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## ***The American Taxpayer Relief Act: Income Tax Planning Strategies – Part I***

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### I. INTRODUCTION

The American Taxpayer Relief Act (“ATRA” or the “Act”) contains provisions which impact both income tax and estate tax planning. While the Act creates some permanency in the estate planning area for the first time in over a decade, it also increases income tax rates, and reduces itemized deductions and personal exemptions. Although the term “permanent” means “permanent until changed” when it comes to tax law, clients and advisors need to be aware of what the new laws entail, and what actions clients should consider when planning.

Our analysis of ATRA is divided into two parts. The first part, which is discussed in this article, will focus on the impact of the new law on income tax planning and investment planning. The second part, which will soon be released in a second *Legal & Tax Trends* article, discusses the effect of ATRA on estate and business planning.

The changes made under ATRA suggest that most taxpayers will be concerned with its income tax provisions rather than its estate tax changes, since the number of estates potentially subject to federal estate tax has been greatly reduced. Even for planners who work with very wealthy clients the shift will be noticeable in the shift of emphasis away from estate tax planning to legacy planning, asset protection planning,

and other types of non-transfer tax planning.<sup>1</sup> The impact of the income tax, both during life while wealth is accumulating and at death when clients seek to preserve it, will weigh more heavily in the planning calculus than it did pre-ATRA. This newsletter will explore how various income tax strategies will work under ATRA

## **II. Income Tax Planning Strategies**

The increase in highest bracket income tax rates as a result of ATRA, along with the adverse impact of the phaseout of personal exemptions and itemized deductions, will precipitate changes in income tax planning for some high income taxpayers, as they generally attempt to limit exposure to the new 39.6% brackets by reducing taxable income.<sup>2</sup> Because of its reach farther down into the brackets, the 3.8% Medicare surtax as part of The Patient Protection and Affordable Care Act of 2010 (“PPACA”) will result in more subtle and more broadly implemented income tax reduction strategies as taxpayers manipulate not only modified adjusted gross income (“MAGI”) (to keep it under the thresholds) but also net investment income. For example, a married couple with high earned income and a relatively small (nonqualified) investment income might prioritize eliminating taxable investment income, while another couple with lower earned income and higher investment income might consider strategies to keep MAGI under the 3.8% tax threshold.<sup>3</sup> Of course, the appropriate strategy for a particular person will depend on the facts and circumstances.

### **A. Managing Taxable Income**

While reducing taxable income is not always possible, taxpayers can manage their activities so as to minimize a given year’s income, to take income in a different year, and to spread income over several years (preventing application of higher income tax brackets). To the extent that taxes will be due, clients should consult with their tax advisors, and be prepared with accurate estimates of any liability.<sup>4</sup>

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<sup>1</sup> The importance of the income tax relative to the estate tax can be seen, at least symbolically, in the income tax’s recapture of the highest nominal rate: 43.4% tax on short-term investments, when including Medicare surtax, compared to the highest estate rate of 40%.

<sup>2</sup> Unless otherwise noted, the examples in this article will not address the impact of the personal exemption phase-out (“PEP”), the limits on itemized deductions, or the alternative minimum tax (“AMT”). The personal exemptions available in 2013 (\$3,900 per person) is completely phased-out for single filers with adjusted gross income (“AGI”) of \$375,000 or more and for joint filers with AGI of \$425,000 or more.

<sup>3</sup> e.g., a married couple with \$500,000 of MAGI with only \$20,000 of net investment income, versus another couple with \$275,000 of MAGI with \$100,000 of net investment income.

<sup>4</sup> An employer will not take a spouse’s income into consideration when withholding for Medicare taxes, but employees may use IRS Form W-4 to have an additional amount deducted from pay to cover the extra 0.9% tax on the amount by which their joint income exceeds the earned income surtax threshold.

## 1. Long-term income timing – Deferrals

Clients with high W-2 and 1099 ordinary income will often be attracted to planning methods that defer income tax to future years. In many cases the ability to receive (and be taxed) on income in retirement will result in significant savings because the client's overall taxable income in retirement will be significantly lower than during his or her working years.

Thus, for example, many owners of small businesses should consider a tax-deductible **qualified plan**. Business owners already with qualified plans should review their qualified plans for efficiency (proportion of aggregate contributions allocated to themselves and possibly to key employees) as well as for the amount of addition to their personal account.

**Example:**<sup>5</sup> Consider the hypothetical dental practice, *Fauchard Dentistry*, an S corporation, which consists of Dr. Fauchard (100% owner), a hygienist (key person), and three administrative personnel.<sup>6</sup> Some possible alternative plan designs are as follows:

- The corporation establishes a SEP plan with a 25% of pay maximum. Of the aggregate \$64,250 plan contribution, Dr. F will receive \$27,500 (or 42% of aggregate plan contributions), while \$15,000 is allocated to the key person, and \$21,750 divided between the other employees.
- Using an age-weighted profit-sharing plan design, the corporation contributes \$63,588 to the plan. Of the total contribution, Dr. F will receive \$51,000 (or 80.2%). The key employee will receive \$5,138 and the others \$7,450.
- The corporation establishes a defined benefit plan, to which it contributes \$154,106.<sup>7</sup> The contribution for Dr. F will be \$95,214 (or 61.8%). The contribution for the hygienist is \$33,334. The remaining \$25,558 will be allocated to the three other employees.

The tax savings on the income deferral of \$10,000 for taxpayers in the highest (39.6%) bracket to the 33% bracket is 6.6%, or \$660 in tax.<sup>8</sup>

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<sup>5</sup> Unless otherwise specified, the hypothetical calculations assume the income tax structure for 2013 will apply in future years (not increased for indexing). In reality, while income tax brackets will be adjusted each year, the MAGI thresholds for the 3.8% surtax are not indexed.

<sup>6</sup> Assume the following ages, respectively, of 52, 43, 40, 31, and 23. Assume annual W-2 compensation, respectively, of \$110k, \$60k, \$30k, \$30k, and \$27k.

<sup>7</sup> For the DB plan example only, assume Dr. F has \$107,360 in compensation. The \$154,106 total annual funding target represents an amount for this hypothetical plan in 2013. An enrolled actuary must determine the actual minimum and maximum annual contributions.

<sup>8</sup> This does not include any savings realized from avoiding the 3.8% tax on some investment income, which might apply to distributions in retirement from an individual nonqualified brokerage account (for example), but which does not apply to qualified plan distributions.

**Traditional IRA** contributions (up to \$5,500 in 2013) by a taxpayer or spouse may also be of benefit for some taxpayers. For taxpayers without a qualified plan, or for lower AGI taxpayers who do participate in a qualified plan, such contributions can be deductible. IRA contributions are not deductible for high income taxpayers who participate in a qualified plan.<sup>9</sup>

For highly-compensated (non-owner) employees, a **nonqualified deferred compensation** (NQ) plan can provide for deferral of current income without the amount limitations associated with qualified plans.<sup>10</sup> A properly structured NQ plan allows for deferral of employee contributions and for payment of benefits over several years (instead of a lump-sum). All of these features can serve to reduce the overall tax burden associated with the income.

***Example:** Keegan, an unmarried executive at ABC Corp., participates in a NQ plan, into which he defers \$36,000 (half of his annual bonus in 2013) and into which the employer contributes an additional \$24,000 per year. With base salary of \$220,000, and a qualified plan contribution of \$10,000, he would expect to pay taxes at a 33.9% rate on the \$60,000 bonus if it were paid to him as current income. During retirement he expects to be in the 28% tax rate. The \$60,000 paid in six equal annual payments after he retires will increase each year's AGI by only \$10,000 and will be reduced by less tax. For each \$60,000 of NQ benefit, even if the balance does not grow during his working years, the expected tax savings would be \$3,540.*

While NQ plans have non-tax benefits, such as the exclusion of rank and file employees, there are drawbacks as well. For example, the requirement that any informal funding of the nonqualified benefit must remain subject to corporate creditors means that even a vested benefit is more at risk than is a benefit protected under an ERISA plan trust (e.g., 401(k) plan).

