

November 20, 2009

Dear Clients and Friends:

For me, it is hard to believe that over one year has passed since the 2008 presidential election. Last fall, many legislative prognosticators attempted to call what changes would occur in the income, estate and gift tax laws based on President Obama's campaign promises. Many thought the following might happen:

1. Repeal President Bush's tax cuts in 2009 for the top two brackets by reinstating the 36% rate for the 33% rate and the 39.6% rate for the 35% rate.
2. No tax increase for those making less than \$200,000 (thus excluding approximately 97% of all taxpayers).
3. Increase tax rates on long-term capital gains from 15% to 20% (lowered from his previous rate of 28%).
4. Increase the tax rate on dividends from 15% to the ordinary income tax rates (for highest tax brackets that would be 35% and 39.6%). As the campaign progressed, candidate Obama indicated the increase on the tax rate on dividends might be limited to 28%.
5. Rather than repeal the alternative minimum tax ("AMT"), prevent its spread through legislation that keeps the exemption amount at current inflation adjusted levels.
6. Freeze the 2009 estate tax exemption at \$3.5 million with a top rate of 45%.

So what happened to income tax rates? As you cannot help but know, the Congress has been busy in 2009 passing legislation to stimulate the economy and revamp healthcare for much of the country. Certainly, all of the various programs Congressional Leaders desire will have huge costs to all taxpayers. So, while taxpayers braced themselves in 2009 for an early end to the top tax rates of 33 and 35% with 36 and 39.6% either this year or 2010, no change has yet occurred. That fortunate bit of inaction means the tax rate on dividends and long-term capital gains remains at 15% for 2009 and (for now) 2010. By law, all of these lower tax rates are to "sunset" by the end of 2010. Taxes on dividends may still get some preferential treatment by Congress before the "sunset" forces it to a potential top tax rate of 39.6%. In addition, the AMT is still alive and well

with only the exemption amount extended to a level to prevent the AMT net from ensnaring more taxpayers.

Yes, Virginia, there is still an Estate Tax: As many thought last year, the Estate tax would not be allowed to expire for one year in 2010. In fact, there seemed to be some agreement on both sides of the aisle for a permanent extension of the current 2009 estate tax exemption of \$3.5 million together with a top estate tax rate of 45%. When the new administration officially took office in January of this year, it proposed similar legislation together with the gift tax exemption remaining at \$1 million. Currently in Congress there are at least four legislative proposals addressing the estate and gift tax arena.

1. The Baucus plan in the Senate (S. 722) would keep the estate tax exemption at \$3.5 million and index it for inflation. In addition, the Baucus bill would reunify the estate and gift exemptions at the \$3.5 million level while keeping the top estate tax rate at 45%.
2. The Pomeroy bill in the House (H.R. 436) would follow the Baucus plan in the exemption area, but would place a 5% surtax on the top rate for estates over \$10 million. The bill would further restrict valuation discounts for minority interests and non-business assets such as family limited partnerships. Along this same theme, Congress has also considered limiting the terms of Grantor Retained Annuity Trusts ("GRAT") to a minimum of 10 years.
3. The McDermott bill in the House (H.R. 2023) would set the estate and gift tax exemptions in 2010 at \$2 million and index them for inflation. The top estate tax rates under this bill, however, jump to 55%.
4. The Mitchell bill in the House (H.R. 498) has provisions that are the friendliest to the taxpayer, and, therefore, probably will finish last in the horse race of proposed estate and gift tax legislation. So, for those of us who like to think positive, this bill would phase in both the estate and gift tax exemption to \$5 million, and adjust for inflation beyond that amount. The bill would cap the rates at 15% on the first \$25 million and then jump to twice the capital gains rate (30%) on estates over \$25 million. To insure the top rate stays at 30%, the bill would make permanent the 15% capital gains rate.

So what bill is likely to emerge as law to prevent the one year repeal of the estate tax in 2010, and when would it happen? Maybe a study of the Congressional Budget Office ("CBO") would give us a clue. Earlier this year, the CBO compiled statistics that lead many to think \$3.5 million would be the level of the

estate tax exemption. In the CBO study, a law with a \$1 million exemption would result in an estimated filing of 58,000 returns annually, while one with a \$5 million exemption would result in only about 5,300 estate tax filings annually. The CBO study indicated that the lost revenue to the government with a \$5 million exemption would be in the neighborhood of over \$125 billion. The \$3.5 million exemption carried a price tag of approximately half that amount (or \$65 billion) and expected 9,400 estate tax return filings.

With healthcare reform taking up much of the oxygen in Congress, legislation on estate tax remains on hold. So, we could see legislation in 2010 that merely extends for one year the current 2009 provisions of an exemption of \$3.5 million. Such legislation would be scored as revenue and not a cost since Congress would have avoided the one year repeal scheduled for 2010. A cynical friend of mine has asked me why Congress would not continue with annual one year extensions of the estate tax exemption. He points out that each side of the estate tax debate (those wanting more tax and those wanting less) is well funded. These opponents would then have reason to visit the halls of Congress more often and contribute to the lawmakers' favorite funds on an annual basis. I hope my cynical friend is wrong and that Congress would eventually put in place more permanent provisions even if a one year "patch" becomes necessary for an overworked Congress.

Suggestions for immediate future? If you are in control over ordinary income recognition such as the timing of the exercise of a stock option, you should weigh your timing for this year with the storm clouds of increased ordinary income tax rates in 2011 (or 2010 if Congress accelerates the "sunset" of the lower tax rates). Further deferral of a stock option exercise to 2011 could incur not only the restored top ordinary income tax rate of 39.6%, but also a possible surtax of 5.4% that Congress is currently mulling as an additional source of revenue to cover the costs of the various programs the Government is proposing.

As you know, unlike a traditional IRA, a Roth IRA is not subject to tax on withdrawals nor is it required to make minimum required annual distributions upon the attainment of age 70 ½. In 2010, a law passed by Congress in 2006 becomes effective. This law eliminates the \$100,000 income limitation on conversions of Traditional IRA's to Roth IRA's, thereby allowing any taxpayer to elect to make a conversion. While the conversion will carry an income tax on any previously deductible contributions and deferred income to date, the income (and the resulting tax) can be spread over 2 years (2011 and 2012). One

can elect out of this deferral of income recognition, and recognize all of the income in 2010. This decision coupled with the higher income tax rates surely to come will require one to think about his/her overall income tax situation before making this election.

Although the market in 2009 has recovered some of its lost value of the last 2 years, some investments still remain at low levels. These low values, together with near historical low interest rates and the tax changes surely to come, offer advantageous planning opportunities. Examples of such techniques would include the following:

1. Freezing transactions such as sales of assets in exchange for promissory notes at an appropriate market rate of interest.
2. Sale of assets to trusts (Intentionally Defective Grantor Trusts - "IDGT") that are intentionally drafted to create both income tax advantages as well as estate and gift tax savings.
3. Use of GRAT's in gifting to reduce the gift tax cost to the grantor.

If you would like to discuss some of these techniques in greater detail, we would be happy to meet with you.

All of these considerations above are costs of your financial decisions, and, certainly, timing and planning are important to that success. We thank you for your confidence in us over the years and look forward to assisting you in attaining your financial goals. Our entire firm wishes you a joyous holiday season and a blessed and prosperous 2010.

Very truly yours,



Joseph W. Thomson

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