HOW TO DEAL WITH INCOME AND ESTATE TAX TIMEBOMBS

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Objectives of Presentation

- Review Selected Recent Federal Law changes on the Income Tax Front
- Review Current Federal Estate Tax Rules
- Review Estate Tax Legislative Proposals
- Review State Estate Tax Issues
- Popular Techniques Used in Estate Planning
- Questions

Selected Business Developments

Expanded Section 179 Expensing

- **Section 179 limit to $250,000, effective for tax years beginning in 2009, 2009 and 2010**

- **Asset Addition phase-out range: $800,000 - $1,050,000**

- **<u>Caution</u>: State nonconformity**

Expanded Section 179 Expensing

2010 Small Business Tax Bill:

- **Expands expensing deduction to $500,000 for tax years beginning in 2010 and 2011**
- **Asset addition phase-out range to $2 million**
- **Specified 15 year real estate improvements eligible (leasehold improvements, restaurant buildings, and retail improvements) – 2010 and 2011 only**

2010 Small Business Tax Act

- **50% bonus depreciation restored for property placed in service in 2010 (new; ≤ 20 year life)**

- **5 year carry-back (not 1 year) for 2010 excess small business tax credits (average gross ≤ $50M) and no AMT limit**

- **S corporation built-in gains period to 5 years for 2011**

- **SE tax reduced by health insurance for 2010**

2010 Small Business Act

- **Failure to file 1099 penalties increased ($15 to $30, $30 to $60, and $50 to $100) effective for 2010 information returns**

- **Employer-funded 401(k) share may be rolled to Roth account within the plan, effective after enactment**

- **<u>Portion</u> of annuity or life insurance contract may be annualized for 10 years +, effective in 2011**

Health Care Legislation:
2011 and Beyond

Health Care Legislation

- **Enacted in a series of bills over last week of March, 2010**

- **Coverage of selected tax-related provision**

W-2 Disclosure of Health Coverage Cost

- **Effective for 2011, W-2 must disclose cost of employer-provided health benefits**
  - Includes medical insurance, dental and vision plans, and self-insured arrangements
  - No reporting for employee salary-reduction FSAs or employer HSA funding
  - Does NOT change tax-free status of employer health benefits!
  - IRC Sec. 6051(a)(14)
  - IRS announced delay- not effective until 2012 W-2s

Expanded 1099 Reporting

- Effective for payments in 2012 and after, a business must issue a 1099 for any payment for property over $600
  - Previously, only services, interest, etc.

- Also, a 1099 must be issued to any corporation, but not to a tax-exempt, for any property or services over $600
  - IRC Sec. 46041(a) and (h)
  - Ag Business must comply with this reporting rule for all payments to others for products and services including fuel, seed, supplies and fertilizer etc.

Increased Medicare Tax on Earned Income

- **Present employee FICA payroll tax: 6.2% OASDI on first $106,800; 1.45% Medicare on all earnings**

- **Effective in 2013, Medicare tax up.9% to 2.35% on higher income earners [IRC Sec.3101(b)(2)]:**
  - **Single earned income over $200,000**
  - **Joint earned income over $250,000**
  - **Assessed on employee share only, but employer withholds**
  - **If withholding inadequate, remit in 1040**
  - **Applies to Schedule F and Farm Partnership SE Income**

Medicare Surtax on Unearned Income

- **New 3.8% Medicare surtax on unearned income also effective in 2013 [IRC Sec. 1411(a)]**

- **Lesser of:**
  - **Net investment income, or**
  - **Excess of MAGI > $200,000 (MFJ: $250,000)**

- **<u>Example</u>: W-2s for (H) & (W) = $280,000 with $20,000 of interest income**
  - **RESULT: 3.8% x $20,000 = $760**
  - **VARIATION: W-2s of $240,000 results in a surtax of 3.8% x $10,000 = $380**

Medicare Surtax on Unearned Income

- **Net investment income**
  - **Interest, dividends, annuities, royalties, rents**
    - **But not tax-exempt interest income**
  - **Passive business income (no Material participation by taxpayer)**
  - **Trading in financial instruments or commodities**
  - **Capital gains and other property disposition gains**
    - **Not gain on sale of an active business**
    - **Not excludable gain (e.g. principal residence)**

