Financial Planning

FINANCIAL-PLANNING.COM
INVESTED IN ADVISORS / FEB. 2013

NEW TAX STRATEGIES

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Theodore Sarenski, CEO of Blue Ocean Strategic Capital in Syracuse, N.Y., has new plans for medical expenses and muni bond investments.

15 TAX MOVES FOR RIGHT NOW

The eleventh-hour tax deal reached in Washington will require some new strategies for advisors and their clients.

By **Ilana Polyak**

Talk about taking it down to the wire: Even as they were watching the ball drop, Americans still didn't know what tax policy they'd be facing come April 15. But by the time the smoke cleared after Washington's fiscal cliff face-off, a new, far-reaching tax law had been approved and signed, with broad consequences for advisors and their clients.

There are other changes in play as well: new Medicare taxes laid out in the federal health care overhaul, the end of the 2% payroll tax holiday, the return of phase-outs for itemized deductions and a higher threshold for writing off medical expenses. Affluent Californians will also face an added state income tax, approved by voters in November under Proposition 30.

"For people in the higher income brackets, in some shape or form, taxes are going up," says Lyle Benson, president of financial planning and CPA firm L.K. Benson in Baltimore and chairman of the executive committee of the American Institute of CPAs' Personal Financial Planning division.

To gear up for the tax changes, *Financial Planning* asked a dozen tax professionals to highlight the most important strategies you can use to help clients handle the new rules. Many of the planning ideas that follow are geared toward helping you ease clients into the new, higher tax reality.

Theodore Sarenski, who heads Blue Ocean Strategic Capital in Syracuse, N.Y., suggests an aggressive approach to discretionary medical expenses.

1. FACE THE MEDICARE SURTAX

Unlike other tax changes this year, the Medicare surtax hasn't been on the negotiating table since last summer, when the Supreme Court upheld the health care law. To cover its costs, beginning this year, there is an additional 3.8% levy on unearned net income for individuals making more than $200,000 or married couples with joint incomes of more than $250,000.

Of course, there is no impact for those earning less than those amounts. And for clients well above the cutoffs, there's little that planning can do to minimize the surtax. But "to those clients who are at that threshold, my best advice for them is to minimize unearned income," says Theodore Sarenski, a certified financial planner and certified public accountant who heads Blue Ocean Strategic Capital in Syracuse, N.Y.

Advisors and their clients may want to think carefully about shifting more money into municipal bonds, which pay tax-free income, Sarenski says.

Timing matters, too: Individuals should consider when to realize gains, perhaps focusing on years when their earned income falls below the threshold such as during the year of a job loss or in retirement and can control their unearned investment income that way.

But remember that the tax doesn't apply only to income from traditional investments: Rental income and capital gains from a property sale also fall into this category. "Someone who is single and living in my area, who bought a home 30 years ago for $100,000, may be selling it for over $1 million," says Michael Eisenberg, founder of Eisenberg Financial Advisors in Los Angeles. "Imagine what their capital gain is going to be."

2. CHECK THE WITHHOLDING

You're not done with Medicare yet: On top of the surtax on unearned income, there's an additional 0.9% Medicare payroll tax for high earners, taking the Medicare levy to 2.35% from 1.45%. "That one's a little sneaky," says Tim

Steffen, director of financial planning for Baird's Private Wealth Management Group in Milwaukee.

Steffen cautions that although the tax is applied to incomes of more than $200,000 for individuals and more than $250,000 for married couples filing jointly, some high earners may be taxed even if they don't reach the cutoff. The reason: In order to comply with the provision, payroll departments have been advised to begin tacking on the additional 0.9% for married employees making more than $200,000 because there's no way for employers to know how much the spouse makes – "even if, ultimately, that employee is not subject to the tax," Steffen says.

Be sure to review withholdings on your clients' W-4 forms if they fall into that gap. (And it's not a bad idea even if they don't: The IRS issued 104 million refund checks last year, suggesting that most taxpayers are having too much withheld from their paychecks.)

