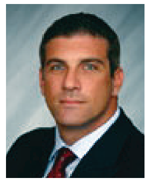
PROFESSIONAL ADVISOR UPDATE

LIFE AUDIT PROFESSIONALS, LLC™

MyLifeAudit® "Life Insurance is an Asset that Must Be Managed"™ MyLifeGiving™ Analyze, Maximize & Give

2101 NW Corporate Boulevard, Suite 300 | Boca Raton, FL 33431 | tf: (855) 543-3283 | MyLifeAudit.com

Richard K. Newman
CPA/PFS, AEP
Managing Member



Jeremy Bloom
Chief Marketing Officer

Andrew M. Shamp
JD, LL.M.
Financial Representative

Potential Tax Reform – Make Hay while the Sun Shines

Regardless of your political affiliation, be it Republican, Democrat, Tea Party or, for that matter, even if you align yourself with the 19th century Whig party, you have to agree that our country cannot sustain the current level of spending with the current level of revenue we are collecting. The recent tax legislation passed in the early morning hours of New Year's Day is like using bubble gum to plug a crack in the Hoover Dam. And the guy we took the gum from is upset we used his gum instead of some other guy's. Logic (and simple math) dictates that the federal government must do more. Most likely we'll hear the typical arguments over spending cuts – you need to cut entitlement – well, only if you cut defense spending – well, we're not raising the debt ceiling – well, we're not touching Social Security – and on and on until they reach an impasse and both sides run to the media claiming it was the other side's fault. It's the intellectual equivalent of two five-year olds fighting over a chocolate chip cookie, but it's the current state of our political system. But, for quite some time now there have been rumblings beyond increasing tax rates and spending cuts. There has been real discussion from both sides of the aisle regarding broader tax reform. Here are a few examples of what we are hearing from our leaders in Washington:

"I think it's important that we got the permanent tax policy, because that lets us pivot to comprehensive tax reform, which is so important for growth and jobs." - Rep. Dave Camp (R-Mich.), chairman of the House Ways and Means Committee.

"Senator Baucus has every intention of taking tax reform up in the next Congress and working to create jobs and boost the economy. He has been laying the groundwork for tax reform for well over a year, meeting regularly with Finance Committee members as well as Ways and Means Chairman Dave Camp." - Sean Neary, communications director.

"The more revenue is raised with rate increases, the easier it is to do tax reform next year." - Sen. Max Baucus (D-Mont.), chairman of the Finance Committee.

"I'm in favor of doing tax reform but I think tax reform ought to be revenue-neutral, as it was back during the Reagan years." - Senate Republican Leader Mitch McConnell (R-Ky.).

"We've done about $2 trillion. I thought $4 trillion is the goal we should reach. I think we're about halfway there. We need another $2 trillion." - Sen. Ben Cardin (D-Md.), a member of the Finance Committee.

"On the day after the election, I proposed that both parties work together to avert the fiscal cliff in a manner that would ensure 2013 is the year we finally enact entitlement reform and pro-growth tax reform to begin to solve our country's debt problem." - House Speaker John Boehner (R-Ohio).

"Democrats want everything on the table from the standpoint of closing loopholes." - House of Representatives Democratic Leader Nancy Pelosi (D-Calif.)

Tax reform is a broad term that means different things to different people. But one area that is typically part of the debate is the idea of closing tax expenditures, otherwise known as tax loopholes. Section 3(3) of the Budget Act of 1974 defines tax expenditures as those revenue losses attributable to provisions of the federal tax laws which allow a special exclusion, exemption, or deduction from gross income or provide a special credit, a preferential rate of tax, or a deferral of tax liability. There are currently over 200 separate tax expenditures, costing the Treasury more than $1 trillion each year . Considering that the recently passed tax act is only projected to increase tax revenue by approximately $60 billion per year, you can see why tax expenditures may draw some interest.

Both Republicans and Democrats are in favor of broad tax reform and simplification of the tax code. Yet the number of tax expenditure items on the books has grown from 128 in 1987 to over 200 today. According to the Joint Committee on Taxation, "Tax expenditures are similar to those direct spending programs that are available as entitlements to those who meet the statutory criteria established for the programs." In other words, tax expenditures are a means for the government to spend money without it having to go through the appropriations process and being considered spending. Our federal government is required to go through an appropriations process based on Article I, Section 9, Clause 7 of the U.S. Constitution, so in many cases it is easier to slide a tax break into legislation than it is to go through appropriations.