Medicare Surtax on Unearned Income

- Exceptions to investment income:
  - Active business income, including working capital interest
  - IRA and retirement plan withdrawals
  - All SE income (even if from a passive activity)
  - Tax-exempt income

- Estates and trusts also subject
  - Limited to excess inv. Income over top rate threshold
  - Subtraction allowed for distributions to beneficiaries

Big-picture Outlook: High-income TPs

- Impacted by other tax law changes and possible modifications to Health reform Act itself
  - Need to look beyond Medicare tax hikes alone
  - Green Book proposal (President's budget)
    - 35% top rate to 39% in 2011
    - Return of exemption and Schedule A phase-outs (+2%)
    - Higher dividend and capital gain rates
    - 2010 Senate Budget Committee Resolution: Dividends as ordinary income for higher income taxpayers

Big-picture Outlook: High-income TPs

- **Probable result in 2011 is top rate of 42%**
  - **Same group targeted to fund health expansion (> $200K single and $250K joint)**

- **Take coordinated approach to rate hikes**

	2010	2011	2013
Salaries	36%	43%	44%
SE income	38%	45%	46%
Ordinary investment income	35%	42%	46%
Ordinary business income	35%	42%	42%
Capital gains	15%	20%	24%

Comparison of Individual Income Tax Rates

Pre EGTRRA	2010	EGTRRA Sunset 2011	Obama Proposed 2011
10.0%	10%	-	10.0%
15.0%	15%	15.0%	15.0%
28.0%	25%	28.0%	25.0%
31.0%	28%	31.0%	28.0%
36.0%	33%	36.0%	36.0%
39.6% ($297,350)	35% ($373,000)	39.6%	39.6% ($200 Single $250 Married)

- Change in where top rate applies
- Qualifying dividends tax rate15%
  - What happens here?
- Long term capital gains tax rate15%
  - 20% or ?
- Pre EGTRRA tax brackets will continue to reflect inflation adjustments
- Proposal to limit tax benefits of itemized deductions to 28% tax rate.
- Lame Duck Congress: Extend 2010 rates to 2011-2012 due to recession.

Estate Tax Update

Federal Estate, Gift & GST Sunsets

<table>
<tr><th colspan="12">Year-by-Year Summary of the Changes Made by ENGTRRA</th></tr>
<tr><th></th><th>2001</th><th>2002</th><th>2003</th><th>2004</th><th>2005</th><th>2006</th><th>2007</th><th>2008</th><th>2009</th><th>2010</th><th>2011 on</th></tr>
<tr><td colspan="12"><u>Estate Tax</u></td></tr>
<tr><td>Exclusion</td><td>$675,000</td><td colspan="2">$1 million</td><td colspan="2">$1.5 million</td><td colspan="3">$2 million</td><td>$3.5 mil</td><td rowspan="9">Not applicable. Replaced with carryover basis</td><td>$1 million</td></tr>
<tr><td>Lowest Rate</td><td>37%</td><td colspan="2">41%</td><td colspan="2">45%</td><td rowspan="2">46%</td><td colspan="3" rowspan="2">45%</td><td>41%</td></tr>
<tr><td>Top Rate</td><td>55%</td><td>50%</td><td>49%</td><td>48%</td><td>47%</td><td>55%</td></tr>
<tr><td>5% Bubble</td><td>Yes</td><td colspan="8">No</td><td>Yes</td></tr>
<tr><td>QFOBI</td><td colspan="3">Yes</td><td colspan="6">No</td><td>Yes</td></tr>
<tr><td>State Tax Credit</td><td>100%</td><td>75%</td><td>50%</td><td>25%</td><td colspan="5">None: State taxes are deductible.</td><td>100%</td></tr>
<tr><td colspan="10"><u>GST Tax</u></td><td></td></tr>
<tr><td>Exemption</td><td>$1.06 mil</td><td>$1.1 mil</td><td>$1.2 mil</td><td colspan="2">$1.5 million</td><td colspan="3">$2 million</td><td>$3.5 mil</td><td>About $1.34 mil *</td></tr>
<tr><td>Rate</td><td>55%</td><td>50%</td><td>49%</td><td>48%</td><td>47%</td><td>46%</td><td colspan="3">45%</td><td>55%</td></tr>
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<tr><td></td><td colspan="11">* This would have been the GST exemption in 2010. In 2011, it is further adjusted for inflation.</td></tr>
</table>

