MORRISON | FOERSTER

Legal Updates & News

Legal Updates

Administration Issues General Explanation of its Fiscal Year 2010 Revenue Proposals, Including Provisions Affecting Individuals

May 2009

Related Practices:

- Federal Tax
- Tax

On May 11, the Obama Administration (the "Administration") issued general explanations of its Fiscal Year 2010 revenue proposals. The proposals provide a more comprehensive look at proposals that had previously been described, and also introduce various new proposals. The proposals include a variety of provisions that will affect individuals. The following is a summary of certain of these provisions. The Federal Tax group at Morrison & Foerster LLP is available to assist you in understanding the proposals and will be ready to assist you in understanding and responding to any legislative changes. *See also* "Administration Issues General Explanation of its Fiscal Year 2010 Revenue Proposals, Including International Provisions", May, 2009, and "Administration Issues General Explanation of its Fiscal Year 2010 Revenue Proposals, Including Provisions Affecting Businesses", May, 2009.

Upper-Income Tax Provisions Dedicated to Deficit Reduction

The Administration proposes to revert to certain pre-Bush administration income tax rates after 2010. Thus, beginning in 2011, the highest income tax rate would be 39.6%, although the proposal does not specify the amount of taxable income to which this rate will apply. (Generally, for 2009 the top tax rate applies to taxable income over $372,950 for both single and joint filers.) The taxable income levels at which the 39.6% rate would apply would vary by filing status, and would be indexed for inflation. The second highest rate would be 36% and generally would apply to taxable income over $250,000 less the standard deduction and two personal exemptions for joint filers, and to taxable income over $200,000 less the standard deduction and one personal exemption for single filers, indexed for inflation; the 28% tax rate bracket would be expanded to apply to taxable income up to these amounts.

In addition, the Administration proposes to reinstate the phase-out of the personal exemption and limitations on itemized deductions (making permanent the sunset provisions in the current law) beginning in 2011 and indexed for inflation. Specifically, (a) the personal exemption would be phased-out for taxpayers with adjusted gross incomes over $250,000 (joint filers) or $200,000 (single filers), and (b) itemized deductions (other than for medical expenses, investment interest, theft and casualty losses, and gambling losses) would be reduced by 3% of the amount by which adjusted gross income exceeds the statutory floors (beginning at $250,000 for joint filers and $200,000 for single filers), but not by more than 80% of the otherwise allowable deductions.

Finally, the 0% and 15% tax rates for capital gains and qualified dividends would be permanently extended for those with taxable income of up to $250,000 less the standard deduction and two personal exemptions (joint filers) and to taxable income of up to $200,000 less the standard deduction and one personal exemption (single filers), indexed for inflation. Those with incomes exceeding these levels would be subject to a 20% rate on all long term capital gains and qualified dividends.

Revenues Dedicated to the Health Reform Reserve Fund - Limit the Tax Rate at Which Itemized Deductions Reduce Tax Liability to 28%

The Administration proposal would limit the value of all itemized deductions by limiting the tax value of those deductions to 28% whenever they would otherwise reduce taxable income in the 36% or 39.6% tax brackets. A similar limitation also would apply under the alternative minimum tax ("AMT"). The proposal would apply to itemized deductions after they have been reduced under the separate proposal to reinstate limitations on certain itemized deductions discussed above, and would be effective for tax years beginning after December 31, 2010.

Tax Cuts for Families and Individuals

The Administration proposes the following changes to certain tax credits for families and individuals for tax years beginning after December 31, 2010:

- The temporary "Making Work Pay" Credit would be made permanent, and the bottom of the phase out range ($75,000 for single filers, $150,000 for joint filers) would be indexed for inflation.
- The phase-out range for the Earned Income Tax Credit would continue, permanently, to be $5,000 higher for joint filers than for individual filers (beginning at an adjusted gross income of $16,420 for single filers with qualifying children, and $21,420 for joint filers). In addition, the credit would be permanently expanded for those with three or more qualifying children.
- The Child Tax Credit would continue, permanently, to be refundable after a threshold of $3,000 in earned income, no longer indexed for inflation.
- The Saver's Credit would become fully refundable, and may be deposited directly into a taxpayer's qualified retirement account or IRA. The Credit would mimic a matching contribution, matching contributions by 50% up to $500, and would begin to phase out at an adjusted gross income of $32,500 ($65,000 for joint filers).
- The new American Opportunity Tax Credit (AOTC) would permanently replace the Hope Scholarship Credit, providing a credit of up to $2,500 of qualified tuition and related expenses, phasing out beginning at an adjusted gross income of $80,000 ($160,000 for joint filers), all indexed for inflation.