3. MAXIMIZE ADJUSTMENTS

With the arrival of a new high-end tax bracket, the top marginal rate for the highest earners has jumped to 39.6% from 35%. To keep taxes down, you'll want to focus on a client's adjusted gross income and find as many above-the-line deductions – technically "adjustments" – as possible.

Contributions to a 401(k) or 403(b) plan (which can top out at $17,500 following a 2013 limit increase, and more for those age 50 and older) will reduce a client's adjusted gross income – so "you want to maximize how much [goes] into the 401(k)," Sarenski says. Other items that fall into this category are moving expenses, health savings accounts and expenses listed on Schedule C forms for self employed clients.

4. SAY YES TO DEFERRED COMP

The accord in Washington offered some certainty about tax rates over the next few years and the new rates favor deferred compensation strategies for executives, argues Daniel Yu, a financial planner and managing director of EisnerAmper Wealth Advisors in New York. "Now that we know that the top tax rate is 39.6%, I might dip my toe back into deferred compensation," he says.

But timing is key, Yu says. In qualified plans, the deferred compensation can grow tax-free and can then be rolled over into an IRA to continue the tax-advantaged growth. Because the top tax rate isn't likely to go higher for the next few years, retirees withdrawing their funds in the near future probably won't wind up paying more than the new top rate and can benefit from the tax deferral, Yu says.

Longer term, however, the tax picture becomes fuzzier, as a future Congress and president will likely take another swipe at deficits. So Yu is cautious on deferred comp as a strategy for younger workers. "Right now, my exposure is 39.6%, compared to what? The top rate could be 45% at some time in the future," he says.

5. MIND THE PHASE-OUT

With the wealthiest taxpayers now paying higher rates, you might in theory be advising your clients to bundle as many deductions into the current year, because the value of those deductions is greater at the higher tax rate.

But it's not that simple. Prior to 2010, itemized deductions were phased out for those who topped certain thresholds. The phase-outs were allowed to expire through 2012, but they're back now. "That's one of those stealth income tax increases that people may not notice for a while, unless somebody does an analysis of what their taxes would have been with and without the phase-out," Steffen says.

The phase-out limits taxpayers' ability to fully deduct charitable contributions, for instance, starting at $300,000 adjusted gross income for married filing jointly and $250,000 for single filers – both thresholds that are less than where the highest tax bracket kicks in.

For taxpayers whose adjusted gross income exceeds those upper limits, the itemized deductions (not including medical expenses, investment interest, casualty or theft losses or allowable gambling losses) will be reduced by the lesser of 3% of adjusted gross income in excess of the threshold amount, or 80% of the itemized deduction otherwise allowable for the tax year.

What to do? Well for one thing, don't be so fast to take those itemized deductions at once. And again, if adjusted gross income can be reduced, there is more likelihood of preserving as much of the value of deductions. "But people aren't always interested in reducing their income," Steffen says.

6. BUNDLE MEDICAL COSTS

Also changing this year is the threshhold at which your clients can deduct medical expenses, which is now 10% of adjusted gross income, up from 7.5%. Sarenski recommends an aggressive approach. "I would suggest loading up in one year, then not doing it the next year, and then [in the third year] do it again," he says.

Be warned: It's likely that other estate planning tools will wind up on the chopping block.

Of course, it's not always possible to time medical expenses. But advise clients to replace a costly pair of eyeglasses, for example, during a year they do extensive dental work that's not covered, Sarenski says.

7. LOCATION, LOCATION

How you allocate assets is important, but so is where you keep those assets. So the tax increases might be a good time to reconsider which assets to hold in tax-sheltered accounts. Assets that give off taxable income, and are therefore tax inefficient, are best held in tax-deferred vehicles like 401(k)s and IRAs. Investments with significant capital appreciation, however, can reside in taxable accounts because rates on long-term gains are only rising to 20% **(or 23.8% for high** earners, with that Medicare surtax), and because you and your clients can control when to realize those gains.