Top Marginal Tax Rates

	Federal	State	Total
"Coupled" State	45%	0	45%
Ordinary "Decoupled" State	38.80%	13.80%	52.60%
"Decoupled" State / No Deduction	37.80%	16%	53.80%
In 2011 (Under Current Law)	39%	16%	55%

Proposed Tax Legislation - Pending

- **EGTRAA Sunset**
  - **Lame duck session?**

Estate Planning

- Five possible outcomes
  - Congress does nothing – law as is for 2010
  - Congress passes "patch" legislation
    - Change effective from date of enactment
  - Congress pass "retroactive" legislation
    - Court challenge won
    - Court challenge lost
  - Congress pass law – "retroactive but"
    - Choice
      - Follow rates now with stepped up basis
      - No estate tax 2010 – carryover basis
- Four of the five possible outcomes offer positive results for planning

Middle Class Tax Cut Act of 2010

- Senate Finance Committee – Max Baucus
- Bill came out of committee Thursday, December 2, 2010
- Full vote in Senate on Saturday, December 4, 2010
- Bill was defeated 53-26 (needed 60 votes)
  - All Republicans voted against it
  - 4 Democrats
  - Independent

Middle Class Tax Cuts Summary of Bill – Key Provisions

- Made permanent the "Bush Tax Cuts" for all those married couples with adjusted gross income of $250,000 or less (single $200,000 or less)
- Ordinary tax rates
- Capital gains and qualified dividends – "middle class"
  - 15% (25% ordinary tax bracket)
  - 0% (10% or 15% bracket)
- Capital gains and dividends 20% for high income
- Number of the provisions

Senate Bill ---Permanent Estate Tax Relief

- Reinstates 2009 law
  - $3.5 million exemption – per individual
  - Indexed for inflation – begin 2011
  - Top tax rate 45% (2009 rate)
  - Effective January 1, 2010
  - Election (Jan. 1 to Dec. 2, 2010), choose no estate tax (2010 current law) and carryover basis
  - Reinstates the Generation Skipping Tax
  - Lifetime exemption portable between spouses

Permanent Estate Tax Relief (continued)

- Deferral of estate tax for farmland
  - Defer tax
    - Family farm

    Until

    - Land is sold or transferred outside the family
    - Ceases to be farmland
    - Income limit on who claims $750,000 (AGOI)
- Increase special use revaluation for $1.0 to $3.5 million

Permanent Estate Tax Relief (continued)

- **GRATs have a minimum term of 10 years (effective after date of enactment)**
- **Basis step up generally applies**
- **Gift tax exclusions: $13,000 annual, $1.0 million lifetime**
- **Gift tax rate for taxable gifts after December 2, 2010**
- **Other provisions**
  - **Makes permanent the $125,000 Section 179 expensing provision for equipment**
  - **$500,000 additions phase out**

Bipartisan Agreement --- Framework

- Extends “Bush Era” tax cuts two years
  - 2011 and 2012
- Tax rates
  - Married highest rate 35%, $379,000
  - Qualified dividends & capital gains 15%
- GRATs
- Portability of exemption
- Farmland deferral
- Special use valuation
- Reinstatement of federal estate tax - $5 million exemption and a top rate of 35%
- Not clear about any other proposals in the Senate Finance version of “Tax Cut for Middle Class”

Framework - Bipartisan Agreement (continued)

- Two year Alternative Minimum Tax (AMT) “Patch” exemption
  - $40,000 (old rule)
  - $70,000 (patch)
- Retain “key tax cuts” for working families
  - Earned income tax credit
  - Child tax credit
  - American Opportunity Tax Credit (education)

Framework - Bipartisan Agreement (continued)

- **Allow business to write off 100% of equipment & machinery purchases in 2011**
- **Reduce worker's share of social security tax (payroll) by 2% from 6.20% to 4.20%**
- **Extend unemployment benefits for 13 months**
- **Not clear on tax extenders and expiring tax breaks**

Estate Planning 2010

- **Carryover basis – death in 2010**
  - How to use $1.3 and $3.0 (spouse) basis step up
  - Records of carryover basis amounts
    - How to report?
    - IRS has issued new Form 8939
    - Form filed with final Form 1040 of the decedent

- **Lifetime giving**
  - Gift tax 2010 – rate 35%
  - No generation skipping tax (GST)
  - Consider large gifts this year
    - Effect of removing gift tax from taxable estate
    - Rate differential 35% vs. 45% vs. 55%

Estate Planning 2010

- State estate planning
  - Decoupled states – Minnesota (example)
- Gifts to dying spouse
  - Utilize $3.0 basis step up allowed
- Low interest rate environment
  - Applicable federal rates (AFR)
    - Outright / Trusts
  - Interfamily sales / loans
  - Grantor Retained Annuity Trusts (GRATS)
    - Ten year term after 2010?