Provide for Automatic Enrollment in IRAs

The Administration proposes that, effective January 1, 2012, employers in business for at least two years that have 10 or more employees would be required to offer an automatic IRA option to employees on a payroll-deduction basis, under which regular payroll-deduction contributions would be made to an IRA. An exception to this requirement would be provided for employers that sponsor certain tax-qualified retirement plans (such as 401(k) plans, including SIMPLE 401(k) plans). Payroll-deduction contributions could be transferred, at the employer's option, to a single private-sector IRA trustee or custodian designated by the employer, or the employer could allow each employee to designate the IRA provider for that employee's contributions, or could designate that all contributions be forwarded to a savings vehicle specified by statute or regulation. The approach would involve no employer contributions, and employers could claim a temporary tax credit for making automatic payroll-deposit IRAs available to employees.

Continue Certain Expiring Provisions Through Calendar Year 2010

The Administration proposes to extend through December 31, 2010, a number of provisions that are scheduled to expire before then, including the optional deduction for state and local general sales taxes.

Eliminate the Advanced Earned Income Tax Credit

Current law provides a mechanism for individuals to receive advance payment of the earned income tax credit. Because eligible individuals have not taken advantage of this option in significant number, and because research shows evidence of significant non-compliance, the Administration proposes to repeal this advance payment option, effective for taxable years beginning after December 31, 2009.

Administrative Provisions

The Administration proposals include a variety of provisions to expand information reporting, strengthen tax administration and expand penalties. These provisions include the following:

Make Repeated Willful Failure To File a Tax Return a Felony

Willful failure to file a tax return is a misdemeanor. The proposal would provide that willful failure to file in any three years within any five-year period, if the aggregate tax liability for such period is at least $50,000, would be a felony punishable by a fine of not more than $250,000 ($500,000 for corporations) or imprisonment for not more than five years, or both. The proposal would be effective for returns required to be filed after December 31, 2009.

Extension of Statute of Limitations Where State Tax Adjustment Affects Federal Tax Liability

In general, additional federal tax liabilities must be assessed within three years after the date a return is filed, although a number of exceptions exist. The proposal would create an additional exception to the general three-year statute of limitations for assessments resulting from adjustments to state or local tax liabilities. Effective for returns required to be filed after December 31, 2009, the statute of limitations would be extended to the greater of: (i) one year from the date the taxpayer first files an amended return with the Internal Revenue Service ("IRS") reflecting such adjustments; or (ii) two years from the date the IRS first receives information under an information sharing agreement. The statute would be extended only with respect to the increase in tax attributable to the adjustment and would be correspondingly extended for refund claims.

Expand Bad Check Penalty to Other Payment Forms

The Internal Revenue Code ("Code") imposes a penalty on taxpayers who attempt to satisfy a tax liability with a check or money order that is not duly paid. The proposal would expand the penalty to cover all commercially acceptable instruments of payment, effective for returns required to be filed after December 31, 2009.

Modify Estate and Gift Tax Valuation Discounts and Make Other Reforms

Requirement of Consistency in Value for Transfer and Income Tax Purposes

Current law does not make it clear that the basis for income tax purposes of property acquired by inheritance from a decedent be the fair market value of the property as finally determined for estate tax purposes. Current law also does not clearly require that the basis of property transferred by gift or inheritance be reported by the transferor or his or her executor to both the recipient of the property and the IRS. The Administration proposes that the basis for income tax purposes of property acquired by inheritance from a decedent would be equal to the fair market value of the property as finally determined for estate tax purposes, and the executor of the decedent's estate would be required to report this value to the beneficiaries of the estate. Also, the basis for income tax purposes of property acquired by gift during the lifetime of the donor would be equal to the donor's basis at the time of the gift, plus a portion of any gift tax paid with respect to the gift, as reported on the donor's gift tax return and to the done. Special rules would apply to situations in which no estate tax return is required to be filed or gifts are not required to be reported on a gift tax return. This proposal would be effective as of the date of enactment.

Modification of Rules for Valuation Discounts

Current Code Section 2704(b) has not been applied as effectively as it could be to prevent the use of inappropriate valuation discounts in connection with transfers of interests in family-controlled entities to family members for estate and gift tax purposes. The Administration proposes that certain restrictions with respect to interests in family-controlled entities transferred to family members would be ignored in valuing those interests for estate and gift purposes if, after the transfer, the restrictions will lapse or may be removed by the transferor and/or his or her family members or others. "Disregarded restrictions" would include limitations on a transferee's (1) right to liquidate the transferred interest that are more restrictive than standard limitations identified in regulations, or (2) ability to be admitted as a full partner or equity member of the entity. This proposal would apply to transfers after the date of enactment of property subject to restrictions created after October 8, 1990 (the effective date of Code Section 2704).

Requirement of 10-year Minimum Term for GRATs

While Grantor Retained Annuity Trusts (GRATs) may continue to be set up with no actuarial remainder, and thus no gift tax cost, the Administration proposes a requirement that GRATs have a minimum term of 10 years. This would increase the chance that a grantor will die during the term of the GRAT (in which case there would be little or no tax benefit), and it also would largely eliminate the benefit of the "rolling GRAT" strategy, where assets are rolled into successive short term GRATs to take advantage of upward moves in the market. This proposal would apply to trusts created after the date of enactment.