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September 24, 2012

Dear Clients and Friends:

We are providing you with the accompanying white paper, **A Look at Tax Reform Pending in Congress in the Context of Imminent Political Elections**, to inform you of pending legislation and how our political elections may affect your income and estate planning. We also provide some insight into current politics, the present economy, differences in approaches to tax reform and their affect on the economy, and planning measures that may be undertaken to cope with what appears to be inevitable change. This is provided in advance of our periodic **Client Update** newsletter, in order to shorten communication time and to highlight the prospects for imminent change.

We hope you will use this information to benefit your year-end planning and family. If you desire extra copies of this report or desire that we email it to you or others, please let us know. We are pleased to be of service.

Good Luck and God Bless!

Joseph C. Kempe

JCK/mpf

# **A LOOK AT TAX REFORM PENDING IN CONGRESS IN THE CONTEXT OF IMMINENT POLITICAL ELECTIONS**

## **A Discussion of Pending Legislation, Political Elections, and Planning to Cope with Change**

**By: Joseph C. Kempe, Esq.<sup>1</sup>  
September 24, 2012**

This paper highlights the status of pending Congressional tax reform and planning that might be undertaken now to optimize an individual's given tax circumstances. Except peripherally, it does not address corporate, foreign, or other tax provisions that are proposed. We focus on domestic income and estate taxation of individuals, current policies and pending legislation, after an introduction that provides background. We then discuss tax reduction planning. This paper is not intended to be political; rather, it is intended to be factual.

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## **I. BACKGROUND**

- A. Congress and Present Law.** Two legislative initiatives automatically come to bear on our budget deficit on January 1, 2013, from two polar extremes. First, the wide-ranging Bush era tax cuts that became law in 2001 and 2003 expire. The result of the expiration is an increase in income tax rates affecting virtually all United States taxpayers. Expiration also dramatically increases estate and gifts taxes, by reducing the estate tax exemption and by raising rates. Also, the Budget Control Act of 2011's automatic spending cuts kick-in, reducing \$1.2 trillion in government spending. Certain programs are exempt from these automatic spending cuts, but others are wide open. One may recall that the so called "Super Committee," composed of members of the Democratic controlled Senate and Republican controlled House, was charged

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with reaching agreement on spending cuts under the Budget Control Act and, if they failed, these cuts would become mandatory. Some believe failure was inevitable given the need for the Republican controlled House to gain bargaining chips (offsetting budget dollars) for the debates that would certainly be needed to address the sunset of the Bush tax cuts.

If the Bush tax cuts are allowed to expire, income tax rates will rise for most income groups. Capital gains tax rates will rise from 15% to 20%, the dividends tax rate will rise to a maximum of 39.6% from its current level of 15%, and the estate tax rate will rise to 55%<sup>2</sup> from 35%, while the estate tax exemption would drop to \$1 million from its present \$5.12 million.

The Health Care and Education Reconciliation Act of 2010 also increases rates on high income taxpayers by imposing a new surtax effective January 1, 2013. These individuals will be subject to a 3.8% Medicare contribution tax on “unearned income.” The revenue from this legislation is intended to pay for President Obama’s health care reform. This new tax will apply to single taxpayers with a modified adjusted gross income (MAGI) in excess of \$200,000 and married taxpayers with a MAGI in excess of \$250,000 if filing a joint return, or \$125,000 if filing a separate return.

In addition to existing legislation, various bills have been introduced in the Senate and House to raise rates and impose new taxes. (These are discussed in the next section of this paper.)

Presently, our Congress is composed of a Democrat controlled Senate and Republican controlled House. The House has 241 Republicans, 191 Democrats, and 3 vacancies. The Senate has 53 Democrats, 47 Republicans, and 2 Independents. These numbers should be monitored as the November elections unfold. The House acts by majority vote, whereas the Senate often requires a cloture vote of 60% to overcome minority party filibuster.

## **B. Pending Legislation and Proposals.**

**(1) Extension of Bush Tax Reductions.** The House voted August 1, 2012, 256-171 to pass a Republican plan (H.R. 8) to extend the 2001 and 2003 tax cuts through 2013 for all taxpayers as a bridge that would allow Congress to work on overhauling the tax code. The House bill also would extend the estate tax at its 2012 level, adjusted for inflation, through 2013. On the other hand, the Senate on July 25 voted 51-48 to pass a Democrat plan (S. 3412) that would extend the tax cuts only for families earning \$250,000 or less. The Senate removed provisions for estate tax reform, thus allowing estate taxes to increase to levels that existed before the Bush tax cuts. The Senate ostensibly did this as a bargaining chip, but publicly stated they did not wish to complicate income tax reform that is needed because of its immediate impact on our economy.

The House and Senate have rejected minority bills in both chambers and are locked in a stalemate that they are expected to negotiate after the elections. Some analysts are fearful that Congress may not act until after the current cuts expire, January 1, 2013. The Obama administration has vowed not to sign into law an extension of the current 35% top income tax rate, preferring that rates be allowed to rise for high income and high wealth taxpayers.

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<sup>2</sup> A 5% surtax (60% marginal rate) will apply to estate and gifts of \$10,000,000 or more, up to approximately \$17,000,000, when the surtax ends. This surtax is designed to eliminate both the lower marginal rates applied in the progressive estate tax system and the estate tax exemption. The result at the upper level is a 55% tax on the entire estate, with no exemption or lower marginal rates.

**(2) “Buffet Rule” Tax.** This legislation imposes a 30% minimum tax on those with \$1 million or more of income. It has been introduced by Democrat members of both the House (H.R. 3903) and the Senate (S. 2230). It is aimed at taxing passive income and capital gains over \$1 million, where the wealthiest Americans may pay as little as 13%, or less, as a result of 15% rates, deductions, and other tax benefits. The Republican majority in the House are opposed to this rule and it is not expected to receive a vote in 2012. The Senate defeated a procedural motion that would have allowed the legislation to come to the floor, and it is unlikely to be voted on this year, even though it is being pushed. President Obama continues to make public appeals in favor of the tax, calling it the “fair” thing to do.

**(3) Internet Sales Tax.** Most recognize the fiscal problems faced by our states. With the increased use of the Internet to purchase retail products, states are expected to lose an estimated \$23 billion in potential sales tax revenues in 2012. (Internet transactions seldom include state sales taxes.) Both chambers of Congress have introduced legislation (H.R. 3179 and S. 1452) to create a national sales tax. The House is not likely to entertain the tax anytime soon, while the Senate has been working on exemptions for certain small businesses in order to secure the necessary votes.

**(4) Small Business Measures.** Both chambers of Congress are moving bills forward that are designed to provide a tax cut to small business owners. The House bill (H.R. 9) would give small businesses with less than 500 employees a tax deduction equal to 20% of their domestic business income, but would limit the value of the deduction to 50% of W-2 wages. The measure is estimated to cost \$46 billion and would benefit 99.7% of the 23.7 million businesses in the United States. The Senate bill (S. 2237) would provide a 10% tax cut to employers that add payroll in 2012, with the benefit capped at \$500,000 per employer. This \$26.7 billion plan would also extend 100% bonus depreciation on qualified capital expenditures through 2012 for all employers. The House passed its bill but the Senate failed to obtain the 60 votes required to advance it. President Obama supports the Senate version but has called the House version a back-door way to benefit the wealthy.

