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Moving Forward in 2013: The Long-Awaited “Green Book” 2014 Budget Proposals

Spring brings government budgets and taxes. And as with Spring, sometimes budgets come later than expected. Taxes, however, are always on schedule.

The Administration released its proposed Fiscal Year 2014 Budget on Wednesday, April 10th and Treasury published the accompanying General Explanations, commonly referred to as the “Green Book,” immediately thereafter. Both arrived later than expected. The Congressional Budget Act of 1974 requires Congress to write a budget each year and instructs the President to submit a proposal for consideration by the first Monday of February (February 4th this year).

The House of Representatives Budget Committee previously released its fiscal year 2014 budget resolution, “The Path to Prosperity: A Responsible Balanced Budget.” The Senate Finance Committee also previously released its fiscal year 2014 budget resolution, “Foundations for Growth: Restoring the Promise of American Opportunity.” The Administration’s budget proposal and Congress’ resolutions are more than numbers on a page to balance (or not). They reflect policy priorities, with expenditures funded by tax revenue. Congress has commenced hearings on the Administration’s 2014 budget proposal and we anticipate that the conversations will be ongoing in the weeks and months ahead. In this Tax News we highlight a number of the Administration’s proposals of particular interest for individual income and wealth transfer tax planning.

The Administration’s Budget

The Administration projects its budget will reduce the deficit by an additional \$4.3 trillion over the next 10 years—in line with the non-partisan Bowles-Simpson Commission’s recommended figure for deficit reduction. Based on current Administration estimates the effect would be to lower the deficit to 2.8 percent of the U.S. economy by 2016, and further to 1.7 percent by 2023.

Chained Consumer Price Index

Numerous federal tax provisions and government benefits are regularly adjusted for inflation. The type of provision and how the inflation adjustment is calculated can have a significant impact on tax revenue and government expenditures, particularly over extended periods. Presently adjustments are made based on the consumer price index (CPI). The Administration proposes to substitute what is referred to as “chained CPI” for CPI. The Congressional Budget Office projects that the chained CPI will increase at an average annual rate 0.25 percentage points less than CPI.

The effect of using chained CPI to compute changes in individual income tax brackets over time would be to cause increased amounts of income to be taxed in higher tax brackets, thus increasing tax revenue. On the government expense side, benefits such as Social Security

would be adjusted at a lower rate, thus slowing the rate of growth.

Tax-Preferred Retirement Accounts

Tax-preferred retirement accounts such as 401(k) plans and individual retirement accounts (IRAs) are a common means of saving for retirement. The 2014 proposed budget contains multiple provisions affecting tax-preferred retirement accounts including automatic employee enrollment in IRAs, elimination of required distribution rules for small IRA balances, required inherited beneficiary distribution payments over no more than 5 years and a limit on the total accrual of tax-favored retirement benefits.

The proposal seeks to encourage retirement savings by requiring “payroll deduction IRAs” to be provided by employers in business for at least two years that have more than 10 employees if the employer does not sponsor a qualified retirement plan, SEP or SIMPLE for employees. The objective is to increase the rate of employee participation in retirement savings even if the employer does not sponsor a plan. Similar automatic enrollment requirements (requiring an election by an employee to opt out) for employer sponsored qualified retirement plans under the Pension Protection Act of 2006 were effective to substantially increase employee participation in retirement savings.

Individuals are generally required to receive “required minimum distributions” from qualified retirement plans and IRAs shortly after attaining age 70-1/2, in order to prevent ongoing tax-free build-up of accounts. For purposes of simplification, the proposal exempts individuals from the minimum required distribution requirements if the aggregate value of the individual’s traditional IRA, Roth IRA and tax-favored retirement plan accumulations does not exceed \$75,000 (indexed for inflation).

