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PLANNING POTPOURRI

S corporation Charades: Your CPA recommended an S corp. instead of an LLC to save payroll taxes? Slick move dude. Like the IRS wouldn't suspect that. Peek at "Report to the Committee on Finance, U.S. Senate Tax Gap Actions Needed to Address Noncompliance with S Corporation Tax Rules." http://www.gao.gov/new.items/d10195.pdf. "Even though a majority of S corporations used paid preparers, 71 percent of those that did were noncompliant." Got your attention? Now try this: "Some S corporations also failed to pay adequate wages to shareholders for their labor for the corporation, which led to underpaying employment taxes."

So what's the real deal? Determining how much can be distributed from a business without being subject to payroll taxes should be based on an appropriate analysis of the facts. One approach might be to independently determine a reasonable return on business capital, and determine a reasonable compensation for the services rendered to the business (considering industry data, comparable compensation for others providing similar services, and adjusting for the differences of your particular business). Subtract these from profits. If there's a difference evaluate a reasonable method to allocate that difference against your estimates for compensation and/or return on capital. You could take the approach of hiring an appraiser to document the figures.

Tax laws provide guidance as to the factors to consider in the analysis. The determination should be based on the facts and circumstances of each case. Treas. Reg. 1.162-7(b)(3). Factors might include: The employee's role and contribution. How the employee's compensation compares with similar employees of other businesses. The nature and financial condition of the corporation. Dividend payment history. Compensation to other employees relative to their work load and responsibility and the internal consistency of the compensation for the employee in question. Mayson Mfg. Co. v. Comr., 178 F.2d 115, 11/17/1949.

Don't simply set up your business as an S corporation and assume that you can just treat some modest amount as wages, and take the bulk out as an S

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PRACTICAL PLANNER

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BEN FRANKLIN WAS WRONG!

Summary: Benjamin Franklin penned the famous phrase: "In this world nothing can be said to be certain, except death and taxes." But Ben, smart as he was, couldn't conceive of our current Congress! Nothing is certain about taxes any longer. (1) Everyone expects tax rates to rise to cover growing deficits, but what form that takes and when it will happen all remain to be seen; (2) President Obama's proposed budget has nasty stuff for wealthy folk endeavoring to plan their estates; and (3) The "Now you see it, now you don't" estate tax remains in flux. Since you've no doubt heard about repeal, possible reinstatement, and carryover basis, we'll provide a broader discussion of the current estate tax environment and pro-active steps you can take. A recent survey of CPAs said 83% of their clients are taking a "wait and see" approach to the estate tax. Hmmm. Sounds a bit like Nero and the fiddle.

Estate Tax Repeal, Well Maybe: Everyone expects Congress to "patch" the estate tax so that in 2010 we'll have the same $3.5 million exemption and 45% tax rate as in 2009. Baucus and Geithner stated that they support extending the 2009 estate tax rates for 2010 retroactive to 1/1/10. We might know the result by the time you read this, but maybe not. Whatever happens, planning should be more flexible.

Obama Budget - Estate Restrictions: In addition to repeal uncertainty, changes proposed in President Obama's budget proposal creates additional concerns. These include a restriction on Grantor retained annuity trusts (GRATs) a technique used to shift growth in asset values outside your estate. GRATs will have to last a minimum 10 years. This is significant because if you don't survive the 10 year term the trust assets will be included in your taxable estate. This expanded mortality risks will make GRATs, which are commonly two years under current law, impractical for many seniors. Hug your insurance agent. If you use a 10 year GRAT odds are good that you'll want to at least consider a 10 year term insurance policy to cover the risk of dying prematurely. The investment strategies of GRATs will have to change. You can't immunize a single asset class GRAT with cash and sit on it for a 10 year term. With a 2 year GRAT that was tax-groovy. Discounts, long the bane of the IRS, and fodder for more cocktail conversations than any other tax topic in history, will be subject to new limitations. The Treasury will issue regulations identifying restrictions (e.g., in a partnership agreement or state law) that will be ignored when valuing interests in family entities, if the ownership interests involved are transferred by bequest or gift to family. These will include transfer restrictions that can be removed by family members. If you're planning a discount move, swing before the window closes. Restrictions on valuation discounts will take juice out of planning. Don't despair, grantor trusts are becoming the "new tax normal." See Practical Planner May 2009.

