INDIVIDUAL INCOME TAX UPDATE
AND
ESTATE/INSURANCE PLANNING

PITTSBURGH CHAPTER

PENNSYLVANIA INSTITUTE OF
CERTIFIED PUBLIC ACCOUNTANTS

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INDIVIDUAL INCOME TAX

I. Filing Status

- Married Filing Jointly
- Single
- Head of Household

II. Tax Rates

2011 Income Tax Brackets (Est.)		2011 Rates	2012 Rates	2013 Rates
Single Filer	Joint Filer			
$0 - $8,375	$0 - $16,750	10%	10%	15%
$8,375 - $34,000	$16,750 - $68,000	15%	15%	
$34,000 - $82,400	$68,000 - $137,300	25%	25%	28%
$82,400 - $171,850	$137,300 - $209,250	28%	28%	31%
$171,850 - $373,650	$209,250 - $373,650	33%	33%	36%
Over $373,650	Over $373,650	35%	35%	39.6%

Qualified Dividend	15%	15%	39.6%
Long-Term Capital Gain	15%	15%	20%

NOTE: 1. New Medicare tax on investment income - 2013; additional 3.8% for taxpayer with AGI of more than $250,000.

2. Medical hospital insurance tax – 2013 – 0.9% on wages and self-employment income ($250,000).

EXAMPLE:

Mary and Ian, a married couple who file a joint return, collectively earn $270,000 in wages, and have $80,000 of net investment income, in 2013. Their modified adjusted gross income is $350,000. Mary and Ian will incur a 3.8% tax on the lesser of their (1) $80,000 of net investment income or (2) $100,000 of modified adjusted gross income in excess of the $250,000 threshold for married taxpayers filing jointly. Thus, they will incur a $3,040 (3.8% x $80,000) unearned income Medicare contribution tax.

III. Compensation

- Federal
- State
- Local

IV. Withholding and Estimated Payments

- 90% of 2011 tax
- 100% of 2010 tax
- 110% of 2010 tax

V. Investments

- Dividends - 15% tax rate
- Interest - Review interest strategy - tax exempt
- Capital Gains/Losses
    - Short Term
    - Long Term
    - Collectibles/antiques
    - Wash Sale Rule
    - Identification
        - Specific identification

        - First acquired/sold
    - Basis
        - Estate Step-up to fair market value at date of death
        - Sale of stock obtained by exercise of option
- Year -end purchase of mutual funds

VI. <u>Retirement Planning</u>

- Contribution to 401(k), 403(b) Plans
- Catch-up contributions
- IRA Contributions
- Deductible
- Non-deductible
- Roth IRA
- Distribution
    - Rollover
    - Required Minimum Distribution
    - Net Unrealized Appreciation
- Keogh Plans
- Simplified Employee Pension Plan
- Charitable remainder trusts
- Review investment option
- Review beneficiary designation
- Roth 401(k)
- Retirement Elections - single vs. joint and survivor
- Required Minimum Distribution - suspended for 2009, not 2010

VII. <u>Roth IRA conversation opportunities in 2011</u>

- Beginning in 2010, more people will be able to convert a traditional IRA to a Roth IRA -- and take advantage of potential tax benefits.

    - Permanently repeal the income limit for Roth conversions.

  - Permit conversions by taxpayers who are married but filing separately.
  - Allow you to report income from Roth IRA conversions completed in 2010 equally over tax years 2011 and 2012, or elect to tax all in 2010.
  - Conversion after 2010 will be reported in full in the year in which made.

- While you will pay taxes now on the pre-tax assets you convert, your money will grow tax-deferred in the Roth IRA -- and withdrawals will be tax-free as well, when you have met certain requirements. New 2010 conversion rules may make converting to a Roth IRA more attractive, depending on your circumstances.