Conversely, the proposal generally limits the timeframe within which an individual is required to take inherited distributions from a qualified retirement plan or IRA to no more than 5 years. Presently, the rules with respect to inherited distributions to a beneficiary vary depending on the age of the deceased owner and the identity of the beneficiary. In some circumstances distributions may be extended over the life expectancy of the beneficiary. Under the proposal, non-spouse beneficiaries would be required to take distributions over no more than 5 years, subject to certain exceptions for “eligible beneficiaries,” including, for example, a child who has not attained the age of majority or a disabled or chronically ill person.

In addition, the proposal limits accumulations in tax-preferred accounts to approximately \$3.4 million. Under present law there are limitations on the amounts that may be contributed to retirement accounts and requirements with respect to distributions, but there is no limit on total account balances. The proposed limit, determined at the end of the year, is the amount necessary to provide the maximum benefit permitted under a tax-qualified defined benefit plan under current law. At present, the maximum annuity is \$205,000 for a joint and 100% survivor annuity beginning at age 62 (or the equivalent of an accumulation of approximately \$3.4 million). Once the maximum is reached, no additional contributions may be made or accruals received, but the balance could continue to grow with investment performance and income. Any additional contributions or accruals would be included in current income, with a grace period to withdraw any excess.

Income Taxes

There was much discussion of revenue raising in the negotiations leading up to and culminating in the American Taxpayer Relief Act of 2012 (ATRA). Although the ATRA income tax rate

provisions are “permanent,” meaning they are not scheduled to sunset on a date certain, the proposed budget seeks to again increase tax revenue from high-income taxpayers, using a dual approach – capping the value of certain “tax expenditures” at 28% and imposing a new “Fair Share Tax.”

“Tax expenditures” include personal exemptions, deductions and exclusions. Personal exemptions and certain itemized deductions are subject to phase-outs for high-income taxpayers in 2013. In addition, various items are currently excluded from income altogether, including tax-exempt state and local bond interest, contributions to qualified defined contribution plans and IRAs, and employer-sponsored health insurance paid for by employers or with pre-tax employee dollars. The proposal limits the value of the tax benefit of specified itemized deductions and exclusions to 28%. The proposed 28% limitation on itemized deductions would be applied after the current phase-out. Note that limiting the value of deductions and exclusions to 28% only impacts the 33%, 35% and 39.6% income tax brackets, and in those brackets, reduces, but does not eliminate, tax savings associated with these items.

The proposal also includes for the first time the much discussed “Buffett Rule” imposing a new Fair Share Tax (FST) on high-income taxpayers. The FST is 30% of adjusted gross income, with a credit for charitable contributions. The threshold for the FST is \$1 million of adjusted gross income (\$500,000 for married filing separately) and the FST is fully phased in at \$2 million (\$1 million for married filing separately), with each level being indexed for inflation.

Modification of the income taxation of carried (profits) interests of partners in investment partnerships is again suggested in the proposal. Under current law a partner may receive an interest in future profits of a partnership in exchange for services. Part or all of the associated income may be characterized as capital gain and taxed to the partner accordingly. Under the proposal, a partner’s share of income from an “investment services partnership interest” (ISP) in an “investment partnership” would be taxed as ordinary income, even if its character at the partnership level is capital gain. Ordinary income tax rates will apply and the income will be subject to self-employment tax.

Summary of Income Tax Proposals

<u>Area of Focus</u>	<u>Current Law</u>	<u>Green Book Proposal</u>	<u>Estimated Revenue Impact</u>	
			<u>1 Year</u>	<u>10 Year</u>
Inflation Adjustments	CPI	Chained CPI	\$0	\$100 billion
Automatic employee enrollment in IRAs	Not required	Required to be provided for employees by certain employers	\$0	-\$17.6 billion
Require non-spouse beneficiaries of deceased IRA and retirement plan participants to take inherited distributions over no more than 5 years	Not uniformly required	Distribution required within 5 years, subject to specified exceptions	\$86 million	\$4.9 billion

