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Planning for the Investment Income Surtax

The Patient Protection and Affordable Care Act and the reconciliation bill include one particular provision that should be of interest to clients with investment income – a 3.8% surtax. For individual taxpayers with adjusted gross income over \$200,000 and joint filing taxpayers with adjusted gross income above \$250,000 the Health Care Bill levies an additional tax on investment income of 3.8%. The tax is levied on the lesser of, 1) net investment income, and 2) the amount by which their AGI exceeds the threshold limit of \$200,000 or \$250,000 respectively. Investment income specifically includes gross income from interest, dividends, annuities, royalties, and rents. Investment income does not include distributions from qualified retirement plans, IRAs, gain on the sale of certain business interests, active trade or business income, or ANY income taken into account for self-employment tax purposes. The surtax is effective after December 31, 2012.

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There are a number of planning opportunities clients should consider prior to 2013. Conversions from traditional IRAs to Roth IRAs, maximizing qualified plan contributions, implementing non-qualified deferred compensation plans and contributing to charitable remainder trusts are a few strategies to consider. In addition, cash value life insurance will become a much more attractive option. The cash values inside life insurance policies grow on a tax-deferred basis, and when designed correctly, may be withdrawn free of income taxes – including the 3.8% surtax discussed above. In addition, death proceeds may be received income and estate tax free. When you combine the tax advantages (amplified by the addition of the surtax) with the statutory creditor protection afforded life insurance (if applicable in your state), cash value life insurance will become a much more popular choice for financially successful clients.

H.R. 4849 - Potential GRAT Restrictions

There has been a lot of discussion in the past year regarding Grantor Retained Annuity Trusts. Both the Obama Administration and Congress have commented on their desire to place additional restrictions on this wealth transfer technique. More specifically, both have been outspoken about wanting to restrict GRATs to no less than 10-year

terms. On March 24, 2010, the House passed H.R. 4849, The Small Business and Infrastructure Jobs Tax Act of 2010, which does just that. We obviously have a long way to go before the new rules would become law (only four Republicans voted for it), but the passing of this Bill is definitely a step in that direction.

The Bill adds certain requirements for an annuity interest retained by the transferor to be treated as a qualified interest for purposes of the special valuations rules applicable to transfers of a trust interest to a member of the transferor's family: (1) the retained annuity interest must have a term not less than 10 years; (2) the annuity (determined on an annual basis) may not decline during the first 10 years of the annuity term; and (3) the remainder interest must have a value greater than zero at the time of the transfer. The goal in creating the 10-year minimum term was apparently to subject the grantor / taxpayer to a real risk that they would not survive the term, thereby bringing a portion of the trust back into the estate for estate tax purposes. The Ways and Means Committee stated the following in their report on this Bill - "The provision is designed to introduce additional downside risk to the use of GRATs by imposing a requirement that GRATs have a minimum term of 10 years. Relative to shorter-term (e.g., two year) GRATs, a GRAT with a 10-year term carries greater risk that the grantor will die during the trust term and that the trust assets will be included in the grantor's estate for estate tax purposes. The provision limits opportunities to inappropriately achieve gift tax-free transfers

to family members in situations where gifts of remainder interests in fact have substantial value."

There are many different uses for GRATs that would be affected. For example, when working with clients who have substantial life insurance needs and wish to avoid federal gift tax liabilities, we often look at strategies such as private loans and private split dollar to create the funds necessary to pay the premiums while avoiding gift taxes. In order to be effective, these strategies require an exit strategy, or in other words, a way to pay off the loan. We often suggest GRATs as a tax-efficient means of paying off the loans. If passed, this law would essentially kill the concept of rolling GRATs and would also cause a timing issue for 9-year GRATs that are used as an exit strategy for self-financing plans that are designed to use 9-year private loans (to take advantage of lower mid-term applicable federal rates). The law, as written, would apply to transfers made after it is signed by the President and goes into effect. If you have estate planning clients that are considering a shorter term GRAT as part of their overall estate plan, the Bill should provide some incentive for them to act sooner rather than later.

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