BETH SHAPIRO KAUFMAN

Budget and Health Care and Taxes. Oh My!

Dorothy: Do—do you suppose we'll meet any wild animals?
Tin Man: Mmm, we might.
Dorothy: Oh!
Scarecrow: Animals that—that eat straw?
Tin Man: (nonchalantly) Uh, some. But mostly lions and tigers and bears.
Dorothy: Lions?
Scarecrow: And tigers?
Tin Man: (nodding) And bears.
Dorothy: Oh! Lions and tigers and bears. Oh my!

There seems to be little appetite in Washington for providing a permanent fix to the estate tax, but that does not mean there will be no legislative action of concern to estate planners this winter. Our country is faced with the largest budget deficits in history, with a national debt of nearly $12 trillion. Our President is determined to fix what is wrong with the health care system. Unemployment is at a 25-year high. Our armies are fighting in two wars. Addressing all these issues is going to require money, and what better source of tax revenue than those who still have income and assets! Budget and health care and taxes. Oh my!

Expiring provisions

We know all too well that the estate tax exemption level and rates are set to revert to 2001 levels on 1/1/2011. However, absent action by Congress, there are other expiring provisions from the 2001 tax bill and elsewhere on which we should keep watch because of their impact on high net worth individuals. The capital gains rate, reduced to 15% for most gains, will increase to 20% in 2011. It may make sense for clients to realize gains—if they have any—in 2010. The special low tax rate for qualifying dividends will also expire, causing all dividends to be taxed at ordinary income rates. And those ordinary income tax rates themselves will be increasing unless Congress acts on them. Absent Congressional action, the 36% and 36.9% marginal rates will spring back into existence in 2011.

Don't forget "PEP and Pease." PEP is the personal exemption phase-out and Pease is the shorthand name for the phase-out of itemized deductions for certain high-income taxpayers. PEP and Pease are both ways of increasing the tax collected from high-income individuals without having to state a higher marginal tax bracket in the rate tables. Thus, PEP and Pease can be viewed as yet another income tax rate increase. PEP and Pease have been reduced considerably since 2006, but will resume in full force in 2011.

Another expiring provision is the IRA charitable rollover. Under present law, an IRA owner who is over age 70 ½ can donate up to $100,000 from an IRA to a public charity without taking the distribution into income. Of course, the donor also does not get a charitable deduction for that donation. Congress initially enacted the charitable rollover only for 2006 and 2007. Each year since, it has been extended, but without Congressional action, it will expire at the end of 2009.

The real benefit of the IRA charitable rollover is that it avoids limitations on the deductibility of charitable gifts. First, it avoids the percentage limitation rules, which limit charitable deductions to 50% of the taxpayer's adjusted gross income for donations to public charities. Second, it avoids having Pease apply to the charitable donation by bypassing Schedule A altogether, providing obvious benefits to a high-income taxpayer.

With the budget deficit at an all-time high, it is highly unlikely that

BETH SHAPIRO KAUFMAN, of the District of Columbia and Maryland Bars, is a partner in the Washington, D.C. office of the law firm of Caplin & Drysdale, Chartered. She is also a Fellow of the American College of Trust and Estate Counsel, and has written and lectured extensively on estate planning.

all these expiring provisions will be extended. In fact, I would expect that most of the benefit of these provisions, as they affect high-income people, will be allowed to expire.

While digesting all the bad news, it would be easy to overlook a new IRA opportunity in 2010. Starting in 2010, the income limitations for converting a traditional IRA into a Roth IRA will be lifted. Accordingly, the opportunity to accelerate income tax into 2010 and then have a retirement account that will not be subject to income tax in the future will become available to high-income individuals.

Determining whether a Roth conversion is right for your client is a more difficult matter. Here is what you need to know: Will your client be in a higher tax bracket in 2010 or after retirement? How many years are left until your client retires? How much of the retirement money will be used before death and how much will be left to heirs? What rate of return will be obtainable on the invested IRA funds? Assuming your crystal ball can give you answers to these questions, it would be possible to calculate whether Roth IRA conversion would be advantageous. Even without a crystal ball, it is clear that the Roth conversion will be advantageous for many high net worth individuals, so it is worthwhile to attempt to forecast these unknowns to see whether it makes economic sense for a particular IRA owner.

For conversions in 2010, a special provision allows the income tax to be paid over two years. Be careful, though. The current income tax rates are scheduled to expire in 2010, so by accepting the offer to defer half the income taxes for a year, your client may inadvertently subject him or herself to a higher marginal income tax rate in 2011.

While some people have expressed concern that the opportunity to convert to a Roth IRA might have limited longevity, the provision actually generates revenue in the short term, so it may not be an endangered provision. A Roth IRA conversion accelerates the payment of income tax into the year of conversion. The revenue loss associated with the conversion does not occur until the year in which funds would be required to be withdrawn from the account if it remained a traditional IRA. The majority of the people who do Roth conversions would otherwise have left the funds in their traditional IRAs for more than ten additional years. Because Congress looks at the revenue impact over no more than a ten-year period, the Roth IRA conversion is a net revenue raiser in their view. Although the provision is shortsighted from a budgetary perspective, under Congress' rules, it is a winner, and unlikely to be repealed.

