

An Update from Washington: Impending Income, Gift and Estate Tax Law Changes

NOVEMBER 14, 2012



Agenda

- Post Election Review
 - *Presented by Rob Smith*
- Tax Policy Following the Elections: What Happens Next
 - *Presented by Sam Olchyk*
- Taxmageddon: What Should We Do Now That the Election is Over?
 - Discussion of Income Taxes and the New Medicare Tax
 - *Presented by Brian O'Connor*
 - Discussion of Estate and Gift Taxes
 - *Presented by Sarah Johnson, Jeanne Newlon, A. Christopher Segal*



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Agenda

- The President is re-elected
- The composition and dynamics of the newly elected Congress
- Impact on Tax Policy (including the year-end expiration of the Bush-era tax cuts)
- Potential for and implications of Tax Reform
- Approaches towards resolution of the “fiscal cliff”
- Continued viability of Obamacare and healthcare reform



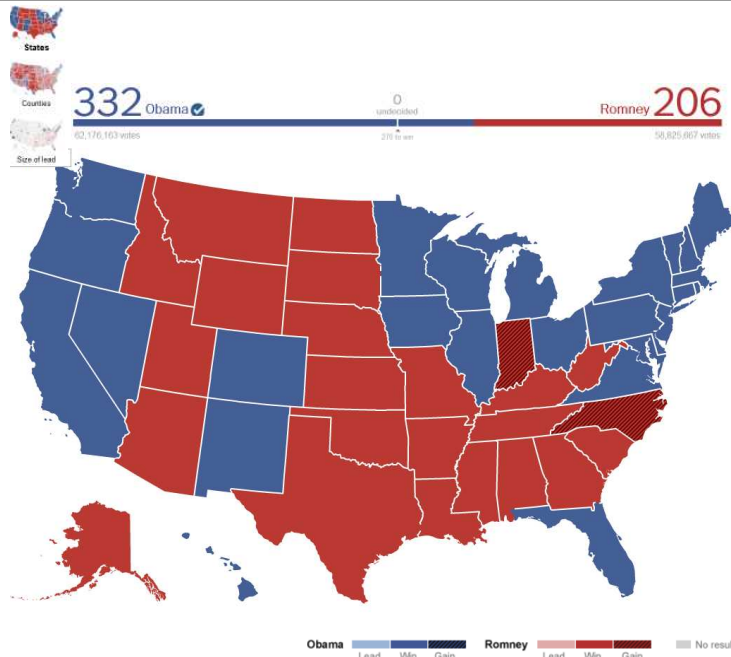
Four More Years



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How the President Won?

- States that mattered
- The ground game
- Counties and cities



Why the President Won?

- Merit
- Romney flaws
- Demographics
- Disciplined campaign
- Powers of incumbency



The Economist. July 14, 2012

- “Mr. Obama and Mr. Romney disagree only on what would make things worse: re-electing a left-wing president who has regulated to death a private sector he neither likes or understands; or swapping him for a rapacious private-equity man bent on enriching the very people who caused the mess.”



The Senate

- Democrats (53)
- Independents (2)
- Republicans (45)



Key Races

- Indiana
- Massachusetts
- Missouri
- Montana
- Nevada
- North Dakota
- Virginia
- Wisconsin



Leadership

- Harry Reid (Nevada) retains majority leader
- Dick Durbin (Illinois) stays majority whip
- Mitch McConnell (Kentucky) retains minority leader
- John Cornyn (Texas) becomes minority whip



Important Committee Chairs

- Finance Committee



Max Baucus (D-MT),
Chairman

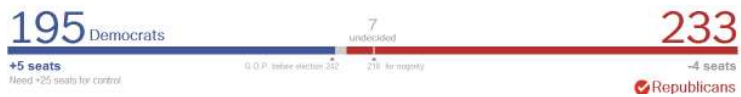


Orrin Hatch (R-UT),
Ranking Member



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The House



Source: NYTimes, 11/13/12

Dem. Lead Win Rep. Lead Win Ind. Lead Win No results



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New House Make-Up

- Democrats (195)
- Republicans (233)
- Undecided (7)



States That Really Mattered (House)