Note that income from Treasury inflation-protected securities, bonds and REITs are taxed at the ordinary tax rate. "Stocks go into a taxable account, but TIPS and REITs go into a tax deferred," says Jean-Luc Bourdon of Brightpath Wealth Planning in Santa Barbara, Calif.

Be careful about selling securities that would generate gains just to move them, though. That wouldn't be terribly tax efficient, would it?

8. MUNIS MORE THAN EVER

For many advisors, municipal bonds are the go-to source of tax-free income. This year, they're an even better deal because their income isn't subject to the Medicare surtax. Buying in state munis also nets filers dual tax-free income especially important in high tax states like California, New York and New Jersey.

Though their yield may not seem like much 1.75% for AAA rated 10 year bond — on an after-tax basis, that compares favorably to Treasuries.

"If I have someone with an AGI north of $400,000 or $500,000, then I would probably have the lion's share of their assets in munis," Yu says.

But there are a couple of complicating factors with owning munis. First, bear in mind that investor interest in munis has been high over recent years, driving up prices — and higher prices mean lower yields for bonds.

Also, the uncertain interest rate environment should make even the biggest muni fan a little wary. "I wouldn't want a client out greater than 10 years," says Yu, who also oversees investments for his clients. "You do sacrifice some yield by staying shorter, but it gives me more latitude and flexibility."

9. GIFT TILL IT HURTS

Tax preparers are always baffled when wealthy clients don't take advantage of the full yearly gift-tax exclusion, which in 2013 climbs to $14,000 per recipient. Even with the gift exemption locked at $5 million, the gift-tax exclusion can help a high-net-worth client move even more assets out of an estate.

"A married couple with 10 grandchildren has the ability to gift $280,000 a year," Benson says. "To be able to move almost $300,000 out of a wealthy couple's estate every year can really chip away at the estate tax."

But some clients may not want the money out of their control. For them, consider a 529 college savings plan, suggests Bourdon of Brightpath Wealth Planning. Clients can gift up to five years all at once (getting five years of the exclusion, assuming they live for the full five years), but they can remain the account's owners. If they have gifting remorse, they can withdraw the funds, albeit with a penalty.

For clients who have no problem with gifting, however, a 529 may not be the best use of the annual gift allowance. Here's why: Education payments aren't subject to the gift tax if made directly to an institution. Advise these individuals to still make a yearly gift and then pay separately for school when the time comes.

10. CONSIDER A GRAT (SOON)

The extension of the $5 million gift and estate-tax exemption and the modest rise in estate taxes may lull some high-net-worth clients into a false sense of security. But be warned: Other estate planning tools may be on the chopping block in the future. One area President Obama has singled out in the past is grantor retained annuity trusts.

Here's how a GRAT works: An individual sets up and funds a GRAT for a certain number of years. The funds are invested in any way the owner wishes. Each year, the owner must take a certain amount of money out of the trust as an annuity. The IRS assumes the GRAT will grow at a given rate, and sets it monthly for new GRATs. Here's the sweet part: That rate is currently 1.2%. Anything the trust earns beyond that can be passed on to beneficiaries free of gift taxes. "Because the IRS rate is so low, it's not hard to outperform that rate," Benson says.

One hitch: If clients die before the expiration of the trust, the remaining money must be added back into the estate. That gets particularly tricky given that the Obama administration wants to impose a 10-year minimum on GRATs, up from the current two-year requirement. Bottom line, advises Steffen: "Do the GRAT sooner rather than later."

11. ZERO IN ON UNDERVALUED ASSETS

One estate planning technique that makes sense more because of the sluggish economy than the tax changes is a grantor trust. This tool may appeal particularly to business owners, who can gift undervalued assets, such as shares of a closely held business, to the trust.

"As the business recovers through the economic cycle, the appreciation would happen outside their taxable estate," says Annika Ferris, a partner and wealth advisor with Atlanta based Brightworth Private Wealth Counsel.