Estate Tax Legislative Proposals

Other Proposals – Obama Administration

- **Valuation Discounts**
  - **Limits on valuation discounts when transfers of business ownership between family members**
- **Grantor Retained Annuity Trust (GRAT) minimum term ten years**
- **Portability of each spouses' lifetime estate tax exemption**
- **Recouple lifetime gift tax exemption with estate tax exemption**

State Estate Tax Issues

- **Estate tax exposure at state levels**
  - **At least 24 states have some form of estate tax currently**
  - **Example**
    - **Minnesota has $1 million individual estate exemption**
    - **Minnesota has no gift tax**
- **Inheritance taxes – tax on heirs (Indiana, Iowa, Pennsylvania, Nebraska)**
- **States currently without estate tax include Wisconsin, South Dakota, Wyoming, Missouri, North Dakota and Michigan**
- **Treatment of state estate tax for calculation of federal estate tax**
  - **Deduction in computing federal estate tax**

Specific Estate Planning Objectives

- Maximize use of tax exemptions and exclusions
- Minimize complexity
- Transfer substantial values to the next generation quickly
- Minimize IRS audit risk/challenge
- Avoid probate
- Privacy
- Philanthropy
- Maintain continued financial security for senior family members, their spouses & family
- Family harmony

- Do you have wills and other documents reflecting your wishes?
  - NO- Your state will write one for you (statutory).

Do You Have a "Taxable Estate"?

Total Assets
- Total Liabilities
- Expense of Estate
- Charitable Bequests
- Asset passing to surviving spouse
+ Taxable Lifetime Gifts
= Taxable Estate

Do You Have a "Taxable Estate"?

Total Assets – Total Liabilities = Total Estate

- Total assets include
  - Home
  - Farm
  - Business
  - Equipment
  - Real Estate
  - Inventory
  - Value of ownership interests
  - Investments
  - Personal property
  - Other real estate
  - Other assets and property

Payment of Estate Tax

- General Rule
  - Federal
    - Due 9 months after date of death
    - Estate return can be extended six months but tax is due
      - Interest due
      - Penalties may apply
        - Reasonable cause exceptions
  - Filing of federal return
    - Gross estate plus adjusted taxable gifts exceed $3.5 million (2009)

Payment of Estate Tax (continued)

- **Valuation understatement – failure to value assets correctly**
  - **20% penalty**
  - **Underpayment of estate tax exceeds $5,000**
  - **The underpayment is attributable to valuation understatements**
  - **Valuation understatement exists when**
    - **Value of property reported is 65% or less than actual value**

Deferral of Estate Tax – Section 6166 Election

- What is it?
  - Deferral of estate tax payment "attributable to interest in a closely held business"
  - Allows heirs/estate to retain business
  - Federal Estate Tax payable over 14 years
    - Maximum of ten annual installments
    - Delay payment for first four years
      - Pay interest only
      - Low interest rate
    - Interest rate 2% on tax attributable to asset value of $1.3 million
    - Balance of tax interest 45% if IRS market rate

Payment of Estate Tax (continued)

- What estates qualify?
  - Value of business must be 35% or more of gross estate
  - Closely held business is
    - Sole proprietorship
    - Closely held
      - Corporate stock
      - Partnership interests
    - Attribution rules apply for ownership
- Loss of deferral?
  - Accelerated if payments are missed
  - Sell Property or Business

Special Use Valuation

- Qualified Real Property included in decedent's estate
  - Used for farming
  - Other trade or business
  - Located in US
- Up to $1 million reduction in value used to determine estate tax
  - Current use value vs. highest & best use value
- Complex rules regarding use before death
  - Material participation
    - Owned by you on date of death and five of eight years before death
      - Directly or
      - Indirectly
        - Trusts
        - Partnerships
        - Corporations
    - Five of eight years or more ending on
      - Death
      - Disability
      - Date starting social security benefits

Special Use Valuation (continued)

- Percentage Test Requirement
  - Value of business and Land
  - At least 50% of Adjusted Gross Estate

  - At least 25% of Adjusted Gross Estate must consist of
  - Farm land or closely held real property

- Election is made on timely filed Estate Tax Return.
  - Real Estate appraisals MUST be included with return

- Recapture
  - Property must be used as a farm
  - Qualified heir/immediate family member who materially participates in operations.

