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2012 Election Results - Potential Tax Planning Impact
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MARKET TREND: President Obama's re-election and the retention of the Democratic majority in the Senate will significantly affect the overall direction of federal tax reform, and the possibility of higher income and transfer taxes in 2013 exists. Tax planning and specialized advisors will be at a premium. SYNOPSIS: Unless Congress and President Obama act on intervening tax legislation during the 2012 lame-duck legislative session, numerous tax changes will take effect on January 1, 2013 that will significantly increase the income and transfer tax rates. While President Obama has expressed his support for tax increases on upper income taxpayers (e.g., adjusted gross income (AGI) of $200,000+ for single filers, and AGI of $250,000 for joint filers) and a return to 2009 transfer tax rates and exemptions, the on-going division in party control between the Senate (Democrats) and the House (Republicans) means continuing uncertainty regarding the specific direction and terms for overall tax reform. TAKE AWAY: Despite continuing uncertainty, the election results ensure implementation of the new health care taxes on wages and net investment income and likely increase the probability of higher income and/or transfer tax rates in 2013. While often repeated over the past two years, time is of the essence for individuals wanting to lock in the planning benefits offered by the current tax laws, as 2013 is less than two months away. The best laid investment plan likely cannot outperform the best laid tax plan, given the potential changes.

President Obama's re-election and the retention of the Democratic majority in the Senate will significantly affect the overall direction of federal tax reform. The following summarizes what we know, what could happen, and the potential planning implications for clients.

What We Know

Changes Scheduled for 2013. Unless Congress and the President enact intervening tax legislation during the 2012 lame-duck session, the following changes will take effect on January 1, 2013:

Health Care Taxes	Income Taxes	Transfer Taxes
· *3.8% Medicare Tax on Net*	· *Higher Top Ordinary Income*	· *Higher Rates*. Reinstatement

Investment Income. 3.8% tax on the lesser of (1) net investment income (*e.g.*, dividends, interest, rents, capital gains, passive activity income) or (2) the excess of modified AGI over applicable thresholds (*e.g.*, $250,000 - joint filers; $200,000 - single filers). · *0.9% Increase in Hospital Insurance Tax on Wages*. 0.9% increase (1.45% to 2.35%) in the employee portion of the Hospital Insurance Tax on total wages in excess of set thresholds (*e.g.,* $250,000 - joint filers, $200,000 - single filers).	*Rates*. Increase in the top two individual income tax rates, (33% to 36% and 35% to 39.6%). · *Increased Capital Gains Rate*. From 15% to 20%. · *Higher Dividend Tax*. Qualified dividends taxed as ordinary income rather than capital gains, at rates up to 39.6%. · *Deduction Limitations*. Re-instatement of personal exemption phase-outs and limits on itemized deductions for high income tax-payers (effective tax rate increase of 1.2%).	of a 55% top marginal federal estate and gift tax rate and a flat generation skipping transfer (**GST**) tax rate (up from 35%). · *Lower Exemptions*. Reduction in estate, gift, and GST tax exemptions to $1 million (down from $5.12 million).* · *Loss of Portability*. Loss of estate and gift tax exemption portability between spouses. *For the GST tax, the 55% applies at a flat rate, and the GST tax exemption would be approx. $1.43 million, as inflation-indexed from 1998.

Tax Proposals Supported by Obama. The President has indicated his support for several individual income and transfer tax changes, including the following:

· Income Taxes:

o *Expiration of Tax Cuts*. Allow individual income tax cuts to expire as scheduled in 2013 ***for high income taxpayers only*** (*e.g.,* AGI of $200,000+ for single filers, and AGI of $250,000 for joint filers).

o *Limits on Itemized Deductions and Tax Expenditure*. Limit itemized deductions and certain tax expenditures (*e.g.*, muni-bond interest, employer provided health care, etc.) for income taxed at more than 28%.

o *Minimum Tax Rate*. Implement the “Buffett Rule,” which generally subjects taxpayers with over $1 million of income to a 30% effective tax rate.

