Foreshadowing Change Again?

President Obama previously released his 2016 federal budget proposal. This budget proposal recommends limitations to drive income tax and to limit retirement account benefits further. It also recommends substantial changes to wealth transfer tax laws. It further recommends reducing or eliminating the use of successful wealth transfer and family succession planning techniques. The following will summarize the President’s proposed changes that he would like take effect within the next year for your convenience.

Income Tax

Eliminating Stock Sale Techniques
Taxpayers currently can choose to sell stocks by lot or by choosing a method that assumes sales of stocks according to default basis rules such as first in first out (FIFO) or last in first out (LIFO). The President’s budget proposal would change this by requiring taxpayers to report all stock sales based on the average cost basis of the position owned. This would bring stock sale reporting in line with mutual fund sale reporting and eliminate the ability of investors to choose the best (lowest) tax result available for each stock sale.

Apply Health Care Surtax to S Corporations
Taxpayers who own S Corporations currently can make choices between receiving earned income (subject to) and dividend income (not subject to) employment taxes. Taxpayers therefore have made income payment and dividend distribution decisions designed in part to minimize the amount of wage income on which they pay employment taxes. These employment taxes include the 2.9% Medicare and 0.9% surtax on employment income (3.8% total).

The President’s budget proposal would subject any S Corporation dividend distributions to the 3.8% Surtax created under the Health Care Act which previously was not applied to self-employment income. This would ensure that all S Corporation distributions would pay an additional 3.8% Surtax regardless of whether they were made in the form of wages or dividends.

1031 Exchange Limit
Under current law, real estate investors can exchange any current property with another similar investment and defer gain until sale of the last owned property. The President’s budget proposal would limit investors to defer only $1 million of capital gains in any particular year. Any profit exceeding this $1 million limit would be treated as a sale subject to immediate capital gains tax.
Retirement Accounts

Capping Retirement Accounts
Taxpayers currently can accumulate any amount in qualified retirement accounts subject only to their yearly contribution limits. The President’s budget proposal would change this by capping lifetime retirement account contributions at approximately $3.4 million based on a hypothetical 62 year old. No further contributions would be allowed thereafter; however, tax deferred growth on the remaining account balance would be permitted. The threshold is designed to limit retirement benefits to the equivalent of purchasing a lifetime annuity with $210,000 annual benefit.

Eliminating Stretch IRA Benefits
Taxpayers who inherit qualified retirement accounts currently can stretch payout of their benefits over their lifetime. The President’s budget proposal would change this by only permitting certain beneficiaries to enjoy that benefit. For this purpose, only beneficiaries who are (1) disabled, (2) minors (until age 18) or (3) not more than 10 years younger than the account owner could stretch benefit payouts. All other beneficiaries would be required to withdraw all inherited IRA benefits within 5 years of the original account owner’s death. This would greatly accelerate the payment of income taxes on inherited IRA benefits by all beneficiaries other than those excluded above.

Subject Roth IRAs to RMD Requirements
Taxpayers currently can choose never to withdraw assets from their Roth IRAs even after attaining age 70 and 1/2. This distinction has driven conversions and savings within Roth IRAs because account owners can choose to spend these accounts last during retirement or otherwise leave them to benefit family. The President’s budget proposal would change this by requiring account owners to begin taking Required Minimum Distributions from their Roth IRAs by the time they attain age 70 and 1/2. This proposal is designed to bring Roth IRA distribution rules in line with traditional IRAs; however, it also is designed to prevent ongoing tax free growth currently available to owners who leave these accounts to family beneficiaries.

Eliminate “Back Door” Roth IRA Contributions
Since 2010, taxpayers of any income level could make a Roth IRA conversion from a traditional IRA or even from a non-deductible IRA account. This latter conversion has been referred to as a “back door” Roth IRA contribution because it’s used by high income earners to fund a Roth IRA for which they otherwise would not be eligible under normal income limitations. The President’s budget proposal would eliminate the back door Roth IRA conversion along with any other conversion of post-tax dollars from a retirement account to a Roth IRA. This latter technique has been referred to as the “mega backdoor Roth conversion” and was approved previously by the IRS under its Notice 2014-54. This proposal is designed to prevent any conversion of post-tax dollars from a traditional retirement to a Roth IRA.

Estate Tax
The President’s budget proposal intends to minimize or eliminate the benefits of using the following planning techniques.

