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Beyond First Blushes and Gut Reactions: Planning for the Coming Tax Increases (Slides)

Mitchell A. Drossman

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Mitchell A. Drossman
U.S. Trust, Bank of American Private Wealth Management
Managing Director
National Director of Wealth Planning Strategies
Mitchell.Drossman@USTrust.com

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Forget the Crystal ball --We can see potential tax increases on the horizon

Sunsets:

- The temporary tax reductions enacted in 2001 and 2003 are scheduled to "sunset" at the end of 2010.
  - **Ordinary Income** –top tax rate on ordinary income increases from 35% to 39.6%
  - **Dividends** –top marginal tax rate for qualified dividends jumps from 15% to 39.6%
  - **Capital Gains** –rate on long-term capital gains jumps from 15% to 20%
  - **Itemized Deductions and Personal Exemption** – Tax hikes in disguise - return of the phase-out of certain itemized deductions and personal exemptions.

Sunrises:

- Synopsis of President Obama's tax plan for high-income households:
  - **Ordinary Income** – restore the top two income brackets to 36% and 39.6%
  - **Dividends** –for taxpayers in the top two tax brackets, dividends rates would increase to 20%
  - **Capital Gains** – for taxpayers in the top two tax brackets, capital gains rates would increase to 20%, but capital gains would be eliminated for investments in small and start-up companies
  - **Itemized Deductions and Personal Exemption** – restore phase-outs of deductions and exemptions thereby raising marginal rates for high-income families and individuals; limit deductions as if taxpayer is in a 28% tax bracket
  - **Payroll Taxes** – While there appears to be no official tax policy relating to payroll taxes, the President has suggested retaining the Social Security tax on wages up to $106,800 (for 2009) and then adding (possibly effective in 10 years) a surtax of approximately 2% for high-income earners (an additional 2% may also apply to employers).

Planning From the Income Side: Harvesting Gains

Long-Term Capital Gains

- Given the "sunset" of the 2001/2003 tax cuts and the resulting capital gains tax increase from 15% to 20%, does it make sense to accelerate the tax and incur the lower rate now?
- Answer: Not necessarily. The tradeoff is between:

Locking in a lower rate now for the existing gain and losing the growth on the funds used to pay the tax	*VS*	Continuing to defer taxes but then paying the capital gains tax at a higher rate later

Accelerating or Deferring Sales
Sale This Year or in 2011 with Capital Gain Increase to 20%

Example: Investor has a $10,000 stock with a tax basis of $0. The stock is anticipated to earn 10% over the next 2 years.

Sale in 2009:

$1,500 in capital gains tax, leaving $8,500 to reinvest ($10,000 - $1,500). If a new investment is purchased, and earns 10%, over the 2 years and then sold, the after-tax gain would be $1,428 [$1,785 gain ($8,500 x 10%^{2}) - $357 in taxes] resulting in **$9,928**.

Sale in 2011:

$10,000 stock grows to $12,100, then sold. The sale in 2011 would presumably incur a higher tax rate, resulting in **$9,680**

[$12,100 - $2,420 ($12,100 x 20% = $2,420]

The decision to defer the sale until 2011 would be unwise for two reasons:

1. The total tax paid is greater in 2011;
2. The investor's net proceeds after liquidating the investment would be less.

Bottom Line: This investor would be better off selling the stock this year and locking in the lower tax rate on the existing gain.

Break-even Rate of Return: 19.03%

Key Factors: Investment Returns, Time Horizon and ...

Investment Returns

- The break-even rate of return required to neutralize a capital gains tax increase from 15% to 20% is as follows:

3 years	5 years	10 years
12.3%	7.2%	3.5%

Example: if the average investment return is less than 12.3%, it would have been better to sell the investment now at a 15% rate than it would be to sell it at the end of three years at a 20% capital gains rate.