  - **No income limit**. The previous $100,000 income limit for Roth IRA conversions is repealed for 2010 and future years.
  - **Special tax treatment for 2010 conversions**. Income from 2010 conversions can be reported either on your 2010 tax return or equally on your 2011 and 2012 returns – watch estimated tax
  - **Low market value opportunity.** IRAs and qualified plans with depressed values are especially advantageous to convert. The current value will be taxed at conversion and the future growth will be tax-free (if qualifications are met).
  - **Multiple Roths**. Convert into several Roth IRAs for flexibility.
  - **Roth conversions can be recharacterized**. You have until October 15 of the year following the year you converted to recharacterize back to a traditional IRA for any reason, with limitations on reconversions.
  - **Estate planning Strategy**. Roth IRA conversions can reduce the size of your taxable estate because of the income tax already paid and can allow you to pass income on to beneficiaries income tax-free. The Roth assets may still be subject to estate tax.

VIII. Home Ownership

- Mortgage interest expense
- Home equity loans
- A new Revenue Ruling (Rev. Rul. 2010-25, 2010-44 IRB) concludes that acquisition indebtedness incurred by a taxpayer to buy, build or substantially improve a qualified residence can also qualify as home equity indebtedness under Code Sec. 163(h)(3)(C) to the extent it exceeds $1 million. As a result, a taxpayer can deduct up to $1.1 million of the debt securing the purchase of his principal residence.
- Vacation/Rental homes
  - More than 14 day personal use/rented fewer than 15 days
  - More than 14 day personal use/rented more than 14 days
  - Fewer than 15 days personal use/rented more than 14 days
- Rental Property
- Home Office
  - Exclusive and regular use
  - Principal place of business
- Home Purchase/Sale
  - Real Estate Tax
  - Mortgage points
  - Refinancing
  - Principal residence gains exclusion
  - Unamortized points
- Qualified Personal Residence Trust
- Exclusion on sale of $500,000 for married if lived there 2 out of 5 years. Applies to surviving spouse who has not remarried and who sells principal residence within two years of spouse's death.

IX. Education Expenses

- Qualified Section 529 Tuition Program

- Shift Income – watch Kiddie Tax exposure
- Employer Education Assistance ($5,250)
- Pay directly to avoid gift tax limitation

X. Itemized Deductions

- Medical
  - 7.5% AGI (beginning in 2013 increase to 10% of AGI)
  - Cosmetic
  - Dental
  - Assisted Living Facilities
  - Pay directly to avoid gift tax limitations
- Taxes
  - Income
  - Real Estate
  - Limited or no benefit because of Alternative Minimum Tax
  - Itemized deduction for state and local general sales tax
- Interest Expense
  - Mortgage
  - Investment
- Charitable Deduction
  - Appreciated property
  - Charitable IRA available in 2011, not after 2011
  - Fractional Interest in Property
  - Conservation Deduction
  - Substantiation of Cash Gifts - $250 or more
  - Contributions of Clothing Household Goods Not Allowed Unless They are in Good Condition
  - Donation of vehicle, boat or airplane worth more than $500, deduction equal to fair market value of contribution only if charities use the property in its tax exempt function. If charity sells the item, deduction generally limited to proceeds.

- Miscellaneous (2% AGI)
- Claim of Right Payback (§ 1341)

XI. Self-Employed Persons

- Capture all expenses
- SEP/Keogh
- Self Employment Tax

XII. Equity Arrangements

- Incentive Stock Options - watch AMT (see detail later)
- Nonqualified Stock Options
- Stock Appreciation Rights
- Phantom Stock
- Restricted Property (IRC § 83)
- Watch for § 409A - Deferred Compensation

XIII. Kiddie Tax Planning

- Taxed at parent's rate until age 18, or full time student under age 24
- Planning
    - Growth Investments
    - Section 529 Plan
    - Other trusts
- Set up Roth IRA for children with earned income

XIV. Alternative Minimum Tax

- Incentive Stock Option
- Large fourth quarter state and/or local tax payment
- Miscellaneous itemized deduction (2%)
- Private activity bonds

- Refund of state and local taxes from a year in which taxpayer subject to Alternative Minimum Tax
- Home equity loan interest is not deductible for Alternative Minimum Tax if the funds are not used for primary or secondary home.

