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Re: The State of Federal Estate and Income Taxation -- Obama Administration Proposals

Dear Clients, Friends and Colleagues:

If you read our client tax advisory in January of this year, then you know Congress, in a late-night session, approved the American Taxpayer Relief Act of 2012 (herein "ATRA") which was signed into law by President Obama on January 2, 2013. Generally, ATRA extended certain "Bush Era Tax Cuts" (which had significantly lowered income and estate tax rates), but ATRA also imposed some tax increases. A copy of our summary on ATRA is available on our website http://www.ceacpa.com/newsletters.html or you can request a copy by e-mail (krb@ceacpa.com).

Congress stated that the estate and gift tax provisions of ATRA were "**permanent**." In January, we articulated our view that the word "permanent" meant "until the next time Congress tinkers with the estate and gift tax law." We also stated that, given the economic morass and the significant shortfall of revenue necessary to meaningfully reduce the budget deficit (certainly, we do not expect the deficit to be closed), it was possible that later this year additional changes in the estate and gift tax law would be proposed.

Recently, the Obama Administration has proposed a number of tax revisions which raise estate and income tax rates while reducing the estate and gift tax exemption and eliminate certain estate tax planning techniques. These changes, as proposed, are designed to become effective in 2018 (perhaps because the Administration did not want to insult the word "permanent"). We are articulating these changes here, both to "bask in the accuracy of our prediction" that tax change might quickly ensue and to give you the impetus to plan now while you have the opportunity to do so. While most of the Administration's proposals will not pass with the current political make up of the House of Representatives, they certainly indicate where we may be going, and some may become part of debt ceiling or deficit legislation.

Here are the principle Administration proposals:

A. ESTATE AND GIFTING TAX PROPOSALS

Here, in tabular form, is a summary of some of the principle proposals and how they contrast to the tax law as enacted in January of this year:

	Pre-ATRA 12/31/2012	ATRA Provisions 1/1/2013	Obama Administration Proposals
Estate Tax Rate	35%	40%	45%
Estate Tax Exemption	$5 million	$5.25 million plus CPI escalator	$3.5 million No CPI escalator
Lifetime Gift Tax Exemption	$5 million*	$5.25 million*	Capped at $1 million*; unused balance available at death

* A person has one exemption from the estate and gift tax; to the extent not used for lifetime gifts, the exemption is available at death. Under ATRA, a person could use his entire exemption during lifetime to remove appreciating property from his estate or wait and use it at death. In any event, each person has one aggregate exemption for both the estate tax and lifetime gift tax. To the extent that a person uses his exemption to shelter lifetime gifts, such use reduces the estate tax exemption available at death, dollar for dollar. The Obama proposal limits the use of the exemption to $1 million during lifetime (a decrease of over $4 million from the ATRA exemption). This means that individuals who want to move the appreciating property to the next generation should do so now while this opportunity is in town.

In addition to the above, a number of changes have been proposed to eliminate perceived abuses in the estate tax area. Most of these changes impact the estate planning techniques used to assist clients in transferring assets to children on a tax efficient basis. These include:

- Elimination of so-called grantor retained annuity trusts (“GRATs”). GRATs have worked very well in recent years because of the low interest rate environment. Under a typical GRAT, a grantor contributes assets into the GRAT and retains the right to receive a fixed “pay back” for a number of years. For a two-year term, the pay back is approximately 51% of the asset value at the end of each year. Whatever is left in the GRAT at the end of the term passes to children (or other heirs) without any gift tax. In most cases, because of the machinations of IRS rules and low interest rates, GRATs have been very effective devices to pass assets down to subsequent generations with minimal estate and gift tax. The GRAT will be eliminated under the Administration’s proposals.

- Gifts of interests in family limited partnerships will no longer be eligible for valuation discounts reflecting the recipient's lack of control and illiquidity. The discount, in some cases, enables a donor to transfer a limited partnership interest, the underlying value of which is greater than the discounted value.

- Tightening up of certain Grantor Trust provisions.[1] Transactions between a Grantor and his Grantor Trust would be restricted.

