WRMarketplace
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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: Administration's Proposed Tax Reforms Target High Net Worth Individuals.

MARKET TREND: Tax reform efforts are ramping up, but with a Democratic President and a Republican-controlled Congress, clients likely will face continued planning uncertainty.

SYNOPSIS: As outlined in the State of the Union Address, President Obama's recent tax proposals seek additional revenue from higher net worth individuals ("HNWIs") to fund middle-class tax relief. These proposals take a two-pronged approach:

- Higher Taxes for HNWIs. Increasing taxes and eliminating so-called "loopholes" for HNWIs, including: (1) imposing capital gains tax on appreciation in assets upon transfer by gift or bequest, (2) raising the top capital gains and dividend rate from 20% to 28%; (3) imposing a new tax on certain financial institutions, which could be passed through to HNWI customers, and (4) limiting tax-deferred growth in retirement plans and individual retirement accounts ("IRAs") by capping contributions and growth on account balances.

- More Tax Savings for Middle-Class: Adding or expanding credits and incentives for middle-class taxpayers, including: (1) increasing automatic employer retirement savings provisions and expanding plan access to part-time employees, (2) adding a new "second earner" tax credit for dual-employed married couples, (3) consolidating and expanding education tax benefits, and (4) expanding and making permanent the earned income tax credit and child care tax credit.

TAKE AWAYS: The Administration's proposed tax rate increases would significantly alter the investment and planning behavior of HNWIs, potentially increasing the need for planning to mitigate and manage income tax liabilities, such as through life insurance. These proposals only reflect a Presidential "wish list" for future tax legislation and cannot take effect without Congressional approval, which may be difficult to achieve with a Republican-controlled Congress. However, since several of the proposals could significantly impact the life insurance industry, AALU will remain vigilant in its continued monitoring and advocacy, and will continue to assess the specific implications of these proposals.

MAJOR REFERENCES: *White House Fact Sheet: A Simpler, Fairer Tax Code That Responsibly Invests in Middle Class Families (January 2015).*

As outlined in a recent White House-released fact sheet and President Obama's annual State of the Union address, the Administration wants to reform the tax code to provide greater tax credits and savings to middle-class taxpayers, as funded through certain tax increases and changes targeting higher net worth individuals ("**HNWIs**"). These proposals reflect a Presidential "wish list" for future tax legislation, and we will likely see more detailed explanations of them when the Administration releases its proposed Fiscal Year (FY) 2016 budget, expected on February 2, 2015. Note that none of these measures can take effect without Congressional approval, which may be difficult to achieve with a Republican-controlled Congress. The proposals, however, may reveal future battlegrounds and/or areas of negotiation as Congress looks to address components of tax reform.

HIGHER TAXES ON HNWIs

The first part of the Administration's two-part, proposed tax reform would directly impact top income earners and HNWIs by increasing taxes and changing tax rules, as follows:

Impose Capital Gains Tax on Bequests/Gifts of Appreciated Assets

Current Law. Assets held in a decedent's estate may incur federal estate tax but generally are not subject to current federal capital gains tax when they pass to the decedent's heirs. An heir also typically takes the asset with a "stepped-up" income tax basis equal to its fair market value as of the decedent's date of death.[1]

> ***Example:*** B owns real property with an income tax basis of $100,000 and a current fair market value of $500,000. B dies and leaves the property to C. No capital gains tax is due on the $400,000 of property appreciation. Moreover, C receives the property with an income tax basis of $500,000. If C promptly sold the property for that amount, he would not recognize any taxable gain on the sale, meaning $400,000 would not be subject to capital gain taxation (although B's estate may have incurred estate tax on the property's full value).

Likewise, when gifts are made, the gift generally does not generate a capital gains tax liability to the donor or the donee. The donee, however, takes a carryover basis in the property for income tax purposes, such that appreciation in the gifted property likely will be subject to capital gains tax upon a subsequent sale.

Proposal. The Administration would change the above by making bequests and gifts of assets "realization events" for federal capital gains tax purposes. Capital gains tax would be triggered on the asset appreciation as of the time of the transfer (rather than when the recipient later disposes of the property). This proposal essentially eliminates the basis "step-up" at death, which the Administration believes permits HNWIs to effectively remove large quantities of built-up capital gain from taxation. It also would accelerate the payment of capital gains tax when gifting assets, since the taxable event would occur on the date the gift is made rather than when the gifted assets are subsequently sold by the recipient.

