



AS CONGRESS TURNS TO TAXES . . . FIVE BIG THINGS TO WATCH FOR

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#1 THE ESTATE AND GENERATION-SKIPPING TRANSFER TAXES

Background. At the end of 2009, Congress was unable to reach agreement on an extension of 2009 transfer tax law. As a result, the unthinkable actually happened: the estate and generation-skipping transfer taxes are suspended as of January 1, 2010, while the top gift tax rate has fallen from 45 percent to 35 percent.

What to Watch for. Democrat Sandy Levin, Chair of the tax-writing committee in the House of Representatives, has expressed his intent to pass legislation that would permanently restore 2009 transfer tax law, retroactive to January 1, 2010. Similarly, earlier this year, Democratic Senator Max Baucus (Chair of the Senate Finance Committee) and Timothy Geithner (Secretary of the Treasury) issued a joint statement expressing their desire to see a retroactive permanent reinstatement of 2009 law. If these plans were to be enacted, we would see estate and generation-skipping transfer taxes reappear in 2010 with \$3.5 million exemptions and 45 percent top rates.

Watch to see how hard the Republicans fight for their alternative scenario, a \$5 million estate tax exemption and a top 35 percent estate tax rate. Last week, it appeared that the G.O.P. had prevailed, with agreement in the Senate on a \$5 million/35 percent package. On May 20, however, the fragile deal collapsed, with Senator Baucus announcing: “There is no agreement in either substance or process.”

The stakes are high. If Congress is unable to reach agreement, the estate tax exemption will fall to \$1 million in 2011 and the maximum estate tax rate will rise to 55%.

Impact. Many estate planning documents use formulas that incorporate the estate and generation-skipping tax exemptions of prior law. Changes in these exemptions may change the amount beneficiaries receive. For example, a formula gift of “an amount equal to my available generation-skipping transfer tax exemption” will result in a maximum \$1 million transfer if the generation-skipping transfer tax exemption is \$1 million. On the other hand, if the generation-skipping transfer tax exemption is \$3.5 million, the maximum transfer under the same formula would be \$3.5 million.



We have already communicated the importance of visiting your estate planner in 2010. If 2011 brings changes in the exemption amounts and rates, you should consider reviewing your estate plan with your estate planner once again. You may need to consider planning alternatives to achieve your wealth transfer goals.

#2 EXTENDERS

Background. The “extenders” are a package of 40 popular income tax provisions that expired at the end of 2009, including the IRA charitable rollover and enhanced charitable deduction limits for qualified conservation contributions, such as qualified conservation easements. The estimated cost of making the extenders effective through 2010 is \$32.5 billion over 10 years.

On Thursday, May 20, Congressional leadership released text of a compromise bill, the “American Jobs and Closing Tax Loopholes Act of 2010,” that includes not only the extenders but also unrelated provisions affecting unemployment insurance benefits, COBRA and physician reimbursement under Medicaid and Medicare, among others. The total estimated cost of the compromise is \$174 billion over 10 years.

What to watch for. A key issue is finding acceptable revenue raisers or budget cuts large enough to offset \$174 billion of outlays. Fiscally conservative “Blue Dog Democrats” are quick to point out that only about \$56 billion of the cost of the May 20 package is currently offset. The balance is either exempted from pay-as-you-go budget rules or would be treated as emergency spending that does not require offsets.

Likely to be part of any final measure: provisions that tax at least a portion of “carried interest” paid to investment fund managers as ordinary income, rather than as capital gain. This revenue raiser is highly controversial, with many in Congress arguing that an exception (“carve-out”) for both venture capital and real estate investment funds is essential for future job creation. Another proposed revenue raiser would ensure that professional service providers who are partners in a limited liability partnership or limited liability corporation (or shareholders in an S corporation) pay Social Security and Medicare taxes on all of their self-employment and compensation income.

