



From the Desk of Dean Zerbe.



Obama Budget Proposal and Taxes Part I: The Dog That Didn't Bark

by Dean Zerbe

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The new administration released its budget and included its revenue proposals, detailed by the Department of Treasury in the "Green Book." There is quite a bit of material, so I wanted to narrow the focus to two areas: 1) proposals that didn't happen that were of concern to accountants and clients; and 2) proposals that will directly affect the work of accountants (as well as many of your clients) – information reporting and e-filing requirements (and there are a good number of them). But today, we will focus on what didn't happen.

Individual Income Tax Rates

As I (and others) have been predicting for some time, the administration did not seek to increase the top two rates in 2009 or 2010. The budget proposal is to have the two rates increase to 36 and 39.6 percent on January 1, 2011 (when they expire under current law). The salary level at which the rates apply will be indexed annually for inflation. I expect Democratic leadership in Congress to follow the administration's budget here, and only continued bad news on the economic front would cause a rethink in D.C. about allowing the rates to go up. I do expect the Republicans to cause some significant discomfort to the Democrats on the issue of the marriage penalty in the rates: \$200K for singles; \$250K for married couples when the 36% rate kicks in.

Capital Gains and Dividends

Similarly with the top rates, the administration is not seeking to accelerate the January 1, 2011 date for when the rates go from 15% to 20%. The administration is proposing to permanently extend the zero and 15% tax rates for dividends and capital gains (which would otherwise expire) for lower incomes. Again, I anticipate Congress to follow the administration's proposals in this area.

IC-DISC

Interest-Charge Domestic International Sales Corporation (IC-DISC) is without a

doubt one of the most beneficial tax provisions in the code for small and medium businesses that export goods and certain services. Because the bureaucrats in Brussels and the World Trade Organization don't like IC-DISC, there was some concern that the administration might propose its elimination. The administration's budget is loud in its silence on this issue.

It appears that the administration has no immediate interest during this economic downturn in eliminating IC-DISC, a significant tax benefit for small and medium businesses that export manufactured goods and certain services. The White House can read the tea leaves that a proposal to eliminate IC-DISC would be a political loser and would meet very real bipartisan opposition in the Senate. IC-DISC will remain in place for the foreseeable future.

A reminder also that the advantages of IC-DISC remain in place even when the rates go up – given that the IC-DISC benefits rely on the differential between the ordinary income rates and the dividend rates – and both the top rates and the dividend rates will be going up on January 1, 2011 as discussed above. One last note: the IC-DISC benefits are only on a going-forward basis, so accountants and their clients need to get on this horse. With the economy where it is, we need to do all we can to help American manufacturers take advantage of this tax incentive. The brilliant and capable Jim Young at alliantgroup can answer all your questions on IC-DISC. You can reach Jim at jim.young@alliantgroup.com.

28% Cap on Itemized Deductions

While we've talked about dogs that didn't bark, here is an example of a dog that barked but no one listened. The administration's proposal to limit itemized deductions at 28% to help pay for its health proposals is not going anywhere. While the press has focused on the impact on charitable giving, this actually reflects only a small part of the revenues gained under the pro-

posal. The big dollars in this proposal are in the limitation on the mortgage deduction. Congress is in little mood to reduce this tax benefit, particularly in today's real estate market. Note: this proposal to limit at 28% is separate from the administration's proposal to reinstate the limitations on personal exemptions and itemized deductions (PEPS and PEASE) which will be resurrected at the \$200K single; \$250K married level. I anticipate that the PEPS and PEASE proposals, which are effectively hidden increases in the marginal rate, will garner sufficient Congressional support.

The growing consensus in Washington is that to replace the lost revenues from Congress rejecting the proposed 28% cap on itemized deductions we will instead see a limitation on the tax exemption for employer-provided health insurance. The Finance Committee is looking at either limiting the dollar amount (Ex: no more than \$10K per year tax-free) or phase-out the exemption based on income (Ex: At \$200K single; \$250K married, the exemption begins to phase out). Or even a combination. Most Democrats favor the phase-out based on income, but it is uncertain whether that proposal will raise sufficient revenues to pay for the health care program they envision.

Estate/Death Tax

To continue the dog theme, this is a bit of a mongrel. The Obama administration proposed, as it campaigned, for basically extending the Bush estate tax cuts as of 2009: \$3.5 million unified credit and 45% rates. The administration also proposed a limitation on discounting/valuation of Family Limited Partnerships (FLPs) as well as requiring that Grantor Retained Annuity Trusts (GRATs) be for at least 10 years. The estimates of revenues raised that Treasury provided for these two proposals, particularly FLPs, is significantly higher than the official scorekeeper for Congress, the Joint Committee on Taxation (JCT).



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The general outlook is that Congress will take up the estate/death tax issue this Fall (Democratic leadership does not want to do nothing and have the tax fall to zero in 2010). The Chairman of the Finance Committee, Senator Baucus, has put forward legislation (S. 722) that will most likely serve as the starting point for this debate. The legislation provides for \$3.5 million (indexed for inflation) and 45% rates and adds some additional estate tax relief. For example, land would be valued at present use not highest best use (Ex. Land that was used for a winery for 10 years and used as a winery for 10 years after death will be valued as a winery, not as an office building). Another provision is portability of exemption. Grandmother dies before grandfather, and they haven't established an A/B trust. Previously, Grandmother's \$3.5 million dollar exemption went unused. Under Senator Baucus' legislation, her \$3.5 million exemption will be transferred to Grandfather, and he will have a \$7 million exemption.

It is a little too early to read Congress regarding the proposals on FLPs and GRATs, but I would say that because of the strong push by many Senators on both sides of the aisle to provide estate/death tax relief beyond what the administration has proposed, it would really cause a dust-up if these two revenue raisers were included. The two provisions would be viewed as reducing the amount of estate/death tax relief being provided, especially to family businesses (given their traditional reliance on FLP valuation discounting for estate planning). As I've said in my speeches to many of you, it all comes down to scoring by JCT. When we looked at limitations on FLPs and GRATs when I was on the Finance Committee, the simple reality is it raised a limited amount of money relative to the howling it engendered. Bottom line: it wasn't worth the candle. However, if members saw that limitations on FLP and GRAT raised the amount of dollars claimed by Treasury, AND those revenues were used to offset greater estate/death tax relief (Ex: Raising the unified credit amount or low-

ering the rates), THEN you might begin to have some interest. As of now, though, the administration is using the revenue raisers to pay for health care proposals, not further estate/death tax relief. These two proposals face a tough road.

Finally, the great unknown is whether the Democratic Congress will agree with the new administration's budget proposal to make the \$3.5 million exemption and 45% rates permanent law. I am very concerned that while Congress will act this Fall on estate/death tax, they will only approve the Obama estate/death tax relief for 2-3 years, and kick the can down the road.

Part II coming soon. Please feel free to email me at dean.zerbe@alliantgroup.com if you have any questions about the administration's budget or Washington in general.

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