For some taxpayers, the use of a higher deductible **health savings account** medical insurance plan (HSAs) may allow for deferral similar to that available in a qualified plan. Contributions to HSAs are limited (e.g., \$3,250 for individuals), but these accounts receive significant income tax advantages: contributions are deductible; accounts grow tax-free; distributions for qualified medical expenses are tax-free.<sup>11</sup>

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<sup>9</sup> For married taxpayers filing jointly, where the working spouse participates in a qualified plan, the working spouse's ability to make a deductible IRA contribution for 2013 is phased out between AGI of \$95,000 and \$115,000. The deductibility of the nonworking spouse's IRA contribution for 2013 is phased out for couples with AGI between \$178,000 and \$188,000.

<sup>10</sup> Because funding mechanisms (e.g., life insurance premiums) for NQ plans are not deductible to the employer, such plans do not generally result in current year income tax savings for owners.

<sup>11</sup> Unlike FSA accounts and other reimbursement arrangements, the contributed value can accumulate from year to year if not used. A full discussion of HSA rules is beyond the scope of this article.

For taxpayers nearing retirement, another potentially helpful deferral technique involves **delaying the Social Security** beginning date. Instead of starting payments at full retirement age (or earlier), a deferral can push Social Security income into later years, when other income has perhaps been reduced. This may be applicable, for example, for an executive who expects to receive NQ compensation for several years and who does not want the social security payments to overlap with the deferred compensation. Deferral in this example will be advantageous since it gives the taxpayer the opportunity to lower taxable income in the years of receipt.<sup>12</sup>

While this discussion has centered on federal income tax planning, clients should keep in mind the potential for **state income tax** savings that can be achieved by moving to a state with lower (or no) state income tax. Clearly, tax considerations are not the primary factor for determining where to spend one's retirement, but the ability to protect deferred income (e.g., qualified plan, NQ, annuity income) from state income tax could be as meaningful as the deferral itself.<sup>13</sup>

Finally, certain high income taxpayers with charitable goals may harness a special form of charitable remainder trust ("CRT") to delay income tax and provide a legacy to a charity. A net income make-up charitable unitrusts ("NIMCRUT") operates as a traditional CRUT—it provides that a specific percentage of the trust principal is to be distributed each year for a specified term, after which all assets remaining pass to a designated charity. Unlike a basic CRUT, however, the **NIMCRUT** contains a clause suspending the required distribution if the trust has insufficient income in a given year.<sup>14</sup> In such trusts, the trust pays the deficiency or shortfall amount to the grantor in later years through larger than normal distributions. Coupled with a "flip" clause that allows distributions of income and principal after a designated event, a NIMCRUT can influence the timing of income and cash flow to the grantor.<sup>15</sup>

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<sup>12</sup> Up to 85% of Social Security Income will be taxed to the recipient, depending on combined income at the time payments are received. Another advantage to delaying Social Security retirement income is the increase in monthly benefit amount. The decision to delay should take into account more than just these factors, of course. For example, a delayed distribution will entail loss of use of money and may affect survivor's benefits.

<sup>13</sup> Consider this sampling of state income tax brackets for married filing jointly: AZ= 4.24% for income over \$100,000; CA= 9.3% for income over \$96,058; CT= 5% for income over \$20,000; NC=7% over \$21,250.

Source: Taxfoundation.org, State Income Tax Rates (as of July 1, 2012).

<sup>14</sup> During the early years, the trustee is not allowed to use principal to satisfy the distribution obligation. Only net income may be distributed during this period.

<sup>15</sup> To qualify for the flip treatment, the CRT must meet several requirements specified in Treasury Reg. §1.664-3(a) and following, including that the change in the trust payout method must be "triggered on a specific date or by a single event whose occurrence is not discretionary with, or within the control of the trustees or any other persons." A sale of unmarketable assets will not be considered a prohibited discretionary event. The flip causes the trust to operate as a traditional CRUT beginning in the year after the triggering event. Note the charitable deduction remains the same whatever date of flip is specified.

**Example:** Dr. Kuthroppali, unmarried and age 46, earns \$800,000 per year in his medical research practice, \$500,000 of which he does not need for current living expenses. He plans on retiring around age 55. He would like not only to provide for himself a comfortable retirement, but also to leave a large donation to his alma mater. Absent planning, he can expect to pay income tax of \$195,000 on his excess \$500,000 (an effective rate of 39%).

In 2013 he gives \$500,000 to a flip NIMCRUT. The trust will flip at the beginning of year 9 (his age 55) to a standard 10% CRUT. He may deduct \$60,900 of the gift. The trust invests in non-income producing real estate for the first 9 years (growth rate 6%), and in a blended portfolio for the remaining 11 years (combined 2% growth and 4% income). He can expect total distributions of approximately \$771,600 from the trust, on which he expects to pay tax at an effective rate of 28%.<sup>16</sup> The trust remainder which is projected to be \$488,283 will pass to the university.

In this example, Dr. Kuthroppali could have generated the same future income stream by paying tax on the \$500,000 of excess income in 2013, and investing the difference (\$305,000) at a 6% rate.<sup>17</sup> However, the NIMCRUT provided him with a one-time charitable deduction (\$23,750 in 2013) as well as nearly half a million dollars to the school. The NIMCRUT can achieve this through deferral of the income the grantor receives and a presumably lower future income tax rate.

## 2. Short-term income timing

Managing AGI may also be accomplished through more short-term, tactical actions. For example, it may be prudent to **recognize investment losses** in years in which the 3.8% surtax may apply, to maximize the tax value of the loss. For some pass-through entities (S corporations, LLCs, and partnerships) planned **deductible equipment purchases** and delayed/accelerated client billing can be used to smooth income between years. Owners may benefit where K-1 income might otherwise trigger higher tax levels or put the taxpayer over AGI thresholds for reduced itemized deductions.

A **qualified charitable distribution** (QCD) from an IRA may be of benefit for some taxpayers in 2013. This direct-to-charity transfer of funds is not included in the income of the IRA owner. Though it does not create a tax deduction, it does not increase AGI.<sup>18</sup>

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<sup>16</sup> The taxation of the CRUT distributions will depend on actual trust investments. In this example, it is assumed that a portion of the distribution will be taxed at Dr. K's future ordinary income rate of 33% and a portion at capital gains rates 15%, for a blended effective rate of 28%.

<sup>17</sup> For the comparison, the tax rate on distributions from his hypothetical investment of the \$305,000 was 20%, to reflect a portfolio weighted towards long-term capital gain and qualified dividends.

<sup>18</sup> To qualify, the distribution must be \$100,000 or less, made to a public charity, and from the account of an IRA owner age 70 ½ or older. See IRS Pub. 590.

### 3. Spread income instead of receiving income in lump-sum

Higher capital gains rates will encourage planning methods that allow clients to avoid recognizing large gains in a single year. Taxpayers with capital gain assets should consider using **partial sales** over time instead of full lump-sum liquidations, in order to spread gain over several years. As the following example demonstrates, however, the lower tax rate is only one factor in determining which sale method is best in a given situation.

**Lump-Sum Example:** Larry, unmarried, sells \$1,000,000 of stock in ABC Corp. (basis \$500,000, held long-term) for a lump-sum and reinvests the proceeds. His goal is to have \$100,000 of after-tax income for ten years. With his \$200,000 of earned income, Larry's AGI is \$700,000 in the year of sale. As a result, he will pay tax on \$200,000 of the capital gains at 18.8% and \$300,000 at 23.8% (the rates include the 3.8% surtax on NII), for a total tax of \$109,000. Invested at 3.29% (or 2.67% after-tax rate), the net proceeds of \$891,000 will create a ten-year payment stream of \$100,000.<sup>19</sup>

Compare the results of a series of ten **partial sales**.

**Partial Sale Example:** Larry instead sells the ABC stock in parcels over the ten years. If the retained portion of the stock is growing at 2.53%, he can expect to be able to liquidate \$111,576 worth of stock each year, recognizing tax at 18.8% on \$61,576 of gain from each sale.<sup>20</sup> After this \$11,576 of tax, he can expect to net about \$100,000 from each of the ten sales

Interestingly, there is an advantage for the partial sale method under the assumptions in this hypothetical even if the ABC stock will grow at a rate .75% less than that in the installment sale (i.e., 3.29% vs. 2.53%). This example shows that the difference in growth rates (between the asset to be sold and an alternative investment) is still a critical factor, even where the partial sale provides an opportunity for a 5% lower capital gains rate.