According to the Administration, to address middle-class taxpayers, the proposal would limit application of capital gains tax to certain bequests and gifts, as follows:

- Exemptions: (note that these exemptions would be automatically portable between spouses):
  - *Basic Exemption:* Up to $100,000 of capital gains ($200,000 for married couples) would be exempt from capital gains tax when assets are transferred by gift or bequest.
  - *Personal Residence:* An individual would have an additional $250,000 exemption for gain in a personal residence ($500,000 for married couples). Note that the White House fact sheet does not say whether this exemption is in addition to the existing $250,000/$500,000 exemption for the sale of a principal residence.
- Married Couples. No capital gains tax would be due until the death of the surviving spouse.
- Tangible Personal Property ("TPP"): Gifts or bequests of TPP, other than expensive art or similar collectibles, would pass free of capital gains tax, without the need to value or report them. The fact sheet does not specify a dollar limit as to what would constitute expensive art or similar collectibles.
- Small Closely-Held Businesses: No capital gains tax would be due on inherited, small family-owned and operated enterprises until the business is sold. The fact sheet does not specify a dollar limit as to what would constitute a small family-owned enterprise. In addition, this exception would apply only to transfers by bequest, not by gift.
- Deferred Payment of Capital Gains Tax. A closely-held business that is transferred by gift or bequest that would not be eligible for non-taxable treatment because it falls outside of the "small family-owned and operated business" exception would have the option to pay the tax on the triggered capital gains over 15 years.
- Charities. Capital gains tax would not apply to bequests and gifts to charitable organizations.

Comment. If enacted, this proposal would dramatically alter income and estate tax planning for HNWIs. While a "carryover basis" regime applies for gifts and has been enacted before for inherited assets in certain situations (e.g., it was an option for estates in 2010), appreciated gain in the gifted or inherited assets generally remains untaxed until sold. This is consistent with the long-standing general rule that, if an individual taxpayer does not realize income on a cash basis, then the taxpayer neither recognizes nor owes tax on such amounts. Among the policy reasons which direct this result is the acknowledgment that a tax liability should not be imposed upon a taxpayer unless a taxable event also provides that taxpayer with the means to pay the tax imposed. Policymakers also have long recognized the difficulty many heirs would have in finding and keeping records to establish the decedent's basis (carryover basis) in the asset when it was first acquired. Each asset would have different acquisition dates and costs, often with subsequent events (e.g., depreciation, renovation, additional investment) impacting basis. Because there has been a step-up in basis on inherited assets throughout this century, decedents have lacked the incentive to keep records. Congress previously enacted carryover basis in 1976, but repealed it retroactively in 1978 due to outcry over the administrative difficulties a system of carryover basis/capital gains taxes represented.

Under this proposal, however, the gift or bequest is the taxable event that would trigger federal capital gains tax on the asset appreciation, imposing a significant liquidity burden for estates, especially those with highly-appreciated, illiquid assets. This liability would be exacerbated by the proposed increase in the top federal capital gains tax rate and by the state income or capital gain taxes that could be triggered by the gift or bequest, since the vast majority of states tie their taxable income to the determination of income for federal income tax purposes. Combined with the estate tax, (something not addressed in this proposal), there could be a double income and estate tax hit.

The proposal to trigger capital gains upon the gift or bequest of assets would affect far more families than the existing estate and gift tax regime -- the current estate and gift tax exemption of $5.43 million ($10.86 million for a married couple) is vastly higher than the $100,000 exemption ($200,000 for married couples) from capital gains under this tax reform proposal. Enactment of some form of this proposal, with or without corresponding changes to the federal transfer tax laws, could significantly increase the need for tax and liquidity planning, including through life insurance.

> ***Example***: B, a HNWI, dies, leaving undeveloped real property worth $5,000,000 and a basis of $100,000 to his son, C, and leaving the balance of his estate to his surviving spouse. B lives in a state with a 6% income/capital gains tax rate but no estate tax.
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> No federal estate tax should be due on B's estate, because of the available $5.43 million federal estate tax exemption and the unlimited federal estate tax marital deduction. However, capital gains tax would be due on the $4.8 million of taxable gain on the land ($5 million fair market value - $100,000 tax basis - $100,000 proposed exemption). Assuming a combined tax rate of 37.8% (i.e., 28% proposed federal capital gain rate + 3.8% federal net investment income tax rate + 6% state tax rate), a combined federal and state tax of up to $1,814,400 could be due. This tax obligation would result in material liquidity requirements that would have to be satisfied by the estate and paid out of the balance of the estate going to the surviving spouse, unless addressed through alternate planning (like life insurance).

Raise Top Capital Gains and Qualified Dividend Rate to 28%

Current Law. A top capital gains tax rate of 20% currently applies to long-term capital gains and qualified dividends of single taxpayers with taxable income of over $413,200 ($464,850 for joint, married tax filers) for 2015.

Proposal. The President proposes raising this top capital gains tax rate to 28%. It would apply to married, joint filers with taxable income greater than $500,000.

Comment. If enacted, the higher top rate would directly impact HNWIs, who typically have significant capital gain and dividend income, as well as tax planning for sales and acquisitions of business interests. Assuming continued application of the 3.8% net investment income tax as a separate tax, the effective top tax rate on capital gains and qualified dividends would be 31.8%. When state income taxes are added, many HNWI's could face a combined federal and state capital gains tax rate approaching, and in some states, exceeding 40%. This higher tax rate could increase the interest of HNWIs in a variety of planning options, including annuities, life insurance, and corresponding private placement alternatives for these products.

Impose a New Financial Institution Fee on Certain Borrowing Transactions

Proposal. The Administration would impose a seven basis point fee on the liabilities of large U.S. financial firms, affecting roughly 100 institutions with assets over $50 billion. The stated purpose of this fee would be to discourage financial institutions from borrowing heavily to finance activities in a manner that is detrimental to the U.S. economy by raising the risk of financial defaults and related consequences.