- California
- Illinois
- New Hampshire
- New York
- North Carolina



Leadership

- Speaker Boehner (Ohio) returns
- Leader Cantor (Virginia) returns
- Majority Whip McCarthy (California) returns
- Speaker Pelosi (California) returns
- Leader Hoyer (Maryland) returns
- Minority Whip Clyburn (South Carolina) returns

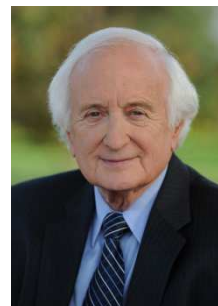


Important Committee Chairs

- Ways and Means Committee



Dave Camp (R-MI),
Chairman



Sander Levin (D-MI),
Ranking Member



Interesting Characters

- Allen West
- Mary Bono-Mack
- Mia Love
- Richard Tisei
- Kelly Bontivolio
- Kyrsten Sinema



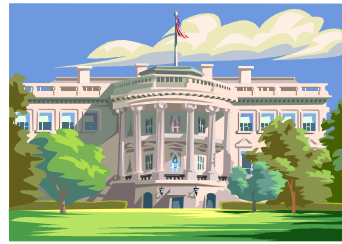
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It's all Over –
but Lots and Lots of Crying



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TAX POLICY FOLLOWING THE ELECTIONS: WHAT HAPPENS NEXT?



NOVEMBER 2012

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Overview

- What is the “Fiscal Cliff”?
- Post-Election (“Lame Duck”) Session
- Potential Tax Reform
- Emphasis on New Revenue
- Final Observations



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What is the “Fiscal Cliff”?



What is the “Fiscal Cliff”?

- The “fiscal cliff” is the combination of unrelated fiscal policy events caught in the political atmosphere:
 - Taxmageddon
 - Sequestration
 - Lurking: further increase in the debt ceiling



Taxmageddon Defined

- “Taxmageddon” – expiration of tax provisions on 12/31 that will increase taxes by \$494 billion in 2013.
- Key provisions from 2001 and 2003 legislation:
 - Tax rates, marriage penalty, child credit (\$150B)
 - AMT “patch” (\$122.2B)
 - Reduction in estate & gift tax rates (\$31.2B)
 - Increased capital gains & dividend rates (\$25.9B)
- Other key provisions:
 - Payroll tax cut (\$125B)
 - Medicare tax on passive income (\$23B)
 - Medicare “doc fix” payments (\$10B)



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Sequestration: Mandatory Spending Cuts

- Last year’s budget agreement mandated a process (“sequestration”) that will automatically cut spending by \$1.2 trillion for fiscal years 2013 – 2021 if the “super committee” failed in its efforts.
 - Scheduled to take effect on January 3, 2013
 - Evenly divided between defense and non-defense
 - Eligible defense programs cut by 10%
 - Eligible non-defense or “discretionary” programs cut by 8.5%
 - Payments to Medicare providers cut by 2%
 - \$109+ billion in yearly savings required to avoid sequestration (50% defense and 50% non-defense).



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What is the “Fiscal Cliff”?

Wild Card: Increasing the debt ceiling limit

- Last year’s budget agreement reached hours prior to the U.S. reaching its statutory borrowing limit.
- Current borrowing limit: \$16.394 trillion
- Current debt: Approximately \$16.16 trillion (\$235B below the ceiling as of 10/31)
- Treasury expects to reach limit in late 2012; can use “extraordinary measures” to delay effect until early 2013.



Post-Election (“Lame Duck”) Session



Post-Election Session

- House and Senate have scheduled work period starting on Tuesday, November 13.
- Likely adjournment date – Friday, Dec. 21.
- “Must-pass” vs. “important” lame duck legislation:
 - Must-pass: AMT “patch”
 - Must-pass/important: delay sequestration
 - Must-pass/important: extend tax cuts
 - Important: tax reform



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Scheduled 2013 Individual Tax Rates*