XV. Tax Planning Concepts

- Credit Shelter Trust - 2011 vs. 2012 vs. 2013
- Irrevocable Life Insurance Trust
- Grantor Retained Annuity Trust
- Qualified Personal Residence Trust
- Dynasty Trust
- Charitable Remainder Trust
- Charitable Lead Trust
- Intentionally Defective Trust
- Qualified Domestic Trust - non-U.S. citizen
- Family Limited Partnership
- Inter-Family Loan – low AFR

XVI. Choice of Entity Consideration

- C Corporation
- S Corporation
- Sole Proprietorship
- Limited Liability Company (consider PA capital stock tax)
- Partnership

XVII. Business Succession Planning

- Buy/Sell Agreements
- Funding
- Covenant not to compete

- Earn-out (contingent sale price)
- Section 338(h)(10) Election
- Grantor Retained Annuity Trust (GRAT)

XVIII. Pennsylvania Tax Considerations

- Deduction for Contributions to Section 529 Plan
  $13,000 x 3.07% = $399
- Capital losses from one spouse, gains from the other - no offset to absorb loss
- Capital losses not carried over, sell gain securities and buy back
- Accelerate fourth quarter estimated tax payment, watch AMT

XIX. Charitable Contribution

- Documentation
- Appreciated Property
- Gift of life insurance - life settlement
- Private foundation

XX. Miscellaneous

- Exclusions for damages (§ 104) - need physical injury
- Like-kind Exchanges (§ 1031)
- Disability Insurance - paid with after-tax dollars
- Domestic Employee - Social Security tax

XXI. Mortgage Relief: 2011 - 2012

- Income from cancellation of indebtedness related to a principal residence - discharge of indebtedness
- Exclusion of $2,000,000
- Secured debt on principal residence

- Acquisition indebtedness

XXII. <u>Gas Exploration - Marcellus Shale – Utica Shale</u>

- Upfront payment for exploration
- Royalty
- Depletion
- Property owned by 501(c)(7) organization
- Importance of lease

XXIII. <u>Exclusion for Gain on Sale of Principal Residence</u>

- Surviving spouse may claim exclusion up to $500,000 for two years after spouse's death
- Conversion of vacation home to principal residence
- Gain attributed to nonqualified use period (not before 2009) not excludible
- Effective for sale after 2008
- Example:
- Purchase vacation home 1/1/09
- Vacation home 10 years, principal residence 2 years
- Sell
- Total ownership - 12 years
- Qualified period - 2 years
- Nonqualified period - 10 years
- $500,000 x 1/6 = $83,333 Exclusion

XIV. Withholding Review

Cumulative amount of estimated taxes to be paid		Due date		
2011 Tax Payment Method	April 15, 2011	June 15, 2011	Sept. 15, 2011	January 16, 2012
Current year's tax or annualized income method	22.5	45%	67.5%	90%
Prior year's tax -- safe harbor for AIG of $150,000 or less	25%	50%	75%	100%
Prior year's tax -- safe harbor for AIG over $150,000	27.5%	55%	82.5%	110%

The above table illustrates the amount required to be paid cumulatively for 2011 taxes under each method by each date for calendar-year taxpayers.

Planning Tip #1: Income tax withholdings are considered paid equally throughout the year, even if the withholdings are made near the end of the year. If you anticipate that you have underpaid your estimated taxes for 2011, consider adjusting withholdings for the remainder of the year to avoid penalties for underpayment of estimated taxes.

Planning Tip #2: In certain circumstances, supplement wages (e.g., bonuses) may be subject to a flat 25 percent withholding rate. If this rate is different from your normal withholding rate, be sure to factor the different rate into your estimated tax calculations. Similar to withholding on regular wages, taxpayers may increase the withholding amount on their supplemental wages to avoid penalties for underpayment of estimated taxes. Supplemental wages in excess of $1 million are subject to a 35 percent withholding rate.

Planning Tip #3: If you anticipate being liable for underpayment penalties on estimated tax, you may consider taking an indirect rollover distribution from a traditional or Roth IRA account during the year of underpayment. If an indirect rollover of an IRA occurs, the trustee of the IRA is required to withhold 20 percent of the funds distributed as a prepayment of federal income tax unless you elect not to have federal taxes withheld on Form W-4P. You may also elect to have an additional amount withheld from the distribution by providing the trustee of the IRA with Form W-4P. By triggering sufficient withholding tax, you can "cure" prior underpayments of estimated tax and avoid or reduce penalties. As long as you re-deposit the gross amount of the IRA distribution to another IRA within 60 days, no adverse tax consequences result from the rollover, provided you meet the once-per-year rollover limitation.

