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Strategies for reducing the tax bite

A new levy on unearned income takes effect in 2014, but smart planning can help minimize its effects

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HIGHLIGHTS

01 You can minimize the impact of the new surtax on unearned income by moving securities that generate interest and dividends into tax-free accounts.

02 You can avoid taxes on capital gains, and receive a tax deduction, by giving away assets that have increased in value such as securities, real estate, and works of art.

The rules governing how much Americans owe the government rarely stay the same from year to year, and 2013 has been no exception.

For physicians, the most significant change was the American Taxpayer Relief Act that Congress passed in 2012 and President Obama signed into law in January 2013. Because of it, many physicians with investment income, high wages, and those with significant assets will see tax increases. If you have not increased your withholding or estimated tax payments, you may find that you owe a large sum when tax day arrives.

What follows is a summary of the major elements of the legislation and what they mean for you.

NEW TAX ON UNEARNED INCOME

The Taxpayer Relief Act contains a 3.8% tax on unearned income, the proceeds of which will be used to help fund the Affordable Care Act. It is levied on single individuals with a modified adjusted gross income (AGI) of more than $200,000 and on couples with an AGI of more than $250,000 ("the income threshold"). You will owe the tax based on either your net investment income or the amount by which your modified AGI exceeds the thresholds, whichever is less.

Investment income includes capital gains, rental income, dividends, interest, annuities, and royalty income. It does not include tax-exempt income, distributions from 401(k) accounts, regular or Roth individual retirement accounts (IRAs), or pensions.

Most gains on the sale of a primary home are exempted from the tax, and profit in excess of the $250,000 exclusion for individuals or $500,000 for couples could be subject to the surtax if the selling individual or couple exceed the income threshold. The surtax applies to all gains on the sale of second homes and investment properties.

LIMITS ON DEDUCTIONS AND EXEMPTIONS

In addition to the new 3.8% Medicare tax, the taxpayer relief act includes new limits on deductions and exemptions. Individuals earning more than $250,000, and couples earning more than $300,000 will see their itemized deductions reduced by 3% of the amount by which their income exceeds the threshold. In addition, indi-

> "You can avoid capital gains taxes entirely and receive a charitable tax deduction by giving away appreciated investments such as securities, real estate, works of art, or other capital assets that have appreciated in value and deducting their full value."

viduals with $250,000 or more of AGI and couples with $300,000 or more will lose personal exemptions.

To find out how the legislation will affect you, go to the Tax Policy Center's free online calculator at www.calculator.taxpolicycenter.org. It provides a side-by-side comparison of your 2012 and 2013 taxes.

Several strategies are available to you during 2014 to minimize the impact of the new tax. For example, you can move interest- and dividend-generating investments into tax-sheltered accounts, and use tax-free investments in your personal accounts instead.

If you are near the income threshold and you anticipate selling a large number of securities that will be subject to capital gains, it might make sense instead to sell a portion during one calendar year and the balance in the following calendar year so as to minimize each year's AGI. Also, certain sales permit use of the installment sale method, which spreads the payments and the tax on such payments over several years.

Another method of minimizing your AGI is to increase your retirement plan or tax-deductible IRA contributions. In addition, you can reduce your capital gains by subtracting your current capital losses and up to $3,000 of prior capital loss carry-forwards. Doing so will reduce your AGI and the amount subject to the new tax. Losses on one stock sale can offset gains on another and the excess losses can be carried forward if they are not currently used.

Taxable payments from retirement plans, regular IRAs, and Social Security are not subject to the new 3.8% surtax. They will still increase your AGI, possibly subjecting other investment income to the tax. For example, if a couple had $250,000 in retirement plan distributions and $100,000 income from interest and dividends, the 3.8% would apply to the entire $100,000 by which their AGI exceeds the surtax's threshold.

Note that Roth IRA and Roth 401(k) qualified distributions generally are not taxable and do not count as part of AGI. The surtax also does not apply to capital gains at death, Social Security income, municipal bond income, pension income, life insurance proceeds, or business income earned by active partners in a partnership.

It makes sense to consider converting your 401(k) or IRA into a Roth so that the future distributions will not raise your AGI above the income threshold. This is especially true if you have little investment income today and are otherwise below the income threshold.