Carryover basis Rules: For those dying in 2010 there will be a limited basis step up. This effectively substitutes a future income tax cost for the estate tax. If you die owning a stock you paid $1 for and it is worth $1M under 2009 law, you would pay an estate tax (if your estate exceeded

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CHECKLIST: MODWEALTH PLAN

Summary: So the super wealthy can still try to do cool stuff but what about folks that Robin Leach wouldn't bother with? They can plan, even with uncertainty the rule.

√ Non-tax planning should lead the way. Don't let the tax tail wag your dog. Estate and financial planning should consider taxes, but truth be told taxes are the ultimate cop out. Minimizing taxes is a safe goal. You don't have to address the kids that you don't speak to, the shortfall in your retirement funds, and all that other unpleasant stuff. Whatever happens with the federal estate tax the reality is that only a tiny percentage of estates will ever be taxed. Some estimate only 6,000 estates in 2009 would file estate tax returns when the exclusion was $3.5 million. Not many. So, in the words of Dr. Phil, "Get real" and focus on what's important to you.

√ Integrate estate, financial and income tax planning – holistically. Income tax rates are likely going up – so plan accordingly. Municipal bonds (but consider interest rate risks), more carefully planning to harvest capital gains and losses to minimize tax, charitable gift annuities, tax deferred exchanges of real

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...BEN FRANKLIN WAS WRONG!

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$3.5M) but the "tax basis" in that stock would be increased to $1M value at death. IRC Sec. 1014. If your kids sold it for $1M they would not pay capital gains tax. Under the 2010 law, unless Congress changes it, the basis step up is limited under arcane new rules that every tax geek hopes they don't have to learn. Every estate will get to increase the tax basis in assets owned at death by $1.3M (only $60,000 for non-resident aliens, sorry Sigourney). $3M more can be allocated to increase basis of property passing to, or in a qualifying trust for, a surviving spouse. These rules will require substantial recordkeeping, regardless of the size of your estate, because everyone is potentially subject to income and capital gains taxes. Unlike the fiddling Nero -- do something! Re-title accounts to tenants in common with your spouse. The planning paradigm with the estate tax had been to divide assets 50/50 so whichever spouse checked out first could fund a bypass trust. The new carry over basis paradigm is to divide assets by appreciation. But just like Doublemint gum you can get two, two tax plans in one! Tenants in common gets you the right division under either scenario.

Revise your documents! Yes, you need to. Build in more flexibility, specific powers and instructions on how an executor should divvy up the basis adjustments if they apply, and other goodies discussed below.

<u>Your Will is Probably Wrong</u>: If your will leaves property to a family trust or children based on the amount that doesn't create a federal estate tax (a common way to write will language because of the many changes the law has taken over the years) what happens if there is no estate tax? Your plan may just go haywire! You need to revise your will to contemplate a world without an estate tax. Few tax advisers had this scenario on their radar screens. Consider appointing an independent fiduciary to address tax decisions while uncertainty reigns. Putting this off won't help. And even if Congress reinstates the estate tax retroactively, issues may remain for some time to come. Include statements clarifying your personal objectives independent of tax considerations. That will help interpret and apply your will regardless of how the tax system is jiggered.

<u>Return of GST</u>: Everyone is confident Congress will bring back the estate and GST tax. If Congress reinstates the estate and GST taxes but does not make them retroactive what happens during that interim window when there is no estate or GST tax? You may not be able to set up a dynasty trust and make it GST exempt because you may not be able to allocate GST exemption to protect a trust if there is no GST tax. Does that put the freeze on that type of planning until Congress acts? What if you set up a GST exempt trust and Congress retroactively reinstates the GST tax? Will that result in a retroactive allocation of GST exemption to that trust? Instead of fiddling consider funding a trust now using a defined value clause to allocate transferred assets between a GST exempt and non-exempt trust based on how the law shakes out. If you have a trust that is not exempt from the GST tax but for which grandchildren ("skip persons" in tax jargon) are beneficiaries, consider making distributions now while there is no GST tax. You might be able to make distributions subject to an agreement of the beneficiary to refund the distribution if a GST tax is reinstated 1/1.

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<u>Gift Planning</u>: Make taxable gifts! If you're loaded and on in years, you can make large taxable gifts at the 2010 35% gift tax rate. That could be a whopping tax savings considering the 55% gift tax rate that comes into play in 2011 and later years if Congress does nothing. Also, if you survive 3 years the gift tax you paid is removed from your estate as well as the asset (in tax jargon that's a net gift). That's a winner. Just make conforming updates to your health proxy — you'll need to survive 3 years after making the taxable gifts to get the gift tax out of your taxable estate. If you wait for the tax issues to resolve, interest rates and asset values might be higher, and tax planning strategies more limited.