<u>Area of Focus</u>	<u>Current Law</u>	<u>Green Book Proposal</u>	<u>Estimated Revenue Impact</u>	
			<u>1 Year</u>	<u>10 Year</u>
Limit on total accrual of tax-favored retirement benefits	Not limited	Limit to amount sufficient to fund specified annuity amount (\$205,000 annuity in 2013)	\$802 million	\$9.3 billion
Tax carried (profits) interests as ordinary income	May be taxed as capital gain not subject to self-employment tax	Tax as ordinary income and subject to self-employment tax	\$3.4 billion	\$15.9 billion
Cap the value of certain tax expenditures	Some phase-outs for high-income taxpayers but no cap	Cap value at 28% for high-income taxpayers in addition to current phase-outs	\$24.6 billion	\$529.3 billion
Buffett Rule "Fair Share Tax" (FST) on high-income taxpayers	None	30% of adjusted gross income with charitable credit FST	\$5.3 billion	\$53.4 billion

Gift, Estate and Generation-Skipping Transfer Tax Provisions

Restore the Tax Parameters in Effect in 2009

ATRA "permanently" unified the estate, gift and generation-skipping transfer taxes, while maintaining portability of a spouse's unused exclusion amount at death. Pursuant to ATRA, the highest marginal transfer tax rate is 40% and the applicable exclusion and exemption amounts for gift, estate and GST tax purposes remains unified at \$5 million, adjusted annually for inflation from 2010 (\$5.25 million in 2013).

The Administration seeks, beginning in 2018, to make permanent the estate, GST and gift tax parameters as they applied in 2009. If enacted, the proposal would make the top marginal tax rate 45%, and the exclusion amount would be \$3.5 million for estate and GST taxes and \$1 million for gift tax purposes, without indexing, but with estate tax exclusion portability.

Consistency in Value for Transfer and Income Tax Purposes

Gift and estate taxes are determined based on the fair market value of the property transferred. And, although the determination of the basis of the property received by the donee or beneficiary differs depending on whether the transfer was by gift during life or at death (and if a gift, whether or not the property is appreciated and whether or not the donee pays any part of the gift tax), in all circumstances determination of fair market value is necessary. While the same valuation standards apply to donors and estates when the transfers are reported for gift and estate tax purposes and for donees and beneficiaries in determining their basis in the property received, there is currently no explicit consistency and associated reporting requirement. Therefore, the potential exists that the respective values will be reported differently by donors and estates and by donees and beneficiaries. In order to avoid any irregularities, the proposal requires consistency in valuation and reporting of valuation by donors and estates to donees, beneficiaries and the Internal Revenue Service.

Minimum and Maximum Term for Grantor Retained Annuity Trusts (GRATs)

The proposal requires the minimum term for a GRAT to be ten years and the maximum term to be the life of the expectancy of the annuitant plus ten years. This proposal has appeared in a number of prior proposed budgets, but has yet to progress through Congress. Thus, planning with GRATs remains an effective strategy at present, particularly in light of the inflation-adjusted increases to the applicable exclusion amount – \$130,000 in 2013 (the increase from \$5.12 million in 2012 to \$5.25 million in 2013), \$260,000 for a married couple.

Limit Duration of GST Tax Exemption

Many states currently allow trusts created subject to the law of those jurisdictions to continue in perpetuity. As a result, the transfer tax shield provided by the GST exemption effectively has been expanded from trusts funded with \$1 million (the exemption at the time of enactment of the GST law) and a maximum duration specified by law, to trusts funded with \$5.25 million and continuing (and growing) in perpetuity.

The proposal provides that, on the 90th anniversary of the creation of a trust, the GST exclusion allocated to the trust would terminate. However, the proposal provides an exception intended to permit an incapacitated beneficiary's distribution to continue to be held in trust without incurring GST tax on distributions to the beneficiary as long as the trust is to be used for the sole benefit of the beneficiary and any trust balance remaining on the beneficiary's death will be included in the beneficiary's gross estate for Federal estate tax purposes. The other rules regarding the taxation of multiple skips would continue to apply, and would be relevant in determining when a taxable distribution or taxable termination occurs after the 90th anniversary of the trust.

