Bloomberg
Businessweek

Obama Squeeze on Savings of Wealthy Muddles Estate Plans

By Margaret Collins & Richard Rubin - April 11, 2013

President Barack Obama wants to prevent people from accumulating too much money in their tax-advantaged retirement accounts or trusts for heirs, adding to pressure on the wealthy after raising tax rates in January.

Obama's 2014 budget proposal, released yesterday in Washington, would increase estate taxes and limit techniques used by the wealthy to transfer assets through trusts.

The plan also caps at $3.4 million the amount individuals can amass in tax-preferred individual retirement accounts and requires those who inherit IRAs to take taxable distributions within five years instead of over their lifespan.

Financial planners and tax professionals said such changes could mean big headaches for individuals, especially the wealthy, as they plan for retirement or strategize about passing on assets to their heirs.

"We are going to penalize people for being diligent about their planning and their saving and for accumulating wealth," David Scott Sloan, chair of the national estate planning practice at the Holland & Knight LLP law firm in Boston, said of the proposals. "If you save too much, we're going to tax it."

The budget plan calls for returning the estate tax in 2018 to 2009 levels, which is a reversal from the so-called fiscal- cliff budget deal Obama signed in January. That law made the estate-tax terms permanent and indexed them for inflation.

"We believe that in these fiscal times, that it's responsible policy in 2018 for the estate tax to return to the 2009 parameters," Jeffrey Zients, acting director of the Office of Management and Budget, said in a press briefing yesterday.

Not 'Permanent'

Obama's budget would drop the per-person exemption from estate taxes to $3.5 million from $5.25 million this year and increase the top estate tax rate to 45 percent from 40 percent. The $3.5 million exemption wouldn't be indexed for inflation.

"It gives us new meaning to the word permanent," Sloan said. "Apparently permanent means five years."

The proposal to restore the estate tax to 2009 levels may re-ignite discussions among wealthy families and advisers that occurred last year when the threshold was set to drop to $1 million, said Jay Messing. He's a senior director of planning in the Northeast for the private bank unit of San Francisco-based Wells Fargo & Co. (WFC)

Obama's proposal, which lays out his priorities on taxes and spending, is not expected to advance in Congress, where the Republican-controlled House and Democratic-held Senate have adopted non-binding budget resolutions so different in their goals that there's little prospect for compromise.

Recycled Proposals

The budget plan recycles proposals from prior years including those to curtail the use of so-called grantor trusts, change rules around valuations of assets in estates and limit to 90 years how long trusts can escape generation-skipping transfer taxes. The proposals related to estate and gift taxes are projected to raise about $79 billion over the next decade.

"These are powerful tools," said Carol Harrington, head of the private client group at the law firm of McDermott, Will & Emery in Chicago. While the proposals would have a long-term effect if enacted, they probably won't raise as much revenue as the budget projects over the next several years, she said.

"People just won't use the technique," Harrington said. Instead, they will look for other tax-advantaged ways to pass wealth to heirs or keep appreciating assets in their estate until they die, she said.

IRA Limits

Obama's budget plan also would limit using IRAs as an estate-planning tool because it generally would require non- spouse beneficiaries to take distributions from IRAs they inherit over no more than five years. That provision would raise about $4.9 billion over the next decade.

IRAs are retirement accounts that let people contribute money without paying income taxes up front. The money grows tax- free inside the account, and holders must pay taxes at ordinary income rates when they withdraw the funds.

IRA owners can begin withdrawing money without penalty after they turn 59 1/2 and must start withdrawing money after they turn 70 1/2.

Heirs of IRAs must take distributions and pay taxes on them, though currently the payments can be stretched over a long period. A five-year limit would make the accounts less attractive for heirs because the distributions are taxed as ordinary income and the tax hit would come much sooner, said Suzanne Shier, director of wealth planning and tax strategy at Chicago-based Northern Trust Corp. (NTRS)

"It's shifting the economics if you don't have the extended payout," she said.

Traditional Accounts

People may look instead to save in traditional investment accounts where long-term capital gains are taxed at lower rates than ordinary income, she said.

IRAs have evolved from a retirement-planning technique into an estate-planning tool for some wealthy families. The issue gained attention during the presidential campaign last year when Republican nominee Mitt Romney disclosed that his IRA held between $18.1 million and $87.4 million, and at one time the maximum value exceeded $100 million.

The budget's proposed cap on retirement savings would apply to the total of an individual's tax-favored accounts including IRAs and 401(k)s. It would be reached by barring taxpayers from adding more tax-free money once the limit is reached. Sponsors of retirement plans and IRA trustees would report each participant's account balance as of the end of the year.

Roth IRAs

The limit would be set starting at $3.4 million, the amount needed to fund a $205,000 annual annuity for a

62-year-old, and be indexed for inflation. Balances from Roth IRAs and the value of defined benefit plans would count toward the cap, said a Treasury official who briefed reporters on the condition of anonymity.

Less than one percent of Americans age 60 or older had combined 401(k) and IRA balances totaling $3 million or more as of year-end 2011, according to the Washington-based Employee Benefit Research Institute.

The budget plan also reprises many of the administration's proposals including a 28 percent cap for high earners on the value of tax breaks such as the mortgage interest deduction, retirement contributions and municipal bond interest.

The limit on the value of itemized deductions and the so- called Buffett Rule proposals revived in the budget would increase income taxes for some wealthy families, said Messing of Wells Fargo Private Bank.

The Buffett Rule, named for billionaire investor Warren Buffett, would impose a 30 percent minimum tax on households with more than $2 million in annual income after charitable contributions.

The budget also repeats a call to tax the share of private- equity managers' profits in buyout deals, known as carried interest, at ordinary income rates rather than preferential rates provided to long-term capital gains.

To contact the reporters on this story: Margaret Collins in New York at mcollins45@bloomberg.net; Richard Rubin in Washington at rrubin12@bloomberg.net

To contact the editor responsible for this story: Jodi Schneider at jschneider50@bloomberg.net