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The implications of political positions on tax reform for estate planning

By Richard A. Sugar

Everyone complains about the Internal Revenue Code—Democrats, Republicans, and Independents. Yet every critic has his own pet peeve or untouchable provision. There have been lots of proposals that have been introduced over the last five years by proponents and critics. What is most interesting is to compare those proposals from different political philosophies, and identify principles which overlap. Going through that exercise will give us insight into which planning opportunities are likely under attack, and which are safe.

Three Reform Samples

I have chosen to look at three tax reform proposals. The first one is the National Commission on Fiscal Responsibility and Reform (Simpson Bowles) proposals from December, 2010. That Commission, consisting of both Republicans and Democrats, published suggestions for tax reform within a broader budget-balancing effort. The membership represented views from both sides of the aisle. Unfortunately, because of the self-imposed vote rules, they did not get a super-majority approval to be able to have their plan fully endorsed. The second tax reform proposal is Congressman Camp's Tax Reform of 2014 discussion draft, issued in his capacity as Republican Chairman of the House Ways and Means Committee, which was released in February of 2014. Finally, there is the Obama 2016 Fiscal Year Budget (Green Brook) published in February of 2015. I will refer to these as "Simpson Bowles," "Camp," and "Obama."

Tax Rates and Measures of Taxable Income

Both Simpson Bowles and Camp made an effort to lower rates and broaden the base. Simpson Bowles proposed lower brackets of 12 percent and 28 percent, while Camp proposed 10 percent, 25 percent, and 35 percent. Simpson Bowles eliminated individual deductions and credits, except for a few which were instead capped—mortgage interest, employer health care premium exclusion from income, and charitable giving. Simpson Bowles capped contributions to retirement plans, and the tax exemption for municipal bonds was eliminated.

Camp had proposed taking away preferential tax treatment for items that affected the top 35 percent bracket, and only allowed them against the 25 percent bracket. Thus, tax-exempt interest, itemized deductions, employer contributions to health plans and retirement plans excluded from gross income, and Social Security benefits excluded from income were capped. Mortgage interest deduction was allowed as an itemized deduction, but capped when related to a loan exceeding $500,000, and the $500,000 exclusion from gross income for gain on sale of a principal residence required residency for five of the eight prior years, instead of two of the five prior years, and phased out for AGIs above $500,000 for joint filers. Camp also repealed state and local income tax and real estate tax deductions, except those incurred for trade or business or for production of income; eliminated the deduction for personal casualty losses, eliminated gambling losses in excess of winnings, eliminated medical expense deductions, tax preparation fee deductions, alimony payment deductions, and moving expense deductions.

Obama's plan did not reduce the individual income tax rates. However, he did propose to broaden the base in a way that echoed Camp's proposal, by limiting the tax values of deductions and exclusions to the 28 percent bracket. He applied these broadening rules to cap tax exempt municipal bond interest, employer-paid or self-employed health insurance premium income exclusion, employee contributions to defined contribution plans and IRAs, certain trade or business deductions of employees, moving expenses, contributions for HSAs and MSAs, and interest deductions on educational loans. Obama proposed a new "fair share tax," which consisted of a brand new regime, a new minimum tax. The minimum tax would equal 30 percent of AGI less a credit for charitable contributions (remembering that charitable contributions were still subject to a 28 percent deduction cap under the standard regime). If the new minimum tax was greater than the regular income tax, plus AMT, plus employee payroll taxes, then a taxpayer had to pay that excess. The new "fair share tax" applied to high income taxpayers earning in excess of $1,000,000 of AGI. Many of these proposals (not the new minimum tax) appeared previously in prior annual budget plans of President Obama.

Capital Gains

Camp proposed changing the capital gains rates for non-corporate taxpayers. Such taxpayers would get an above-theline deduction of 40 percent for net capital gains and qualified dividends (resulting in marginal capital gain rate of 6 percent to 21 percent). The 3.8 percent net investment income tax remained in addition, resulting in a high of 24.8 percent on capital gains and dividends. Simpson Bowles did not address capital gains. Obama proposes to raise capital gains from 20 percent to 24.2 percent, so that together with the net investment income tax of 3.8 percent, capital gains could reach a high of 28 percent.

Camp proposed repealing the IRC Section 1411 exclusion of 50 percent of the gain from sale of C corp original issue small business stock held for at least five years. Obama proposed expanding the exclusion to 100 percent of gain (not just 50 percent) instead of repealing the exclusion. Obama expanded the ability of investors to defer gain on sale of qualified small business stock if proceeds of sale are reinvested within six months after sale (instead of just 60 days, as under current IRC Section 1045), provided the stock was held at least three years. Camp did not address the permissible deferral of gain on sale of qualified small business stock.