Impact. The fight over offsets for the American Jobs and Closing Tax Loopholes Act of 2010 should provide insight into how serious Congress is about narrowing the budget deficit.

#3 THE INCOME TAX

Background. Current income tax rates (including the 15 percent maximum rate on qualified dividends and long-term capital gains) all expire on December 31, 2010. President Obama’s non-binding 2011 budget proposal would extend these low rates for lower income taxpayers. However, the President’s plan would tax single individuals with adjusted gross income in excess of \$200,000 (and joint filers with adjusted gross income in excess of \$250,000) at top rates of 36 percent and 39.6 percent on ordinary income (see projections in chart below).



Obama Proposal, Highest Marginal Rates, 2011 Regular Income Tax

| Married Filing Jointly | | Single | |
|------------------------|--------------|-----------------------|--------------|
| <u>Taxable Income</u> | <u>Rate</u> | <u>Taxable Income</u> | <u>Rate</u> |
| \$67,901 – \$137,050 | 25% | \$33,951 – \$82,250 | 25% |
| \$137,051– \$231,300 | 28% | \$82,251 – \$190,650 | 28% |
| \$231,301- \$372,950 | 36% | \$190,651 – \$372,950 | 36% |
| Over \$372,950 | 39.6% | Over \$372,950 | 39.6% |

Source: Joint Committee on Taxation, JCS-2-09 (using 2009 dollar amounts).

Under the President's plan, long-term capital gains and qualified dividends received by those in the two top brackets would be taxed at a maximum 20 percent rate.

What to watch for. One major question is whether Congress will pass legislation this year that addresses the income tax. If Congress fails to act, pre-2002 law roars back into effect for all individual taxpayers, *with a 39.6 percent top rate for both ordinary income and qualified dividends* and a top 20 percent rate for capital gains.

Impact. Whatever happens will affect relative after-tax yields of different investment asset classes. Yield, however, is only part of the story. Other factors include diversification, quality and risk.

#4 THE ALTERNATIVE MINIMUM TAX

Background. The alternative minimum tax is a special tax system with a minimum 26 percent tax rate, originally designed to ensure that the ultra-affluent “paid their share.” This year, it is estimated that 27 million taxpayers (20 percent) will be subject to this tax, up from 4 million in 2009. The reason? The alternative minimum tax exemption, which was temporarily increased in 2009, fell this year from \$70,950 to \$45,000 for marrieds filing jointly and from \$46,700 to \$33,750 for singles. The one-year cost of restoring the exemption to its former level is estimated at \$70 billion, a heavy lift given the current budget deficit. The non-binding Senate Budget Resolution (passed to date only by the Senate Budget Committee) would accommodate a temporary two-year increase in the alternative minimum tax exemption amount.

What to watch for. Again, the question is whether Congress will choose to deal with this issue in 2010. Note: an alternative minimum tax “patch” is not part of the pending “extenders” package.

Impact. When the dust from tax season settles, ask your accountant if your marginal income tax rate for 2009 was less than 26 percent. If so—particularly if you live in a state with significant state income and/or property taxes--you may be paying alternative minimum tax in 2010.



#5 TAX REFORM

Background. With the 2009 budget deficit at \$1.4 trillion, more tax changes seem inevitable. The President's bi-partisan, 18-member National Commission on Fiscal Responsibility and Reform has been tasked with finding ways to decrease that deficit, whether through budget cuts or revenue raisers. The Committee held its first meeting at the end of last month and is required to issue its final report by December 1 of this year.

What to watch for. Some, like the Blue Dog Democrats, are calling for a new focus on tax expenditures—i.e. a closer look at the true cost of tax breaks such as deductions, exclusions and exemptions. Others see a flat tax or a value added tax in the not-too-distant future. With few attractive alternatives, the Commission will have to work hard to meet its December 1 deadline.

Impact. If Republicans and Democrats on the Commission are unable to produce a report, the prospects for reducing the deficit will remain uncertain.

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