Intentionally Defective Irrevocable Trust (“IDIT”)
An IDIT is a type of trust to which transfers are deemed complete for gift and estate tax purposes but incomplete for income tax purposes. This technique has proved successful because it allows a taxpayer to sell assets to the IDIT without triggering any
corresponding capital gains tax. This technique also has proved successful because the IRS does not treat the taxpayer’s ongoing payment of income taxes as additional gifts to the trust.

Why would someone want to give assets away but retain income tax liability related to them? These tax payments foster preservation and growth of IDIT assets. These payments also allow taxpayers to remove assets from their estates that would be subject to future estate taxes.

The President’s proposed budget would eliminate the benefits of IDITs by treating all beneficiary distributions as gifts during the taxpayer’s lifetime. The President’s proposed budget further recommends that all remaining IDIT assets be subject to estate tax at the taxpayer’s death.

Grantor Retained Annuity Trust (“GRAT”)

A GRAT is a type of gift trust that allows a taxpayer to transfer property while retaining the right to receive an annuity payment for a term of years. Thereafter, the remaining assets of the GRAT will benefit other family members. The value of the family gift for these purposes will equal the difference between the property’s value and the taxpayer’s retained annuity value.

Family businesses with low values that are expected to appreciate have been used for gifting through a GRAT. The most famous example of this type of GRAT planning involved the transfer of Walmart stock within the family of Sam Walton. Sam Walton created a series of short-term GRATs funded with Walmart stock, and his required annuity payments exactly equaled the value of the stock. This resulted in no initial gift by Mr. Walton to his family and ultimately removed all of the gifted stock from his estate (at no tax cost) as he survived each GRAT term.

The President’s proposed budget would mandate that GRATs remain in existence for at least 10 years. This would eliminate the use of successful, short-term GRATs like those created by Sam Walton. It also would increase the likelihood of death during the GRAT term (which would subject the remaining GRAT assets to estate tax).

Dynasty Trusts

States previously had maintained “rules against perpetuities” to force the distribution of trust assets to beneficiaries within a measurable time period. Many states since have extended their rules against perpetuities allowing trusts to last forever. Estate planners have used these changes to create perpetual “dynasty” trusts that can benefit several generations without becoming subject to transfer taxes over time. The President’s proposed budget would restrict the lifespan of dynasty trusts to 90 years and subject their assets to transfer taxes then.

Limiting Annual Exclusion Gifts to Trusts

Taxpayers currently can gift $14,000 outright to any one or more person(s) at any time during the year without it being treated as a taxable gift. These gifts are referred to commonly as “annual exclusion gifts”.

Some taxpayers prefer to make gifts to trusts for the benefit of their family. In order to qualify as an annual exclusion gift; however, the gift in trust must represent a “present interest”. In order to qualify as a gift of a present interest, a prior court case held that the beneficiary must have a right to withdraw the gift from the trust for at least a limited period of time. Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968). Gifts in trust that apply the technique blessed by this court case are often referred to as “Crummey” gifts.

Under current law, a taxpayer could make multiple Crumme gifts to a trust for family members each year. If the trust would have 10 beneficiaries, for instance, a taxpayer could make $140,000 of
Crummey gifts to that trust (or $280,000 if his spouse would join in making those gifts). This has provided a powerful tool for taxpayers to shift wealth through trust gifting for their descendants (especially if the trustee would use the gifts to leverage the purchase of an insurance policy).

The President’s proposed budget would limit the total annual exclusion gifts to $50,000 when using this technique. By doing so, the President’s proposed budget would significantly limit the power of using Crummey gifts when funding trusts for the benefit of families.

Limit Basis Step Up at Death
Under current law, when a taxpayer dies, all of his assets acquire a new basis equal to their respective date of death value for Federal estate tax purposes. This provides taxpayers’ families with a chance to (1) resolve missing basis on long term assets and (2) limit subsequent capital gains when selling those assets.

The President’s proposed budget would eliminate the basis step up rule and replace it instead with a deemed sale of all assets at death to collect capital gains except for limited situations involving (1) personal property, (2) a spouse’s inheritance, (3) a residence and (4) limited other assets. These limited exclusions would (1) protect all personal property from capital gains tax, (2) not apply to a spouse’s inheritance, (3) also not apply to a residence and (4) not apply to the first $100,000 of other estate assets.

A spouse would receive her inheritance with full carry over (original) basis and inherit the residence with the predeceased spouse’s $250,000 capital gains sale exclusion intact to combine with her own if later sold.

Lifetime gifts (except for spousal gifts) similarly would be treated as deemed sales of the assets gifted away to collect capital gains tax immediately. Under current law, gifted assets carry basis over to a beneficiary who can defer any capital gain until a later sale of the gifted asset.

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