Should Larry sell in a lump-sum? In his case, alternative investments offered only .75% higher return than his ABC stock. The partial sale method also will help Larry avoid stepping too far over the \$250,000 AGI threshold (for single filers) that triggers the itemized deduction limitation. However, if diversification is a higher priority, or if Larry

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<sup>19</sup> A 2.67% after-tax rate is the equivalent of a 3.29% pre-tax rate, if all gains/earnings are subject to 18.8% tax.

<sup>20</sup> This example assumes that Larry recovers his \$500k basis at \$50k per year over the ten years of partial sales. Note that if the stock is not growing, then the partial sale method will prove worse for Larry: he will sell in ten equal amounts of \$100,000; from each sale netting \$81,200 (equal to \$100,000 less capital gains tax of \$18,800).

could reinvest the lump-sum proceeds at more than 3% (after-tax), he would likely choose the lump-sum sale method.

An **installment sale** can also be used to spread gain over multiple years, yielding the benefit of potentially lower capital gains rates for some taxpayers. Unlike the series of partial sales above, the installment sale will also include a portion of ordinary income with each payment, triggered by the interest portion of the payment. Where the basis is recovered in equal amounts over the payment stream, as in the net after-tax amount of each payment will be lower in the early years and higher in later years.

***Installment Sale Example:** Instead, Larry sells the \$1,000,000 of stock in a ten-year installment sale, secured by a note with 2.67% interest. Each year, Larry will receive a payment of \$115,265. Of each payment, he will recognize \$50,000 of capital gain and a decreasing amount of interest as ordinary income.<sup>21</sup> For example, the first year's payment represents \$26,700 of interest, \$50,000 of capital gain, and \$38,565 return of basis. The capital gain will be taxed at 18.8%, the interest at 33%. Larry can expect to net \$99,204 from the first payment; \$102,570 from the last.*

The installment sale results in a slight advantage to Larry compared to the lump-sum sale because the tax rate applied to part of his \$500,000 gain was reduced. However, the advantage of the installment method is limited by the ordinary income component. Thus, while the overall tax on the \$500,000 gain was higher (by \$26,706) in the lump-sum example, the net proceeds could be invested in a way that resulted in an after-tax rate of 2.67% (e.g., a blended portfolio with some qualified dividends, some ordinary income). The installment note had less capital gain tax on the \$500,000 but a lower earnings rate, since the 2.67% return on the note interest is taxed as ordinary income.<sup>22</sup>

#### 4. Charitable Remainder Trust

Some taxpayers should consider direct charitable contributions or a **charitable remainder trust** ("CRT") to offset one-time income items, such as income from a Roth IRA conversion or the sale of appreciated property.<sup>23</sup> This can lower the tax bracket applicable in years with such events. A CRT can also defer recognition of income from the sale of an asset by spreading the gain over the installment period. (i.e., the periodic annuity amount). While the additional "cost" of a charitable gift is the mandatory

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<sup>21</sup> e.g., \$24,335 interest income in the second year; \$2,997 in the final installment.

<sup>22</sup> In a sense, in the installment method the seller is investing in a promissory note with a 2.67% return taxed as ordinary income, as opposed to the 2.67% net rate assumed in the lump-sum example.

<sup>23</sup> The Roth conversion opportunity may not be right for everyone. The cost of having to pay taxes now may outweigh the benefit of tax-free qualified distributions in the future. Other factors are also important to consider prior to converting. Be sure to confer with an independent tax and/or legal advisor about whether a Roth conversion makes sense for a given situation.

charitable gift portion, for those taxpayers with a charitable goal, the CRT offers a unique combination of benefits.

**Example:** *In 2013 Larry's sister, Mary, contributes \$1,000,000 of appreciated stock with \$500,000 basis to a CRAT. The trust will run for 10 years, paying Mary \$95,000 per year. Based on a 1.2% 7520 rate and the \$95,000 annuity amount, Mary will receive an income tax deduction equal to about \$110,000.<sup>24</sup> Since the stock is not income-producing, the CRAT trustee sells the stock and invests in tax exempt bonds (3%). For the first five years, Mary will report the entire \$95,000 payment as capital gains (resulting from the trustee's original sale). The \$95,000 of capital gains will be taxed at 15%.<sup>25</sup> As in Larry's case, had the gain all been realized in 2013, \$300,000 of the \$500,000 gain would have been taxed at 23.8%. She will save \$34,000 in capital gains via the CRT by spreading the gain over the first 6 years instead of recognizing all the gain in a single sale. In addition, Mary expects to save about \$30,100 in income tax from the \$110,000 deduction, in years 2013 and 2014.<sup>26</sup>*

On balance, factoring in the net after-tax payments from the CRT and the value of the income tax deduction, Mary will not have an income stream as large as if she had simply liquidated the stock in a lump-sum and invested the after-tax portion in similar tax-exempt bonds.<sup>27</sup> However, under the foregoing assumptions, she will have also provided over \$250,000 to a charity in the year the CRT expires.

Similarly, a direct charitable contribution can lower income tax, though it's charitable "cost" is higher.

*Ramon and Gustavo, two single taxpayers identical in all relevant respects, each own a \$300,000 traditional IRA. In addition, each has \$300,000 in cash and earns \$200,000 in other income. Ramon converts his IRA, with the following results. His taxable income is \$500,000 in 2013, resulting in tax of \$156,664. Paying the tax from his cash account, Ramon ends up with a \$300,000 Roth IRA and \$143,336 left in the cash account. Gustavo also converts his IRA, but in the*

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<sup>24</sup> Note that for many taxpayers, but not Mary, the itemized deduction limits may reduce the amount of deduction available.

<sup>25</sup> In this simplified example, the CRT has no taxable income from investments. As a result, Mary is taxed at capital gains rates on the first five payments and part of the sixth year's payment. Having distributed the \$500,000 gain by that time, the payments in the final four years will not be taxable. The CRT is exempted from the Medicare 3.8% surtax.

<sup>26</sup> Based on Mary's \$200,000 of earned income (all years) she will be able to use \$88,500 of the full \$110,000 deduction in the year she creates the CRT. Gifts of long-term gain property to a public charity via CRT qualify for a deduction in the year of gift up to 30% of AGI. The balance (\$21,500) may be carried over to the next year. Her expected tax savings of \$25,400 in 2013 and \$4,700 in 2014 stem from removing her ordinary income from exposure to the 33% bracket.

<sup>27</sup> Compare Larry's results in the lump-sum sale example, above.

same year contributes \$200,000 in cash to a public charity. His taxable income is \$300,000, resulting in income tax of \$86,516, which he pays from the \$100,000 remaining in his account. Gustavo ends up with a \$300,000 Roth IRA and \$13,484 in his cash account. While Ramon has more cash than Gustavo (\$129,852), Gustavo has also accomplished his goal of making a \$200,000 gift. In effect, he has provided \$200,000 to his chosen charity at a net cost of \$129,852, thanks to the tax savings provided by the gift.

As with the CRT, the charitable component of a direct gift will prevent the taxpayer from netting a larger amount for himself/herself, but will provide an efficient charitable gift.

## 5. Income-shifting

In addition to techniques that shift the time of income recognition, another approach to limiting the impact of higher income tax brackets is to shift income to a taxpayer who is in a lower bracket. This will often entail either a direct gift of assets to a child or to a trust on behalf of the child.

While the “kiddie tax” will limit the opportunity for income-shifting with minor children, **gifts of income-producing assets** to adult children in lower tax brackets can result in substantial income tax savings.<sup>28</sup> This will be of particular advantage where the parent will be exposed to the Medicare surtax and the child is not.

