

Highlights of President Obama's 2010 Federal Budget Proposals

President Obama has proposed significant tax cuts and increases in his first budget, although most of them would be delayed until 2011. Many of the tax proposals build on the recently enacted American Recovery and Reinvestment Act of 2009 (2009 Recovery Act), some are extensions of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) provisions enacted in 2001 and some stem from the President's campaign for the White House.

At this point, these budget recommendations are just proposals, which must be enacted by Congress. The budget process can be a long drawn out process resulting in Congress fine tuning these proposals and, of course, there is the potential for compromise from both sides of the aisle. Notwithstanding the fact that many proposals may be dropped or revised, they clearly provide a snapshot of future tax policy.

High income individuals would see their marginal income tax rates increase under President Obama's plan. At present, the high income distinction will be set at income in excess of \$200,000 for individuals and \$250,000 for married individuals (filing jointly). The increased rates will result from the partial sunset of rates enacted under EGTRRA.

President Obama's proposal seeks to extend the 10%, 15%, 25% and 28% rates after 2010, but increases the top two rates from 33% and 35% to 36% and 39.6%; limits the benefits of itemized deductions (including mortgage interest and charita-

ble contributions) to the 28% rate for high-income individuals; reinstates the personal exemption phase-out for high income individuals; and increases the capital gains rates to 20% on long-term capital gains and qualified dividends for high income individuals while maintaining the current 15% rate for individuals with taxable income below the high income thresholds.

By not accelerating the rate increases into 2009 and/or 2010, higher-income taxpayers have an opportunity to plan for the rate changes. For example, individuals with the ability to accelerate income and/or defer deductions may want to analyze the potential tax benefit of such planning. If the itemized deductions limitation is ultimately not enacted, postponing the payment of itemized deductions may result in an added benefit. Of course, when accelerating deductions, the impact of doing so may result in the imposition of the Alternative Minimum Tax; so proceed with caution!

The limitation of mortgage interest and charitable deductions is certain to affect the housing market and charitable giving. Currently, there is strong opposition from lobbyists and members of Congress from both sides of the aisle who have already weighed in with their opposition to these limitations. Thus, compromise on this issue should be expected!

The following proposals are less controversial; high income individuals will not benefit from them, but their adult children may:

- Make permanent the enhancements made to the child tax credit and the Earned Income Tax credit (EITC) by the 2009 Recovery Act. The 2009 Recovery Act temporarily reduced the earnings threshold for the refundable portion of the child tax credit to \$3,000 and expanded the EITC.
- Extend marriage penalty relief beyond its scheduled sunset date of December 31, 2010. A “marriage penalty” exists when the combined tax liability of married individuals (filing jointly) is greater than the tax liability of each individual computed as if they were not married. EGTRRA reduced the marriage penalty by gradually raising the standard deduction for married individuals (filing jointly) and increasing the income threshold for the 15% tax bracket for married couples.
- Make the temporary “Making Work Pay Credit”, enacted as part of the 2009 Recovery Act, permanent. The credit is an offset to payroll (FICA) taxes on the first \$6,450 of wages, resulting in potential credits of \$400 for individuals and \$800 for married couples filing jointly. However, this credit is phased-out starting at adjusted gross income (AGI) levels of \$75,000 for individuals and \$150,000 for married couples filing jointly; the credits are completely phased out when AGI exceeds \$95,000 and \$190,000, respectively.

Alternative Minimum Tax

The Alternative Minimum Tax (AMT) was enacted to ensure that very wealthy (and high-income) individuals pay their fair share of tax. The AMT initially accomplished its goal; however, the AMT, which is not indexed for inflation, now ensnares many taxpayers it was not intended to affect. Congress does not seem inclined to repeal the AMT, but they have annually “patched” the AMT to stem its reach to middle income taxpayers. In essence, the patch is comprised of higher (annual) AMT exemption amounts, which are phased-out at higher-income levels, and some other relief. The current proposal extends the 2009 AMT patch annually for the next ten (10) years and includes indexing for inflation.

Retirement

Since many employer sponsored plans, such as 401(k) plans, are optional, many taxpayers choose not to participate, leaving

many workers unprepared for retirement. This was the case before the recession and the economic downturn has compounded this problem. Even those workers who participate in retirement plans have seen the value of their retirement accounts shrink. Automatic enrollment in employer-sponsored plans is optional under current law, but President Obama’s proposal calls for mandatory automatic enrollment in such employer plans or Individual Retirement Accounts (IRAs) set up by the employer. This is a very prudent approach to bolster retirement savings although employees may still opt-out of automatic enrollment.