· Transfer Taxes:

o *Return of 2009 Transfer Tax Laws*. Adopt a top 45% estate, gift and GST tax rate, with a $3.5 million estate and GST tax exemption and a $1 million gift tax exemption. The lower cap on the gift tax exemption may prove to be the most problematic here.

o *Permanent Exemption Portability*. Permanently extend estate tax exemption portability, which allows a surviving spouse to use the remaining estate tax exemption of a deceased spouse, if his or her executor elects.

o *Coordination of Income and Transfer Taxation of Grantor Trusts*. (1) Include assets of a trust taxed as a grantor trust for federal income tax purposes in the grantor’s estate, (2) during the grantor’s lifetime, impose a gift tax on grantor trust distributions and on all trust assets if the trust ceases to be a grantor trust, and (3) impose transfer taxes on property sold to a grantor trust by a non-grantor (*e.g.*, a beneficiary) if the sale was not subject to capital gains tax because of the grantor trust rules.

o *Minimum Term GRATs*. Require that GRATs (1) have a minimum 10-year term, (2) prohibit any reduction in the annual annuity payable during the minimum term, and (3) have a remainder interest with a value (currently unspecified) that is greater than zero.

o *Limits on Duration of GST-Exempt Status*. Terminate a trust's GST-exempt status on the 90th anniversary of its creation, generally resulting in the imposition of GST tax on taxable distributions and taxable terminations after the trust's 90th anniversary.

o *Additional Limits on Valuation Discounts*. Have the IRS issue regulations providing additional "disregarded restrictions" for the valuation of family entity/business interests transferred to family members.

What Could Happen

The election results essentially guarantee full implementation of the Patient Protection and Affordable Care Act, which means an increase in effective tax rates for most investment income and wages above specified thresholds. The Republican's continuing control of the House, however, will temper the extent to which Democrats can enact the President's other desired income and transfer tax proposals. Leading members of both parties have already indicated their intentions to remain faithful to the tax positions staked out during President Obama's first term, although there may be some Republican "give" over limiting or eliminating various income tax expenditures, particularly at the higher-income levels.

With the "fiscal cliff" quickly approaching, the parties may compromise on a temporary, short-term extension of many, if not all, of the current tax laws. The appetite for long-term tax reform, however, remains and, given the current economic climate, could be addressed during President Obama's second term. While his re-election may increase the probability of higher income and/or transfer tax rates, the terms of any legislative compromise remain uncertain and the possibility of tax increases, limits on tax expenditures, and cuts to spending all continue to be "on the table." Obviously, AALU, through the active engagement of its membership and industry partners, will continue to engage to preserve and protect the current tax treatment of life insurance products in this debate.

Potential Planning Implications

Year-End. We likely will see some significant tax changes in the future, including the possible reduction of the current $5 million+ estate, gift, and GST tax exemption. Individuals wanting to take advantage of the current tax laws must act now, as even "simple" plans take time to implement.

<u>High Net Worth Clients</u>. Clients with sufficient assets to make large gifts comfortably should exhaust their

gift and GST tax exemptions with gifts to grantor, dynasty trusts. These gifts will make tax-efficient use of their exemptions by deferring transfer taxes on trust assets for multiple generations. Grantor trust status also allows the grantor to pay the trust's income taxes without making additional taxable gifts to the trust, and the trust assets grow income tax-free (although given the potential of high tax burdens to the grantor if income tax rates rise, the trust should include provisions that allow for the "toggling-off" of grantor trust status). Should President Obama's proposals regarding the transfer taxation of grantor trusts and/or limitations on a trust's GST tax exempt status are enacted, pre-existing trusts may be grandfathered (although AALU has strongly opposed the Administration's grantor trust proposal given the negative implications for successful long-term planning utilizing life insurance). Finally, large gifts in trust can facilitate the purchase of life insurance, as clients may appreciate the simplicity of using a large, single gift for premium funding.

Note that clients wishing to give hard-to-value assets (*e.g.*, a closely-held business interest) may have difficulty in obtaining valuations prior to year-end. One option is to have the client make a gift of easy-to-value assets (such as cash or marketable securities) and later exercise a non-fiduciary power of substitution to substitute the harder to value assets after the appraisal has been obtained.

Mid-Range Clients. These clients, who will have concerns over permanently parting with significant assets, may want to consider gifts to spousal lifetime access trusts (**SLATs**). The client makes a gift to an irrevocable trust that benefits the spouse during the spouse's life. The gift to the SLAT uses the client's $5.12 million exemption but still offers the client's spouse (and indirectly, the client) access to the funds, if needed, during life. Descendants also can be named as discretionary beneficiaries, and the beneficiary-spouse can serve as trustee, provided that the power to make distributions to him or herself is limited by an ascertainable standard (*e.g.*, health, education, maintenance, and support). Concerns over the loss of access to the SLAT assets if the beneficiary-spouse predeceases the donor-spouse can be addressed by acquiring life insurance on the beneficiary spouse that is made payable to the donor or to a trust for the donor's benefit.