If you are older and have significant appreciation on a piece of real estate or stock, it might be wise to hold it until death, since capital gains at death are not subject to the surtax due to the step-up in basis. Therefore, the tax liability would be much greater if the asset were sold just prior to death instead of just after. With the current $5.25 million exemption per person at death, there is not the same motivation to dispose of assets during the owner's lifetime to avoid the estate tax.

Avoiding the capital gains tax by utilizing the step-up in basis can save close to 25% in the form of capital gains tax. Prior to the change in the law, the capital gains tax was 15%.

THE VALUE OF CHARITABLE DEDUCTIONS

You can avoid capital gains taxes entirely—and receive a charitable tax deduction—by giving away investments such as securities, real estate, works of art, or other capital assets that have appreciated in value, and deducting their full value. The deduction applies even to the portion of the asset on which you have not paid capital gains taxes. In addition, if you are 70-1/2 years or older, you can gift up to $100,000 annually from your IRA and have

→ 45

→44 such contributions count toward your required minimum distribution obligation.

If you believe that charity begins at home and would rather give gifts to family members, you can gift appreciated stock. For example, if you have a child age 23 or older who is in the 10% or 15% tax bracket, and is single with an AGI of up to $36,250, or married with AGI of up to $72,500 in the year he or she liquidates the gifted security, he or she would not pay any federal long-term capital gains tax.

It is important to note that if the recipient is age 23 or younger and a full-time student this strategy would not work, because he or she would be taxed at your rate. Also, when appreciated assets are inherited, their cost basis steps up to the value as of the owner's date of death, so it may make sense to postpone gifts from people who are older.

Thanks to the $5.25 million individual tax exemption for estates, couples can exempt up to $10.5 million from federal estate taxes. During the last 30 years many estate planners have utilized "credit shelter trusts"—also called "exemption equivalent trusts"—which allow both spouses to fully utilize their credit.

Such trusts are usually no longer necessary or beneficial because of increases in the exemption amounts and the ability of one spouse to carryover any unused credit from the other spouse. Such trusts not only complicate planning, they also restrict distributions to the second spouse after the first has died. You should review and update your wills to remove any outdated or unnecessarily restrictive trusts.

STRATEGIES FOR GIFTING

Part of estate planning often involves leaving tax-advantaged assets, such as retirement accounts, so that the benefits of their tax-free status are passed down to another generation.

Gifting strategies still make sense as part of estate planning if you have sufficient other assets to enable you to live comfortably for the rest of your life. When appreciating assets are gifted to the next generation, you are not only passing on the principal, but also the future appreciation, all of which grows outside of your estate. You avoid not only federal estate taxes, but also your state inheritance tax (if any).

BENEFITS FOR SAME-SEX COUPLES

The Taxpayer Relief Act has not been the only major change to the tax code in 2013. Earlier this year in *United States vs. Windsor,* the U.S. Supreme Court ruled that same-sex couples are entitled to the same federal benefits as opposite-sex couples. Following the court's decision, the Internal Revenue Service (IRS) ruled that couples are considered married for federal purposes if they are married under their state's marriage law.

The IRS looks at the state in which the marriage occurred, not the couple's state of residence, for all federal tax purposes. So if a same-sex couple marries in New York (which permits same-sex marriage) and live in Pennsylvania (which does not permit same-sex marriage), they would be considered married for federal tax purposes, because New York is the state in which the marriage took place. This effectively means that if you lawfully marry anywhere, then for federal tax purposes you are considered married.

The IRS also ruled that civil unions and domestic partnerships are not marriages for federal tax purposes. It noted that married couples may retroactively apply the recognition of same sex marriage by amending their tax returns for the past 3 years, but they are not required to do so.

That's important because in general, a joint income tax return results in less tax if one person makes most of the couple's income, but if both spouses earn similar amounts, a joint return usually results in additional tax. Therefore, same-sex marriages may result in higher income taxes for the couple.

On the estate tax side, the unlimited marital deduction often results in significant tax savings upon the demise of the first spouse. This deduction can now be used by same-sex couples.

Using specific investment strategies in tax planning throughout each year will allow you to keep more of your income and pay less tax. Understanding the new Medicare tax, the application of capital gains taxes and the alternative minimum tax and estate taxes can help you structure your planning in the most tax efficient manner so that you can lawfully pay the smallest total tax. A little tax planning requires less effort than working many additional hours practicing medicine. ■