**Example:** *Min-Jun, a successful cardiologist, owns 100% of Songpa LLC, which owns several rental apartments in Atlanta as well as some dividend paying publicly-traded stocks. Songpa LLC’s net K-1 income includes \$80,000 of rental income and \$10,000 of qualified dividends. His son, Jeremy, 26, works in a bakery, earning about \$40,000 per year.<sup>29</sup> Min-Jun’s earned income places him in the 39.6% income tax bracket, so the LLC rental income is taxed at 43.4% (combined income and surtax) and the dividends are taxed at 23.8%. After consulting with his advisors, Min-Jun gives 50% of the LLC interests to Jeremy. Min-Jun estimates that the overall tax on LLC income will be reduced from \$37,100 to \$29,300 because of the lower rates at which Jeremy will pay tax.<sup>30</sup>*

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<sup>28</sup> A minor child’s unearned income below the standard deduction amount (\$1,000 in 2013) is not taxed or reported to the IRS. Under the kiddie tax, children pay tax at their own income tax rate on unearned income they receive up to \$2,000 (in 2013). Unearned income above the threshold amount is taxed to their parent’s. Thus in 2013, the child’s lower tax rate applies only to an amount above \$1,000 and below \$2,000. A child is a minor for these purposes if either under age 19, or under 24 and a full-time student. For more information, see IRS Topic 553 or Publication 929.

<sup>29</sup> Jeremy specializes in baking kang jung (sesame candies), nokcha cakes (made with green tea), and japqwapyon (nut and rice cakes).

<sup>30</sup> Jeremy is in the 25% tax bracket, which will apply to his \$40,000 of rental income. The 25% income tax bracket means his \$5,000 share of the qualified dividends will be taxable to him in the 15% bracket.

Trust income tax planning will be important under ATRA to minimize income tax exposure. Amongst other objectives, planners will have to decide if and when the use of grantor trusts will be advantageous and if and when to pass distributable net income (DNI) to trust beneficiaries so as to shift the tax burden to those beneficiaries.<sup>31</sup>

Traditionally, **grantor trusts** have been used in estate planning trust situations to provide gift tax leverage. The grantor's payment of the income tax, in effect, operates as an untaxed gift. Such trusts have also been used to avoid the generally higher income tax rates applied to non-grantor trusts. Given compressed trust brackets (achieving the highest rate at \$11,951 in 2013), the income-shifting potential will continue to be limited. However, higher overall income rates under ATRA allow for a small benefit for some taxpayers, particularly with respect to short-term income for those in the 39.6% bracket.<sup>32</sup>

Perhaps, a more effective income-shifting technique is the use of a trust of which the beneficiary is treated as the grantor for income tax purposes. Under IRC §678, it is possible for the trust beneficiary to be treated as grantor for income tax purposes.<sup>33</sup> In a §678 trust, the beneficiary will be taxed on all trust earnings, whether distributed or not. Assuming the beneficiary has sufficient funds to pay for the taxes, the application of lower tax on trust income can be of benefit to both the actual grantor and the beneficiary.

**Example:** Assume the same facts as the prior example, except that Min-Jun transfers 50% of the LLC interests to a trust for Jeremy. Under the trust, Jeremy has a power, exercisable solely by himself, to vest all income in himself. The trust assets are treated under §678 as owned by Jeremy for income tax purposes. The trust's income of \$50,000 will neither be taxed to the trust nor to his father, but to Jeremy. As a result, his tax on the attributed income (owed personally) is \$10,750 just as in the prior example. In contrast to the earlier example, Jeremy has not yet received any of the actual income; he may need a cash distribution from the trust to pay his income tax.

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The total tax with equal ownership of the LLC is about 79% of the tax paid when Min-Jun solely owned the LLC.

<sup>31</sup> A Grantor trust is one in which the grantor is treated as the owner of the trust assets for income tax purposes only. The grantor pays tax on the trust income, though she receives none of the actual cash. This ultimately favors the trust beneficiaries since the trust assets are not reduced by income taxes. That the income tax payment is not considered a gift is good news for the grantor, at least from an estate planning perspective. See *Legal & Tax Trends: Grantor Trusts* for a more detailed examination.

<sup>32</sup> In 2013, the first \$11,950 of trust income creates \$3,090 of tax, an effective rate of about 25.9%. For a taxpayer in the highest income bracket, \$11,950 of nonqualified investment income, taxed at the maximum 43.4% rate will generate \$5,186 of tax. The difference represents a maximum potential tax savings of \$2,096.

<sup>33</sup> For more information about beneficiary grantor trusts, see LISI Estate Planning Newsletters #1730 (December 14, 2010) and #1559.

Income tax savings is important, but as with all planning techniques, there are disadvantages. For example, the powers necessary to bestow grantor trust status for a beneficiary may have adverse estate tax consequences or may reduce the creditor protection capability of the trust.

Another trust-related income-shifting technique involves **distributable net income** (DNI) and taking advantage of differences in tax rates between the trust and the DNI recipient. Income of a trust (or estate), when paid to a trust beneficiary, may be deductible to the trust and taxable to the beneficiary.<sup>34</sup> Thus, a trust will only be taxed on the net income that was not passed out as DNI. This presents an opportunity for income tax savings in situations where the beneficiary is in a lower bracket than the trust. Given that a trust will pay income tax at the highest rate on income over \$11,950, an overall tax savings will often be possible.

***Example:** In 2010 Ken funds an irrevocable grantor trust with 100% of an LLC that owns parking spaces near Phenway Park, a minor league cricket stadium. The LLC nets \$20,000 in income from the parking venture each year. The trustee has discretion to make distributions of income to the trust beneficiaries, John and Tom. In 2013, Ken has AGI \$250,000 (not including the trust income) placing him in the 33% bracket. If the trust retains the \$20,000, then Ken can expect to pay tax at 36.8% (a rate that includes the Medicare surtax), or \$7,360 of tax. If, instead, the trust distributes all of the income to John, the trust may deduct the income. In this case Ken will not have any income attributable to the parking spaces. John, who is married and files jointly, will pay tax on the trust income distributed to him at a rate of 25% (based on his AGI of \$100,000), or \$5,000 of tax.<sup>35</sup>*

To harness the potential savings possible with DNI distributions, trusts should give distribution flexibility to the trustee, whether using a grantor trust, a non-grantor trust, or a trust whose income is taxed to a beneficiary. Of course, this should only be considered when it comports with the grantor's distribution objectives.

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<sup>34</sup> See IRC §661 and §662. Note that a trustee may not always have the discretion to allocate income by class or type, but may instead be bound by ordering rules under state law or the terms of the trust instrument itself (e.g., to a strict pro rata allocation).

<sup>35</sup> John's tax of \$5,000 is about 68% of the tax Ken would have paid. Absent other income, if the trust were a non-grantor trust and had retained the income, it would have paid tax of \$6,583.

## B. Investment Strategies

### 1. Roth IRAs: Tax Diversification and Distribution Flexibility

Higher tax rates and the imposition of the surtax will make **distribution flexibility** in retirement important. The ability to manage one's tax bracket in a given year by taking withdrawals from various types of tax vehicles (e.g., taking withdrawals from a Roth account in a high income year) will enable a taxpayer to limit exposure to higher brackets and thereby, minimize the overall tax burden.

**Example A:** *Kieran, age 65, requires \$100,000 of after-tax income in retirement, of which \$50,000 (net after-tax) must come from his traditional IRA. In order to net \$50,000 from the IRA, he will have to take \$67,868 since some of the distribution (\$37,850) is taxed in the 25% bracket, and the balance at 28%.*

**Example B:** *Kieran has both a traditional IRA and a Roth IRA, having converted a portion of the IRA years earlier. The conversion(s) triggered tax at 25%, based on his taxable income at the time. To meet his \$50,000 goal, he first takes \$37,850 from the traditional IRA. The tax rate on the \$37,850 is 25% since he did not have AGI over \$87,850 (the top of the 25% bracket in 2013). He also takes \$21,613 from the Roth. Since Kieran was able convert to the Roth at a tax cost of 25%, he would have only needed to convert \$28,817 of traditional IRA to net \$21,613 he needs from the Roth.*

Example B is preferable for Kieran, since it required less in total distribution from the traditional IRA than in Example A. Even including the conversion cost, Kieran will leave more in the IRA in Example B.<sup>36</sup>

Of course, one must have accumulated assets in various tax vehicles in order to draw from them, so creating tax diversification in one's savings prior to retirement will be important as well. **Tax diversification** here refers to the process of investing in various types of tax vehicles that have different tax characteristics. For example:

- Tax-Deferred: 401(k), traditional IRA, nonqualified deferred compensation
- Taxable: certificates of deposit, bonds, REITs
- Tax Preferred: life insurance, nonqualified annuities, real estate, oil and gas interests, long-term capital gain assets, stocks paying qualified dividends
- Tax Free: Roth IRA, Roth 401(k), municipal bonds

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<sup>36</sup> It would take Kieran \$67,868 in total distribution from the IRA in Example A, but in Example B a total of only \$66,667 (\$28,817 for the prior year Roth conversion plus \$37,850 for a portion of the current year's income).