Description	Current rates	Scheduled rates for 2013	Other additions
Individual income tax rates	10%; 25%; 28%; 33%; 35%	15%; 28%; 31%; 36%; 39.6%	Individuals with income over \$250,000 (joint) or \$200,000 (individual) face Medicare tax increases of: <ul style="list-style-type: none"> ▶ 0.9% on wages (on amounts exceeding threshold) and ▶ 3.8% on the lesser of: <ul style="list-style-type: none"> ▶ Net investment income (e.g., interest, dividends, capital gains) or ▶ Excess of modified AGI on amounts over the \$250,000/\$200,000 threshold
Qualified dividends	0%; 15%	Individual income tax rate, with top rate of 39.6%	
Long-term capital gains	0%; 15%	20%	
Estate tax	35% top rate; \$5 million exemption	55% top rate; \$1 million exemption	

* If no legislation is enacted

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Key Expired and Expiring Business Tax “Extenders”

Expired – 2011	Expiring – 2012
100% of additional first-year depreciation of qualified property placed in service in 2011	Extension of 50% additional first-year depreciation for qualified property placed in service in 2012
Research and experimentation tax credit	Renewable energy production tax credit
15-year straight-line recovery for certain leasehold improvements	WOTC targeted to hiring qualified veterans
Exceptions under subpart F for active financing income	Section 179 expensing (125K/500K)
Section 179 expensing to the 2011 levels (500K/2MM)	
Expensing for film and television production	
Look-through treatment of payments between related controlled foreign corporations	
Work Opportunity Tax Credit for targeted groups	
Section 1603 grants in lieu of energy tax credit	



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President Obama’s Tax Priorities

Tax	Current	President Obama’s Proposals
Top individual tax rate	35% (set to increase 39.6% in 2013) excluding the 0.9% Medicare payroll tax on high-income taxpayers.	Extend lower Bush-era tax rates for families making less than \$250,000 a year. Allow tax rates for families earning more than that to increase.
Top corporate tax rate	35%	Change to 28% Lower top corporate rate to 28% by limiting deductions. Create new incentives for companies to bring jobs back to U.S. Add incentives for manufacturers.
Dividends	15% top rate increasing to 43.4%* in 2013	43.4%* rate for top earners
Long-term capital gains	15% top rate increasing to 23.8%* in 2013	23.8%* long-term rate for top earners
Estate tax	35% top rate for estates over \$5 million, reverting to 55% in 2013 for estates over \$1 million.	45% top rate for estates over \$3.5 million



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*Includes 3.8% Medicare tax on high-income taxpayers beginning in 2013

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Post-Election Session: Possible Scenarios for the Obama Administration (status quo Congress)

- Scenario 1: short-term extension (3-6 mos.) during lame duck; “grand bargain” reached in 2013
 - AMT patch extended for 2012
 - Budget savings to offset cost of delay
 - 2001-03 tax cuts extended for same duration
 - Business tax extenders

- Scenario 2: Extension (for 2013) early next year
 - Increase in debt ceiling limit
 - Sequestration delayed (with budget offsets)
 - AMT patch (either stand alone in 2012 or early 2013)
 - 2001-03 tax cuts extended for all but high-income tps: Is the cut-off at 250K? 500K? \$1 million?
 - Withholding tables adjusted via Executive order?



Potential Tax Reform



Potential Tax Reform

- Most likely in later 2013 (could slip to early 2014)
- Extraordinary challenges
 - Additional revenue (political and budgetary)
 - “Base broadening” = winners and losers
 - Business reform tensions
 - Corporate vs. pass-through businesses
 - Domestic vs. international
 - Manufacturing vs. service sectors
 - Individual reforms
 - Distributional effects



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Potential Tax Reform – Key Elements (continued)

- President Obama's *Framework for Business Tax Reform*:
 - Reduce corporate tax rate to 28%
 - Manufacturing income at 25% with enhanced section 199 deduction (to 10.7%)
 - Increase R&D credit to 17% and make permanent
 - Eliminate dozens of unspecified tax expenditures
 - Reduce distortions
 - “By allowing large pass-through entities preferential treatment [i.e., no entity-level tax], the tax code distorts choice of organizational form...”
 - “Reducing the deductibility of interest for corporations should be considered as part of tax reform.”
 - Current depreciation schedules generally overstate economic depreciation.