Budget

President Obama's budget proposal would address some of the expiring tax provisions, but primarily in a fashion that would not benefit high-income taxpayers. He would extend the 10%, 15%, 25%, and 28% income tax rates for individuals, but increase the 33% and 35% rates to 36% and 39.6%. With respect to capital gains, the President's proposal reintroduces progressive rates for capital gains and qualified dividends: capital gains and qualified dividends that would be taxed at the 36% or 39.6% rate if ordinary income would be taxed at 20%; otherwise, the 15% capital gains rate would be maintained.

President Obama did not propose to extend the phase-out of PEP and Pease. In fact, he has included two proposals for limiting the deductions of high-income taxpayers. First, the President's budget proposal would reinstate PEP and Pease, albeit with higher income thresholds, and it would index the thresholds to avoid PEP and Pease creeping down to affect the middle class. In addition, whatever deductions remain would be allowed only against a 28% tax rate (whether or not the taxpayer is subject to the alternative minimum tax).

The most vocal objections to the proposal to limit itemized deductions to the 28% bracket have come from charitable organizations. They fear that the reduced tax benefit will result in a decline in charitable giving. Already reeling from the economic downturn, which has caused a reduction in charitable donations and an increase in the need for charitable services, this limitation would clearly operate to the detriment of charities.

The President's budget proposal also includes revenue raisers in the estate and gift tax area. These include imposing a duty of consistency between the estate tax and the income tax, limiting the availability of minority discounts for estate and gift tax purposes, and requiring grantor retained annuity trusts ("GRATs") to have a minimum term of ten years.

The duty of consistency provision requires that the donor of a gift and the executor of an estate report to the beneficiary or heir (as well as to the IRS) the amount at which the property was valued for gift or estate tax purposes. The recipient of the gift or bequest would then be required to use that value as the property's basis under Section 1014 or 1015.

The second proposal provides that certain "disregarded restrictions" will not be taken into account when valuing an interest in a family-controlled entity being transferred to a family member. The disregarded restrictions include those that can be removed by the

transferor or the transferor's family. The proposal includes a broad grant of regulatory authority, including the right to create safe harbors. And look out! This proposal is slated to be retroactive in its effective date—to 1990!

Finally, the President proposes to require GRATs to have a ten-year minimum term. This proposal is a clear attempt to attack so-called zeroed-out GRATs—short-term GRATs with an annuity valued at 100% (or nearly 100%) of the property value. The proposal is intended to introduce "downside risk" to GRATs by increasing the length of the commitment and increasing the probability that the grantor will die during the trust term. This proposal would also put an effective age cap on who can create a GRAT since the risk of dying within the term of the retained interest will be too great for older grantors.

Health care

Continuing down the yellow brick road, we next run into health care reform and, unfortunately, someone has to pay for it. At press time, there are still several competing proposals for reforming our health care system, but with four recurring themes on how to raise money from high-income taxpayers.

Initially it was proposed that health care reform be funded by a surtax on high-income individuals. While different proposals contained different thresholds, a House of Representatives proposal called for a 1% surtax on incomes from $350,000 to $500,000 and a 1.5% surtax on incomes in excess of $500,000, with increases to 2% and 3% respectively in 2012. Annual incomes over $1 million would be subject to a 5.4% surtax.

A second proposal would help fund health care reform by increasing Part B and Part D Medicare premiums taxable for high-income taxpayers. This proposal is estimated to generate $34 billion over ten years, paid by our nation's wealthiest seniors.

A third option is to tax high-cost insurance premiums. Typically a high-cost policy is defined as one for which annual premiums for a single person exceed $8,000 or family premiums exceed $21,000. While highly paid individuals are often the beneficiaries of these so-called Cadillac plans, many union workers are also provided with such high-cost insurance. This tax would be imposed on the insurance companies, but they would undoubtedly find a way to pass the tax on to the consumers. Alternatively, the tax could result in insurance companies refusing to offer Cadillac plans, which would cause a different kind of loss to high-income individuals.

Finally, President Obama has suggested that the revenue increases from limiting the deduction of itemized deductions to the 28% rate (discussed above) could be used to offset the cost of health care reform. Combined with the limitations from Pease, high-income individuals subject to this limitation could receive only a 5.6¢ tax reduction from each dollar of itemized deduction items, a huge reduction from full deductibility against the highest marginal rate.

Oh my!

It doesn't take a wizard to figure out that taxes are going to increase. The confluence of record deficits, increased government spending (on the economic recovery and wars), and the high cost of health care reform make some tax increases a virtual certainty. The country can't afford to maintain all the Bush cuts and satisfy the present economic needs. Moreover, the increased taxes cannot be borne by those who are already in economic distress. Warning to high-income individuals: Look for increased taxes to be coming down the yellow brick road. ■

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