Time Horizon

- The time horizon needed to break-even (to neutralize a capital gains tax increase from 15% to 20%) based on various annualized return assumptions, which are as follows:

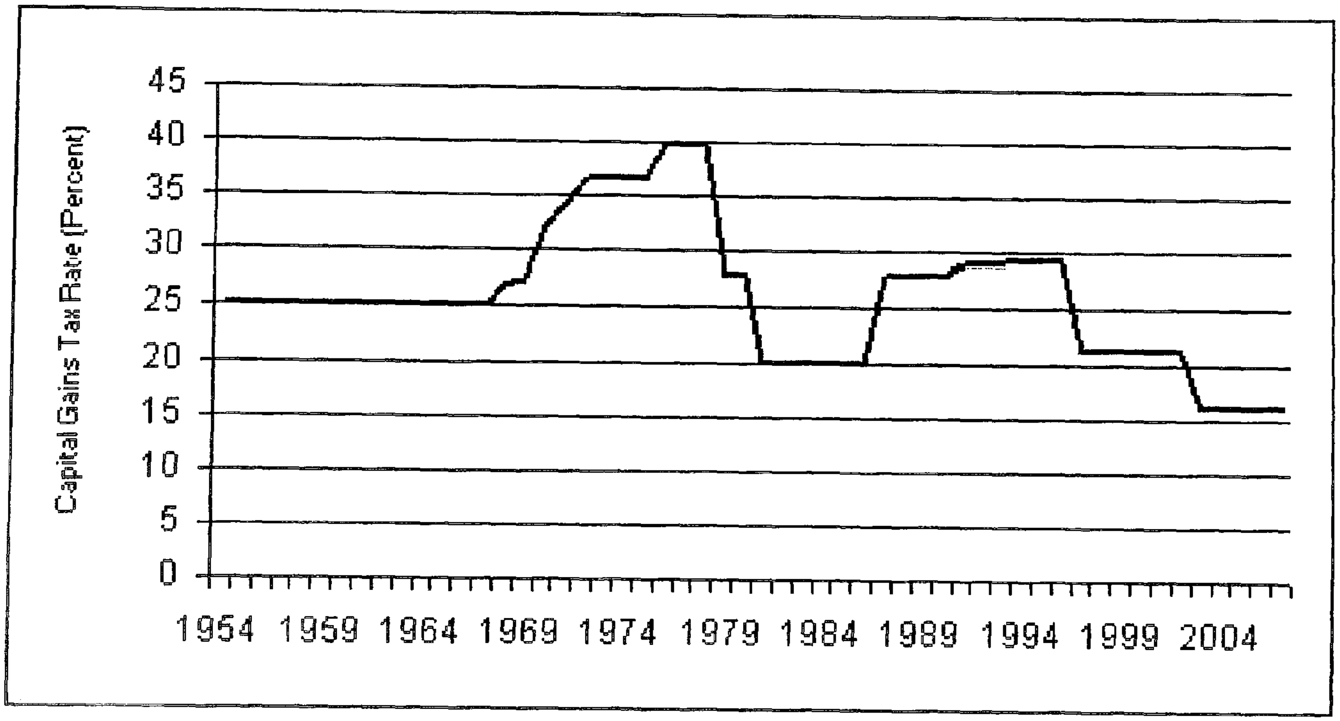
6% Return	8% Return	10% Return
6 years	4.5 years	3.65 years

Example: if the investment yields (or appreciates) at an annual rate of 8%, and is held less than 4.5 years, it would have been better to sell the investment now at a 15% rate than at some point thereafter, but prior to the 4.5 years at a 20% capital gains rate.

Key Factors: Future Tax Rates

Future Tax Rates

• **The ever-changing tax rate.** Tax rates tend to change over time, and there is no certainty that the tax rates proposed for future years will remain in effect. Over the past 30 years, the top long-term capital gains tax rate has fluctuated from a high of 39% in 1978 to its current low of 15%, with seven changes, both up and down, in that time period.



Having Your Cake and Eating it too: Installment Sales for Certain Property

Example Assume an individual (Dad) sells a portion of his stock in a family business which has a tax basis of zero ($0) to his son for $1 million dollars, in return for four annual payments of $250,000, commencing December 2010

- The default rule is that in 2010, Dad will recognize $250,000 of capital gain, which will translate to a capital gains tax of $37,500.
  - In 2011, 2012 and 2013, assuming a 20% capital gains tax rate, the capital gain tax will be $50,000.
  - Interest will be taxed at Dad's ordinary income tax rate. Assuming a 39.6% tax rate, Dad will pay tax of $14,850, $9,900 and $4,950 for 2011, 2012 and 2013, respectively.
- Dad can elect out of installment sale treatment and recognize the full capital gain of $1,000,000 in 2010, and the interest income of $37,500, $25,000 and $12,500, in 2011, 2012 and 2013, respectively.

