

# WHAT DO I DO NOW?

## INCOME TAX & ESTATE TAX PLANNING AFTER THE ELECTION



### Income Tax Planning – To Accelerate or Defer?

There appears to be little doubt that the Obama administration, working in concert with a heavily Democratic Congress, will increase marginal income tax rates on upper income individuals. The questions at the forefront for most taxpayers are - when will they be increased, and by how much? While no one knows the answers to these questions, the following analysis and observations may be helpful to you.

There appear to be two schools of thought on the timing of the increase. Many analysts have commented that it is likely that the current “Bush” tax rates (top ordinary rate of 35%, top long-term capital gain rate of 15%) will continue until their expiration date at the end of 2010. Under this scenario, at the beginning of 2011, the rates will automatically return to those under President Clinton prior to 2001 (top ordinary rate of 39.6%, capital gain rate of 20%). This is based on the premise that the new administration would not attempt to increase taxes on the struggling economy, which could cause further deterioration.

Others think it is more likely that the Obama administration, with the strong encouragement (pressure?) of Congress, will increase rates in 2009. This is based on the following:

- Ø The economy could begin to rebound in late 2009, perhaps enough to absorb the potentially negative impact of a tax increase. Such an increase could be enacted late in 2009, and still be effective as of January 1, 2009. (The courts have generally ruled that retroactive tax increases are constitutional, as long as the time periods were “modest”.) Remember, in 1993, President Clinton’s tax increases were not signed into law until August, but were retroactive to January 1 of that year.
- Ø There will be enormous pressure for new federal spending (health care, infrastructure, etc.), and the current fiscal situation simply does not allow it. Proponents of new spending will need additional revenue now, and cannot wait until 2011.
- Ø Remember that 2010 is an election year for Congress. If the Democrats do not act to extend the Bush tax cuts in 2010, their election opponents could claim that this is effectively a prospective tax increase – a position that many incumbents

would not want to defend. They might decide to go ahead and do the “hard part” (i.e., raising taxes) in 2009, while they enjoy broad popular support.

- Ø A return to the Clinton-era rates may not be enough anyway (see below), so why wait until 2011?
- Ø If the current Congress takes no action in 2009 or 2010, there is no guarantee that they will still have control in 2011. (Remember 1994?) A change in control in 2011 could even result in an extension of the current tax rates.

Now, what about the new maximum income tax rates? President-elect Obama has signaled that he wants to simply return to the Clinton-era rates. However, there is no real limitation on setting a higher rate, since the vast majority of Americans would not be directly affected. A review of Bill Clinton’s campaign rhetoric versus the legislation that was ultimately passed is instructive:

“...We want to raise the marginal rate on taxpayers earning more than \$200,000.00 from 31 to 36%...”

Candidate Bill Clinton, in response to a question during a debate in 1992

“For the wealthiest, those earning more than \$180,000 per year, I ask you all who are listening tonight to support a raise in the top rate for Federal income taxes from 31 to 36 percent. We recommend a 10 percent surtax on incomes over \$250,000 a year, and we recommend closing some loopholes ....”

President Bill Clinton, First State of the Union Address, February 17, 1993

Notice the subtle differences – a lower income threshold and a new “surtax”. We have recited this not to single out President Clinton for criticism, but to illustrate that candidates frequently change their proposals once they are in office. We think it entirely possible that President Obama will propose a rate that he thinks is appropriate, without regard to his previous statements. While there is no indication of how high this might be, we think the maximum rate on ordinary income could be as high as 45%, and the maximum capital gain rate could be as high as 25%.

As a candidate, Senator Obama also signaled that higher payroll taxes for upper income wage earners would be a part of his overall tax plan. His stated plan would end the Social Security payroll tax cap for those over \$250,000 in earnings. (The cap is currently set at \$102,000.) These individuals will then face a tax rate of 15.3% from payroll taxes and the top income tax rate of (at least) 39.6% for a combined top rate of almost 55% on each additional dollar earned. In such an environment, techniques to minimize earnings from self-employment (e.g., use of S corporations) may become even more widespread.