- New limitations on the term of so-called Dynasty Trusts which enable family funds to pass down from generation to generation without incidence of estate taxation.

B. INCOME TAX PROPOSALS

Here are the income tax highlights of the Administration's proposals:

Limitation on Itemized Deductions: The Administration has proposed a limitation on the benefit of itemized deductions. Pursuant to this new limitation, the itemized deductions will be limited to a 28% deduction for high income householders.

Buffett Rule: Under the so-called Buffett Rule, individuals whose adjusted gross income exceed $1 million would pay a minimum tax rate of 30% on the taxpayer's Adjusted Gross Income after giving effect to his charitable contribution deduction for the tax year; this represents, in the Administration's view, the Fair Share Tax ("FST"). Capital gains and dividends would also be subject to this increased Fair Share Tax rate of 30% to the extent overall income exceeds the $1 million threshold.

We already have an "Alternative Minimum Tax" which traps middle class Americans. This Fair Share Tax is an alternative "Alternative Minimum Tax" and brings with it tax complexities involved in yet another special calculation. (The IRS still has not fully documented how taxpayers are to handle the new special 3.8% Medicare tax.)

C. OTHER PROPOSALS IMPACTING OUR CLIENTS

These Administration proposals do not fit squarely in either the estate tax or the income tax realm, but have a financial impact on our clients:

- New higher Medicare premiums for individuals who have higher levels of income.

- *IRAs: A Cap on IRAs and Retirement Accounts:* The Administration's proposal would cap retirement accounts at approximately $3 million. Hence, once a person funded $3 million in an IRA or certain annuities, he would not be able to fund, on a pre-tax basis, any additional amounts.

[1] A grantor trust is a special type of trust, the assets of which are outside a person's estate, even though the income tax attributable to the trust is taxed to the grantor. Nonetheless, the grantor continues to pay all income tax on the trust's assets. Such a vehicle is very effective in estate planning purposes because it enables the grantor to supercharge his gifts by paying the beneficiary's taxes.

- *IRAs: New Pay Out Requirements:* Because IRAs are not subject to income tax until the funds are withdrawn, IRAs are a very effective tool for individual savings. In many instances, parents will carefully plan the beneficiary designations of their IRAs to enable the payouts to be made over the lifetime of their children or grandchildren. Under the Administration proposals, all IRAs would have to be completely paid out within five years following the death of the surviving spouse. This will significantly curtail the ability to "stretch out" the payouts.

As noted above, most of the above changes are not scheduled to be effective until 2018.

What is the likelihood of these changes becoming law?

Based on the structure of the House of Representatives, virtually nil, but the proposed changes show how the Administration is hankering to extend the reach of the estate tax more robustly and to limit the recent changes benefiting higher net worth individuals. Some of the proposals could find their way into debt ceiling or deficit legislation later this year.

Where are we going?

There is a tremendous dissatisfaction with the Internal Revenue Code and our current system of federal tax collection. The problems have not been created by the Internal Revenue Service, but rather by politicians in Washington and Congress' engaging in social engineering through its providing incentives (and disincentives) in the Internal Revenue Code. (Examples: Purchase an electric car, get a tax credit; adopt a child, get a tax credit, install energy efficient equipment, get a tax credit. These incentives might be better off being paid directly, but rather they are embedded in the Internal Revenue Code and administered by the IRS.) Most recently, a significant administrative burden has been foisted upon the IRS: the enforcement of revenues and penalties under the Affordable Healthcare Act. We think there is significant momentum building for another attempt at Internal Revenue Code simplification and a general broadening of the tax base by eliminating deductions and special tax breaks. However, having seen the sorry Kabuki theater that brought us the Tax Act of 2012, we are not optimistic.

What should you do?

Given the lack of "permanence" of the present tax law, smart taxpayers are taking advantage of tax breaks now while the tax breaks are "in town." They may not be here that much longer, and the estate tax rate can only go up while the exemption will only go down. This is the reality.

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