**(5) Tax Extenders.** Both chambers are also confronting the expiration of various tax cuts that occurred in 2011 and that will occur in 2012. There are many bipartisan provisions, including the research and development tax credit and the state and local sales tax deduction. An increase in the alternative minimum tax exemption is also likely to be included in these measures. The House has not yet introduced a bill, but the Senate has approved its \$205 billion package which extends these measures through 2013 (S. 3521). The House intends to bring its bill to the floor by the end of the year. It is possible for a floor vote of the Senate version by the end of the year, which President Obama with some exceptions supports.

**(6) Overall Tax Reform.** The Senate Finance Committee introduced a bipartisan Senate bill which would reduce corporate tax rates to 24% and set individual rates at 15%, 25%, and 35%, while tripling the standard deduction. The alternative minimum tax, deferral of taxes on “active financing,”<sup>3</sup> and several other major tax provisions would be eliminated. Chairman Baucus has indicated that the debate over this legislation would likely span a few years. The House has not

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<sup>3</sup> The active financing exception under the Internal Revenue Code allows corporations that establish captive foreign finance subsidiaries to exclude interest they earn offshore from their US taxes. The 1997 subsidy was meant as a temporary measure to help US banks and manufacturers compete internationally.



introduced any official tax reform measure, but has introduced a plan to create an expedited process for rewriting the tax code (H.R. 6169).

**(7) Estate Tax Proposals.** A Democrat bill was introduced in the House by Congressman McDermott (WA-7) to lower the estate tax exemption to \$1 million (increased for inflation from 2000) and increase the highest rate to 55%. There were rumors that the Super Committee would make the same recommendations, which never materialized. The Obama Administration and McDermott also proposed limiting the duration of generation skipping exempt trusts to 90 years. (Most states have changed their laws to permit multigenerational trusts to extend for longer periods.) The Obama Administration has also proposed limiting traditional estate tax planning techniques, some of which are presently statutorily provided (qualified residential interest trusts, grantor retained annuity trusts, and the manner in which interests in closely held businesses, investment holding companies, and family partnerships are valued).<sup>4</sup>

**(8) Governor Romney Proposals.** Governor Romney's stated tax policy goals are not yet finalized, but are intended to (a) cut current income tax rates by 20%, (b) preserve and enhance incentives for saving and investment, (c) eliminate the alternative minimum tax, (d) eliminate the estate tax, and (e) maintain revenue neutrality. These are broad principles and he has not fully specified his tax plan. He has, however, explicitly promised to retain the current preferences for dividends and capital gains. A study by the Brookings Institute<sup>5</sup> concludes that simultaneously meeting the first four goals would imply reduced tax burdens on families with incomes above \$200,000. Meeting the fifth goal, revenue neutrality, was found to imply an increased tax burden on other taxpayers (those with incomes below \$200,000), a consequence that the Institute believes is perhaps unintended. Governor Romney argues that Simpson-Bowles<sup>6</sup> illustrates how tax rates can be lowered, deductions and exemptions for the wealthy limited, and with additional growth that comes from this stimulative action you can reach a balanced budget. He intends to follow this model.

**C. Historic and Constitutional Context of Tax Reform.** In many cases, tax reform can be applied retroactively. Whether it actually is, however, can be more of a political question and we will discuss here what has actually occurred under recent tax reform.

**(1) Two Prong Test.** In order for tax legislation with retroactive effect to withstand a Constitutional challenge, a two part test must be passed: (1) the legislation must have a rational legislative purpose and not be arbitrary, and (2) the period of retroactivity may not be excessive<sup>7</sup>. In general, "rates" are more apt to be retroactively applied than fundamental changes of law. For example, in Nationsbank v. US<sup>8</sup>, the 55% top estate and gift tax rate lapsed on January 1, 1993 and the decedent died in March 1993 with a \$26.4 million estate when the top rate was 50%. President Clinton signed OBRA on August 10, 1993, raising the top rate to 55% retroactive to January 1, 1993. The result was a \$1.32 million increase in tax. The Federal Circuit held that the retroactive rate increase was Constitutional under the Carlton<sup>9</sup> test because it had a rational

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<sup>4</sup> See Section IV of this paper.

<sup>5</sup> Urban- Brookings Tax Policy Center, Implications of Governor Romney's Tax Proposals (August 16, 2012).

<sup>6</sup> An economic report on fiscal responsibility by the National Commission on Fiscal Responsibility, co-chaired by Alan Simpson and Erskine Bowles. The Commission was created in 2010 by President Obama, was bipartisan, but was never sent to Congress for a vote because 4 Democrats and 3 Republicans voted against it. President Obama also rejected it.

<sup>7</sup> United States v. Carlton, 512 US 26 (1994); Nationsbank of Texas, N.A. v. US, 269 F3d 1332 (Fed. Cir. 2001)

<sup>8</sup> Id.

<sup>9</sup> Id.

legislative purpose (to apply the same rate to all decedents dying in 1993, regardless of the month of death); and (2) the 8 month period of retroactivity was not excessive (because the Supreme Court had approved a 14 month period in Carlton).

**(2) Does the Type of Tax Matter?** Both Carlton and Nationsbank involved estate tax. Prior to Carlton there had been a belief that there may be an implicit distinction between retroactive application of income taxes versus retroactive application of excise taxes on transactions. The estate and gift tax are excise taxes on transactions; i.e., the gratuitous passage of property from one person to another. Retroactive income taxes were distinguished as intending to avoid the administrative inconvenience of calculating one year's income under two different tax rates. An excise tax, on the other hand, doesn't have this problem. Nevertheless, the Supreme Court in Carlton permitted the retroactive application of an excise tax (the estate tax) that exposed a transaction (a sale to an ESOP) to a tax that previously didn't exist.

**(3) Political Fallout.** Whether tax laws are imposed retroactively have administrative and political consequences. Pursuing a transaction under current law and having the tax results changed as a result of a retroactive change of that law seems unfair. There are due process arguments that have been used in the past and have merit, but if the law passes the two prong test of Carlton it will likely be upheld. With that said, the potential unfairness presents political ramifications associated with potential outrage of the electorate and also administrative burdens associated with policing transactions that were previously proper. As such, there appears to be a tendency to enact tax laws that tax previously untaxed transactions prospectively while applying rate changes retroactively, to the first day of a year. Furthermore, there seems to be a recent tendency to treat the electorate fairly to minimize criticism that translates into positive votes. For example, in 1990 the Revenue Reconciliation Act created a new Chapter in the Internal Revenue Code that provided valuation rules for commonly used estate tax planning techniques, such as family partnerships, grantor retained income trusts, and others. All of these fundamentally new laws were applied prospectively.<sup>10</sup> Furthermore, as recently as December 17, 2010, the Tax Reform Act of 2010 retroactively reinstated the estate tax to January 1, 2010. The estate tax had expired and did not apply to decedents dying in 2010, prior to this retroactive change in law. However, the 2010 Tax Reform Act provided taxpayers with a choice to use either preexisting 2010 law or the new law, thus minimizing electoral outrage.