12. CONTINUE ROTH CONVERSIONS

The last three years were a godsend to anyone considering a Roth conversion. Without income limits, high earners could convert traditional IRAs into Roths, paying income tax up front, but at a historically low rate. In exchange, they could let their accounts grow tax-free and have tax-free withdrawals in the future, a time when tax rates will most likely be higher. On top of that, the markets' rise over the last few years has eased the conversion pain, in many cases making back the money that account holders paid in taxes.

The new higher tax rates do make the Roth a bit less attractive than it was before, and many taxpayers may crave the tax deduction of traditional IRAs — but don't rule out Roths quite yet. "I think that, for 2013, a Roth can still make sense depending on how long you have to go before retirement," says Mark Luscombe, principal federal tax analyst with tax publisher CCH. Clients who have 10 to 20 years can easily break even on the amount of tax they pay.

Further, a Roth can be done piecemeal over a number of years, depending on a client's cash flow. Or time the conversion for a year when clients might have negative income — perhaps when they're starting a new venture or experiencing a job loss. "People still think that they have to do this all at once," says Michael Goodman, president of Wealthstream Advisors in New York. "If I have someone with a $400,000 traditional IRA [and a lower income], I'll tell them we can convert 40 grand every year and keep the tax rate down."

For clients who don't qualify for a Roth contribution due to income restrictions, Brightworth's Ferris suggests a back door. She advises clients to make a yearly contribution to a nondeductible IRA, and then convert almost immediately to a Roth. Bear in mind that, by waiting too long, clients run the risk that the account has appreciated and may owe some tax.

Finally, notes Bourdon, a Roth conversion carries little risk because the IRS allows taxpayers to recharacterize a conversion within 18 months. "It gives you the benefit of hindsight," Bourdon notes. "If you do a conversion and it goes down, you can always change your mind and recharacterize regardless of tax rates."

13. GIVE ROTHS A TWIST

Don't stop at retirement planning with Roths, Yu says. They can also be used as a powerful estate planning tool.

Converting a traditional IRA or a rollover from a retirement account to an IRA means paying tax up front, with a top rate of 39.6%. After the conversion, the asset can grow tax-free throughout a client's life and later that of his or her spouse. After that, it can be passed to heirs, who will be required to take annual minimum distributions based on life expectancy.

Compare this strategy with leaving the assets in the estate and then paying estate tax, now set at 40% for estates in excess of $5 million, at the time the (presumably appreciated) assets are inherited. "You've essentially made a gift that you don't need to pay gift tax on," Yu says.

14. GIVE BIG NOW

Clients who are charitably inclined can front-load their charitable donations all at once without deciding where to direct those gifts. A contribution to a donor-advised fund — essentially a mutual fund set up for the purpose of funding charities — can be written off this year, even if donations are not made until subsequent years.

Depending on your client's income, those gifts may be subject to the new phase-out. That doesn't mean they're not worth doing, though. If the gift is large enough relative to a client's income, the deduction might be worth more in the new higher tax bracket than it was in 2012.

"This would be a good strategy for people for whom 2013 may be their last high-income year as a way to accelerate deductions," says Steffen, of Baird. "They can wait until 2014 or 2015 to decide where they want to dole out the money."

15. FACE CALIFORNIA'S TAX HIKE

As if taxes weren't high enough in California, they're going even higher. Proposition 30, approved by voters in November, tacks on an additional 1% on incomes between $500,000 and $600,000, another 2% between $600,000 and $1 million, and 3% beyond that for married couples filing jointly. (The thresholds are essentially halved for single filers.) What's more, the tax is retroactive to the start of 2012 and came late in the year, so advisors had little time to prepare.

Shifting money into tax-free California municipal bonds might alleviate some of the sting. However, California's finances are still shaky, so advisors need to be cautious about how much money they think is prudent to tie up with the state.

While onerous, Eisenberg, the Los Angeles advisor, recommends a little perspective. The tax is levied on the excess of the above amounts, not the full sum. "If somebody is making $600,000, they're actually just paying $1,000 more," he says. **FP**

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