<u>Conclusion</u>: The uncertainty is wild,

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...CHECKLIST: PLANNING FOR THE MODERATE WEALTHY

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estate, and other techniques, will all become more popular as rates rise. Estate tax will get tougher not easier and is pretty unlikely to disappear. Budgets need to be created, and monitored, as conditions continue to evolve. Super-rich folks can make gifts without a thought, but plenty of wealthy people who think they don't have a care in the world could be spending/gifting themselves into financial worries. Everyone likes a quickie. Multiply your investment assets (leaving off your house, art and bottle cap collection) by 4%. Can you live on that? If you're laughing, hustle over to your financial planner and get on the wagon. You can't do an estate plan, make gifts, figure out how much insurance to buy, if you don't have a handle on your financial picture. What's this boring stuff have to do with economic turmoil and tax uncertainty? Everything. Solid broad based planning, monitored regularly, is the key during uncertainty.

√ Life insurance becomes more attractive. Insurance has performed better then some asset classes. If income tax rates rise the tax benefit insurance provides is more valuable since assets will grow inside the tax advantaged insurance envelope. Insurance, if properly owned by an irrevocable trust, is outside your estate whatever happens.

√ Asset protection – litigation is always a concern that trusts, FLPs and LLCs all help minimize. Even if discounts are restricted or repealed FLPs and LLCs are great for control and asset protection. Lawsuits won't disappear. FLPs will be increasingly used to shift income to lower bracket family members if the spread between the highest and the lowest tax brackets increases. The Code Section 704(e) family partnership rules were enacted long ago to prevent abusive income shifting. Planning around 704 (e) will get more attention.

√ 529 plans remain great. Assets are outside your estate, tax favored, etc. You can inexpensively and simply plan for children or grandchildren. If you're the account owner you can reclaim the assets if economic or tax developments change your situation.

√ Domestic Asset Protection Trusts (DAPT) have become more practical for wealthy, not only super-wealthy folks. Competition has increased among trust companies willing to serve for relatively modest fees to facilitate this planning. You can set up a trust in a slew of states: Delaware, South Dakota, Alaska or Nevada (Dick, we wouldn't leave out Nevada!). The trust assets might avoid estate tax, and from the reach of creditors. See PLR 200944002 which dealt with a DAPT under Alaska law. This is a great technique to consider with so much uncertainty affecting the tax laws and the economy. It was a completed gift even though the trustee had discretion to make distributions to the grantor or grantor's spouse. Great maneuver for those with enough wealth to worry about taxes and creditors, but not so much wealth that they can give away tons of it. An open issue is whether the trust property will be outside the grantor's taxable estate. Some believe that if the gift is complete it should be outside the estate. Other's don't. The ruling specifically stated that the person who created the trust

RECENT DEVELOPMENTS

<u>CPA Confidentiality Rules</u>. Tough rules restrict CPAs use of tax return information. Treas. Reg. Sec. 301.7216. The general rule is that a tax return preparer cannot use tax return information without first receiving the client's written consent. So you want to protect yourself from a potential claim of an estate plan gone awry by informing all clients for whom you have addresses of the impact of estate tax repeal. Sure makes sense to do. But hold your horses. Before you trot off consider that the IRS recently issued Revenue Ruling 2010-4 and 2010-5. For you not to be subject to criminal penalties for improper disclosure of client tax return information you have to take precautionary steps. But being careful not to tell the guys around the poker table what old man Jones earned last year is not enough. Yes, the IRS might actually view the names and addresses you extract for mailing your newsletter as constituting tax return data! Consider requesting your printer/fulfillment house to confirm that they have procedures in place which are consistent with good business practices and designed to maintain confidentiality. You should then make a determination that if those procedures are in fact followed the printer will be able to assure the confidentiality of the data. Have your printer acknowledge that it is prohibited from the further use or disclosure of the tax return information (names and addresses) provided by you for purposes other than those related to the provision of the printing and mailing of your newsletter.

<u>Palimony.</u> Dukes, the former paramour, claimed that for over a decade she and Fritz resided together and held themselves out as married, with Fritz assuring her that they would be married. They parented two children and shared ownership of a home. They separated in 2006 and Dukes filed a complaint for palimony which was dismissed for failure to prove an underlying promise of