Year	Principal Payments	Interest Payments	Total
2010	$250,000		$250,000
2011	250,000	$37,500	287,500
2012	250,000	25,000	275,000
2013	250,000	12,500	262,500
Total	$1,000,000	$75,000	$1,075,000

Year	Tax (Capital Gain) with an Installment Sale	Tax (Capital Gain) if Opt Out of Install. Sale
2010	$37,500	$150,000
2011	50,000	0
2012	50,000	0
2013	50,000	0
Total	$187,500	$150,000

Equity Compensation and Retirement Income Planning

- **Compensatory stock options and stock appreciation rights:** In light of potential changes to ordinary income taxes, should compensatory stock options be exercised now or later?
- **Restricted Stock -- Section 83(b) election**: The decision – whether to be taxed now or later at a higher rate.
  - A tax election -- known as a Section 83(b) election – made within 30 days of the stock grant allows the recipient to pay taxes on the value of the restricted stock grant at date-of-grant values rather than its value on the date the restrictions lapse.
- **Aspects of ordinary income:** With earned income, there really isn't much of an option beyond deciding to earn or not to earn.
- **Retirement Income Planning**
  - **Retirement plans:** Funding IRAs (assuming you're eligible to do so) and 401k plans does seem to be more attractive in a higher-tax-rate environment. In most cases, maximizing tax deferrals and lowering taxable income is attractive, even though amounts withdrawn from these accounts may eventually be taxed at higher marginal tax rates.
  - **Nonqualified Deferred compensation plans:** Executives at certain companies are often able to defer a portion of their compensation into nonqualified deferred compensation plans; they are basically deferring their income into a later year, and in the meantime allowing it to grow on a tax-deferred basis.
  - **Short-term vs. long-term deferrals**
- **A special case: Roth IRA conversion: In 2010, for the first time, all investors are eligible to convert their traditional IRAs to a Roth IRA**

Capital losses:

- The questions:

  Whether to harvest or defer capital losses?

  Is it better to take a capital loss in a 15% capital-gains-rate environment or when rates stand to increase to 20% or higher?

- The answer is not so simple.
  - The psychology of whether to accelerate or defer a loss is very different from dealing with gains. Accelerating a loss means paying less tax sooner, and that means gratification is sooner.
  - Special rules that apply to capital losses that do not apply to capital gains.
    - **Limited:** Net capital losses are limited to a maximum of $3,000 per year (any excess can be carried forward to later years).
    - **Wash Sales**: Losses are sometimes disallowed where one sells a stock and repurchases it in a short time period (i.e., the so-called "wash sale" rule).
    - **At-Risk:** Losses might be limited by special rules such as the passive activity loss rules or the "at risk" rules.
    - **Related Parties**: There are limitations to recognizing losses when the transaction generating the loss is between the taxpayer and a related party.
- Given our expectation of higher taxes, harvesting sooner would be a net tax loser, because the higher the tax rate, the more valuable the loss. But, when it comes to investments, it's always risky to let "the tax tail wag the investment dog." Put another way, sometimes it's just best to get the losers out of your portfolio.

Taking Advantage of Excess Capital Losses

Capital losses:

- Utilizing "excess" capital losses
  - Converting interest income into capital gain.
    - Sales of individual appreciated taxable bonds
    - Sale of taxable bonds funds prior to interest payment dates
  - Tax inefficient investments

- Harvesting additional capital losses? Wash-sale strategies
  - Losses are sometimes disallowed where one sells a stock and repurchases it in a short time period (i.e., the so-called "wash sale" rule).

Planning on the Deduction / Loss Side

Charitable deductions:

- Does it make sense to defer charitable gifts from this year to 2011? Generally, deductions are worth more in a higher-income-tax-rate environment than in a lower-rate environment. So waiting for the higher rates could be the way to go.
  - The ability to actually use the charitable deduction should not be overlooked. Most charitable deductions are deductible only up to a percentage of a taxpayer's "adjusted gross income," or AGI.
  - Charitable deduction could be further limited by phase-outs of itemized deductions for high income taxpayers.