Camp repealed the like-kind exchange rules. Obama narrowed them by prohibiting like-kind exchanges for art, collectibles, and exchanges for real estate in excess of $1,000,000 per taxpayer per year. Like-kind tax-free exchanges would otherwise be permitted by Obama for trade or business property or investment property.

With respect to partnerships, he has once again re-proposed that carried interests be treated as ordinary income (not subject to capital gains). The carried interest rule would apply to an "investment services partnership interest," As a bow to Congress, Obama's proposal said he would work with Congress to identify when a partnership has goodwill or other assets unrelated to the services of the investment services partnership interest, to avoid unreasonable recharacterizations of capital gains into ordinary income. These provisions had been presented before in prior budget plans of President Obama.

Retirement Plans

Obama prohibited further contributions or accruals to retirement plans or IRAs, when an individual has accumulated assets having a value greater than that permitted by defined benefit plans (currently $210,000 per year annuity providing 100 percent joint and survivor annuity commencing at age 62 for the life of the participant and the spouse) which today equals $3,400,000. Obama also proposed that non-spousal benefits of retirement plans and IRAs must be distributed over no more than five years after a participant dies. Exceptions are made for the disabled, chronically ill, and beneficiaries not more than ten years younger, and for a child who has not yet reached majority. In each of the exception cases, you use the life expectancy of the beneficiary, except for the minor child, rules required to have a payout within five years after a minor reaches majority. These provisions were included in Obama's previous year's budget plan.

Estate and Gift Taxes and Insurance

Neither Simpson Bowles nor Camp addressed estate, gift, or generation-skipping taxes.

Obama proposed that the estate tax, gift, and GST tax rates be increased from 40 percent to 45 percent and that the exemption by reduced to $3,500,000 for estate taxes and GST taxes, and to $1,000,000 for gift tax. There would be no inflation index for the $3,500,000 and $1,000,000 exemptions. Obama recognized the portability of the unused, deceased spouse's exemption for the surviving spouse, but cautioned that only $1,000,000 for gift tax purposes was available to the surviving spouse. This provision has been included in previous Obama budget plans.

Most strikingly, Obama proposed to recognize a taxable gain on unrecognized appreciation upon transfer at death or upon a gift. Only transfers to spouses or charity would avoid the recognition of gain on transfer. Transfers of tangible personal property and personal effects (excluding collectibles) would be excluded from recognition. There would also be a $100,000 exclusion from capital gain recognition at death per person. The $100,000 would be portable to the surviving spouse. There would also be a $250,000 per person exclusion for transfers of appreciated principal residence which also is portable to the surviving spouse if not used by the transferor completely. Any payment of this new gain recognition passing at death affecting small, family-owned business would be postponed until the business was sold or ceases to operate. Any tax owed at death when the estate was illiquid could be deferred over 15 years (presumably like Section 6166 treatment). Underpayment of estimated tax penalties would be waived with regard to unrealized gain at death. This new gain recognition would apply gains realized after December 31, 2015. There was no precedent for this proposal in either Obama's prior budget plans, or in the Camp or Simpson Bowles proposals.

Obama made changes to GRATs—requiring a minimum of a 10year life and a maximum life consisting of a life expectancy of the annuitant plus ten years. The remaining interest in the GRAT must have a minimum of 25 percent of initial value or $500,000, whichever is greater. No front loading of the GRAT would be permitted and no tax-free exchanges of assets between the GRAT and the grantor would be permitted. A similar provision was included in Obama's previous budget proposal, but the new proposal is far more restrictive.

Any sale or exchange between the grantor and a defective grantor trust will cause the property contributed to the trust and all of its appreciation and income to be includable in the estate of the donor, less a consideration the donor received in the sale or exchange. Furthermore, any termination of the donor's grantor trust status creates a gift, and any distribution to another from the defective grantor trust is deemed a gift from the donor. These new rules were not intended to apply to GRITs, GRATs, personal residence trusts, and QPRTs. They are also not to apply to the typical irrevocable life insurance trust which only owned life insurance as an asset. This provision appeared in Obama's prior year's budget proposal.

Obama imposes a 90-year life on the use of GST exemptions, defeating any perpetual dynasty trusts, the same provision in his prior year's budget proposal.

