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Tax Topics
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Fiscal Year 2014 Budget issued
On April 10th, President Obama issued his Fiscal Year 2014 budget. Shortly thereafter, the Treasury Department issued its "Green Book," which explains the tax provisions in the budget. Although most of these provisions are familiar and have appeared in previous budgets, a few were new. Here is a selected overview of some of these provisions, most of which would apply (assuming Congress enacts them) as of 2014:

• Limit the value of certain tax benefits. As in previous budgets, the current budget proposes to limit the value of various tax benefits so that they only reduce or shelter income that would be taxed at 28% or less. In other words, taxpayers with income that would be taxed at the 33%, 35% or 39.6% rate would see tax benefits curtailed, including ALL itemized deductions (these include deductions for mortgage interest, charitable contributions and state and local taxes), tax-exempt municipal bond interest, employer and employee contributions to employer-sponsored health insurance, employee contributions to retirement plans such as 401(k)s, contributions to health savings accounts and Archer medical savings accounts, interest on education loans and certain higher education expenses. Because an affected taxpayer's pre-tax contribution to her retirement account would be taxed, the account's "basis" would be increased accordingly.

Comments. This proposal is not new, but the basis adjustment for retirement accounts is an equitable provision that was previously missing. Also, because the proposal would apply to income that is taxed at 33%, 35% or 39.6%, it would increase taxes on some of those President Obama has previously pledged to insulate from higher taxes – namely, individuals with income under $200,000 or married couples filing jointly with income under $250,000. That is, in 2013, the 33% tax rate applies to taxable income in excess of $183,250 (single taxpayers), $203,150 (head of household) and $223,050 (married filing jointly).

• The "Buffett Rule." To limit the advantage that high-income taxpayers enjoy from the preferential low rates on dividends and long-term capital gains, the budget proposes the "Fair Share Tax" (FST), a new

minimum tax designed to ensure that taxpayers pay at least 30% on their adjusted gross income (AGI)
(a credit for charitable contributions would be allowed). Translated, this means that if the taxpayer's
"regular" taxes (including certain credits, the alternative minimum tax and the new 3.8% surtax on net
investment income) and payroll taxes didn't reach 30%, the FST would make up the difference. The
FST would be phased in starting at $1 million of AGI, and would be fully phased in at $2 million of AGI
(these thresholds would be indexed for inflation as of 2015).
Comments. Taxpayers who already pay an aggregate 30% in regular and payroll taxes would not be
subject to the FST – but those who chiefly have income from qualified dividends and long-term capital
gains (and therefore have lower than a 30% effective rate) would see a significant tax increase.
• Restore the 2009 transfer tax parameters. Beginning in 2018, the transfer tax provisions that were in
effect in 2009 would be restored. The top transfer tax rate would thus be 45% instead of 40%; the
estate tax exclusion and generation-skipping transfer tax (GST) exemption would be $3.5 million, and
the gift tax exclusion would be $1 million (these amounts would not be indexed for inflation). In
computing gift or estate tax liability with respect to these reduced exclusions, taxpayers would not be
affected by "clawback." That is, they wouldn't be subject to additional tax if they had taken advantage of
the previous (higher) exclusion amounts (in 2013, the applicable exclusion amount (AEA) against gift
and estate tax is $5.25 million, and is indexed for inflation; the GST exemption equals the AEA).
"Portability," which allows a surviving spouse to effectively "inherit" the deceased spouse's unused AEA,
would continue.
Comments. Despite President Obama's urging to the contrary, the American Taxpayer Relief Act of
2012 (ATRA), enacted on January 2, 2013, made permanent most of the transfer tax provisions that
were in effect in 2011 and 2012: a $5 million exclusion amount, indexed for inflation, against gift and
estate taxes and GST, and portability. (ATRA increased the top transfer tax rate from 35% to 40%.) In
other words, Congress just "permanently" stabilized transfer taxes, and is probably not eager to revisit
them anytime soon. Yet the budget proposes relitigating the issue, and reverting to the 2009 regime –
but not until 2018. Perhaps this is more protest than blueprint.
• Require consistent basis for transfer tax and income tax. The basis of inherited property would

have to equal the property's estate tax value, and the basis of property received by lifetime gift would have to equal the donor's basis. Although these are, in fact, generally the current rules, the proposal would require executors of estates and donors of lifetime gifts to report the property's value and basis to both the recipient and the IRS.