## **II. IT'S ALL ABOUT JOBS: OR, IS IT THE ECONOMY AND SIMPSON-BOWLES?**

**A. Paradigm Shift: What's the Discouraged Worker Effect?** Some argue that the unemployment rate has permanently shifted higher as a result of technological advances.<sup>11</sup> The thesis is that our rapidly evolving world is rendering a large percentage of our workforce population obsolete. It is likely that our currently reported unemployment rates are understated. As Federal Reserve Chairman Ben Bernanke has been quoted in support of his belief that the job market isn't as strong as the steadily declining unemployment rate might suggest:

*"It's very important to look not just at the unemployment rate, which reflects only people who are actively seeking work." "There are also a lot of people who are*

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<sup>10</sup> Chapter 14 of the Internal Revenue Code was enacted under this legislation. The new rules apply to transactions, rights, restrictions, and agreements occurring or created after October 10, 1990, the date the Revenue Reconciliation Act became effective.

<sup>11</sup> Joseph Stuber, High Unemployment: The New Economic Paradigm (September 6, 2012).

*out of the labor force because they don't think they can find work. There are also a lot of people who are working part-time, and they'd like to be working full-time but they can't find full-time work.”<sup>12</sup>*

Chairman Bernanke refers to this as the “Discouraged Worker Effect,” since those that aren’t seeking employment aren’t counted in reporting unemployment figures.<sup>13</sup>

**B. It’s the Economy, Nevertheless!** Notwithstanding whether we have a Discouraged Worker Effect and other labor data errors, what is clear is that we won’t be improving the jobs market unless the economy improves. We are in the doldrums and there is a malaise, that isn’t just because it’s September. As several economists have written, “we are presently in the most anemic economic recovery in the memory of most Americans.”<sup>14</sup> Our GDP for the first quarter of 2012 was 2%, and in the second quarter it was 1.5%. The economy isn’t getting stronger.

Recently released 2011 US Consensus data has produced significant reaction. Words like “astounding” and “devastation” are used to describe data that shows the poverty level increasing above 15%, both locally and nationally.<sup>15</sup> The census shows that the annual increase in poverty has been steady since 2008. As could be expected, the report shows that those on food stamps have followed this same increasing trend.

QE1 and QE2<sup>16</sup> haven’t caused the economy to turn the corner in a profound way, and we are now on a path of indefinite QE3. Since QE1 and QE2 haven’t done enough, the old saying that with “three strikes you’re out” doesn’t provide us with comfort in our future. Perhaps something is different now and having banks flush with all the money in the world to lend isn’t enough.<sup>17</sup> Where should that money be spent and is monetary policy the answer? Some believe that Federal Reserve Chairman Bernanke is banking on a hoped-for wealth effect from a stock market recovery and recovery in housing.<sup>18</sup> The perceived problem with this is that the housing problem is far from over and stock market pricing may also await future rounds of QE3 announcements.<sup>19</sup>

### C. What’s Simpson-Bowles Got to Do With It?

**(1) Context of Debate.** The National Commission on Fiscal Responsibility and Reform (“NCFRR”) was established by President Obama in 2010 as a bipartisan effort to reign in the

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<sup>12</sup>Bernanke, Job Market Remains Weak Despite Gains, Associated Press (February 8, 2012).

<sup>13</sup>Id.

<sup>14</sup>R. Glenn Hubbard, Dean and Russel L. Carson Professor of Finance and Economics, Columbia University, supported by N. Gregory Mankiw, Professor of Economics, Harvard University and Chairman of Economic Advisors; John B. Taylor, Mary and Robert Raymond Professor of Economics, Stanford University; and Kevin A. Hassett, an economist at the American Enterprise Institute. All of them co-wrote a paper titled The Romney Program for Economic Recovery, Growth, and Jobs, that was paid for by the Romney Campaign.

<sup>15</sup> Stapleton and Valdes, Census Numbers Show Poverty’s Increasing Hold on Palm Beach County, Palm Beach Post (September 21, 2012).

<sup>16</sup> Quantitative easing (“QE”) is intended to create lender demand for government long term securities that keep interest rates low. If the Federal Reserve and central banks fill the demand for low interest rate loans, that others aren’t necessarily willing to make at low interest levels, cash can flood the monetary system while maintaining low rates.

<sup>17</sup> There are numerous cases of banks not lending, including banks that must increase their Tier 1 capital ratios and because of problems in the valuation industries. The appraisal industry is predisposed to use poor data that underestimates or lags current values for fear of liability.

<sup>18</sup> Vaknin, et. al., Macro Skinny, When the S&P Becomes a Policy Tool, J.P. Morgan (September 16, 2012).

<sup>19</sup>Id.

national debt. It was co-chaired by Alan Simpson (a Republican) and Erskine Bowles (a Democrat) and the cover page prominently states “The Movement of Truth,” above a White House logo. The NCFRR has come to be known as “Simpson-Bowles.” According to Governor Romney:

*“Simpson-Bowles laid out a formula that shows that you can do just as I described. That you can bring down the rates, limit deductions and exemptions for people at the high end, and with additional growth that comes by virtue of the stimulative action you can reach a balanced budget. I will follow a model similar to Simpson-Bowles and work with Congress to identify which of the alternative methods we should apply to reduce “tax expenditures.”<sup>20</sup> Those reductions will occur for people at the high end. I have noted before my commitment to preserve tax preferences for middle-income taxpayers such as homeownership, charitable giving, and health care.<sup>21</sup>*

The final Simpson-Bowles report was issued in December 2010, but was not voted upon by Congress because 7 of the 18 committee members (4 Democrats and 3 Republicans) voted against it. Noteworthy, since then the publicly held federal debt has increased from 62% of GDP to 73%, as of September of this year. President Obama has not endorsed the results of the Simpson-Bowles (his own) committee because it doesn’t support his agenda, which has opened the door for Governor Romney to use it to rally economists.

**(2) Is It Fairy Dust?** Governor Romney supports the NCFRR (“Simpson-Bowles”), but in modified form. It provides him the offensive on tax reform and the economy. However, his critics call his version of the NCFRR, “Simpson-Bowles on steroids.”<sup>22</sup> President Obama calls it a “trickle down tax cut fairy dust” plan.<sup>23</sup> Nevertheless, most noted economists and think-tanks that have studied Simpson-Bowles find support for its conclusions, that reducing taxes, eliminating tax expenditures, and broadening the tax base will have a substantial impact on the economy. Governor Romney’s plan extends tax cuts further, however, which is where his critics attack his plan and claim it will necessitate increased taxes on the middle-class to achieve his goals. His hope is that economic expansion will produce the needed revenues to avoid an increase in taxes on the lower middle class.

A study by the Center for Federal Tax Policy, a nonpartisan tax research think-tank in Washington, compared President Obama’s and Governor Romney’s plans with Simpson-Bowles.<sup>24</sup> It cited models using Treasury data that conclude that a capital gains tax increase to 20% would reduce the GDP by 1.19%; an increase to 23.8% would reduce GDP by 2.1%; and an increase to 28% would reduce GDP by almost 3%.<sup>25</sup> The study concluded that Governor Romney’s plan takes concrete steps in the direction of Simpson-Bowles, while not excessively taxing savings and investment. Governor Romney’s plan maintains the 15% capital gains rate for

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<sup>20</sup> Tax expenditures are essentially tax preferences given to taxpayers for tax policy reasons, and include credits, deductions, exemptions, reduced rates, and others. Elimination of tax expenditures moves us to a flatter tax system.