The appropriate weighting of each type of tax vehicle will vary from person to person, and must be considered against the backdrop of the client's risk tolerances, his or her current investments, and his or her investment style preferences. For some, this will mean moving assets from a tax-deferred (e.g., IRA) or taxable vehicle (e.g., bonds) to a tax-preferred (e.g., annuities) or tax-free vehicle (e.g., Roth accounts). This could mean contributing to a Roth IRA or converting a portion of a traditional IRA to a Roth.<sup>37</sup> It could also entail taking early (prior to required, that is) distributions from an IRA or nonqualified annuity.<sup>38</sup>

Roth IRA conversions will extend the benefits of Roth taxation for many interested taxpayers.<sup>39</sup> Even though there is a dollar limitation on who can contribute to a Roth, those individuals whose income exceeds the contribution limit should be eligible to complete a Roth conversion.<sup>40</sup> The Roth conversion works best when the taxpayer can use assets, other than the conversion amount, to pay the income tax on the conversion. It is also better if the assets are not needed for retirement income and the individual may be subject to estate taxes. The amount converted to a Roth will not be subject to the 3.8% surtax. The amount of the conversion will, however, count in determining the MAGI. This income, however, does count in determining how much investment income is subject to the surtax.

**Example:** Tom, who is single, has wages of \$180,000 and net investment income of \$15,000. His MAGI is \$195,000. If Tom decides to do a \$20,000 Roth conversion, his MAGI will be \$215,000 and the \$15,000 of net investment income will be subject to the 3.8% surtax or \$570 of additional taxes.

A Roth IRA typically is a great investment for someone who has sufficient retirement assets (other than the Roth IRA itself) and wants to provide for their heirs; it also works well when the Roth is left to accumulate for the heirs who will receive the benefits of compounding. Qualifying distributions from the Roth IRA are not income taxable, at the state or Federal level, and there are no required minimum distributions ("RMDs") for the Roth owner, although the Roth beneficiary must take RMDs over his or her remaining life expectancy

Completing a Roth conversion in a tax year when the client's MAGI will be lower may enable the client to minimize, and possibly avoid the surtax in later years when he or

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<sup>37</sup> As always, each Roth conversion's suitability must be examined at the time of conversion, under the specific circumstances at that time.

<sup>38</sup> i.e., before age 70 ½ (early), but not before 59 1/2 (premature).

<sup>39</sup> Assuming the Roth IRA has been in existence for at least five years and the distribution is a qualifying distribution, then the distribution will not be taxable and the surtax will not apply. Unfortunately, those for whom the surtax is a concern typically are the same taxpayers who are ineligible to contribute to a Roth IRA.

<sup>40</sup> The income restriction on Roth conversion was repealed effective January 1, 2010.

she may have higher MAGI. The income tax free nature of a qualifying distribution makes the Roth a very attractive investment for most people, particularly by someone in the top federal tax bracket.

In such cases, taxpayers will often recognize a tax in an early year, at a known cost, rather than expose themselves to potentially higher taxes in the future.

**Example:** “Real Estate” Ruksana, age 60 and single, has a number of deals in the works. In addition to real estate parcels in development, she has \$1,000,000 in a traditional IRA. Ruksana expects to realize \$150,000 of net rental income each year from property ventures when their mortgages are paid off (in 2023). Instead of waiting until distributions are required (in 2023), she plans to take the income/growth from the IRA each year. Assuming she distributes \$40,000 from the IRA, and has \$35,000 of other earnings, her AGI will be \$75,000 in 2013. Thus, the tax rate for the IRA distributions will be 25%. If Ruksana waits to take distributions until 2023, the IRA required distribution will be taxed in the 28% and 33% brackets (effective rate approximately 30%) because it will be stacked on \$150,000 other ordinary income. Over the 10 years, the tax savings on the \$400,000 of early distributions (compared to distributions made when her income is higher) will be \$20,000.<sup>41</sup>

While growth in the IRA is not burdened by taxes as it accumulates, the IRA generates ordinary income when liquidated. Growth in a well-managed portfolio, while potentially subject to the Medicare investment surtax, will largely be taxed at capital gains rates. Ruksana will also have given herself distribution flexibility in establishing a sizable nonqualified portfolio not subject to RMDs

Since the long-term objective will be tax reduction, strategies to create differently taxed sources of future income must be sensitive to how much tax will be created when funds from one type of tax vehicle are moved to a different type of tax vehicle. Stated another way, while it is important to the long-term plan to have different tax groups, the tax cost of moving assets to achieve tax diversification may outweigh the benefits.<sup>42</sup> Thus, having a Roth IRA account may be an important objective in general, but if the conversion will be taxed in a much higher rate (e.g., 39.6%) than would apply to later distributions from the traditional IRA itself (28%), then the conversion might not make sense. To this end, **clients generally should consider repositioning assets only when the overall tax rate in that year will not be increased**, taking advantage of an

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<sup>41</sup> Note that IRA will have the advantage of tax-free growth, where the nonqualified account may have its rate of return diminished by taxes on some of its growth every year. IRA distributions are not subject to the Medicare surtax.

<sup>42</sup> Consider the result for Kieran in the Example B, above, if the Roth conversion had come at a tax cost of 33% instead of 25%.

excess room within their tax bracket, or when the repositioning will likely incur a lower tax than that applicable in retirement.

## 2. Portfolio Optimization

Higher taxes under ATRA will encourage taxpayers to optimize their retirement accumulation not only through investment diversification but also by matching the tax attributes of the asset to the most appropriate tax vehicle. A complete analysis is beyond the scope of this material, but in general, taxpayers can maximize their after-tax returns by limiting the tax drag on their investments.

A common approach to consider limits the tax drag on a particular type of investment in proportion to expected tax on that investment. Assets will be paired with an appropriate tax vehicle: income-generating investments in qualified accounts; growth assets in taxable accounts. For example, bonds, which have interest taxed annually at potentially the highest tax rate (i.e., short-term ordinary income rate of 39.6% plus the 3.8% surtax), are placed in an IRA, so that 100% of each year's income may be reinvested. The tax-deferred IRA provides shelter for the bond income and eliminates the 3.8% surtax. Long-term growth investments, which produce less annual income and generally have multi-year time horizons, are placed in taxable accounts, to take advantage of long-term capital gains rates when liquidated. Here, an IRA might not be as good as the taxable account since there is limited annual income to report. If placed in an IRA, growth would ultimately be distributed as ordinary income instead of at the lower capital gains rates.

## 3. Types of Investments

**Life Insurance** – The growth of a life insurance policy's cash value is tax-deferred and the surtax will not apply until such time as there is a taxable distribution from the life insurance policy. This may make life insurance an attractive option for those who are in a high tax bracket and subject to the surtax. As a pure investment, life insurance is more expensive than other investments because of the cost of insurance. Life insurance does, however, afford the owner the opportunity to recover his/her basis before there is a distribution of gain.<sup>43</sup> This is not true of most other assets. The policy owner can

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<sup>43</sup> This assumes the life insurance policy is not a modified endowment contract otherwise known as a MEC. A MEC is taxed on a last in first out basis (LIFO) meaning that gain will be distributed before the policy owner recovers the basis in the policy. A loan from a MEC is considered a deemed distribution and as such, the taxable portion of the distribution will count towards MAGI in determining whether the client is subject to the surtax.

access policy values on a tax-favored basis by withdrawing cash value up to basis, taking a policy loan, and receiving dividends in cash.<sup>44</sup>

The death benefit paid under a life insurance policy is generally not considered to be net investment income and as such it is not subject to the 3.8% surtax. The tax-favored nature of life insurance, particularly when combined with investment options found in a variable universal life policy, can be extremely powerful. Owners of these types of life insurance policies can rebalance the policy subaccounts to insure that their investment portfolio continues to reflect their risk tolerance. This is something that an owner of mutual funds cannot do, at least not without possibly incurring taxable income while trying to rebalance their investments.