Special Use Valuation (continued)

- Land
  - Rented to others or
  - Recently acquired
  - Does not qualify

- Qualified Heir
  - Immediate family member
    - Spouse
    - Ancestors
    - Lineal decedents
    - Spouse's descendants
    - Spouse of lineal decedents

Popular Techniques Used in Estate Planning

- **Annual Gift Tax Exclusion**
  - **$13,000 per year per donee**
  - **Tuition & medical expense exclusion unlimited**
    - **Example:**
      - **Assume Dad & Mom have 2 children and 4 grandchildren**
      - **Can gift up to $156,000 per year without any federal transfer tax assessed**

- **Lifetime Gift Exclusion**
  - **$1.0 million per donor**
  - **Uses up portion of $3.5 million life time exemption**
    - **Shift future appreciation and income to donor**

Married Couples

Key Issues

- Proper use of each spouse's $3.5 million exemption
  - In theory, married couple can leave up to $7.0 million to heirs estate tax free
- Property ownership
  - Separate property vs. community property
  - Separate ownership
  - Joint ownership
- Beneficiary Designations
  - IRAs & retirement plans
  - Annuity contracts
  - Life insurance
- Unlimited marital deduction

Example

	(H)	(W)	Joint	Total
Land	$ 5,000,000			$ 5,000,000
Equipment	$ 500,000			$ 500,000
Home			$ 300,000	$ 300,000
Insurance	$ 1,000,000	$ 500,000		$ 1,500,000
Investments		$ 500,000		$ 500,000
	$ 6,500,000	$ 1,000,000	$ 300,000	$ 7,800,000

Estimated tax if (H) dies first:

Gross Estate	$ 6,500,000
One-half Joint Property	$ 150,000
Less Exemption	$ (3,500,000)
To (W) (Marital)	$ 3,150,000
Wife's Assets	$ 1,000,000
One-half of Joint Property	$ 150,000
	$ 4,300,000
Less Exemption	$ (3,500,000)
Taxable Estate	$ 800,000
Tax Rate	45%
Federal Estate Tax	$ 375,000

Example

Now assume wife dies first

Gross Estate	$	1,000,000
One-half Joint Property	$	150,000
Less Exemption	$	(3,500,000)
Taxable Estate	$	(2,350,000)
Husband's Assets	$	6,500,000
Joint Property	$	300,000
Subtotal	$	6,800,000
Less Exemption	$	(3,500,000)
Taxable Estate	$	3,300,000
Tax Rate		45%
Federal Estate Tax	$	1,485,000