The last time we had tax legislation that included major tax reform was back in 1986. President Ronald Reagan presided over one of the largest tax decreases in our country's history, starting with the Economic Recovery Tax Act of 1981 and ending with the Tax Reform Act of 1986. This is a well-known part of our political history. What many are not as familiar with is that between 1981 and 1986 Reagan signed a number of bills into law that eliminated or reduced the effect of many tax expenditures. One of the stated reasons for eliminating many of the tax expenditures was to achieve simplification of the tax code, but there was more to it than that. While an oversimplification of the situation, essentially the federal deficits started to increase dramatically and the government needed to find some revenue. For many, that sounds like blasphemy, we're talking about the president who in March of 1985 said, "I have my veto pen drawn and ready for any tax increase that Congress might even think of sending up. And I have only one thing to say to the tax increasers. 'Go ahead, make my day.'" Nevertheless, lowering tax rates while broadening the tax base through various methods, including a reduction in tax loopholes, is an effective way to retain or increase government revenue, and this was part of the story through the mid to late 1980s. In hindsight it appears the deficit increase had more to do with increased spending than a lack of revenue, but while in the midst of it all I'm sure there were a number of elected officials and a few economists who agreed that closing a few loopholes might help.

There was certainly disagreement between the two parties in the 1980s, but by all accounts the political environment today is much more toxic and polarized, making it difficult to see a path towards agreement on spending cuts and major tax reform. And even the soft whisper of removing any one of the expenditures currently on the books will result in a stampede of lobbyists that Congress and the president will have to contend with. That said, it does appear there are a sufficient number of tax reform proponents on both sides of the aisle to make an attempt this year. So the question becomes, which tax expenditures are in the cross-hairs. The following is a list of current tax expenditures and their projected cost to the Treasury from 2013 to 2017 (in millions) :

Exclusion of employer contributions for medical insurance premiums and medical care	1,012,320
Deductibility of mortgage interest on owner-occupied homes	606,420
401(k)-type plans	428,760
Accelerated depreciation of machinery and equipment (normal tax method)	374,640
Exclusion of net imputed rental income	337,380
Capital gains (except agriculture, timber, iron ore and coal)	321,470
Employer plans	298,040
Deductibility of nonbusiness state and local taxes other than on owner-occupied homes	295,050
Deductibility of charitable contributions	293,160
Exclusion of interest on public purpose state and local bonds	227,500
Deferral of income from controlled foreign corporations (normal tax method)	216,020
Step-up basis of capital gains at death	182,210
Capital gains exclusion on home sales	171,110
Social Security benefits for retired workers	149,280
Exclusion of interest on life insurance savings	140,630
Deductibility of state and local property tax on owner-occupied homes	140,630
Self-employed plans	112,200
Individual Retirement Accounts	100,080
Exception from passive loss rules for $25,000 of rental loss	99,810
Deduction for US production activities	81,080

In addition to eliminating tax expenditures, broad tax reform may also bring an end to short term grantor retained annuity trusts, reduce the advantages of sales to intentionally defective trusts, eliminate the discount on gifts of limited partnership interests to family members, and impose a ninety year limit on the duration of all dynasty trusts. Each one of these has been proposed by the president over the past few years.

Clients need to be aware that time may be running out to take advantage of a number of opportunities for tax savings. A good example of this is the income tax-free nature of cash values that build up inside life insurance policies, which dates back to 1913. A number of laws were passed in the 1980s that attempted to limit this tax advantage (TEFRA 1982, DEFRA 1984, and TAMRA 1988). Key to this discussion is that policies issued prior to the enactment of these laws were grandfathered. Even with these limits however, many considered life insurance to have an unfair advantage over other investments. President Reagan proposed to eliminate this tax advantage during discussions over the Tax Reform Act of 1986, but his proposal did not make it into the Act. The issue has been raised many times since then. In 2010 the Senate Committee on the Budget prepared a report on tax expenditures and specifically with regards to life insurance stated that, "The tax treatment of policy income combined with the tax treatment of life insurance company reserves makes investments in life insurance policies virtually tax-free. Cash value life insurance can operate as an investment vehicle that combines life insurance protection with a financial instrument that operates similarly to bank certificates of deposit and mutual fund investments." It is interesting to note that this tax break enjoyed by life insurance ranks fifteenth out of over 200 tax expenditures when it comes to how much it costs the federal government in revenue.

There is an old saying – you should make hay while the sun shines. Well the sun may be setting on a number of tax breaks we have enjoyed for years. With tax rates increasing for high-income earning clients, I encourage anyone who advises clients on financial and tax matters to take a quick look through the full list of tax expenditures. While this Congress may or may not be successful at passing major tax reform, and it is difficult to predict what would be included in the final legislation, another old saying may be appropriate – chance favors the prepared mind (Louis Pasteur).

For questions or comments please contact 855-LIFEAUDIT (855-543-3283)

Richard Newman, 561-948-2421

Jeremy Bloom, 561-948-2423

Andrew Shamp, 561-948-2425