XXV. Year End Diagnostic Review

- Current estate plan
  - Will
  - Power of Attorney
  - Living Will/Healthcare Directive
  - Life Insurance Trust
- Insurance Planning
  - Life Insurance
  - Property Insurance
  - Umbrella/Personal liability
  - Do not cancel before renewal
- Review beneficiary designation
- Asset Ownership
- Gifting
- Disaster Planning
- Responsible party for payroll taxes - personal liability

XXVI. Foreign Bank Account Reporting - Form 90-22.1

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ESTATE/INSURANCE PLANNING

I. Estate Tax - Repealed for 2010

Year of Death	Exclusion Amount	Top Estate and Gift Tax Rate
2006 through 2008	$2 million	35% (gift tax only)
2009	$3.5 million	55%
2010 - election	N/A	35% (gift tax only)
2011-2012	$5 million	35%
2013 and thereafter	$1 million	55%

- Limited basis step-up in 2010 ($5,600,000 for married couple); Carryover basis (see below)
- Marital Deduction
- Unified Credit Equivalent - Credit Shelter Trust
- Minimum Gift Tax rate 35%
- Annual Gift Tax Exclusion $13,000 in 2011 and 2012
- Spouse not a U.S. citizen - no marital deduction unless qualified domestic trust: gift exclusion $136,000
- Life insurance
- Review asset ownership
- 2013 - exclusion $1,000,000 and 55% income tax rate

II. Gift Tax in 2011 and 2012, $5,000,000 Per Person Lifetime Exemption, 35% Tax Rate

III. Stepped-Up Basis Rule

Except for decedents dying in 2010, when your heirs received property, their basis was generally stepped-up to the fair market value of the property at the date of your death. This stepped-up basis rule was extremely beneficial because the recipient could avoid paying tax on the appreciation.

Example: John's estate includes stock for which he paid $1 million, and this stock has a fair market value of $6 million when he died in 2011. Jon's son, Tom, inherits the stock from this father. Under stepped-up basis rules, Tom would take a $6 million basis in the stock and could sell it immediately without recognizing a gain. Any subsequent sale would only have to take into account as gain any increase in value above the $6 million amount.

Beginning in 2010 (the year of the estate tax repeal), the law limits the amount of property that can receive a stepped-up basis upon a decedent's death. Under this rule, the recipient of the property will receive a basis equal to the lesser of: (1) the adjusted basis of the property in the hands of the decedent; or (2) the fair market value of the property on the date of death. However, the executor of the decedent's estate may elect to increase the basis of the assets passing to the heirs by a total of $1.3 million. In the case of a surviving spouse who receives assets from your estate, he or she is entitled to an additional $3 million basis step-up. Thus, a family could get a $5.6 million step-up.

Example: Assume the same facts as in the example above except that John died in 2010. As a result of the change in the law, Tom's basis in the stock would be limited to only $2.3 million. If instead of leaving the stock to his son, John left the stock to his wife, her basis in the stock would be limited to $5.3 million.

IV. <u>Portability of Exemptions</u>

- Consider use of Credit Shelter Trust

V. <u>Issues to Consider</u>

- Section 1035 Exchanges
- Transfer for Value Rule

- Gifts of life insurance
- Sale of life insurance
    - o Lifetime settlement, Section 108(g)
    - o Other sales
- Charitable
- Life Settlement Transaction

VI. <u>Types of Insurance Policies/Premiums</u>

- Term
- Whole Life
- Split Dollar
- Second to Die
- Business Succession

VII. <u>Circumstances for Use of Life Insurance</u>

- Estate Planning
- Business Buy/Sell Agreements
- Protect Marital Settlement
- Cash for family

VIII. <u>Who Should Own Life Insurance</u>

- Insured
- Spouse/Family
- Business
- Irrevocable Life Insurance Trust

VIX. <u>Carefully Review All Beneficiary Designations</u>

VX. <u>Special Needs Trust</u>

VXI. Real Estate Owned in Another State – Consider Ownership Through a Trust to Avoid Ancillary Probates

VXII. Working in Another State – Tax Liability

PTIN System

All paid tax return preparers (including CPAs, attorneys and enrolled agents) must renew their PTIN by January 1, 2012.