<sup>21</sup> Center for Federal Tax Policy, Romney, Obama, & Simpson-Bowles: How Do the Tax Reform Plans Stack Up? (September 6, 2012).

<sup>22</sup> Joseph Lazzaro, Romney’s Tax Plan: Bush’s Tax Plan on Steroids, International Business Times (September 9, 2012).

<sup>23</sup> Stephanie Condon, CBSNEWS, Obama Mocks Romney’s “Trickle-Down, Tax Cut Fairy Dust” Plan (August 2, 2012).

<sup>24</sup> William McBride, Romney, Obama & Simpson Bowles: How Do the Tax Report Plans Stack Up?, Center for Federal Tax Policy (September 6, 2012).

<sup>25</sup> *Id.*; also see Chart 1.

high income earners, but eliminates it for some low income earners. (Simpson-Bowles raises the capital gains rate to 23% or 28%, depending on which version of it is chosen.) According to John Diamond, PhD,<sup>26</sup> in his study in support of Governor Romney's plan, GDP relative to baseline would increase by 5.4 percentage points over the next decade, creating 6.8 million jobs. It is worth mentioning that Governor Romney's plan also follows Simpson-Bowles' advice to lower the corporate tax rate and move to a territorial system of international taxation. His plan also incorporates a tax holiday for US taxpayers holding offshore funds in order to repatriate them. See Table I attached for a comparison of the three plans.

**(3) President Obama and His Supporters.** Critics of Governor Romney's plan conclude that it will not only broaden the tax base but it will increase taxes on the middle class and make our system of taxation less progressive.<sup>27</sup> PolitiFact claims to have polled the authors of five studies Governor Romney cites as supporting his plan. The PolitiFact author finds either fault or bias in these studies, including the study by the Center for Federal Tax Policy cited above.<sup>28</sup> Governor Romney is also criticized for not specifying the tax expenditures he would eliminate, though it is politically understandable given median voter theorem.<sup>29</sup> Nevertheless, voters have a right to know. Governor Romney has stated that he will work with Congress to achieve the right plan, which essentially indicates he is willing to compromise, even though it may rub some voters wrong. This position has been used by his critics to claim his tax plan will increase taxes on the middle class, including those making as little as \$100,000 per year.<sup>30</sup>

### III. OR, IS IT POLITICS?

President Obama and Governor Romney clearly have different economic and tax reform agendas. This should allow voters to take sides on which plan to support. President Obama's plan would raise taxes on the wealthy.<sup>31</sup> The majority of taxpayers (pledged by Obama to be 98% of Americans, whose incomes are less than \$250,000) would still benefit from Bush-era tax cuts under the Obama plan. His plan would also cut discretionary spending from 8.4% to 5.2% of the economy, but would exclude certain entitlement programs. This would permit Medicaid, Medicare, Social Security, and certain other programs to grow, rather than be cut. In exchange, Obama's plan would cause spending cuts on agencies like the National Park Service and Environmental Protection Agency, among others. It would also cut defense spending. Governor Romney's plan involves tax reduction across the board to benefit all taxpayers, with spending cuts to many social programs including entitlement programs. He desires to cap spending at 20% of GDP by 2016, devote 4% of the economy to defense, and balance the budget in eight to ten years. See Table 1 at the end of this paper.

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<sup>26</sup> Professor Diamond is the Edward A. and Hermena Hancock Kelly Fellow in Public Finance, James A. Baker III Institute for Public Policy, Rice University. See Diamond, The Economic Effects of the Romney Tax Plan (August 3, 2012).

<sup>27</sup> Implications of Governor Romney's Tax Proposals: FAQs and Responses, Brookings Institute, Urban-Brookings Tax Policy Center (August 12, 2012).

<sup>28</sup> PolitiFact, Romney Claims Five Studies Back Up His Tax Plan (September 14, 2012).

<sup>29</sup> Median voter theorem is the concept that politicians never want to or should cater to the extremes ("factions") of their party. If they do, they risk losing median voters for sake of these factions.

<sup>30</sup> See Huff Post Politics, Mitt Romney Tax Policy Studies: Candidate Seemingly Contradicts His Conclusions, Huffington Post (September 14, 2012).

<sup>31</sup> According to Bloomberg, President Obama's plan would impose a tax increase averaging more than \$21,000 a year for households earning between \$500,000 to \$1 million. See Rubin, Obama Plan Pares Deficit as Romney Pledges End Without the Means, Bloomberg News (September 4, 2012).



Governor Romney's critics complain that his plan is not yet specific, since he uses a five part plan with general policy goals rather than specific reform measures.<sup>32</sup> Recently, he has added some specificity, which is providing critics with ammunition to attack him. Critics argue his plan will increase taxes on the middle class and taxpayers earning as little as \$100,000 per year.<sup>33</sup> Critics of President Obama argue that his plan does not tackle the long term problems that he leaves to his successors. This is conceded by the Obama Administration.<sup>34</sup> As Stanford professor, Keith Hennessey, has stated: "You can reduce the budget deficit by raising taxes. It's a bad idea, but you can do it. In the medium and long term, you can't unless you're willing to raise taxes forever, and ever, and ever."<sup>35</sup>

What is clear is that both men cater to their constituents, and they should. That is what politics is and should be. Both are seasoned politicians using median voter theorem. What is also clear is that Simpson-Bowles is a thorn for President Obama, and a benchmark that is being used by Governor Romney. President Obama abandons that benchmark, claiming he is going to do it in a balanced way that says: "Yes, we cut spending we don't need, but we also ask everybody to do their fair share."<sup>36</sup> The Obama way is intended to be an investment in the middle class and health care infrastructure. Whether that would be positive, only time would tell. Some economists feel it will produce a long term problem.<sup>37</sup> What is certain is that neither plan will prevail in its entirety. One could argue that the Obama plan is intended to be a long term fix for social entitlement programs, without regard to the short term or long term impact on the economy.<sup>38</sup> As long as the economy moves forward, albeit slowly, that is tolerable and acceptable to President Obama to accomplish his goal, notwithstanding the prospect for ever increasing taxes.<sup>39</sup> The empirical evidence for improving the economy supports Simpson-Bowles and Governor Romney's plan. President Obama has abandoned that empirical evidence in support of his goal for health care and entitlement programs. It can also be argued that the only way President Obama's platform can overcome the effects of our economic doldrums is to rally the masses by claiming to tax the rich to benefit the lower middle class and poor. That group contains the majority of voters. The bottom line on this, as has always been the case, is: who shows up on election day?

#### IV. WHAT YOU SHOULD CONSIDER DOING NOW.

##### A. Estate Tax Planning.

**(1) Background.** Given the current state of our economy, politics, and tax reform, our advice is to consider estate planning measures that use current laws to position estates to confront change. This involves use of techniques that potentially lock-in estate tax reductions, but offer flexibility in the future. Our goal with clients is for them to remain nimble.