***Conclusion: Given the above, it may be prudent to accelerate gains and income into 2008, and defer deductions until 2009 or beyond. If in fact rates are not increased until 2010, then the taxpayer would have lost the time value of those tax dollars for that period of time. Of course, given the current interest rate and investment environment, this value is probably relatively low compared to past years. The individual will have to weigh the possibility of avoiding significantly higher tax rates against the cost of prepaying taxes. Of course, there are still a few weeks to go before the end of 2008, and during that time the incoming administration could give us further clarification as to their plans. The reader should follow events closely.***



## Estate Tax Planning – A Window of Opportunity

The federal estate tax applies to decedents' estates over a certain exemption amount. If no changes are made to current law, the exemption and rates will apply to estates as follows:

<u>Year of Death</u>	<u>Result</u>
2008	Exemption of \$2 million (flat rate of 45%)
2009	Exemption of \$3.5 million (flat rate of 45%)
2010	No federal estate tax
2011 and after	Exemption of \$1,000,000 (maximum rate of 55%)

You should remember that the above pertains only to the federal estate tax. Many *states* have separate estate or inheritance tax regimes with exemptions that are different from federal law, which should be considered in the planning process.

It is almost universally agreed that the ascendancy of Democratic majorities in both houses of Congress in the November 2006 elections, followed by the election of Senator Obama, has extinguished the possibility of repeal. As a candidate, Senator Obama indicated that he favors maintaining the 2009 exemption and rate. Furthermore, few (if any) Democrats have indicated that they wish to return to the pre-2001 levels of taxation. Therefore, there appears to be a strong possibility that in 2009, we will see new legislation that:

- Ø Sets the exemption at or near \$3.5 million, indexed for inflation.
- Ø Sets the rate at 45% (although this could well be higher).
- Ø Adds "portability" to the exemption. That is, if one spouse dies without fully using his or her exemption, the surviving spouse can use both his/her own exemption and the "leftover" exemption from the predeceased spouse.

Having said that, Congress and/or the new administration could attempt to curtail the use of certain techniques that are in use today to reduce one's estate tax. These could include so-called "discount planning" (such as family limited partnerships), grantor retained annuity trusts ("GRATs"), QPRTs (described below), and installment sales to grantor trusts.

Depending on the likelihood and timing the reader assigns to these and other possible outcomes, it is advisable for higher net worth individuals to consider methods to freeze or reduce their taxable estates now. Some of these include:

- Ø Maximizing use of each spouse's estate tax exemption by including proper language in each Will and making sure each spouse owns (or has a power of appointment over) property with a value of at least \$3.5 million. (Note, however, that this would probably become unnecessary if the exemption is made portable between spouses.)
- Ø Use of family limited partnerships where appropriate. Although the IRS has been successful in certain recent cases in having these entities disregarded for tax purposes, they remain a viable technique where the taxpayer has substantial nontax reasons for creating it.

- Ø Installment sales and GRATs may be considered where the taxpayer wishes to transfer assets in return for a stream of payments or access to property over a term of years. These are especially attractive now because the historically low interest rates applicable to these transactions minimizes the value of the retained interest.
- Ø Implementing a “qualified personal residence trust”, or “QPRT”, for one’s residence. In this transaction, a taxpayer transfers the home out of his/her name into the name of the QPRT. The taxpayer retains the legal right to continue living in the residence for a set term of years. At the end of the term, the residence passes to the taxpayer’s children or other family members. The taxpayer’s gift that is reported to the IRS is substantially reduced by the value of the retained interest.

There is another reason to consider implementing these transfer techniques in the near future. Asset values – both real estate and securities – are generally depressed. Therefore, the gift and estate tax savings from implementing these ideas are substantially magnified.

***Conclusion: Higher net worth individuals should consider implementing one or more of the techniques described above before January 1, 2009 due to: (i) possible changes in tax legislation or administration that would restrict or eliminate these techniques, (ii) the low interest rates applicable to certain family transactions, and (iii) the depressed values of real estate and stocks.***

### **Further Assistance**

This summary is intended only as a general overview of current income tax issues and selected estate planning opportunities, and cannot be relied on as investment, legal, or tax advice. If you have any questions or if you would like specific guidance as to how these matters may relate to your particular situation, please contact one of our attorneys.

## **GOMEL & DAVIS, LLP** **ATTORNEYS AT LAW**

(404) 223-5900

[www.gomeldavis.com](http://www.gomeldavis.com)

700 MARQUIS TWO TOWER  
285 PEACHTREE CENTER AVENUE, N.E.  
ATLANTA, GEORGIA 30303-1230

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