The tax-favored nature of life insurance will continue to be a popular option for clients' because of tax deferral and the ability to access policy values on a tax-favored basis. The higher income tax rates for wealthy Americans, along with the new 3.8% surtax on net investment income, will only serve to increase its popularity.

Life insurance will continue to be used for income replacement, to build an estate, to provide liquidity for estate taxes, along with a host of business insurance needs such as key person insurance, collateral for a loan, buy-sell funding, and executive bonus plans. The 3.8% surtax only applies to a taxable distribution from a life insurance policy and it is possible to access the policy's cash value without creating a taxable distribution by withdrawing to basis and then borrowing against the policy's cash value.

**Annuity Contracts** – An annuity contract is another tax-favored investment that avoids the impact of the 3.8% surtax, at least until such time as there is a taxable distribution. The tax treatment of a distribution from an annuity contract differs from how a life insurance distribution is taxed. With an annuity contract, all gain is distributed first and only after all gain from the annuity has been distributed will the annuity owner begin receiving his or her basis. A loan is treated as a deemed distribution which requires the distribution of all of the contract's gain before there is any recovery of basis.

As with a life insurance policy, it is possible to rebalance a variable annuity contract without creating a distribution that could trigger the recognition of gain. This is an important benefit since it enables the contract owner to maintain their risk tolerance without having to take a distribution from the annuity contract or adding money to the contract as a rebalancing method.

The annuity contract will continue to be an important retirement savings vehicle. Often times the subaccounts offered under the annuity contract are very similar to their mutual

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<sup>44</sup> Dividends received as cash are taxable once the total cumulative dividends received exceed the owner's basis in the life insurance policy.

fund counterpart (there will generally be some differences between a mutual fund account and a similar subaccount). The tax deferral, the ability to rebalance, and the option to receive payments for life make the annuity an attractive investment choice.

**Mutual Funds** – Those high income individuals that have invested in mutual funds may be impacted by the 3.8% surtax. Generally, mutual funds will make annual distribution to its investors. The distributions will usually be comprised of capital gains or losses, ordinary income or losses, and dividends. Most mutual funds turnover their portfolio at least once a year. Buying and selling the stock in the investment portfolio may result in the application of the surtax. Recognizing losses may help reduce the taxable gain and the imposition of the 3.8% surtax. The client may wish to consider purchasing tax-efficient mutual funds in which the fund manager holds the underlying assets longer in the attempt to minimize the amount of gain distributed to each investor.

Unlike life insurance policies and annuity contracts, rebalancing may create taxable income or losses for the investor. The account owner could adjust the allocation of his/her contributions until the client has effectively rebalanced the account(s). The investor may be pleased to recognize losses since the losses could reduce the amount of the taxable income for the year.

Unlike the owner of a life insurance policy and/or annuity contract, the owner/investor in a mutual fund has little control in the recognition of gain or loss, other than liquidating some or all of the fund units. Compare this with the control maintained by an owner of an annuity contract or life insurance policy. The owner of these investment vehicles has total control over the recognition of income since the owner controls when and the amount of any distribution. Having control over the recognition of income affords the investor with the opportunity to have control over the timing of the income.

Mutual funds are a little less attractive as an investment because of the surtax, the income tax cost of rebalancing and the increase in the federal income tax rates. Tax efficient mutual funds may be an attractive investment alternative since the fund manager does not regularly turn over the funds. A municipal bond fund may be another investment that should be considered in light of these changes.

**Municipal Bonds** – The income from a municipal bond is exempt from federal income taxes<sup>45</sup> and is not subject to the 3.8% surtax which may make municipal bonds an attractive investment, especially for someone in the top tax bracket and subject to the 3.8% surcharge. While some investments, like mutual funds, may have a greater return than municipal bonds, this may not be true when you factor in the taxes on the income

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<sup>45</sup> Some municipal bonds are both federal and state income tax-free.

and the 3.8% surcharge. The higher the individual's tax rate the greater the equivalent yield on the municipal bonds.<sup>46</sup>

Municipal bonds become a more attractive investment for the client when the individual or married couple is in a high federal income tax bracket, subject to the 3.8% surcharge, and the state also has an income tax. The equivalent yield of a municipal bond increases as the client(s) tax bracket increases.

**Real Estate** – The sale of real estate generates either a capital loss or capital gain. Property that is held for more than a year will generate either a long-term gain or a long-term capital loss. For property held for one year or less, the gain or loss will be considered to be short-term. If the gain is from the sale of the personal residence, then a single individual could exclude up to \$250,000 of gain while a married couple could exclude up to \$500,000 of gain. The amount of gain excluded from income will not be considered to be net investment income and will not be subject to the 3.8% surtax. However, any gain in excess of those amounts would be subject to the surtax, provided that the taxpayer's income exceeds the applicable thresholds for the surtax.

If the client(s) are selling real estate held as an investment, then they cannot exclude any of the gain. It still may be possible to dispose of the real estate without recognizing the gain by entering into a §1031 tax-free exchange. There are strict requirements that must be adhered to in order to defer the recognition of gain using §1031. It is recommended that a client work with a broker that specializes in this type of exchange and can identify property that qualifies as a tax-free exchange.

It may also be possible to take a federal income tax deduction for depreciation of real property. Generally, it is not possible to depreciate land but buildings on the property can be depreciated based upon tables that determine the life expectancy of a building. The depreciation deduction may not eliminate the surtax but it may help offset the effect of the 3.8% surtax.

Rental income from a passive activity is subject to the surtax while rental income from a trade or business is not. Therefore, if the taxpayer could become more involved in the management of the real estate, the net investment income may be reduced and the earned income increased which may reduce the effect of the surtax.

Greater involvement in the management of the real estate may result in some passive income being treated as income from a trade or business and is, therefore, not subject

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<sup>46</sup> For example, consider the equivalent yield on a tax-free bond for a married couple in the 33% federal (AGI over \$250,000) and 7% state income tax brackets. For taxpayers, a 3.5% tax-free yield is the equivalent of a 5.95% taxable yield.

to the 3.8% surtax. The deduction for expenses and depreciation may help reduce the net investment income which will reduce the impact of the 3.8% surtax.

**Master Limited Partnership** – The Master Limited Partnership (“MLP”) is a limited partnership that is publicly traded and can only invest in certain industries. The MLP can be involved in activities involving the production, processing, or transportation of coal, oil, or natural gas. The Service refers to these activities as qualifying sources and 90% of the MLP’s income must be from these sources. The MLP pays its investors in quarterly distributions in an amount as stated in the contract and the general partner receives a management fee that is also specified in the contract. For these types of investments, it will be difficult for the client to argue that the income is from an active business interest since the client’s ownership interest is a limited partnership interest.

**Oil and Gas Investments** – This may be an attractive investment for someone who has high income in a particular year because of the deduction for intangible drilling costs which can produce a large current deduction for the client. There is also a depletion allowance deduction which may help reduce the income subject to the surtax.

Care must be taken before entering into an oil and gas deal. “Boiler rooms” are used along with the internet, and an unscrupulous promoter will often make statements that are inaccurate and misleading. This type of promoter will often overstate the success the company has experienced in the exploration for oil and gas reserves. For many clients, investing in oil and gas investments may be outside of their risk tolerance level so care must be exercised by the advisor when considering this as a recommendation.

### **III. Conclusion**

Since the passage of EGTRRA in 2001, income tax planning has taken somewhat of a backseat to estate planning. ATRA has, however, increased the income tax rates so the top income tax rate is almost the same as the highest estate tax rate. The increase in the exemption amount, along with portability, has reduced the number of individuals that may be subject to the estate tax. These changes will increase the attention paid to income tax planning and may impact the selection of investment assets utilized by high income wage earners.