Under current law and unless Congress acts, on January 1, 2013 the estate, gift, and generation skipping tax exemptions are reduced and rates are increased to pre-2001 levels: an estate tax

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<sup>32</sup> Id.

<sup>33</sup> See text at footnote 30, infra.

<sup>34</sup> Rubin, text at footnote 31, infra.

<sup>35</sup> Id.

<sup>36</sup> Id.

<sup>37</sup> See text at 34.

<sup>38</sup> Id.

<sup>39</sup> Id.

exemption of \$1 million (with no inflation indexing) and a top tax rate of 55% (with a 60% marginal rate between \$10 million and approximately \$17 million); a gift tax exemption of \$1 million and rates that are the same as the estate tax; and a generation skipping tax exemption of \$1 million and flat tax of 55%. Democrats have submitted bills in favor of allowing the reversion to 2001 levels.<sup>40</sup> Another proposal by the Economic Policy Institute would lower the exemption to \$2 million with a 45% tax. Under President Obama's proposals, the estate tax is intended to stay at 2009 levels. This means a \$3.5 million estate tax exemption, \$1 million gift tax exemption, and a 45% top tax bracket. He would also propose to Congress a \$3.5 million exemption and a 45% flat generation skipping tax on taxable skips, terminations, or distributions that skip a generation of tax. In addition, on February 13, 2012, The General Explanations of the Administrations Fiscal 2013 Budget Proposals (the "Greenbook") contained the following additional estate tax reform proposals, among others:

- (a) Modify valuation rules commonly used to value family partnerships to gain estate tax reduction;
- (b) Require a minimum 10 year term on grantor retained annuity trusts ("GRATs") to avoid the benefit of rolling short term GRATs;
- (c) Establish a maximum permissible term for GRATs, to avoid long term low payout GRATs that are used in *Walton-style* GRATs;
- (d) Limit the duration of generation skipping exempt trusts to 90 years, thus federally overriding state laws that are generally much longer; and
- (e) Enact several income tax rules aimed at providing uniformity in tax basis for capital gains purposes after gifts and deaths.

Notably, the report by the National Commission on Fiscal Responsibility and Reform ("Simpson-Bowles") did not make a recommendation on the estate tax. This may have been the result of the belief by some economists that the estate tax at current levels does not contribute to federal revenue, since revenue approximately equates to the cost of estate tax compliance.<sup>41</sup> Nevertheless, the Simpson-Bowles report on page 8 provides that 2009 level estate taxes "are likely to happen." The report thus includes estate taxes in its baseline scenario. Furthermore, a recent study by the Center on Budget Policy Priorities provides that keeping the estate tax system is an important backstop to the capital gains tax system, because without it unrealized gains would go untaxed.<sup>42</sup> The study also argues that the estate tax has to be increased to generate positive revenues, because at today's levels it is a revenue neutral system.<sup>43</sup>

Governor Romney has proposed that the estate, gift, and generation skipping taxes be eliminated.

**(2) Phases of Estate Tax Planning.** We commonly view there to be four phases of estate planning: (i) Phase 1, that incorporates basic estate planning documents intended to avoid probate and guardianship and utilize given estate and generation-skipping tax exemptions; (ii) Phase 2 techniques, that are commonly based upon Internal Revenue Code rules and regulations and that are designed to reduce estate taxes, while resulting in little or marginal loss of control and use of wealth being transferred; (iii) Phase 3 techniques, that often involve transfers of assets to trusts for junior family members in exchange for a cash flow stream that is acceptable to senior family

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<sup>40</sup> On November 17, 2011, Congressman Jim McDermott (WA-7, Democrat) introduced legislation to reinstate the \$1 million exemption (indexed for inflation from 2000) with a top rate of 55%.

<sup>41</sup> Huang, Senate and House GOP Leaders' Tax Proposals Would Provide Windfall for Heirs of Largest Estates, Center on Budget Policy Priorities (July 24, 2012).

<sup>42</sup> Id.

<sup>43</sup> Id.

members; and (iv) Phase 4 techniques, that are available after death. We assume that most people reviewing this paper have completed Phase 1 of their planning.

### (3) Phase Two Planning to Consider Now:

**(a) Family Partnerships.** Family partnerships have been involved in family planning for generations. The Rockefeller and Rothschild families, among others, have used them for a variety of reasons.<sup>44</sup> Many families with much less financial means have also found benefit in creating family partnerships. Historically, they were used in the United States for income tax planning, which continues today. See Section IV(b)(6) of this paper. More recently, they have grown in popularity as a vehicle to manage family wealth, whether that entails only investment securities or complex family business operations. They are also commonly used in order to pool family resources in the creation of a family office. The peripheral estate tax reduction benefit of family partnerships is how ownership interests are valued. Recent estate tax valuations of ownership interests in family partnerships, conducted by nationally regarded appraisal companies, have provided values that discount the value of assets (including investment portfolios, by as much as 50%) that would otherwise be taxed in a senior family member's estate. This results in substantial estate tax savings. These valuations, if debated by the IRS, have been upheld by the courts.<sup>45</sup> The other reason they are a primary choice for those pursuing family planning of this nature, is that they can be fairly easily unwound and liquidated without adverse tax consequences and without loss of control of financial assets. In other words, wealth does not generally need to be shifted to junior family members to secure benefits for estate tax purposes.

As noted earlier in this paper,<sup>46</sup> the last legislation that impacted family partnerships for estate and gift tax purposes was in 1990. That legislation was not retroactively applied and, still to this day, partnership agreements drafted prior to October 10, 1990 are exempt from that legislation.

**(b) Qualified Personal Residence Trusts.** A qualified personal residence trust ("QPRT") is a type of trust created under an exception to normal rules imposed under the Internal Revenue Code.<sup>47</sup> President Obama has in the past proposed eliminating QPRTs, as a tool only used by the wealthy to reduce taxes under an exception to normal rules. The technique involves a transfer of one or more personal residences to a trust, where the senior family member retains the right to use of the home for a set number of years. The results can be substantial. For example:

*John, age 70, transfers his residence, valued at \$1 million, to a QPRT in September 2012 with a 15-year term. John will be treated as making a gift of \$396,000, untaxed because of use of his exemption. Upon the expiration of the QPRT's 15-year term, the residence, assuming that it appreciates at 3% per year, will be worth \$1,557,967. Therefore, for a "gift tax cost" of \$396,000, John will essentially transfer an asset worth \$1,557,967. The estate tax savings assuming a 45% rate (as proposed by President Obama) is \$522,444.*

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<sup>44</sup> It is noteworthy to mention that a Rothschild family entity has just invested in a Rockefeller family partnership. See Bennett, The Rockefellers and Rothschilds Make a Deal, *Forbes* (May 5, 2012).

<sup>45</sup> See, for example, *Stone v. Commissioner*, TC Memo 2012-48; *Estate of Anna Mirowski*, T.C. Memo 2008-74 (March 26, 2008); *Keller v. US*, 62 US Dist. Ct. (S.D. Tex. August 20, 2009); *Estate of Kelley v. Commissioner*, TC Memo 2005-235; *Knight v. Commissioner*, 115 TC 506(2000); *Estate of Dailey v. Commissioner*, 82 TCM 710 (2001).