• Require a minimum term for Grantor Retained Annuity Trusts (GRATs). To limit the effectiveness of GRATs, which are designed to pass potential appreciation at little or no gift-tax "cost," GRATs would be required to have: 1) a minimum term of 10 years and a maximum term of the annuitant's life expectancy plus 10 years; 2) at least some gift at the trust's creation (i.e., no more "zeroed-out" GRATs); and 3) no declining annuity during the trust's term.

• Limit the duration of the GST exemption. A trust that is protected from generation-skipping transfer tax would lose that protection after 90 years, when GST would again apply to the trust.

• Coordinate income and transfer tax rules regarding grantor trusts. The grantor of a "grantor trust" is responsible for paying the trust's income taxes. Such trusts are often includible in the grantor's estate (as in a "revocable trust" or a GRAT). A trust that is not includible in the grantor's estate but for which the grantor is responsible for paying the income taxes is a "defective" grantor trust. Transactions between the grantor and his grantor trust are not recognized for income tax purposes, so that if, for example, the grantor sells appreciated property to a defective grantor trust in exchange for an interestTax

bearing note – known as a “sale to a defective grantor trust” – the sale does not trigger capital gains taxes and the grantor is not taxable on the trust’s interest payments to him. Such transactions can pass significant potential appreciation to the grantor’s heirs free of gift tax and generation-skipping transfer tax.

To eliminate this planning technique, the proposal provides that if the deemed income tax owner of a trust (this could be the grantor or a beneficiary) “engages in a transaction with that trust that constitutes a sale, exchange, or comparable transaction,” then the portion of the trust attributable to this transaction (along with income or appreciation on the property): 1) would be includible in the deemed owner’s estate; 2) would be subject to gift tax if the deemed owner ceased to own the trust during life; and 3) would be treated as a gift from the deemed owner if, during the owner’s life, distributions were made from the trust to another person. Any gift or estate tax triggered by the proposal would be payable from the trust. The proposal would not apply to trusts that are already includible in the grantor’s estate, “rabbi trusts” (non-qualified deferred compensation plans that are subject to claims of the grantor’s creditors) or trusts that are grantor trusts solely because the trust’s income can be used to pay insurance premiums on the life of the grantor or the grantor’s spouse (i.e., insurance trusts that are designed to remove insurance proceeds from an insured’s estate).

Comments. Last year was the first appearance of this proposal to unify income and transfer tax rules for grantor trusts. It was so broadly worded that it would have caught existing trusts, such as insurance trusts. This new iteration simply targets sales to defective grantor trusts.

• Extend the lien on estate tax deferrals. The tax law allows the estate tax on certain closely held business interests to be deferred for up to 15+ years from the decedent’s death. Another provision of the tax law imposes what is generally a ten-year lien on the estate’s assets to ensure payment of the estate tax. Because that lien can expire before the estate tax is paid, it may be difficult for the IRS to collect those tax dollars. The proposal would extend the lien through the permitted deferral period.

• Clarify the GST treatment of “HEETs.” Donors can make direct payments of tuition and medical expenses free of gift tax. If that donor is a grandparent, for example, such payments are also free of generation-skipping transfer tax. Specifically, the tax law provides that the GST will not apply to “any

transfer which, if made inter vivos by an individual [i.e., during the donor's life], would not be treated as a taxable gift" because it is a direct payment for tuition or medical expenses. This language has been read to mean the following: GST will not apply to a trust's direct payments for, say, a grandchildbeneficiary's tuition or medical expenses, even though the trust is otherwise subject to GST.

Some planners have taken this understanding a step further with "HEETs," or Health and Education Exclusion Trusts. These trusts purportedly are fully protected from GST, despite not having any GST exemption allocated to them. That is, because charity has an ongoing "substantial" income interest in the HEET (say, 10%), gifts into the trust are not subject to GST, and GST won't apply when one generational level of beneficiaries dies off. In addition, trust distributions on behalf of beneficiaries such as grandchildren can only be made for tuition or medical expenses, and are therefore GST-exempt. The proposal says that it would "clarify" that this GST exclusion for direct payments of tuition or medical expenses only applies to payments made by a living donor, and not from a trust. The proposal would apply to trusts created after the bill proposing this change is introduced in Congress, and to transfers after that date made to pre-existing trusts.

