Personal Planning Practice Group
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Alert

President-Elect Barack Obama's Tax Proposals

As President-elect Obama prepares to take office in January, many observers are trying to anticipate the changes that may be made to the federal tax laws. Any tax legislation will take many months to gain the support and approval of Congress and may undergo substantial changes before being enacted into law. Nonetheless, this seems an appropriate time to review the President-elect's tax proposals that may affect our clients, in both the estate tax and income tax areas.

Estate Tax Changes

1. Applicable Exclusion Amount and Estate Tax Rates

Under current law, the first $2 million of an individual's estate will pass without incurring federal estate taxes. (This is referred to as the "federal estate tax exclusion amount".) The exclusion amount is $2 million for individuals who die in 2008 and will rise to $3.5 million for individuals who die in 2009. The top marginal estate tax rate for estates over the exclusion amount is 45% in 2008 and will remain at that rate until 2010. The estate tax is set to be repealed completely in 2010, and then return in 2011 with the higher rates and the lower exclusion amount in effect in 2001. (This is referred to as a "sunset" provision.) Most commentators think that Congress will "repeal the repeal" – that is, take steps to enact permanent estate tax reform before the repeal takes effect in 2010. President-elect Obama has endorsed this. He has proposed that the federal estate tax exclusion amount remain at the 2009 amount of $3.5 million and that the top marginal estate tax rate remain at 45%.

While President-elect Obama has made no proposals regarding the gift tax laws, practitioners are hopeful that any future legislation will include an increase in the amount an individual may transfer during his or her life without incurring gift taxes (referred to as the "federal gift tax exclusion amount") to equal the federal estate tax exclusion amount. This is referred to as "unification" of the gift tax exclusion and the estate tax exclusion amounts. Currently, the federal estate tax exclusion amount is "decoupled" from the federal gift tax exclusion amount. An individual may transfer up to $1 million during his or her life without incurring gift taxes, and, as noted, may transfer a total of $2 million (rising next year to $3.5 million) at his or her death (including any transfers made during his or her life) without incurring estate taxes. Unifying the amount an individual may transfer during life and at death would be easier for taxpayers to understand and would create increased opportunities for wealth transfer during a taxpayer's lifetime.

2. "Portability"

Another important concept that President-elect Obama has endorsed is the "portability" of the federal estate tax exclusion amount in the case of husbands and wives. Today, the exclusion amount applies to each person individually. In order to ensure that a

married couple gets the full benefit of the federal estate tax exclusion (i.e., currently $4 million per married couple rising to $7 million per married couple in 2009), planning techniques must be used to "preserve" the exclusion amount at the first spouse's death. Most practitioners recommend the creation of a "credit shelter trust" to accomplish this. With portability, the exclusion amount would be transferable from one spouse to another, enabling a surviving spouse to make use of a deceased's spouse exclusion amount if that was not properly planned for during the deceased spouse's lifetime.

Even if the portability concept becomes law, however, there will be many important reasons for couples to consider making full use of each spouse's exclusion amount in his or her own estate plan rather than waiting until the second spouse's death. For instance, current planning techniques involve the creation of a credit shelter trust, funded with the first spouse's exclusion amount, at the death of the first spouse. The property in this trust can continue to grow over the lifetime of the surviving spouse, and the trust offers the advantage of entirely removing that appreciation from the imposition of the federal estate tax. If, instead, a couple takes advantage of portability and waits until the death of the second spouse to make use of the first spouse's exclusion amount, the couple will lose that opportunity, and the appreciation on that property may be subject to federal estate tax at the second spouse's death.

In addition, it is currently not possible to allocate the first spouse's exemption from generation skipping transfer ("GST") taxes after the due date for the filing of his or her federal estate tax return. Unless this issue is addressed in connection with portability, taking advantage of portability may cause the loss of the use of the first spouse's GST exemption. Finally, since each state's estate tax laws and exclusion amounts may be different from the federal law, planning techniques which make use of each spouse's exclusion amount individually may still be required to protect against an undesirable state tax result.

3. Basis for Calculating Capital Gains on Sale of Estate Assets

The long-standing method for calculating capital gains on the sale of estate assets uses either the value of estate asset at the decedent's date of death or the value six months after the decedent's date of death as the basis of the estate asset. This system is referred to as the "stepped-up basis" system. The stepped-up basis system means that surviving family members do not have to determine the decedent's original cost of an estate asset when calculating capital gains upon the sale or disposition of that asset. The stepped-up basis system is scheduled to continue until 2010, when, as part of the "sunset provisions" of the current law, the calculation of capital gains on the sale of estate assets will become much more complex.

After 2010, the calculation of capital gains on the sale of estate assets will use the decedent's original cost as the basis of the estate asset (referred to as the "carry-over basis" system). The carry-over basis system will require surviving family members to determine what a decedent originally paid for his or her assets. Most practitioners believe that the carry-over basis system will be prohibitively complex to implement and is, as a practical matter, unworkable. President-elect Obama proposes to maintain the current stepped-up basis system of using the asset's value as of the date of the decedent's death for calculating capital gains.

Income Tax Changes

President-elect Obama favors tax cuts for middle-class workers and tax increases for top earners (families earning more than $250,000 and individuals earning more than $200,000 per year). He has proposed to raise the top two marginal income tax rates to 36% and 39.6%, from 33% and 35%. With respect to capital gains and dividends, President-elect Obama proposes to raise the tax rate to 20% from 15% for those earning more than $250,000 per year.

He also proposes to reinstate the phase-out of the personal exclusions and itemized deductions for married couples making more than $250,000 per year. Some commentators estimate that the phase outs will raise the top marginal tax rate by another 1.5 percentage points. Finally, President-elect Obama proposes to lift the cap on income on which the Social Security payroll tax is applied and increase payroll tax rates above $250,000 by two to four percentage points. These changes taken together are estimated to increase the marginal rate by 10 percentage points for those making more than $250,000 per year.

The turmoil in the financial markets, which has worsened since the election, may persuade President-elect Obama and his advisors to revise these proposals and to defer tax increases. The Obama team may decide to leave the current income tax rates (which were part of the Bush administration's 2001 tax cuts) in place next year and let them expire in 2010, as they are now scheduled to do.

Stay Tuned!

President-elect Obama's tax policy proposals contain many significant changes to the existing estate tax and income tax laws. The proposals could undergo major revisions in the weeks ahead. Once new legislation is enacted, we suggest you contact your estate planning advisor to determine whether any changes in your estate plan are advisable as a result of the changes to the tax law.

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