While reducing income tax is not always possible, informed taxpayers can create a plan that gives them the best chance to meet their retirement and legacy goals. A plan that looks not only an investment’s return, but its tax character and place within the owner’s overall plan, will better allow the taxpayer to succeed. In the wake of the changes made by ATRA and prior legislation, clients will be well served by consulting with their tax and financial advisors to determine what is most appropriate for them.

**Legal & Tax Trends** is provided to you by a coordinated effort among the advanced markets consultants. The following individuals from the Advanced Markets Organization contribute to this publication: Thomas Barrett, Michele Beauchine, Kenneth Cymbal, John Donlon, Lori Epstein, Jeffrey Hollander, Jeffrey Jenei, and Barry Rabinovich. All comments or suggestions should be directed to Thomas Barrett at [tbarrett@metlife.com](mailto:tbarrett@metlife.com) or John Donlon at [jdonlon@metlife.com](mailto:jdonlon@metlife.com).

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## Appendix A: Summary of Key ATRA Income Tax Provisions

### Medicare Increases

As part of the healthcare reform legislation of 2010, two Medicare tax increases take effect in 2013. A 0.9% payroll tax increase on earned income and a 3.8% tax on investment income. While these changes were not part of ATRA, their timing will affect many taxpayers just the same.<sup>47</sup>

For 2013 and later, an Additional Medicare Tax of 0.9% will apply to earned income and self-employment income above a certain threshold (\$200,000 for single filers; \$250,000 for joint filers).<sup>48</sup> While this surtax applies only to the employee portion of Medicare, an employer must withhold the additional tax from wages over the threshold that it pays to an individual, regardless of the individual's filing status. As illustrated in the tax rates table (included as Appendix B), the 0.9% tax simply creates higher combined tax brackets for those subject to it.

Example: In 2013, Luke (unmarried) earns \$200,000 in salary and \$100,000 bonus. He has no other income. Under ATRA, his income above \$200,000 is taxed at 33%. The Additional Medicare Tax of 0.9% also applies to this portion of his income. In effect, the combined rate applicable to Luke's bonus is 33.9%.

Example: PR-Inc. employs Agnes and Jeremy, a married couple who file taxes jointly. Agnes earns \$250,000 while Jeremy earns \$175,000. In addition to regular withholding requirements, PR-Inc. will be required to withhold the 0.9% on \$50,000 of Agnes' income, but will not withhold the 0.9% with respect to any of Jeremy's income. Note that the withholding of only \$450 will leave the couple short at tax time, since their combined obligation for the Additional Medicare Tax will be \$1,575 (0.9% x \$175,000).

In 2013, for the first time, a Medicare tax will be levied not just on earned income, but also on certain investment income. Under new IRC §1411, a tax of 3.8% will apply to a portion of the net investment income ("NII") of taxpayers with MAGI above the threshold amount (\$200,000 for single filers; \$250,000 for married filing jointly; \$11,950 for trusts). The tax applies to the lesser of the amount of net investment income or the amount by which MAGI exceeds the threshold amount.<sup>49</sup> For these purposes, investment income includes dividends, interest, capital gains from sales of stocks, annuity income, taxable distributions from a life insurance policy, and rents. It does not include distributions

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<sup>47</sup> The Patient Protection and Affordable Care Act of 2010 ("PPACA") was modified by and supplemented with The Health Care and Education Reconciliation Act ("HCERA") of 2010. Together they are often referred to as the healthcare reform legislation of 2010.

<sup>48</sup> IRS Proposed Regulations refer to the tax as the Additional Hospital Insurance Tax or the Additional Medicare Tax (see e.g., Prop. Reg. §1.401-1).

<sup>49</sup> For purposes of calculating net investment income, gain (up to \$250,000 for a single individual and up to \$500,000 for a married couple) from the sale of a principle residence may be excluded if it was excluded for regular income tax purposes. <http://www.irs.gov/uac/Newsroom/Net-Investment-Income-Tax-FAQs>.

from IRAs or qualified plans, municipal bonds income, life insurance death benefits, or income from businesses in which the taxpayer actively participates. Although not expressly addressed in the PPACA, it appears that amounts received on the surrender or sale of a life insurance contract may be subject to the surtax to the extent the amounts received exceed the taxpayer's basis in the contract. However, policy loans and withdrawals to the extent of basis will still be received free of income tax.

Example: Roger has earned income of \$160,000 and rental income of \$30,000 in 2013. The 3.8% Medicare surtax on investments does not apply to Roger since his income does not exceed the threshold amount of \$200,000. However, assume that Roger also converts his \$40,000 traditional IRA to a Roth in 2013. While the taxable conversion amount of \$40,000 is not subject to the 3.8% tax, it increases his MAGI to \$230,000, thereby exposing his rental income to the tax ( $3.8\% \times \$30,000 = \$1,140$ ).

In general terms, this 3.8% tax helps to level the tax treatment of earned and unearned income for taxpayers with income over the threshold amount.

### **Individual Income Tax Rates**

ATRA permanently extended the Bush-era tax cuts. Without this new legislation, the pre-Bush tax cut income tax brackets of 15, 28, 31, 36, and 39.6 percent would have been reinstated. Instead, the lowest marginal income tax bracket of 10% was retained under ATRA, and the 15, 25, 28, 33, and 35 percent tax brackets remain the same. One compromise made is the addition of a 39.6 percent marginal tax bracket but only for single filers above \$400,000 of taxable income and for married taxpayers filing jointly with more than \$450,000 of taxable income, essentially shrinking the 35 percent tax bracket.<sup>50</sup>

### **Dividend and Capital Gains Rates**

Without ATRA the maximum capital gain rate would have increased to 20 percent (up from 15 percent) for all taxpayers above the 15 percent income tax bracket. While ATRA does raise the top rate to 20 percent, it is only for those taxpayers who are subject to the 39.6% rate; that is, single filers with more than \$400,000 of taxable income and married taxpayers filing jointly with more than \$450,000 of taxable income. Those taxpayers who are not in the 39.6 percent tax bracket will continue to be subject to the 15 percent rate. This 15 percent bracket only applies to long-term capital gains and qualified dividends. Under ATRA, ordinary income rates continue to apply to short-term capital gains. Those in the 10 or 15 percent income tax bracket will continue to retain a zero percent capital gains rate.

One caveat – remember that under PPACA an additional 3.8% surtax is assessed on the lesser of modified adjusted gross income or net investment income over the threshold amounts (\$200,000 for single filers/\$250,000 for joint filers/\$125,000 for

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<sup>50</sup> See Appendix B for the 2013 Individual tax rates.

married filing separately).<sup>51</sup> As a result, effective January 1, 2013, the top capital gains rate is 23.8 percent for long-term gains and qualified dividends and 43.4 percent for short-term capital gains and nonqualified dividends.

### **Personal Exemption and Itemized Deduction Phase-Out**

While the Bush-era tax cuts and the 2010 Tax Relief Act repealed the personal exemption phase-out (“PEP”) and the itemized deduction limitation (“Pease”) through 2012, effective January 1, 2013, ATRA reinstated these phase-outs subject to higher income thresholds. The new income thresholds are \$300,000 of AGI for married couples filing jointly, \$275,000 of AGI for heads of households, \$250,000 of AGI for single taxpayers, and \$150,000 of AGI for those married taxpayers filing separately. These amounts are also adjusted for inflation. If full sunset of the 2010 Tax Relief Act had occurred, the applicable thresholds would have been \$178,150 for single and \$267,000 for married couples; significantly less than thresholds established under ATRA.

Medical expenses, investment interest, and casualty, theft, and gambling losses will continue to be excluded from the Pease limitation on itemized deductions. The reduction for itemized deductions is three percent for each dollar of adjusted gross income above the threshold, but the amount of itemized deductions shall not be reduced by more than 80%. Personal exemptions have the same threshold limits as itemized deductions but the reduction rate is two percent for each \$2,500, or portion thereof, by which the adjusted gross income exceeds the threshold level.