Comments. The desire to "clarify" this special exclusion reflects the perception that HEETs are abusive, given the proposal's recommended effective date (introduction, rather than enactment, of legislation). Despite this perception, however, it is worth noting that trusts that typically take advantage

of direct payments for tuition and medical expenses are subject to GST but for this special exclusion.
Also, although HEETs have been written about in planning publications, it is unclear how often they are actually implemented: donors who use their GST exemption for multi-generational trusts often feel that they've done "enough" for those lower generations, and may lack the charitable intent necessary for the HEET to work. In addition, given life's uncertainties, trust creators may be reluctant to limit trust distributions to tuition and medical expenses only.

• Tax "carried" (profits) interests as ordinary income. In exchange for their services on behalf of hedge funds and private equity funds, managers of these entities are often compensated with what are called "carried interests," or profits from the entity. Because these profits interests are structured as partnership interests, they pass through long-term capital gain to the partners/managers, and are therefore taxed at preferential rates. The proposal would not recharacterize the treatment of a partner's investment in the entity, but would tax as ordinary income what is viewed as compensation for the partner's investment management services for the partnership. Thus, a partner's share of income in an "investment services partnership interest" (ISPI), regardless of how the income is characterized at the partnership level, would be taxed as ordinary income, and would also be subject to self-employment tax.
An ISPI is an interest in future profits of an "investment partnership"; an investment partnership is one in which substantially all of the entity's assets are investment-type assets, such as certain securities, real estate, interests in partnerships, commodities, cash or cash equivalents, or derivative contracts related to those assets.

• Tighten up conservation easements. Donors of conservation easements typically get a charitable deduction for the permanent restrictions they put on property that will be used exclusively for conservation purposes. Recent court decisions have upheld large deductions for easements preserving recreational amenities, including golf courses, surrounded by upscale homes. These contributions have raised concerns that the deductions claimed are excessive and seem to promote private interests rather than bona fide conservation activities. The proposal would prohibit a deduction for a conservation easement on a golf course. A second proposal would address historic preservation easements, and would disallow a deduction for restricting the "upward development" of an

historic building, since such development is typically already restricted under local ordinances. In addition, conservation easements on buildings listed in the National Register would need to comply with the same (more stringent) rules applicable to buildings in a registered historic district.

• Limit protracted payout for non-spouse beneficiaries of IRAs and retirement plans. Under current law, a non-spouse beneficiary of an IRA or a retirement plan (such as a 401(k)) must begin taking "required minimum distributions" (RMDs) from the account the year after the account owner's death, but can spread those distributions out over her life expectancy. Thus, if widowed Mom names Child as beneficiary of her IRA, for example, and Child is 40 when Mom dies, Child's RMDs can last over 40 years, assuming those are the only distributions Child takes from the account. The proposal would change this rule, and in general would require that non-spouse beneficiaries withdraw the balance of the retirement account within five years after the owner's death. (Certain exceptions would apply for "eligible" beneficiaries, such as those who are disabled, chronically ill or a child under the age of majority.) The reason for the proposed change is that retirement accounts were intended to benefit owners and their spouses, and not heirs such as children and grandchildren.

Comments. It is not surprising to see this proposal, as last year, something similar was in a highway bill, but was then pulled. Given the need for revenue, limiting the generous protracted payouts currently permitted for non-spouse beneficiaries seems like low-hanging fruit. If enacted, the proposal would potentially make it less attractive for owners of substantial traditional IRAs to convert that IRA into a Roth

IRA, so as to provide, say, children and grandchildren with long-term income-tax free annuities.
Nevertheless, even if those beneficiaries had to take the balance of the Roth IRA within five years of the owner's death, they still would be receiving income-tax free dollars – something that would not be the case if they had simply "inherited" a traditional IRA with its built-in income tax liability. In other words, by converting a traditional IRA into a Roth IRA, the owner is accomplishing something akin to what happens with a defective grantor trust (see above): relieving the beneficiaries of an income tax liability they would otherwise have to pay.