Coordination of Certain Income and Transfer Tax Rules Applicable to Grantor Trusts

The grantor trust income tax rules are separate and independent from the gift, estate and GST tax rules, but may be used under current law to establish what is commonly referred to as an "intentionally defective grantor trust," treated as owned by the grantor for income tax purposes, but considered a completed gift for gift, estate and GST tax purposes. Transactions between the trust and the deemed owner are ordinarily ignored for income tax purposes.

The proposal applies generally to any person who is deemed to be an owner of the trust and who engages in a sale, exchange, or comparable transaction with the trust that would have been subject to capital gains tax if the person had not been a deemed owner of the trust. The portion of the trust attributable to the property received by the trust in the transaction will be subject to estate tax as part of the gross estate of the deemed owner, will be subject to gift tax during life when the deemed owner status is terminated, and will be treated as a gift to the extent of a distribution to another person during the deemed owner's lifetime, subject to reductions for consideration received and any prior taxable gift treatment.

GST Tax Treatment of Health and Education Exclusion Trusts

Under the Internal Revenue Code, certain payments made directly by a donor to a qualified medical provider or educational institution on behalf of another are not subject to gift or GST tax. Thus, for example, a grandparent may make medical expense or tuition payments for a grandchild free of gift or GST tax. Health and Education Exclusion Trusts (HEETS) have been used to place property in trust in order to fund the medical and tuition expenses of younger generations. Amounts contributed to HEETS have the potential to appreciate in value, while

avoiding estate, gift, and GST taxation when distributions are made for qualified medical or tuition expenses. The proposal clarifies that the exclusion from the GST tax applies only to a payment by a living donor directly to the medical provider or to a school for tuition – not to trust distributions, even if distributions are used for the same purposes.

Summary of Gift, Estate and Generation-Skipping Transfer Tax Proposals

Area of Focus	Current Law	Green Book Proposal	Estimated Revenue Impact	
			2014	2014-2023
Restore estate, gift and GST tax parameters in effect in 2009	<ul style="list-style-type: none"> • \$5 million gift, estate and GST tax exemption/exclusion indexed for inflation from 2010, with portability • 40% top marginal tax rate 	Starting in 2018: <ul style="list-style-type: none"> • \$3.5 million estate tax exclusion, with portability, and GST tax exemption, both without indexing • \$1 million gift tax exemption, without indexing • 45% top marginal tax rate 	0	\$71.7 billion
Require consistency in value for transfer and income tax purposes	Consistency not explicitly required	Explicitly requires consistent valuation and reporting	0	\$1.9 billion
Require a minimum and maximum term for grantor retained annuity trusts	No minimum or maximum annuity term	Minimum annuity term of 10 years and a maximum term of the life of the annuitant plus 10 years	0	\$3.9 billion
Limit duration of GST tax exemption	Determined under the applicable state law	For Federal tax purposes, limit to 90 years	Negligible revenue effect	Negligible revenue effect
Coordinate certain income and transfer tax rules applicable to grantor trusts	A perceived lack of coordination between the income and transfer tax consequences of grantor trusts	Subject certain grantor trusts and transactions to gift and estate tax	0	\$1.09 billion
Extend the lien on estate tax deferrals provided under Code Section 6166	Estate tax lien expires approximately 5 years before the final payment of deferred estate tax	Extend the estate tax lien through the estate tax deferral period to lessen risk of default	0	\$160 million
Clarify GST tax treatment of HEETs	Perceived uncertainty regarding GST tax treatment of distributions from HEETs for qualifying medical expenses and tuition	Specifies that GST exclusion for medical expenses and tuition only applies to direct payments by a living donor	\$47 million	-\$171 million
Total			\$47 million	\$78.56 billion

More to Come

If the experience of the 112th Congress in 2012 is an indicator, there will be much debate by

the 113th Congress in 2013 before we have any budget consensus and related tax legislation. As in 2012, we will continue to follow the developments as they unfold, and will provide ongoing updates throughout the remainder of 2013. The path from budget proposal to tax legislation is often circuitous, with many proposals failing to advance and others undergoing substantial modification in the legislative process.

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