Comment. The President has included annual budget proposals going back to 2010 that seek to impose a "financial crisis responsibility fee" on certain financial institutions. The proposed fee could affect the bottom line of several large life insurance companies if they fall within the loose parameters detailed in the proposal. Although more specific details are expected with the release of the Administration's FY 2016 budget, senior administration officials have indicated that the fee is meant to apply "broadly across the largest financial firms without necessarily distinguishing between" different types of firms, which would include not only banks, but insurers and asset managers.[2] If enacted, the fee could be charged to the liabilities of large life insurance companies who have assets greater than $50 billion.[3] Furthermore, this tax could be passed through to HNWI customers in the form of higher fees, and higher costs for products and services, including life insurance products.

<u>Limit High-Dollar Retirement Plans and IRA Contributions and Accumulations</u>

Current Law. There is no statutory limit on total retirement plans and IRA accumulations or rollovers from employer defined contribution plans.

Proposal. The Administration has proposed that certain retirement plans and IRA balances be <u>capped at $3.4 million</u>, allowing no further contributions or accruals once that limit is reached. The President has indicated that this maximum balance should be sufficient to give individuals an annual income of $210,000 (although the White House fact sheet does not specify how it calculated this amount).

Comment. This proposal has repeatedly appeared in the President's past budget proposals. Enactment could increase interest in alternative retirement vehicles, including life insurance products.

CREDITS/INCENTIVES FOR MIDDLE-CLASS TAXPAYERS

As indicated by the Administration, the goal of the above tax increases and changes is to generate additional revenue to offset the cost of increasing various credits and incentives to help produce greater tax savings for middle-class taxpayers, proposed as follows:

- **<u>Retirement Tax Incentives and Savings</u>**. Per the President's proposal, employers with more than 10 employees without current retirement plans would be required, subject to employee opt-out, to automatically enroll their workers in an IRA (also proposed in prior budget plans). Small businesses (i.e., less than 100 employees) who (1) adopt auto-IRA enrollment, (2) introduce a new retirement plan, or (3) offer auto-IRA enrollment with an existing retirement plan would receive a tax credit of $3,000, $4,500, and $1,500, respectively. The proposal also would expand plan access to part-time employees by requiring employers with retirement plans to permit employees who have worked for the employer for at least 500 hours per year for 3 or more years to make voluntary contributions to the plan.

- **<u>Second Earner Credit</u>.** As relief for married couples where both spouses work, the Administration proposes creation of a "second earner credit," capped at $500, which would help offset the costs of commuting and professional child and/or elder care incurred by the family. The maximum credit would be available to families with incomes up to $120,000, with a partial credit available up to $210,000.

- **Education Tax Incentives.** The Administration wants to simplify the current array of higher education tax incentives (e.g., the American Opportunity Tax Credit (**AOTC**), the Lifetime Learning Credit, and the Hope credit) by primarily consolidating them under a more generous AOTC. Note that the White House has now dropped a proposal that would have eliminated the expanded tax benefits for 529 plans that were enacted in 2001 and made permanent in 2006, including prohibiting earnings on new contributions to the plans to be withdrawn without imposition of tax.

- **Expanded Earned Income Tax Credit (EITC) and Child Tax Credit (CTC).** The Administration's proposal for the EITC includes expanding eligibility for workers without children, doubling the available credit amount for childless workers, and increasing the income level at which the credit is phased out.

- **Child Care Tax Benefits**. The Administration wants to scrap the complex child care flexible spending account program and, instead, provide increased child and dependent care tax credits to more families.

TAKE-AWAYS

- The President's proposals only offer high-level details of policy goals that are expected to be more fully explained with technical language in the Administration's FY 2016 budget plan (expected for release on February 2, 2015).

- Although several proposals have their origins in prior Administration budget plans, certain proposed items are more broadly drafted than past iterations and could have a significant impact on HNWIs.

- Specifically, the Administration's proposed tax rate increase on capital gains and qualified dividends and the triggering of capital gains taxes for gifts and bequests would significantly alter the investment and planning behavior of HNWIs, potentially increasing the need for planning to mitigate and manage income tax liabilities, such as through life insurance.

- These proposals only reflect a Presidential "wish list" for future tax legislation and cannot take effect without Congressional approval, which may be difficult to achieve with a Republican-controlled Congress. However, since several of the proposals could impact the life insurance industry and planning if enacted, AALU will remain vigilant in its continued monitoring and advocacy, and will continue to assess the specific implications of these proposals.

NOTES

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[1] IRC § 1014.
[2] *See* "Obama Defends Financial Reform But Avoids Bank Bashing," Wall Street Journal, Jan. 20, 2015.
[3] Note that this fee is different in nature than the one set forth in Ways and Means Chairman David Camp's tax reform discussion draft. Sec. 7004 of the Tax Reform Act of 2014 Discussion Draft imposes a 0.035 percent fee on the "excess total consolidated assets" of certain financial institutions subject to Dodd-Frank (i.e., "systemically important financial institution") with assets over $500 billion.

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