<sup>46</sup> See text a footnote 10, *infra*.

<sup>47</sup> IRC Section 2702(a)(3).

Arrangements are made upon expiration of the trust for continued use by the senior family members. Although we have reviewed some QPRTs where upon expiration of the term the home passes to children, this is not the preferred method and we have never created a QPRT in that manner. We have also authored the IRS private letter rulings that have come to be known as the “reverse QPRT” rulings, which support a technique that has preserved the homestead status of principal residences in Florida after the original term of the QPRT has expired.<sup>48</sup>

**(c) Nonreciprocal Trusts Created by Spouses.** A husband can create a trust for his wife, and include junior family members if he wishes, that uses his currently available estate, gift, and generation skipping tax exemption (\$5 million). The benefit of this is that the husband has used his exemption during 2012, prior to possible reduction, ostensibly locking in the higher exemption before it is potentially reduced under Obama or Democrat reform. What’s more, the wife can create a similar (but not reciprocal<sup>49</sup>) trust for her husband using her exemption. In total, they are potentially able to shelter \$10 million of family wealth, plus future growth, from estate, gift, and generation skipping taxes while retaining sources of access to their wealth. For example, provided they remain married, they both have access to the same resources held prior to the establishment of these trusts. But, what if one dies? Will they still have access to the total \$10 million? Yes, assuming they exercise appropriate powers of appointment that could be included within one or both of these trusts.

What about “clawback,” which some commentators claim can negate the benefit of full use of the \$5 million exemption if the exemption is lowered in the future? Most commentators interpret present law to negate clawback.<sup>50</sup> They also believe, as we do, that there is no downside.<sup>51</sup> Furthermore, a bill sponsored by Democrat members of Congress includes technical provisions that would expressly eliminate the possibility of clawback.<sup>52</sup>

**(d) Discretionary Trusts for Single Individuals.** One of the reasons behind the strategy discussed above concerning nonreciprocal trusts, is the need for a spouse or another person to settle the trust for the strategy to work. In most jurisdictions, a person cannot create a trust for their own benefit and have it escape taxation in their estate. This is based upon a public policy in most jurisdictions that a person cannot escape their own creditors by transferring assets to a trust from which they may benefit. This same public policy, however, does not apply if one spouse creates a trust for the benefit of the other. Under federal estate tax law, if creditors of the transferor can reach assets that were previously transferred to a self settled trust, those assets will be included and taxed in the transferor’s estate.<sup>53</sup>

Some jurisdictions, such as Delaware<sup>54</sup>, Alaska<sup>55</sup>, and Colorado<sup>56</sup>, have enacted laws that are intended to avoid the problem. Assuming sufficient nexus with those jurisdictions, self settled

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<sup>48</sup> See PLR 200935004, PLR 200935005, PLR 200904023, PLR 200904022, PLR 200920033, PLR 200901019, PLR 200848007, PLR 200814011, PLR 200816025, and PLR 200848008.

<sup>49</sup> If reciprocal, the IRS takes the view that the trust was created by each spouse for themselves, which would generally negate the benefit. This is known as the “reciprocal trust doctrine.” See *Estate of Grace v. US*, 395 US 316(1969); *Estate of Levy*, T.C. Memo 1983-453.

<sup>50</sup> Pennell, Thoughts About Planning in Uncertain Times, National Association of Estate Planners and Councils, Journal Issue 9. See also IRC § 2001(g), though unless extended it will sunset July 1, 2013. Nevertheless, we believe it reflects the proper rule and historic approach to taxation of prior gifts.

<sup>51</sup> *Id.*

<sup>52</sup> H.R. 3467, sponsored by Democrat Congressman Jim McDermott (WA-7).

<sup>53</sup> *Paolozzi v. Commissioner*, 23 TC 182(1954); *Estate of Paxton v. Commissioner*, 86 TC 785(1986); Rev. Rul. 76-103, 1976-1 CB 293; Rev. Rul. 2004-64, 2004-2 CB 7; PLR 200944002; PLR 200426008; PLR 96403012.

<sup>54</sup> 12 Del. §§ 3570-3576.

trusts can be created that will avoid estate tax on the transferred assets. As such, using the laws of these jurisdictions would permit a single person to transfer their unused estate tax exemption during 2012 and be a permissible beneficiary. In order to have proper nexus, and because the settlor cannot be the trustee, typically a trust company in those jurisdictions would be used as the trustee and the transferor would be a discretionary beneficiary. As such, generally you would only use this technique with assets which you don't presently rely on but which you would want use of in the event of future need.

**(e) Irrevocable Trust Modifications.** Many individuals have either settled, benefit from, or will benefit from existing irrevocable trusts. It is not uncommon to find that these trusts are not optimized for wealth transfer tax purposes. They should therefore be modified.

Most existing irrevocable trusts are structured to terminate during the life of beneficiaries or to terminate after the death of the senior most surviving generation. Many of these trusts are so-called "pre-1987 trusts," which are grandfathered for generation-skipping tax ("GST") purposes.<sup>57</sup> Others have been created on or after September 25, 1986 and are not grandfathered, but may be GST exempt or have GST exemption allocated to them. With the possibility that the GST exemption may be reduced, now is a good time to consider use of the GST exemption before it is reduced.

Existing irrevocable trusts (especially insurance trusts) should be reviewed for purposes of (i) their generation skipping tax exempt status and (ii) potential modification to effectively use that status. For example, if senior family members created an irrevocable trust (life insurance or otherwise) it is possible that their generation skipping tax exemption is being wasted through automatic allocations.<sup>58</sup> This rule is especially applicable if the beneficiaries of the trust have reached age 46.<sup>59</sup> Where GST exemption is being automatically allocated, it is commonly being wasted which can often be overcome by modification of the trust. (Modification of irrevocable trusts has become common now that the rules have become statutory.<sup>60</sup>) Similarly, trusts created by senior family members who have since passed away are oftentimes GST exempt, but they are not drafted to avoid tax in the estate of the next generation. These trusts too are often modified to perpetuate the tax benefits.<sup>61</sup>

#### **(4) Phase 3 Planning to Consider Now:**

**(a) Sales or Transfers to Defective Trusts.** Various estate planning strategies incorporate use of what are known as "defective trusts." Technically, a defective trust is a trust written to qualify as a "grantor trust" under Subtitle A, Chapter I, Subchapter J of the Internal Revenue Code. These trusts are called defective because they are drafted to have no consequence for income tax purposes. What this means is that the trust and the settlor are treated as the same person for income tax purposes. In other words, the trust is defective for not being recognized as a separate taxpayer.<sup>62</sup> Nevertheless, assets transferred to the trust by gift or sale can be structured

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<sup>55</sup> Alaska Stat § 34.40.110.

<sup>56</sup> Colorado Revised Statute Section 38-10-111.

<sup>57</sup> IRC Section 2601.

<sup>58</sup> IRC Section 2632(c)(3)(B).

<sup>59</sup> *Id*

<sup>60</sup> Fla. Stat. Sec. 736.04113, et al.

<sup>61</sup> One should recognize that it is more difficult and sometimes impossible to modify pre-September 25, 1986 trusts to achieve these benefits. See IRC Reg. Sec. 26.2601-1(b)(4).