### **Alternative Minimum Tax (AMT) Relief**

Prior to ATRA, Congress would annually enact a last minute alternative minimum tax (“AMT”) “patch” which would help limit the amount of taxpayers subject to the AMT tax. For the most part this patch simply increased the amount of the AMT exemption, and without a patch for 2012 it is estimated that almost 30 million taxpayers would have been subject to the AMT. ATRA provides “permanent” AMT relief from this annual Band-Aid. Under ATRA, for 2012, the AMT exemption amount is \$78,750 for joint filers and \$50,600 for single filers. This exemption amount was made permanent and indexed for inflation from the 2012 numbers. There continues to be a phase-out associated with the AMT, with full phase-out above \$465,000 in AMT income for joint filers and \$314,900 for single filers.

### **Marriage Penalty Relief**

Before the passage of ATRA, the marriage penalty relief was gradually increased to twice the basic standard deduction for a single individual to avoid the “marriage penalty” that would have been experienced by many couples. ATRA extended the marriage penalty relief – without this extension the standard deduction for a married couple was

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<sup>51</sup> See the beginning of Section III for a discussion on Medicare rate Increases.

scheduled to decrease to \$10,150, \$1,950 less than double the exemption for single individuals.

### **Charitable IRA Distribution (one-year extension)**

ATRA includes a retroactive extension (through the end of 2013) of the qualified charitable IRA distribution provision.<sup>52</sup> First established in 2006 and extended several times, this provision allows an IRA owner to direct a nontaxable transfer from her IRA to an eligible charitable institution. Known informally as a “charitable rollover,” a qualified charitable distribution (“QCD”) allows the IRA owner to avoid including the QCD from income and to credit the distribution amount towards that year’s required minimum distribution.<sup>53</sup> The limitations and requirements continue to apply for 2013 QCDs:

- IRA owner must be at least age 70½ when the distribution is made;
- The maximum aggregate income exclusion for QCDs in 2013 is \$100,000 per person;<sup>54</sup>
- Only public charities (that are not supporting organizations) are eligible institutions;
- The distribution must be made directly to charity from the IRA custodian;
- The IRA owner may not receive any consideration (e.g., goods or services) in return for directing the QCD;
- Distributions from qualified plans (e.g., 401(k) plans) do not qualify;<sup>55</sup>
- Written receipt/acknowledgement from the charity.

For individuals who received their required minimum distribution in December of 2012, they have until January 31, 2013 to contribute this amount to a charity and avoid being taxed on the distribution. This represents an opportunity to those individuals who are charitably inclined, do not need the distribution amount, and are affected by the phase-out of itemized deductions.

Qualified distributions may become more popular in 2013 with high AGI taxpayers, as the IRA owner may make a charitable gift from the IRA without including the distribution in income. Because the direct transfer is not included in income, this renders inapplicable the itemized deduction phase-out that can reduce a charitable gift deduction.

### **Payroll Tax Holiday**

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<sup>52</sup> The act retroactively affects transfers for 2012 as well (notwithstanding that QCDs were not available during 2012) and allows otherwise qualifying transfers made in January 2013 to be treated as 2012 distributions.

<sup>53</sup> For more information and examples, see IRS Publication 590.

<sup>54</sup> A husband and wife may each have \$100,000 in one year, but the QCDs must come from their respective IRA accounts (i.e., not \$200,000 from one IRA).

<sup>55</sup> Distributions from active SIMPLE IRA or SEP IRA accounts do not qualify. A taxpayer may make a QCD from a Traditional IRA or Roth IRA. If an IRA includes nondeductible contributions, the distribution is first considered to be paid out of the taxable income portion. See IRS Publication 590.

For the past two years, a payroll tax holiday resulted in a two percentage point reduction in employment taxes for both employees and the self-employed. This provision was not renewed by ATRA and an employee and an employer will each now pay an employment tax of 6.20% and 1.45% for hospital insurance (12.40% self-employment tax plus 2.90% for hospital insurance) and this tax is imposed on the first \$113,700 of wages in 2013.

### **Deduction for Qualified Tuition Expenses**

This deduction had previously expired after the 2011 tax year but is reinstated retroactively by ATRA. This deduction is now available, to those that qualify, but is set to expire at the end of 2013. The availability of the deduction is based upon the taxpayers modified adjusted gross income and the taxpayer cannot claim this deduction in the same year they take the American Opportunity Credit or the Lifetime Learning credit. The maximum deduction is \$4,000 and is phased-out when income exceeds a certain threshold amount (2011 it was \$80,000 for a single taxpayer and \$160,000 for a joint filer).

ATRA Individual & Trust Tax Rates for 2013 and following

**Single Taxpayer**

		Earned Income			Qualifying Investment Income*			Short-Term Investment Income**			
----- Taxable Income -----		Income Tax Rate	Medicare Tax	Combined Rate	Effective Rate	Tax Rate	Medicare Tax	Combined Rate	Tax Rate	Medicare Tax	Combined Rate
\$	400,001 +	39.6%	0.9%	40.5%	30.9%	20%	3.8%	23.8%	39.6%	3.8%	43.4%
\$	398,350 up to	35%	0.9%	35.9%	30.9%	15%	3.8%	18.8%	35%	3.8%	38.8%
\$	200,000 up to	33%	0.9%	33.9%	30.9%	15%	3.8%	18.8%	33%	3.8%	36.8%
\$	183,250 up to	33%	2.9%	35.9%	28.0%	15%	0%	15%	33%	0%	33%
\$	87,850 up to	28%	2.9%	30.9%	27.2%	15%	0%	15%	28%	0%	28%
\$	36,250 up to	25%	2.9%	27.9%	23.3%	15%	0%	15%	25%	0%	25%
\$	8,925 up to	15%	2.9%	17.9%	16.7%	0%	0%	0%	15%	0%	15%
\$	- up to	10%	2.9%	12.9%	12.9%	0%	0%	0%	10%	0%	10%

**Married - Joint**

		Earned Income			Qualifying Investment Income*			Short-Term Investment Income**			
----- Taxable Income -----		Income Tax Rate	Medicare Tax	Combined Rate	Effective Rate	Tax Rate	Medicare Tax	Combined Rate	Tax Rate	Medicare Tax	Combined Rate
\$	450,001 +	39.6%	0.9%	40.5%	30.0%	20%	3.8%	23.8%	39.6%	3.8%	43.4%
\$	398,350 up to	35%	0.9%	35.9%	30.0%	15%	3.8%	18.8%	35%	3.8%	38.8%
\$	250,000 up to	33%	0.9%	33.9%	29.2%	15%	3.8%	18.8%	33%	3.8%	36.8%
\$	223,050 up to	33%	2.9%	35.9%	26.4%	15%	0%	15%	33%	0%	33%
\$	146,400 up to	28%	2.9%	30.9%	25.3%	15%	0%	15%	28%	0%	28%
\$	72,500 up to	25%	2.9%	27.9%	22.3%	15%	0%	15%	25%	0%	25%
\$	17,850 up to	15%	2.9%	17.9%	16.7%	0%	0%	0%	15%	0%	15%
\$	- up to	10%	2.9%	12.9%	12.9%	0%	0%	0%	10%	0%	10%

**Trusts & Estates**

		Qualifying Investment Income*			Short-Term Investment Income**		
----- Taxable Income -----		Tax Rate	Medicare Tax	Combined Rate	Tax Rate	Medicare Tax	Combined Rate
\$	11,951 +	20%	3.8%	23.8%	39.6%	3.8%	43.4%
\$	8,751 up to	15%	0%	15%	33%	0%	33%
\$	5,701 up to	15%	0%	15%	28%	0%	28%
\$	2,451 up to	0%	0%	0%	25%	0%	25%
\$	- up to	0%	0%	0%	15%	0%	15%

Medicare Tax is a combined rate including 1.45% employer portion

\* Qualifying Investment Income assumed to be long-term capital gains and qualifying dividends

\*\* Short-Term Investment Income includes rents, interest, and nonqualified annuity income

\*\*\* Effective Rate is a calculated value reflective effect of lower bracket rates on higher income amounts