Education

The Hope credit, which was enhanced by the 2009 Recovery Act, was increased to a maximum annual credit of \$2,500 and is applicable to all four years of higher education – up from two years. It is now known as the American Opportunity credit; however, it is a temporary credit set to expire after 2010. President Obama has proposed making the American Opportunity credit permanent and Congress is interested in simplifying, either through consolidation or clarification, the various federal tax incentives for education.

Health care

Healthcare reform was a key component of President Obama’s campaign and a comprehensive overhaul to make health coverage more affordable, accessible and portable is under way. This is probably the most controversial topic since the proposal would impose a three-tier surcharge on individuals and married taxpayers at modified AGI levels:

- 1 % on modified AGI exceeding \$350,000, but not more than \$500,000 for married couples filing a joint return (\$280,000 and \$400,000 for unmarried individuals)
- 1.5 % on modified AGI exceeding \$500,000, but not more than \$1 million for joint filers (\$400,000 and \$800,000 for unmarried individuals)
- 5.4 % on modified AGI exceeding \$1 million for joint filers (\$800,000 for unmarried individuals)

There are rumblings in the Senate that President Obama’s healthcare reform should not be paid for by additional increases

to individual income tax rates. Lobbyists and the AARP will surely throw their weight around on this very sensitive initiative. Most recently, we have seen some heated debates between politicians and their constituents at several town hall meetings. Healthcare reform may be in for a very bumpy ride!

Interestingly enough, there is no proposal to extend the special COBRA subsidy. Under the 2009 Recovery Act, eligible individuals pay only 35% of their COBRA premiums and the balance (65%) is subsidized by reimbursing the coverage provider (employer) through a tax credit. This COBRA subsidy applies to health coverage beginning on or after February 17, 2009 and lasts for up to nine months.

Enforcement

President Obama will ask Congress to appropriate significant funds to strengthen enforcement of federal tax laws and ensure that the Internal Revenue Service (IRS) has the resources to improve customer service and aggressively close the tax gap. According to IRS estimates, the tax gap, which is the difference between what taxpayers owe and what the IRS receives, is approximately \$300 billion.

Wealth Transfer Planning - Grantor Retained Annuity Trusts (GRATs)

A GRAT is a special purpose trust established by the grantor who transfers assets for a specific term, usually two-three years, in which the grantor retains an annuity interest in the trust for the duration of the term; hence, the name. This wealth transfer technique is successful when the assets appreciate greater than what is known as the “hurdle rate” and there is property left in the GRAT after all annuity payments are made to the grantor. The balance of the GRAT is distributable to the grantor’s beneficiaries, either directly or in further trust, completely free of gift tax. Under this planning, a short GRAT term is utilized to increase the probability that the GRAT will terminate before the grantor’s death.

President Obama has proposed that all GRATs have a minimum term of ten (10) years, increasing the probability that the grantor may not outlive the GRAT term; thus, the GRAT would fail and there would not be a tax-free transfer. Although short-term GRATs are a popular and efficient planning tool, they may not be with a minimum term of ten years.

Carried Interests

In general, carried interests are equity interests in the future profits of a successful partnership given to the manager of the partnership for substantially structuring and directing the partnership activities. Currently, profits allocable to the carried interests retain the tax character of the partnership income and gain and the disposition of such interests generally results in gain taxed at the preferential federal long-term capital gains rates of 15%. That is, to the extent the partnership generates long term capital gains and qualified dividend income, they are taxed at the lower preferential capital gains rate even though they may be related to management services. Furthermore, a carried interest is considered a capital asset and if disposed of for a gain will result in such gain being taxed at the preferential capital gains rate as well, provided it is held long term.

The proposal will re-characterize a carried interest as a service partnership interest if such interest was received for providing services and treat all income as ordinary income to the extent it is not attributable to invested capital. Such ordinary income would also be subject to self-employment taxes. The gain recognized on the disposition of such interest would also be subject to ordinary income tax rates.

These proposals will give rise to much review, analysis and debate among financial and tax professionals and Congress, but one thing is certain, change, for better or worse, is on the horizon!

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