Limitation on Charitable (and other itemized) deductions as if the taxpayer were in a 28% tax bracket:

- Stealth tax increase
- Is the bark worse than the bite? What is the effect if the taxpayer is subject to AMT tax?
- Possible "foot in the door" for elimination of deductibility of all itemized deductions (flat tax) or AMT reform
  - Planning
    - Accelerate charitable gifts to 2009 and 2010 – outright gifts or deferred gifting vehicle
    - Make gifts from IRA Charitable Rollover (expires in 2009, but expected to be extended)
    - Charitable Lead Trust

Planning on the Deduction / Loss Side

State income tax and deductions:

- When is the best time to pay your final installment of state income taxes – in December or January? In most cases, it makes the most sense to accelerate the January payment into December in order to take the deduction sooner. However, if this 2010's income is going to be taxed at 35% and 2011's at 39.6%, it could well be advantageous to reverse that thinking.

Changing Tax Environment: Investment Implications

Private Activity Bonds:

- **New Rule**: Interest on private activity bonds **issued** in 2009 or 2010 will not be subject to AMT tax. For example, if a 30-year municipal private activity bond is issued in 2009 or 2010, then that interest is not subject to AMT for all 30 years - interest is exempt from AMT for duration as long as the bond was issued in 2009 or 2010.
  - **Refunding a bond originally issued in 2009 or 2010.** If a private activity bond is first issued in 2009 and is refunded in 2012. That refund bond also will be considered issued in the year of the original bond -- 2009 in this example, preserving its beneficial tax treatment.
  - **Refunding a bond originally issued in 2004-2008 but refunded in 2009 or 2010.** If a private activity bond is first issued in 2004 and is refunded via another bond in 2009 or 2010, then the "new" refund bond will be considered issued in the year of the refunding -- 2009 or 2010 in this example.

Build America Bonds:

- **Tax Credit Build America Bonds**: Allows state and local governments to issue taxable tax-credit bonds in lieu of tax-exempt governmental bonds.
  - Ex: 100,000 bond
    - 5% interest = $5,000 income tax @35% = $1,750; tax credit @35% $1,750 (interest and credit includible in income)
- **Direct Payment Qualified Build America Bonds**: Allows state and local governments (issuer) to receive a contemporaneous rebate from the U.S. Treasury equaling 35% of interest paid instead of allowing investors to receive a tax credit. Therefore, a state government would receive a check from the federal government equal to 35% of the interest on the bonds.
  - Ex: 100,000 bond 7.7% interest = $7,700 = $0 income tax (if held by tax-exempt)
    - State 7.7% credit 2.7% = 5% net borrowing cost to the state
- BABs can only be issued in 2009 and 2010; available for projects where governments may otherwise issue tax exempt bonds (other than private activity bonds). Qualified Bonds must be used for capital expenditures
- **See IRS Notice 2009-26**

Changing Tax Environment: Investment Implications

Qualified School Construction Bonds:

- **New Rule**: The issuer of a QSCB - the county/school district – generally would pay only principal to the bondholder. This is a zero-interest bond program that allows the holder of the bond to receive a return on investment as a tax credit against its federal tax liability.
  - The rate of the federal tax credit is set by the Treasury Department (Tax credit = principal x credit rate).
  - The Act added IRC§54F to provide a national bond limitation authorization for QSCBs of $11 billion for 2009 and $11 billion for 2010.
- Section 54F(a) defines a "qualified school construction bond" to mean any bond issued as part of an issue if –
  - (1) 100 percent of the available project proceeds of such issue are to be used for the construction, rehabilitation, or repair of a public school facility or for the acquisition of land on which such a facility is to be constructed with part of the proceeds of such issue [within three years of issuing bonds],
  - (2) the bond is issued by a State or local government within the jurisdiction of which such school is located, and
  - (3) the issuer designates such bond for purposes of this section.
- ***See IRS Notice 2009-26***