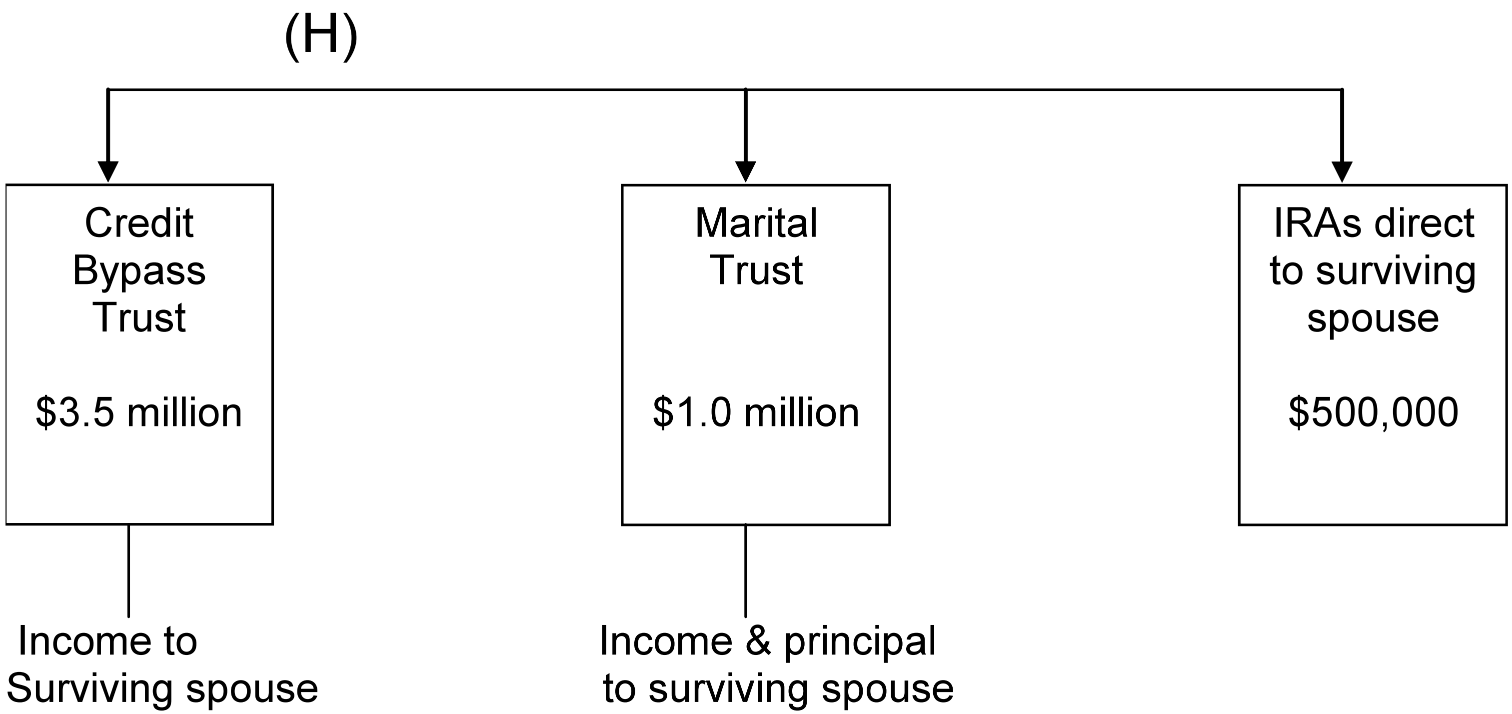
Increase of over $1 million tax due by order of death.
Key Point: Balance estates to make sure exemptions are not wasted.

Use of Trusts for Married Couples

- Credit By-Pass Trust
  - Use to "hold" first spouse to due credit exemption amount
    - Income to surviving spouse
    - Principal to surviving spouse
- Marital Trust
  - Can Hold deceased spouse's assets in amounts greater than united credit amount
- QTIP Trust
- Power of Appointment Trust

Estate Tax Example of Marital Trust

(H)
* $5,000,000 *



*Includes $500,000 IRA

Life Insurance Issues

- **Proper amount of death benefit**
- **Proper ownership of policy**
  - **Who pays premiums?**
- **Keeping death benefit out of estate for estate tax purposes**

Life Insurance Example

- **Total Estate – Assume $7.0 million**

  - **Life Insurance**
    - **Husband has $2.0 million death benefit with wife as beneficiary**
    - **Assume husband dies and wife collects death benefit**

  - **Total Estate now $9.0 million**
    - **$2.0 million exposed to Federal Estate Tax**
    - **Estate tax cost estimated $900,000**

  - **Net death benefit after estate tax erosion is $1.1 million**

Design of Irrevocable Life Insurance Trust (ILIT)

Insured
A

Pays annual premiums by
gift of cash to trust

$20,000/year

Insurance
Trust

Premiums paid by
Trust to Insurance Co.

Insurance
Company

Trustee buys and owns
Policy A

Insurance Trust At Death

Insurance Trust

$1,000,000

Pays death benefit to Trust

Insurance Company

Trustee

•Pays out benefit to beneficiaries

•Lends money to estate for expenses

•Buys assets from estate

•Pays income to surviving spouse

Insurance Issues to be Reviewed

- Transfer of existing policies to insurance trust
  - Gift value
  - Three year rule

- Payment of premiums
  - Annual gift exclusion
  - GST exemption allocation

Estate Transfer Techniques

- Interfamily loans
  - Low interest rate environment
- Use of valuation discounts – fractional ownership in business entities
  - Marketability
  - Control
- Outright sale of property
- Family limited partnerships