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Potential Tax Reform – Key Elements (continued)

- W&M Chairman Camp's tax reform package
 - 25% corporate tax rate (no specifics)
 - Exempt 95% of certain foreign-source income received by 10% U.S. corporate shareholders from CFCs
 - Treat foreign branches as CFCs
 - Anti-abuse rules
 - Subpart F rules for passive income
 - Thin capitalization rules (limit domestic overleveraging)
 - Rules to prevent transfer of IP to low-tax jurisdictions



Emphasis on New Revenue



Emphasis on New Revenue

- Insatiable appetite for revenue
 - Delay effects of sequestration
 - Offset part of tax cuts/extenders
 - Tax reform (particularly with AMT repeal)
 - Increase in debt ceiling

- Everything “on the table”: Incentives considered sacrosanct for decades will be considered and trimmed back.



Emphasis on New Revenue (continued)

Top 10 Tax Expenditures, 2013

Provision	Billions of Dollars
Exclusion of employer contributions for medical insurance	180.6
Deductibility of mortgage interest on owner-occupied homes	100.9
401(k)-type pension plans	72.7
Deductibility of state and local taxes, including property tax	68.6
Capital gains special tax rate	62.0
Employer-provided pension plans	52.3
Exclusion of net imputed rental income	51.1
Charitable contributions	48.9
Exclusion of interest on state and local bonds	36.2
Accelerated depreciation on machinery and equipment	33.2
Top 10 total	796.5

Bruce Bartlett, "The Real Barrier to Tax Reform", *New York Times*, Oct. 30, 2012, citing Office of Management and Budget



Emphasis on New Revenue (continued)

- Vulnerable individual expenditures
 - Mortgage interest deduction
 - Charitable contributions
 - State and local taxes
 - Miscellaneous itemized deductions
 - Overall limits on itemized deductions
 - Retirement savings
 - Estate tax techniques (valuations and structures)
 - Individual credits (education credits, energy-related credits, dependent care credit, etc.)



Emphasis on New Revenue (continued)

- Vulnerable business expenditures
 - Accelerated depreciation
 - Methods of accounting (LIFO, LCM, etc.)
 - Deduction for domestic production activities
 - Limitation on interest expense deduction
 - General business credits
 - Provisions that defer income recognition (such as like-kind exchanges and installment sales)
 - Insurance tax rules
- Other: Imposition of Carbon Tax?

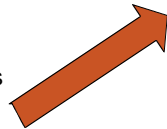


Final Observations



Final Observations - Be Prepared and Pro-active

2012	2013
<ul style="list-style-type: none"> ▪ Remain transactionally nimble ▪ Some present law rates may be “as good as it gets” ▪ Opportunities to maximize capital gains and dividends ▪ Tax reform: Tax staffs want to hear from companies <u>now</u> 	<ul style="list-style-type: none"> ▪ Income taxes will increase ▪ Tax reform <ul style="list-style-type: none"> • Most promising time frame is the last six months • Analyze economic implications of: <ul style="list-style-type: none"> → President Obama's Framework for Business Tax Reform → Ways & Means Chairman Camp's international tax reform package



TAXMAGEDDON: WHAT SHOULD WE DO NOW?

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November 14, 2012



TAXMAGEDDON – INCOME TAX

- ❑ High Income Earners are defined as adjusted gross income of \$200,000 for single taxpayers and \$250,000 for married couples filing jointly. These are the “magic numbers.”
- ❑ Historic health care law subjects unearned income to Medicare taxes.
- ❑ Those W-2 earners over the magic numbers will also be subject to a higher Medicare tax on their earned income.



TAXMAGEDDON – INCOME TAX

- ❑ Top overall ordinary income and Medicare tax rate on earned income for employees with incomes in excess of the magic numbers increases from 36.45% to 41.95%.
- ❑ Top overall ordinary income and Medicare tax rate on unearned income (other than qualified dividends) for individuals with incomes in excess of the magic numbers increases from 35% to 43.4%.
- ❑ Top overall ordinary income and Medicare tax rate on qualified dividends for individuals with incomes in excess of the magic numbers increases from 15% to 43.4%
- ❑ Top overall long-term capital gain and Medicare tax rate for individuals with incomes in excess of the magic numbers increases from 15% to 23.8%.

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TAXMAGEDDON – INCOME TAX What's on the Horizon?