• Limit the size of retirement benefits. Under current law, there are limits as to how much individuals can accrue under a defined benefit plan (such as a pension plan), or how much they can contribute to IRAs and various defined contribution plans, such as 401(k)s. There are no limits, however, as to how much individuals can accumulate in these tax-preferred accounts. Because of this, the proposal explains, individuals can accumulate more than is needed to fund "reasonable levels of consumption in retirement…well beyond the level of accumulation that justifies tax-advantaged treatment of retirement savings accounts." The proposal would therefore cap the size of a taxpayer's various retirement accounts by barring additional contributions (or accruals) if, in total, the accounts exceeded what was necessary to provide the maximum annuity permitted for a defined benefit plan: currently $205,000 per year for a hypothetical 62 year-old and her spouse (this equates to accumulations of about $3.4 million).
When a taxpayer's accounts hit that ceiling, they could still grow through investment returns, but additions to the accounts would only be allowed if the maximum permitted annuity increased, or the taxpayer's investment returns for a given year were less than the actuarial assumptions underlying the annuity. If an addition put a taxpayer's accounts over the ceiling, the taxpayer would include that excess in income, and have a grace period to withdraw it; if the taxpayer did not withdraw the excess, then that amount and attributable earnings would be subject to income tax when distributed, even if the distribution was from a Roth IRA or a Roth 401(k).
Comments. This new proposal seems to be a reaction to this fall's presidential elections and the significant retirement accounts of one of the contenders. Nevertheless, it is not an excise tax to whittle down significant accounts, but a prohibition on additional contributions (or

accruals). As Treasury Secretary Lew has pointed out, we're not saying you can't save for retirement, we're just saying that such large amounts shouldn't be tax-preferred. Still, will Congress really be inclined to limit how much taxpayers can accumulate in their retirement accounts, especially when a rising interest rate environment would make the permitted accumulation smaller? Although anything is possible, particularly if tax reform really comes about, Congressional sentiment might be against what could be viewed as "penalizing" successful savers.

• Replace Consumer Price Index (CPI) with Chained CPI. Every year, the IRS issues inflation-adjusted numbers for a variety of provisions, such as the income thresholds for the individual income tax rate brackets, personal exemptions, and income thresholds and phase-out ranges for various deductions, exclusions and tax credits. The proposal states that the CPI overstates the effects of inflation because it doesn't fully reflect consumer reaction to price changes (as in, if prices go up, consumers will buy something cheaper). A "chained" CPI would "account more fully for this substitution effect" and better reflect changes in the cost of living. The proposal would take effect as of 2015.

Comments. Just as the proposal to limit tax benefits for income that would be taxed at higher than 28% would raise taxes on some of those President Obama has previously pledged to protect (see above), a chained CPI would also raise taxes for everyone, in that tax brackets (and other tax benefits, such as personal exemptions) would increase more slowly. Similarly, a chained CPI would reduce cost-of-living increases for Social Security recipients – again something that would affect those the President has pledged to protect. Although this proposal represents an attempt at balance, Republicans and Democrats generally seem to dislike it, but for different reasons.

Legislative prospects? Where these proposals go may be a function of what happens with possible tax reform – and the prospects of that are…unknown. Rep. Dave Camp (R-MI), Chairman of the House Ways & Means Committee has been holding hearings, and issuing a number of legislative proposals that are designed to elicit comments and prod tax reform. Sen. Max Baucus (D-MT), Chairman of the Senate Finance Committee, has also been pursuing tax reform, but has recently announced his retirement. Does that put him in a better or worse position to achieve this goal? Time will tell. But trying to reconcile the Republican desire for lower rates and a broader tax base with the Democratic desire for higher taxes on those they feel can best afford them will not be easy. Considering the country's pressing fiscal needs, however, it's hard to imagine that tax revenues won't have to go up at some point. The question is how, and whose ox gets gored.

May 7520 rate issued

The IRS has issued the May 2013 7520 rate. It is 1.2%, a drop of 0.20% (20 basis points) from April's rate of 1.4%. May's annual, semiannual, quarterly and monthly mid-term rates are all 1%, a 0.09% (9 basis points) drop from April's annual, semiannual, quarterly and monthly mid-term rates, which were all 1.09%.

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