Loan / Sale Example

- Dad lends son $100,000 for 9 years
  - AFR required interest rate 1.53% (Dec 2010 mid term rate for loans 9 years or less)
- Son invests money and earns 6% per year
- Dad gets
  - Interest $1,530 x 9 $13,770
  - Son earns $6,000 x 9 $54,000
  - Net gain to son (pretax) $40,230

No transfer tax on the $40,230

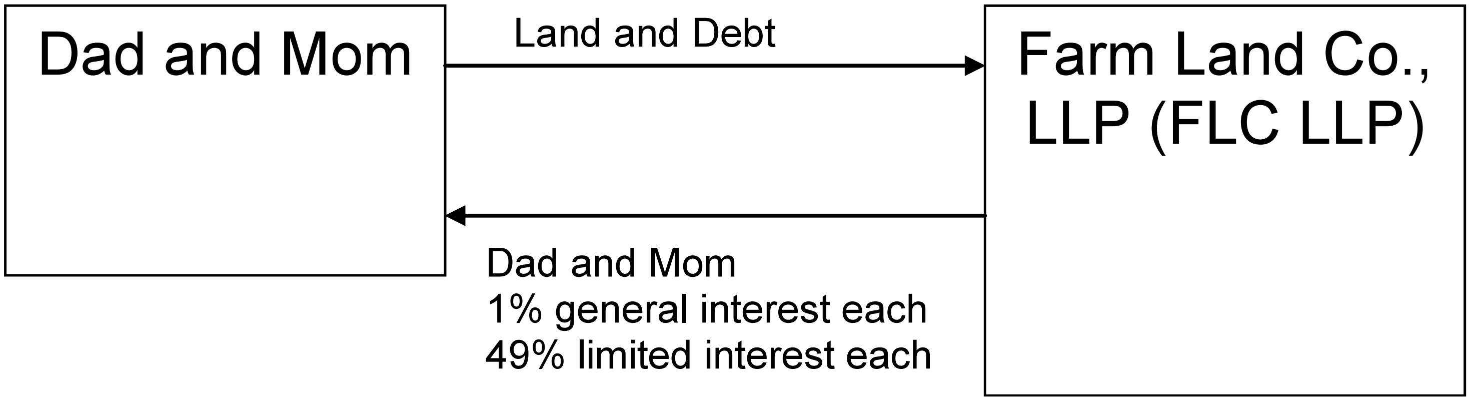
Income tax reporting

- Sale – gain (losses on sales to related parties)
- Loan – interest income / deductible interest expense

Family Limited Partnership

- **What is it?**
  - **Estate planning tool**
    - **Reduce income and estate taxes**
    - **Distribute assets to heirs while keeping control of business**
    - **Ensure continued family ownership of business**
    - **Provides liability protection for all limited partners**

Family Limited Partnerships (continued)



Step 1

- Dad & Mom transfer land and related debt to partnership
- Dad & Mom get back ownership
  - 1% general interest each
  - 49% limited interest each

Alternative: each child puts in cash or other assets in exchange for ownership

Family Limited Partnerships (continued)

<u>Step 2</u>

- FLC LLP enters into lease agreement with farming operation and collects annual rents
- Dad & Mom make management decisions including
  - Collect rents
  - Make payments on purchase debt
  - Buy or sell land
  - File tax return for partnership

<u>Step 3</u>

- Dad & Mom decide to gift to children (3) an interest in FLC, LLP
  - Get appraisals on land to determine current value of entity
  - Assume

• Land Appraisal	$3,000,000
• Debt	<u>$ (500,000)</u>
• Net Value	$2,500,000
• 1.0% Ltd Interest	$ 25,000

Family Limited Partnerships (continued)

Step 3 continued

- Appraiser says limited interest discounts
  - Lack of control 20%
  - Marketability 25%
- Value of 1% limited interest
  - Gross value $25,000
- Less marketability (25%) $ (6,200)
  - Less lack of control (20%) $ (3,700)
  - Net value of 1% $15,000
  - Gift to each child (1.7%) $25,500
  - Annual gift exclusion $26,000

Result

- Kids own 5.1% of FLC LLP
- Gross value $127,500 transferred to gift tax free

Family Limited Partnership

Do's and Don'ts

- Execute written agreement
- Document business purpose
- Prepare written leases
- Open bank account for partnership
- Transfer ownership and debt to entity
- Do NOT co-mingle personal assets
- File annual partnership returns
- DO NOT put entire net worth in entity
- Do when in good health