Qualified Small Business Stock

Municipal Bonds

Selected Proposed Estate Tax Bills

	President Obama's Budget Proposal	Sunset of 2001 and 2003 Tax Bills	Capital Gains and Estate Tax Relief Act of 2009 HR 498	Certain Estate Tax Relief Act of 2009 HR 436	Taxpayer Certainty & Relief Act of 2009 S 722	Sensible Estate Tax Act of 2009 HR 2023
• **Estate Tax Exemption**	• $3,500,000 exemption made permanent for 2010 and subsequent years	• Elimination of estate tax in 2010 • Resurrection of estate tax in 2011 with $1,000,000 estate tax exemption	• Increase estate tax exemption to $5,000,000 by 2015 • Increase exemption for inflation starting in 2016	• $3,500,000 exemption made permanent for 2010 and subsequent years • Estate tax exemption phased-out for estates exceeding $10 million	• $3,500,000 exemption made permanent for 2010 and subsequent years • Increase exemption for inflation starting in 2011	• Reduce exemption to $2,000,000 • Increase exemption for inflation starting in 2010
• **Estate Tax Rates**	• Maximum estate tax rate of 45%	• Maximum tax rate after 2010 would be 55%	• Estate tax rate tied to capital gains rate (15%), or twice the capital gains rate for estate's over $25 million	• Maximum estate tax rate of 45% • Lower bracket rates phased-out for estates exceeding $10 million	• Maximum estate tax rate of 45%	• Estate tax rate of (inflation adjusted): • 45% up to $ 5 mill; 50% from $5 - $10 mill; 55% above $10 mill
• **Other notable provisions:**	• 10 Year GRAT minimum • Valuation discounts under 2704 • Basis reporting		• Portability of prior spouse's unused estate tax exemption • Reunifying estate and gift tax exemptions	• Discounts on family controlled entities and passive assets eliminated for estate tax purposes (not for gift tax purposes)	• Portability of prior spouse's unused estate tax exemption • Reunifying estate and gift tax exemptions – increasing gift tax exemption from $1 million to $3.5 million	• Portability of exemption • Unify the gift tax credit • Restore state death tax credit

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Selected Proposed Income Tax Bills

	Sunset of 2001 and 2003 Tax Bills	President Obama's Budget Proposal	Fair Tax Act of 2009 (National Sales Tax) HR 25; S 296	Taxpayer Certainty & Relief Act of 2009 S 722
• **Income Tax Provisions**	• Resurrection of 33% and 39.6% income tax rates • Resurrection of taxation of dividends at marginal income tax rates	• Maximum income tax rate for high-income households returns to 39.6% (approx $375k) • Maximum income tax rate for qualified dividends at 20% • Reinstate phase-outs	• National sales tax: tax on the use or consumption in the United States of taxable property or services • Initial tax rate of 23% in 2011; formula driven thereafter	• Maintain existing tax rates for lower-income and middle-income taxpayers • Increase rates (from 33% to 36% and from 35% to 39.6%) for high-income taxpayers • Rate change effective 2009
• **Capital Gains Tax Rates**	• Resurrection of 20% capital gains tax rate	• Maximum capital gains rate of 20% (other than for certain collectibles and real estate recapture, etc.) for those earning above approx. $231,000 (MFJ)	• n/a	• Maintain existing capital gains rates for lower-income and middle-income taxpayers • Increase capital gains rates (from 15% to 20%) for high-income taxpayers • Rate change effective 2011
• **Other notable provisions:**	• Return of phase-outs of itemized deductions and personal exemptions	• Limitation on deductibility of itemized deductions to 28% rate (for taxpayers in 28% or higher tax brackets) commencing in 2011 • Taxation of carried interests as orid. income	• Repeal of income, payroll, estate and gift taxes	• Permanent AMT relief; AMT exemption indexed for inflation

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Other Potential Tax Changes

Other Potential Tax Changes under President Obama

- Taxation of publicly traded partnerships
- Carried Interests tax as ordinary income
- Curb Offshore Tax Abuses
- Economic Substance Doctrine
- Close loopholes in the corporate tax deductibility of CEO pay; restrict compensation paid to employees of TARP funds
- Sur-tax on high-income earners to pay to health care reform
- Eliminate oil and gas loopholes
- Increase the maximum amount of earnings subject to Social Security taxes
- Exempt seniors earning less than $50,000 from income taxation (includes tax exempt income, excludes Social Security)