Spouses who each want to implement a SLAT for the benefit of the other, however, must proceed cautiously in order to avoid running afoul of the reciprocal trust doctrine, which could trigger estate tax inclusion of the SLATs' assets in the spouses' estates. There are no IRS sanctioned safe-harbors for avoiding reciprocal trust status. Ideally, the trusts would have substantial differences, including different dispositive terms and beneficiaries, different powers, different trustees, different assets used for funding, etc. Further, the trusts should be created on separate dates, preferably with significant time between each trust's creation. Thus, the limited time left before year-end could make it difficult for spouses to create SLATs that use both of their exemptions.

Hesitant Clients. Numerous clients recognize the substantial tax benefits that may be gained by taking advantage of current tax laws, but have emotional or psychological concerns about transferring significant wealth to younger generations (either outright or in trust). Incorporating flexibility in their planning may help them overcome these concerns. For example, discuss with them the use of an irrevocable trust for the benefit of descendants that incorporates a provision permitting one spouse to be added as beneficiary. Its important to note that this type of planning raises practical planning issues that must be properly addressed, such as the increased need to rely on independent trustees to make any discretionary trust distributions to a settlor's spouse.

Procrastinating Clients. For clients who are uncomfortable with the December 31st deadline and wish they had more time to consider the impact of transferring wealth to their descendants, another alternative to consider is the creation of a marital trust for the benefit of his or her spouse, coupled with a potential qualified disclaimer. The execution and funding of this trust could be accomplished in December 2012, but the spouse's decision of whether or not to disclaim his or her interest in the marital trust may be delayed for up to nine (9) months from the trust's creation. The qualified disclaimer would retroactively create a taxable gift in December 2012, thereby utilizing some of the settlor spouse's 2012 gift tax exemption. This alternative could allow the clients to wait until summer 2013 to determine where the future estate, gift and GST tax laws may be heading.

Clients Who Want to do More Planning. For clients who have fully exhausted their available gift tax exemptions, they may wish to utilize today's reduced marginal gift tax rates of only 35% to accomplish both tax and non-tax planning objectives. The gift-tax exclusive nature of taxable gifts can effectively lower the marginal gift tax rate on transfers from 35% to almost 26% (assuming the client lives more than three years from payment of the gift tax liability). Clients in this situation may also utilize the concept of "net gifts" to allow the donees to receive all of the desired wealth up front, but subject the donee to the obligation to pay the gift tax liability. When gift tax liability is due in 2013, the donor can consider leveraging the initial gift by "financing" the required gift tax payment through a loan at the appropriate federal rates. Today's marginal gift tax rate and the likely low interest rates still in effect next Spring 2013 make this an attractive alternative, especially for those clients considering outrights gifts to their children. This type of planning may not be the most effective GST tax planning, but grantor trusts and trusts that potentially benefit more remote descendants can be utilized as the donee, they just require additional planning considerations.

Income Tax Considerations. With the now certain imposition of the Medicare tax on net investment income in 2013, clients with income levels near the affected thresholds will need to review their potential tax exposure and make some final decisions regarding strategies to mitigate their expected liabilities prior to 2013. Options may include (1) accelerating capital gains into 2012, particularly for assets a client intends to sell in the near term, (2) accelerating qualified dividend payments to individual shareholders of closely held corporations, (3) accelerating the receipt of commissions, bonuses, and nonqualified stock option exercises, (4) converting traditional IRAs to Roth IRAs, (5) making § 83(b) elections relative to stock bonus plans, and (6) exercising vested stock options.

Longer-Term. The long-term planning outlook remains difficult to predict apart from the certainty that any successful tax reform and deficit reduction will require some form of compromise between the Democratic and Republican tax platforms. From an income tax perspective, implementation of the health care taxes and the potential for rising tax rates will likely increase the attractiveness of the income tax-deferral strategies and investments, including annuities, life insurance products and deferred compensations plans. For transfer tax purposes, we may see transfer tax rates and exemptions between 35% and $5 million and 45% and $3.5 million (with likely inclusion of exemption reunification and portability, as bipartisan support, through the work of AALU, has been building for these important provisions). We also will likely see continued pressure on popular estate planning techniques, like GRATs, grantor trusts, dynasty trusts, and valuation discounts, although the extent to which any of the President's proposals on these issues will gain legislative traction remains unclear.

Take-Away

Despite continuing uncertainty, the election results ensure implementation of the new health care taxes on wages and net investment income and likely increase the probability of higher income and/or transfer tax rates in 2013. While often repeated over the past two years, time is of the essence for individuals wanting to lock in the planning benefits offered by the current tax laws, as 2013 is less than two months away. The best laid investment plan likely cannot outperform the best laid tax plan, given the potential changes