In addition to the present interest annual exclusion, certain future interest gifts would qualify up to $50,000 a year (indexed for inflation) per donor. No longer would Crummey and put options convert future interest to present interest for purposes of the annual exclusion gifts. Obama included a similar provision in his prior budget plan.

Obama proposed to capture revenue from the sales of life insurance. He proposed beefing up reporting requirements for sales of policies having death benefits of $500,000 or more. He also altered the Section 101 Transfer for Value rules. He narrowed the exception for transfers so that only transfers to the insured, or to a partnership or a corporation in which an insured is 20 percent or more owner would retain Section 101 tax-free treatment. He eliminated the exception for transfers to a partner of the insured, any partnership in which the insured is a partner, and any corporation in which the insured is an owner or officer.

Planning Implications

Obviously, some of President Obama's proposals will have a hard time in Congress. Indeed, he is swimming upstream in imposing an accelerated gain recognition on death or gifting. He has taken the old idea of carryover basis and moved it to another level by triggering gain recognition immediately. Carryover basis itself was experimented with in 1976 when it was included in the Tax Reform Act of 1976, but because of widespread outcry, was repealed shortly afterwards. Carryover basis was again experimented with in Section 301(c) of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, which was enacted on December 17, 2010 and retroactively reinstated the Federal Estate Tax for the year 2010, when the earlier Economic Growth and Tax Relief Reconciliation Act of 2001 had provided for repeal of the Federal Estate Tax for the year 2010 and only 2010. The 2010 legislation offered taxpayers a choice-pay the retroactively reinstated estate tax or elect to apply a modified carryover basis, if death occurred during a single calendar year—2010. Again, a bitter criticism was leveled at the concept of carryover basis, especially since the complexity only applied to a death occurring in a single year—2010—coupled with the inherent unfairness of the retroactive nature of the change in the law.

So what conclusions do we draw from the survey? A wider use of non-grantor charitable lead annuity trusts, which effectively obtain recurring annual charitable deductions without the itemized deduction limitations, merit consideration. For retirement plan contributions which are limited, we can think about a wider use of life insurance and annuities that accomplish the deferrals of taxable income. We can also think about expanded uses of charitable remainder trusts as retirement vehicles.

Because many of the effective dates for provisions will be set after December 31, 2015, it is wise to accelerate deductions into 2015, while they are likely to be still available. Even if the effective dates are changed to apply during 2015, nothing would be lost because the deductions would have been prohibited anyway. On the other hand, it is not a good idea to accelerate income into 2015, in case Congress applies the effective dates for lower income tax brackets to 2015 instead of 2016. Again, from a timing standpoint, it is prudent to purchase tax-exempts in 2015 in case the tax-exempt status of newly purchased bonds is limited after December 31, 2015.

The traditional structure of marital deduction, Illinois QTIP marital deduction, and credit shelter trusts for many estate plans retain their vitality, provided a "trust protector" is appointed who can choose to terminate the credit shelter trust before the surviving spouse's death and distribute to the surviving spouse, if the estate tax exemptions of the surviving spouse and the portable, unused exemption of the predeceased spouse are adequate to offset any estate tax liability of the surviving spouse. This enables a "second look" at the surviving spouse's death, to determine if a step-up in income tax basis is available to the surviving spouse's assets when there is no estate tax risk at the surviving spouse's death.[1]

More precise attention should be given to the remaining tax-preferred techniques, such as GRATs, GRITs, and QPRTs, and frozen limited partnerships, which remain singularly, Congressionally blessed estate planning techniques. Irrevocable life insurance trusts, which may contemplate private split-dollar arrangements for premium payments if annual gift tax exclusions are capped, seems like a viable alternative. It also makes sense in the future, if capital gains rates are going to increase, to employ installment sales more extensively to defer the ultimate payment of the higher capital gains taxes. Use of non-grantor trusts with spray provisions allowing distribution of DNI to a class of recipients in low tax brackets, and authorizing the trustee to distribute capital gains as part of DNI, remains a viable planning technique. Finally, investing in (a) income producing, true lease, equipment leasing, which has the potential to produce tax-free cash flow and future tax-free exchanges, and in (b) the stock of small business C corporations, with the opportunity to indefinitely rollover gains on sale of such stock, remain attractive tax advantageous investment alternatives. ■

Richard A. Sugar practices with the firm of Sugar Felsenthal, Grais & Hammer LLP and can be reached at rsugar@sugarfgh.com or at 312.704.9400.

1. An alternative "second look" approach was described by Curt Ferguson on page 1 in the February, 2015 ISBA Trust and Estates Newsletter.