May 17, 2013

Senators: Reed, Harkin, Murray, Rockefeller, Baldwin, Schumer, Franken, Brown, Murphy and Durbin have reintroduced a bill to reduce the Federal Exemption to $3.5 Million and Gift Tax to $1 million.

ALSO reintroduced a tax provision :

reduce postmortem IRA payouts to five 5) years

- What's NOT Changing
- Income Tax Planning
  - Mobility to avoid state income taxes
    - Seven States Impose NO Income Tax
    - Two States Tax Only Dividend and Interest Income
  - Income Shifting
  - Opportunity Shifting
- What's NOT Changing
- Elder Law Planning
- Special Needs Planning
- Asset Protection Planning
- What's NOT Changing
- Need for Life Insurance
  - Debt Liquidity
  - Income Replacement
  - Estate Equalization
  - State Death Taxes – 21 States
  - Wealth Replacement for Charitable Giving
  - Buy-Sell
  - Capital Gains Tax Liqui8dity (post-repeal)
  - Supplemental Retirement Planing
- Addressing Change
- Flexibility
  - Trust Protectors/Advisors
  - Marital Deduction Formulas
  - Disclaimers
  - Revocable Irrevocable Trust
  - Self-Settled Trusts – 14 States
- Additional information

<u>Taxes</u>

✖ Estate Taxes

- Income Taxes
- Gift Taxes
- Capital Gains

<u>Legal</u>

- JTWROS
- Probate
- Guardianship
- Positions in a trust
- TYPES OF TRUSTS
- Grantor trusts
  - Trust and grantor treated as one taxpayer
  - Income taxed to grantor
- Charitable trusts
  - Split-interest trust consisting of an income beneficiary and a remainder beneficiary
    - <u>Charitable Lead Trust (CLT)-</u> charity is the income beneficiary
    - <u>Charitable Remainder Trust (CRT)-</u> Charity is the remainder beneficiary
  - Last for a term of years or life

- Main Legal Ingredients
- Revocable "Living" Trusts
- Irrevocable Trusts
  - ILITs
  - Stand Alone "Dry" IRTs
  - ICGTs
  - Inter Vivos QTUIPs
- FLPs LLCs
- Retirement Plans (IRA's, 401(k)s)
- Main Legal Ingredients

- Life Insurance
  - Insured
    - Single Life
    - Survivorship
  - Types
    - Cash Value Policies
      - UL, Guaranteed or Non
      - Variable UL – Non-Guaranteed Only

        - Equity Indexed, Guaranteed or Non
    - Term Policies
- GENERAL TAX RULES
- Income taxed to either the trust/estate or the beneficiary
    - If income is accumulated, then the income is taxed to the trust/estate
    - If income is distributed, then the trust/estate gets an income tax deduction and beneficiaries report taxable income
- What to do Now – The < $5.25M Client
- Estate Tax issue is off the table for this strata of client. The estate-planning drivers will be:

- What to Do Now – The < $5.25M Client
- Family Income Shifting Through Family Entities
- Installment Sales of Real Estate and Business Assets or Entities
- Tax-Free Cash Value of Life Insurance Held Within an Accessible Grantor Retirement Trust
- What to Do Now – The < $5.25M Client
- Remove or Reduce IRA and 401K Assets from Owner and Beneficiary Income Taxes (IRA Annuitization and Life Insurance Within an ILIT)
- Retirement Trust for Maximum IRA Stretch
- Potential IRA/401K Roth Conversions
- KEY TRANSACTIONs
- Outright gifts to children:
- Advantages
    - Easy
    - Effective
- Disadvantages
    - No Asset Protection
    - No Spousal Protection
    - No Spend Thrift Protection
- KEY TRANSACTIONS
- LLC and partnership gifts:
- Advantages
    - Effective from a tax perspective
    - Better control
    - Income without cash flow
    - Some asset protection
- Disadvantages
    - Not the same level of asset protection as a trust

- KEY TRANSACTIONS

Trusts:

  - Gifts to "non-grantor" trusts for family
  - EBSTs & QSSTs
  - Distributions from existing trusts
  - Conversion of grantor trusts to non-grantor trusts
- CHARITABLE REMAINDER TRUST (CRT)
- CRTS- TAXATION
- The Character of income received by the recipient is subject to and controlled by the tier rules of IRC §664(b)
  - First, distributions are taxed as ordinary income
  - Second, distributions are taxed as capital gains
  - Third, distributions are taxed as tax-exempt income (e.g. municipal bond income)
  - Finally, distributions are assumed to be the non-taxable return of principal
- CRTs are not subject to the 3.8% surtax
- CRTs are not subject to the new 5.0% incremental capital gains tax
- CHARITABLE REMAINDER TRUST (CRT)FOR BENEFIT OF DONOR'S CHILDREN
- INCOME SHIFTING CRT
- Shifts ordinary income to family
- Shifts capital gains to family members
- Benefit charity

- Annuitize Your IRA
- Exchange Some of IRA Balance for Immediate Annuity
- Use the Annuity Payments to Fund:
  - Income Tax
  - Life Insurance Premiums
  - Increase Standard of Living
- Life Insurance Trust Owns Life Insurance
- Annuitize Your IRA
- Advantages
  - Spendable income annually, guaranteed for life (not tied to market performance)
  - Eliminates income tax to heirs on inherited asset
  - Eliminates the Estate Tax
  - Guaranteed death benefit beyond age 100
- Disadvantages
  - Largely depends on insurability

BIOGRAPHY:

Karen Carmichael brings an extensive background in business and law to her estate planning practice. An attorney since 1985, Karen earned her law degree from the University of Tulsa, and did her undergraduate and master's degree work at Oklahoma State University. She is a member of both the Oklahoma and Texas Bar Associations, and has been a presenter for the Oklahoma Bar Association at their seminar on Asset Protection. Karen also teaches continuing education courses on Probate, Wills and Trusts, Family Limited Partnerships, and Elder Care. Karen serves on the Board of Directors of the Tulsa Estate Planning Forum, and is currently the President - Elect.

Before focusing her practice solely on estate planning in 1997, Karen was a professional liability attorney for the federal government, a commercial real estate attorney, and earlier was on staff with U.S. Senator Don Nickels. Practicing law during Oklahoma's recession in the mid-1980's, Karen saw the need for estate planning strategies for people who are salaried or nearing retirement, independent or small business proprietors, or involved in family farming or ranching operations.

Karen actively works with many charitable organizations, including serving on the Board of Directors for Heritage Family Services, a not-for-profit adoption agency. She also helped begin the Kaliningrad Project, helping children in orphanages in Kaliningrad, Russia. Karen, a member of Grace Church, teaches a Sunday School class of 100 members called Knees to Earth, and can be found ministering at various churches around the nation and foreign countries, including Poland, China and Africa.