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## Taxes Are Going Up!

Your client should monitor the impact of these increases on his estate plan.

By John J. Scroggin, J.D., LL.M., AEP

The pressure to raise revenue is going to be intense over the next decade. Here are some reasons why:

- Washington acknowledges that the 10-year deficit will be over \$9 trillion – greater than all previous federal deficits combined. As we come out of recession, Congress will hear a growing chorus of demands to reduce the deficit.
- Projections on the 10-year cost of any final health-care bill range from \$600 billion to over \$1.1 trillion.
- The federal cost of reducing global warming remains largely unknown – at least until the terms of any final bill are understood.
- Some experts report that the unfunded obligation for federal entitlement programs is more significant than most Americans realize. David Walker, former head of the GAO, stated in a *Wall Street Journal* article on September 6, 2009: “Our off-balance-sheet obligations associated with Social Security and Medicare put us in a \$56 trillion financial hole – and that’s before the recession was officially declared last year.” Moreover, a recent CBO report indicates that the Social Security system may begin to run a deficit as early as 2011.
- State budgets are in dire straits, with 48 states reporting budget deficits in the current fiscal year. There will be growing pressure to provide federal money to help support state programs.

### Automatic increases

A number of federal tax increases will automatically occur on January 1, 2011: The increase in the top ordinary income-tax rate to 39.6 percent, the rise of capital-gains tax to 20 percent of the elimination of the 15 percent dividend rate.

Even with these automatic tax increases, to cut the deficit and pay for new programs, Congress will have to find other significant revenue sources – and no single tax source will cover the entire shortfall. There will be increases in income taxes at levels below \$250,000 AGI. Social Security and state taxes will probably also rise.

The revenue to reduce the looming deficit will have to include other sources of taxation. Such raises could come in a number of forms:

- Letting alternative minimum taxes continue to tax the middle and upper middle classes
- A “reform” of the tax income tax code – possibly designed to make it hard to determine where the tax increases come from
- An automatic elimination of sun-setting income tax benefits
- An increase in the Social Security wage base limits
- A limit of itemized deductions to no more than 28 percent tax savings
- An increase in the rules that eliminate tax deductions and credits for high-income taxpayers
- An increase in estate taxes

With so much of the focus on taxing the wealthy, how much could be raised from higher estate taxes? A report by the Tax Policy Center (Oct. 20, 2008 at [www.taxpolicycenter.org/](http://www.taxpolicycenter.org/)) estimated that from 2008 to 2018, the current transfer-tax laws (i.e., a return to 2001 in 2011) would generate \$490 billion. Making permanent the 2009 tax rules would reduce this revenue to \$292 billion. Because this report included three years of larger exemptions (i.e., from 2008 to 2010), it understates the total estate taxes that would be paid in the decade following 2010.

As a result of these revenue needs, Congress and the president are, and will be anxiously looking for new revenue sources that produce the least amount of taxpayer anger. A 2009 poll conducted for the Tax Foundation provides interesting insights into how Americans view their tax system and where Congress might go to find more revenue. See the 2009 “Tax Attitudes Study” at [www.TaxFoundation.org](http://www.TaxFoundation.org).

This poll noted that over two-thirds of participants believe the estate tax should be eliminated. Despite the public’s strong animosity toward the estate tax, only a small number of Americans are actually subject to it. Politically, the estate tax is an easier source of revenue than the imposition of broader-based income tax changes.

Also, Congress does not have to do anything to have the 2001 transfer-tax rules return in 2011. Failing to adopt changes or not adopting permanent transfer-tax reform will not be perceived in the same manner as adopting a tax increase. Besides, each party can blame the other party for its inability to compromise on “reasonable” tax legislation.

In 2010, Senate Republicans and some Senate Democrats may push for a \$3.5 to \$5 million estate exemption, but the House congressional leadership will push for a much lower exemption, with the increasing possibility that uncompromising gridlock occurs and no transfer-tax legislation passes in 2010.

If this happens, the estate exemption could become \$1 million in 2011, with a 55 percent estate-tax rate on taxable estates over \$3 million and 60 percent on estates of more than \$10 million.

### **What lies ahead?**

Whatever happens between now and January 1, 2011, virtually every estate plan will need to be reviewed in the next two years to examine the impact of the massive changes to both the income tax and transfer-tax rules. For example:

- Should higher-income taxpayers convert to a Roth IRA in 2010 to benefit their heirs while electing out of paying the income taxes in 2011 and 2012 when their income tax brackets may be higher?
- Should larger estates consider making taxable gifts in 2009 or 2010 when the overall gift-tax is lower and recognizing that the gift tax is a tax-exclusive tax (after three years)?
- What is the impact on dispositions and on bypass trust planning when the estate-tax exemption is changing each year, particularly for clients in second marriages?
- Have the estate taxes been properly apportioned among the heirs?
- Has the estate plan considered the impact of the increase in income taxes, capital-gains taxes and dividend-tax rates that occurs on January 1, 2011?
- Does the estate plan properly account for the impact of state death taxes after 2010, when states that remain “coupled” to the federal estate tax may have their state death taxes automatically restored by the sun-setting of the 2001 laws? Even more important, has the plan addresses state death taxes in states that are no longer coupled to the federal estate tax?

Clients should consider deferring deductions (e.g., expenses, net operating losses and capital losses) to after 2010 and try to accelerate income and capital gains into 2010 (i.e., when tax rates will probably be lower). Contributions to retirement plans for closely held businesses may become more tax-efficient in 2011.

Who benefits from this chaotic environment and the return of higher taxes?

- States that remain coupled to the federal estate tax could receive an unexpected revenue boost.
- States that rely on the federal income-tax rules to determine state income taxes could obtain an increase when federal tax rules change.
- Charities will see increased estate contributions (particularly of IRD assets) to avoid the higher taxes.
- Fee-based planners who provide estate-planning advice and estate attorneys will be inundated with work. CPAs will have more tax returns to file.
- The insurance industry should see substantial increases in life insurance sales to fund estate taxes.
- Politicians will see more contributions to their campaigns from people on both sides of the debate.

And the client/taxpayer? He'll be paying for all of it.

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