- ❑ Limit the value of itemized deductions and exclusions to 28% for taxpayers over the magic numbers.
- ❑ Extend Bush income tax cuts for those taxpayers under the magic numbers.
- ❑ Tax ordinary income and dividends of taxpayers over the magic numbers at 39.6%.
- ❑ Tax capital gains at a rate of 20% for taxpayers over the magic numbers.

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TAXMAGEDDON – PLANNING IDEAS

- ❑ If you are planning to sell at a gain, sell now!
 - consider foregoing installment sale treatment
 - consider related party sales
 - consider corporate-to-LLC conversions

- ❑ If you are planning to sell at a loss, sell later!

- ❑ If you are planning to pay a dividend, pay it now!
 - C corporation dividends
 - S corporation dividends
 - Foreign Company dividends



TAXMAGEDDON – PLANNING IDEAS

- ❑ If you can take or leave income, take it now!

- ❑ If you can postpone an expense, pay it later!

- ❑ If you can fund a pension plan after 2012, fund it as much as you can!

- ❑ If you can qualify as “active” in the business of a pass-through entity, find a way to get it done! Don’t be passive!



TAXMAGEDDON – PLANNING IDEAS

- ❑ Sell dividend stocks?
- ❑ Buy a second home?
- ❑ Invest in tax-exempt bonds?
- ❑ Acquire life insurance?
- ❑ Acquire rental property?
- ❑ Shift income to your kids?
- ❑ Forego a carried interest?

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TAXMAGEDDON: ESTATE TAX

- ❑ Currently there is an Estate, Gift and Generation-skipping Transfer Tax exemption of \$5,120,000. Amounts in excess of this exemption are taxed at 35%.
- ❑ The Gift and Estate Tax exemption is scheduled to decrease to \$1,000,000 in 2013 (\$1,340,000 for the GST tax exemption). Amounts in excess of this exemption are taxed at up to 60% if Congress fails to act.
- ❑ The Obama Administration's Budget Proposals anticipate an exemption of \$3,500,000 for Estate and Generation-skipping Transfer Taxes, with only a \$1,000,000 exemption for Gift Tax.

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TAXMAGEDDON “TIER ONE” GIFTING IDEAS

- ❑ Outright cash gifts to children or grandchildren
- ❑ Outright gifts of real property, expensive art work, collectibles and/or illiquid assets
- ❑ Forgiveness of intra-family loans, including past loans arising in connection with installment sales to trusts



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TAXMAGEDDON “TIER TWO” GIFTING IDEAS

- ❑ Dynasty Trust – gifts to a trust for the benefit of children, grandchildren and more remote descendants
- ❑ Sale to an Intentionally Defective Grantor Trust - a gift of the “seed equity” could be much higher at 15% to 25% rather than 10%
- ❑ Charitable Lead Trusts



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TAXMAGEDDON INSURANCE GIFTING IDEAS

- ❑ Pre-pay life insurance premiums into an existing life insurance trust
- ❑ Gift large cash value life insurance policies to an Insurance Trust
- ❑ Sell large cash value insurance policies to or between Insurance Trust(s)



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TAXMAGEDDON – GIFT PLANNING FOR RESIDENCES

- ❑ Gift and Lease-Back
 - Consider Lease-back from a Grantor Trust
 - Retain Substitution Powers
- ❑ QPRTs
- ❑ QPRT Remainder Purchases
- ❑ Bona-fide Appraisals Required for all Transfers



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TAXMAGEDDON GRANTOR RETAINED ANNUITY TRUSTS

- Grantor Retained Annuity Trusts (GRATs)
 - Current Low “Hurdle Rates”
 - “Zeroing-Out” still an Option
 - Remainder Sales to Eliminate Mortality Risk
- Obama Administration Proposes to Restrict this Technique by setting a minimum trust term and requiring a taxable gift



TAXMAGEDDON ACCESS TRUST GIFTING

- Spousal Limited Access Trust – or “SLAT”
 - Husband creates \$5 million trust for the benefit of Wife and children and/or Wife creates \$5 million trust for the benefit of Husband and children
- Caution Regarding “Reciprocal Trusts”
 - Need to vary the terms of the two trusts so that they are not identical; Otherwise, you risk estate tax inclusion



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QUESTIONS?



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