<sup>62</sup> Rev. Rul. 85-13, 1985-1 CB 184.



to avoid inclusion in the taxable estate of the transferor. They are commonly used in our low interest rate environment by senior family members who sell appreciating assets to such a trust in exchange for a low interest bearing promissory note. (A 3 to 9 year midterm loan made in October, 2012 only needs to bear interest of .93% to comply with IRS rules. A loan of over 9 years would only need to bear 2.36%.) Using assets that are likely to appreciate are the best choices for this strategy. Since the sale is to a defective trust, no capital gains taxes are incurred on the sale and the assets appreciate outside of the transferor's estate. This is why defective trusts are commonly used to transfer low value assets or interests in family limited partnerships. Furthermore, the transferor continues to receive an acceptable level of cash flow from the promissory note. If additional cash flow is needed, additional repayments of principal on the promissory note can be made.

A strategy involving the transfer of assets by gift to a defective trust has recently been featured in Forbes magazine.<sup>63</sup> As a grantor trust, the tax consequences associated with taxable income and capital gains earned by the trust are taxable to the person who established the trust: typically, one or more senior family members. Depending on how you view this, it can be a good thing because it serves to further reduce your estate when you pay taxes on assets that are accumulating within the trust. In other words, the trust is not depleted as a result of income tax payments. The senior family member's payment of the income tax has been determined by the Internal Revenue Service not to constitute a gift to the trust.<sup>64</sup> On the other hand, as described in the previous paragraph dealing with sales, transactions between the Settlor of the trust and the trust do not have income tax effects. The Forbes article provides another example of this and involved a transfer of a home to a defective trust. If the transferor continued to live there without paying rent, the home would have been taxed in the transferor's estate. However, in this example, the transferor paid rent. The rent was not taxable, however, because it was a defective trust and transactions between the transferor and trust are ignored for income tax purposes. Though fair market value rent must be paid, this can be viewed as a good thing. To further reduce estate tax, the author of the article suggests that excess cash from rent that accumulates in the trust provides another means to shift wealth to junior family members.

Not everyone is willing to use grantor trusts because of the imputed income tax to the settlor of the tax consequences occurring to the trust. Generally, however, this is not a concern if the trust was created as the recipient of a sale of assets because the cash flow under the promissory note is structured to satisfy any concern. Nevertheless, they are often used with highly appreciated assets and on a sale adverse capital gains taxes can occur. This has become less of a problem now that the Internal Revenue Service has approved a method of reimbursing the settlor for these taxes without causing the trust assets to be included within the settlor's taxable estate.<sup>65</sup>

**B. Income Tax Planning.**<sup>66</sup> The year 2012 may be the last year that the so-called Bush tax cuts remain in effect, unless Congress acts to extend them. The basic framework to help shape your overall income tax planning (considering the time value of money) is as follows: if you expect to be in a higher income tax bracket in 2013, consider accelerating income into 2012 and deferring deductions to 2013; if you expect to be in a lower income tax bracket in 2013, reverse the strategy

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<sup>63</sup> Clarfeld, Reduce Estate Taxes Without Reducing Your Liquidity, Forbes (September 9, 2012).

<sup>64</sup> Rev. Rul. 2004-64, 2004-27 IRB 7.

<sup>65</sup> *Id.*

<sup>66</sup> The author would like to thank Romita Asrani, CPA and Daniel Alvarado, CPA for their input and assistance with this section of the paper. Both are members of the Tax Compliance and Wealth Management departments of Joseph C. Kempe, Professional Association, Attorneys and Counselors at Law.

by deferring income and accelerating deductions. The following income tax planning strategies present opportunities for coping with the impact of these changes.

**(1) Long-Term Capital Gain Rates.** If the maximum rate increases from 15 to 20 percent in 2013, investors who would ordinarily sell long-term appreciated stocks or securities (held for over one year) at a later date should give additional consideration to selling them in 2012 to lock in the 15 percent lower rate. If desired, investors could repurchase the securities thereby giving them a higher basis available when the securities are later sold. Similarly, business owners planning on selling their business in the near future should consider whether accelerating the gain on sale by electing out of the installment method in 2012 would benefit them given the scheduled rise in long-term capital gain rates. Electing out of the installment method could be made as late as October 15, 2013, once there is a clear indication of where tax rates are headed and whether they will be retroactively applied.

**(2) Medicare Contribution Tax of 3.8 Percent.** Until the Treasury issues clarifying regulations, the definition of investment income to which this surtax applies will remain uncertain under current interpretations. For individuals, the 3.8% tax will be imposed on the lesser of the individual's net investment income or the amount by which the individual's MAGI (adjusted gross income increased by the excess of (a) the income excluded by the foreign earned income exclusion over (b) any deduction that is disallowed with respect to the excluded foreign earned income) exceeds certain thresholds (\$250,000 for married individuals filing jointly or \$200,000 for unmarried individuals). Income from non-passive sources is not included as part of investment income subject to the 3.8 percent Medicare contribution tax. Business owners should carefully plan ahead, specifically, by considering whether it is more advantageous to become "non-passive" in the business as opposed to "passive" for purposes of this tax. Taxpayers would need to plan now to take the appropriate steps to become non-passive income recipients before the end of the year. However, consideration should be given to other traps for the unwary, such as triggering self-employment tax from the conduct of an active business. Investors in pass-through entities should review the relevant entity agreements for provisions pertaining to future tax distributions to partners and owners to account for this new tax. In other words, entity documents may need to be revised to incorporate a tax distribution to the partners for this additional tax.

Individuals should also revisit their retirement plans and consider whether to convert their traditional IRAs to Roth IRAs. Converting now would avoid future taxable distributions from being taxed at ordinary rates scheduled to take effect in 2013. Distributions from traditional IRAs and 401(k) plans are exempt from investment income for purposes of the 3.8% Medicare contribution tax, but the income increases MAGI and may place the individual above the MAGI threshold, subjecting the individual's other investment income to the tax. Conversely, distributions from Roth IRAs or Roth 401(k) plans do not increase MAGI and are not included in investment income. Further, for a Roth IRA, there are no required minimum distributions after age 70 ½. This can be a tremendous advantage – tax-free growth and no minimum distribution requirement. A careful evaluation is needed and should be done prior to year-end to determine whether paying tax on the traditional IRA would benefit the individual, considering the taxpayer's age, income tax bracket, time value of money, and other factors.

**(3) Dividend Income Rates.** Taxpayers in the highest marginal income tax bracket, who currently benefit from qualified dividends taxed at long-term capital gain rates, will be taxed at 39.6% for dividends received from the same issuer in 2013 if the tax cuts expire. Coupled with the 3.8% Medicare contribution tax on dividend income for high-income taxpayers, the rate could be as high as 43.4%. Investors should discuss with their investment advisors the benefits of switching investment strategies by investing in tax-exempt state or local government bonds since

the 3.8% Medicare contribution tax is not imposed on this type of income. A shift in investment strategy from dividend-paying equities to a growth investment strategy should also be considered. Additionally, owners of closely held C corporations should consider paying larger-than-normal dividends in 2012 if the corporation has sufficient earnings and profits.

**(4) Reduction in Itemized Deductions.** Without action from Congress, the overall limitation on most itemized deductions for higher-income taxpayers will be in effect once again. Most itemized deductions will be reduced by the lesser of 3% of AGI above a threshold (approximately \$174,450 in 2013) or 80% of the amount of itemized deductions that would be otherwise available. Careful planning is needed now and a determination should be made whether accelerating certain itemized deductions in 2012 to avoid the limitation would reduce the tax burden considering the tax effects of the alternative minimum tax in 2012. This involves detailed computations to determine the pros and cons of accelerating itemized deductions.

**(5) Passive vs. Active Investments by Trusts and Estates.** The new 3.8% Medicare contribution tax on unearned income in excess of the threshold amount also applies to trusts and estates starting in 2013. For estates and trusts that have investments in pass-through entities, a determination of whether the trust or estate is a passive investor becomes even more important for purposes of determining applicability of the 3.8% tax. Steps may need to be taken now by the trustees to qualify for the desired tax treatment.

For trusts or estates investing in assets generating investment income, the determination of passive vs. non-passive income becomes less crucial because of the automatic Medicare tax applicability if the threshold is exceeded, but the determination of whether to distribute the income to the beneficiaries or keep it at the trust or estate level is still important. Currently, the threshold for trusts and estates is \$11,650, indexed annually for inflation. The net investment income is only taxed once: at the trust level or at the beneficiary level if the investment income is distributed from the trust to the beneficiary. If the investment income is distributed to the individual beneficiaries, the \$200,000 threshold for individuals will apply. So it may be possible to entirely avoid the application of the 3.8% Medicare contribution tax by distributing the income to the individual beneficiaries eligible for the much larger threshold amount.

**(6) Transferring Investments to Family Members.** An unmarried child is subject to the 3.8% Medicare contribution tax only if the child's MAGI exceeds \$200,000. Setting up family limited partnerships or other techniques to spread some of the investment income among family members prior to 2013 could provide tax savings. At the present time, and pending further clarification by the IRS, it appears that children with MAGI under \$200,000 will not be subject to the 3.8% Medicare contribution tax, despite the children's investment income being taxed at the parent's marginal tax rate under the "kiddie tax" rules.

**(7) Other Provisions Affecting Individuals.** Along with the expiring Bush tax cuts mentioned above, there are other changes affecting individuals. For example:

**(a) Additional Employee Portion of Payroll Tax.** Enacted as part of the Patient Protection and Affordable Care Act, the employee portion of the Medicare tax will increase by 0.9 percent (from 1.45 to 2.35 percent) on wages over \$250,000 for married taxpayers filing jointly and \$200,000 for other taxpayers.

**(b) Phase-Out of Personal Exemptions.** The \$3,800 personal exemption for higher-income taxpayers will be phased out when AGI exceeds \$261,650 for married taxpayers filing jointly and \$174,450 for other taxpayers.

**(c) Medical and Dental Expense Deduction.** Enacted as part of the Patient Protection and Affordable Care Act, the threshold for claiming medical and dental expenses as itemized deductions is scheduled to increase from 7.5 to 10 percent of AGI. However, taxpayers who are 65 and older will continue to use the 7.5 percent of AGI threshold currently in place. Taxpayers facing the 10 percent of AGI limitation should inquire about the benefits of accelerating health insurance premiums and other medical deductions in 2012.

**(d) Decrease in Standard Deduction for Married Taxpayers Filing Jointly.** In 2013, the standard deduction for married taxpayers filing jointly will decrease from \$11,900 to \$9,900.

**(e) Home Sale Exclusion.** Heirs, estates, and qualified revocable trusts<sup>67</sup> will no longer be able to exclude \$250,000 of gain from the sale of the decedent's principal residence. If the sale of the inherited principal residence is imminent, heirs should consider closing on the sale of their home before year-end.

**(f) Alternative Minimum Tax Patching.** IRS Commissioner Douglas Shulman said the alternative minimum tax is the biggest problem among a host of legislative issues that could negatively impact the IRS as the end of the year approaches. Every year since 2001, Congress has repeatedly increased the individual alternative minimum tax exemption level to prevent too many taxpayers from being subject to the tax. In years where the alternative minimum tax applies, itemized deductions may be limited. Considering the timing of those deductions in either 2012 or 2013 is important to maximizing their deductibility.

## DISCLOSURES

An attorney-client relationship is not created by this paper and the opinions expressed herein are not intended to be relied upon without the establishment of an attorney-client relationship. Though the opinions expressed herein are believed accurate, the author and Joseph C. Kempe, P.A., assumes no responsibility for any reader's reliance and encourages all readers to verify all items with expert counsel.

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<sup>67</sup> Qualified revocable trusts (trusts that were treated as owned by the decedent by reason of powers in the grantor immediately prior to death)

# Table I: Obama, Romney, and Bowles-Simpson Tax Plans

September 06, 2012

Comparison of Tax and Budget Plans			
	<u>Obama</u>	<u>Romney</u>	<u>Simpson-Bowles</u>
Top Marginal Rate on Personal Income	39.60%	28%	23%-28%
Top Marginal Rate on Long Term Capital Gains	30%*	15%	23%-28%
Top Marginal Rate on Dividends	43.4%**	15%	23%-28%
Top Marginal Rate on Corporate Income	28%	25%	26%-28%
Top Marginal Rate on Corporate Income from Foreign Sources	28%	0%	0%
Tax Expenditures (Some 250 credits, deductions, and other preferences amounting to more than \$1 trillion a year)	Adds more than are taken away and complicates many existing ones, though limits benefits for high-income earners	Potentially eliminates all, except middle-class preferences for mortgage, health, retirement, and charity	Eliminates all under the 23% top rate plan; Eliminates all but Child Credit, EITC, mortgage, health, and retirement benefits under the 28% top rate plan
Alternative Minimum Tax, PEP and Pease (Limitations on high-income tax benefits)	Maintains PEP and Pease; replaces AMT with a "Buffett Rule" minimum tax of 30%	Eliminates	Eliminates



<b>Payroll Tax</b>	Increases the top rate from 2.9% to 3.8%	Maintains	Increases the wage base 2% each year until 2050
<b>Other Taxes Contained in Patient Protection and Affordable Care Act ("Obamacare")</b>	Maintains	Eliminates	Maintains
<b>Estate Tax</b>	Assumed to Stay	Eliminates	Maintains
<b>Gas Tax</b>	18¢ per gallon	18¢ per gallon	23¢ per gallon
<b>Tax Revenue as a Share of GDP in 2015</b>	19.40%	18.00%	19.30%
<b>Spending as a Share of GDP in 2015</b>	22.40%	20.00%	21.40%
<b>Deficit as a Share of GDP in 2015</b>	3.10%	2.00%	2.10%
<b>Publicly Held Debt as a Share of GDP in 2015</b>	79.40%	Not Scored	69.00%
<b>Balanced Budget</b>	Never	2020	2037
<p>* Based on the "Buffett Rule" minimum tax of 30%.</p> <p>** Includes the 3.8% investment tax under the Affordable Care Act.</p> <p><b>Sources:</b> Candidate statements, CBO</p>			

Chart I.

