PRACTICAL PLANNER NEWSLETTER
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Seminars: **5/24** How to Read a Will; Understanding Malpractice Issues Affecting CPAs - guest speaker Howard Mankoff , Esq. Of Marshall Dennehey; Case Study: Purchasing a retirement home.
6/29 How to Read an Insurance Trust; How to Terminate an ILIT - guest speaker Steven Fishman, CLU; Case Study: Business sales.
7/25 Powers of Attorney; Conducting an Annual Planning Review - guest experts. - David Sharp, CPA of Sharp Advisory, Brian Boak of Singer, Nelson, Charlmers.
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PLANNING POTPOURRI

Copy Your Wallet: Simple but effective. Every say 6 months dump the contents of your wallet on a copy machine and copy front and back of everything. File it someplace secure. If you lose your wallet you have a checklist of everything, account numbers, and on the back the phone numbers to call.

Non-Deductible IRA: The general financial literature says don't contribute to a non-deductible IRA as it doesn't make financial sense. That's a one-dimensional planning perspective and not always correct. IRA assets are protected up to $1 million in bankruptcy. IRAs are simple, no cost ways to invest in a format that has tremendous creditor protection. Use them. Rollovers of pension plans into your IRA are protected without limitations, so don't combine them (even if the same financial press says to simplify by consolidating them). Use newly released IRS Form 8606 to report non-deductible IRAs to the IRS with your annual tax return.

QPRTs: Qualified Personal Residence Trusts are special house trusts designed to transfer residences to your kids while minimizing gift tax. When your QPRT ends the trustees must deed the house to the kids (or trusts for them, depending on the terms of the QPRT). The kids need to insure the house and lease it back to you. You need to pay fair rent. Sign a written lease. The kids should sign a document governing their ownership of the house to avoid issues later.

529 Plans: College savings plans are touted, often appropriately, for their tax deferral and other benefits of saving for college costs. But are they really right for you? If you are concerned about asset protection, estate taxes, control and other issues, you might have better options than a 529 plan. Look at your overall estate plan. If setting up a family limited partnership or limited liability company to hold family assets is appropriate to your plan, then making gifts to a trust for your child rather than a 529 plan, might be a much better result. The child's trust can then invest in and become a partner or member in the family entity, thus helping achieve broader and more important family goals. Look at the big picture, not just one income tax savings, in making your decision.

Florida Intangibles Tax: Florida had taxed residents on the value of stock, bonds, etc.. The tax is to be repealed.
PP

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PRACTICAL PLANNER

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IS YOUR LLC ASKING FOR A S.E. TAX AUDIT?

Introduction.

Limited liability companies (LLCs) are the most common entity used for closely held businesses. LLCs are generally easier to use and have better tax results than corporations. But an important and tough tax issue affects most LLCs - is the money you withdraw subject to self employment tax (SE tax)? If so, you'll have to pay 15.3% of the first $94,200 of self employment income, and 2.9% on any excess. If you don't address this issue properly, you can face past due taxes, penalties and interest charges. The question is whether your LLC distribution is SE income or not. The law is unclear, which means planning can minimize the tax, and the risk and cost of an IRS audit. This is complicated, but with some background you'll be better equipped to ask your CPA for help.

Source of the Problem.

The uncertainty over how to treat distributions from LLCs rests on a general tax problem that affects many tax aspects of LLCs. The IRS has generally tried to apply tax laws written for limited partnerships (LPs) to LLCs. But it just doesn't work because LLCs are different creatures. Example: In an LP there are two kinds of partners: general and limited. General partners manage the business. State law prohibits limited partners from participating in management of the LP. So for SE taxes, the answer is generally pretty simple. General partners are subject to SE tax on their distributions. Limited partners are not (because they are, by law, prohibited from participating). IRC Sec. 1402(a). So the IRS would like to make the analogy to an LLC. If the LLC is a manager managed LLC (that means you designate specific persons to manage the business), it will have managers and members (analogous to shareholders in a corporation, or limited partners in an LP). If managers manage and members don't, distributions to managers are subject to SE tax. Distributions to members aren't subject to SE tax, unless they are also managers. Simple. But, most LLCs aren't the plain vanilla comparison to an LP so the IRS analogy won't work. Consider a few examples:
o Members of an LLC can participate in management. There is no prohibition unless one is in the legal documents. Some members can participate, others may not.
o You can have different classes of members with widely different rights.
o You can have different types of managers, some actively participating, some only occasionally. A common example is LLCs that want to have officers and directors (since most non-lawyers remain more comfortable with that terminology). Easy to do...One class of managers are directors, and a second class are officers that report to the first class. The managers/directors may provide some services while the managers/officers may work full time.

Now try to apply the IRS analogy of LPs to LLCs...it doesn't work! The key to planning — more steps which differentiate your situation from the "typical" general partner in an LP, the better your position that you don't have to pay SE taxes.

Proposed Regulations.

Proposed Regulations were issued to address LLC distributions for self employment tax purposes in December 1994 and January 1997. These controversial regulations were held in abeyance by the 1997 Tax Act.

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INSURANCE TRUST CHECKLIST

Most life insurance should be held in an insurance trust to keep it out of your taxable estate, protect the proceeds from creditors and divorce, provide management, save state income taxes and more. With all these tremendous benefits, your trustees should pay careful attention to monitoring and administering your trust. But few do. Here's a check list of steps to help you through the muck. You need to address each item for each trust you have.

Step 1: Be sure everyone has signed the trust: you as grantor (person forming and funding the trust) and the trustees. Too often you and perhaps one trustee sign at the lawyer's office and the other trustee doesn't sign (or fails to get his signature witnessed or notarized).

Step 2: The Trustees must complete and sign (in their capacity as trustees) all applications and forms from your insurance company. The application must correctly name of the trust as owner and beneficiary .

Step 3: Obtain a tax identification number (TIN) for the trust. You can get this online at www.irs.gov/businesses/listssmall/article/0,,id=98230,00.html. Write the TIN on the front page of the trust. Everyone you work with will need it (bank, insurance compa-

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...SELF EMPLOYMENT TAX AND LLCs

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Neither Congress nor the Service has acted since. Hey, if neither the IRS nor Congress can figure it out why should you be at risk for an audit and penalties? 'Cause, that's how it is!

What Approaches Exist.

Approach 1: If a partner devotes his time to the partnership trade or business he will be deemed a self employed person rather than an employee. Rev. Rul. 69-184. This concept should generally apply to members who provide services to an LLC. Further, if you're a member of a service LLC, all your distributions will likely be subject to SE tax. Reg. Sec. 1.1402(a)-(2)(h)(6). A service LLC is an LLC in the fields of health, law, engineering, architecture, accounting, actuarial science or consulting.

Approach 2: The relationship between a member and the LLC could be that of an employer and employee. Treas. Reg. Sec. 31.3121(d)-1(a)(3); GCM 34001 and 34173. If the LLC is deemed the employer, then the LLC and the employee member could each be liable for the hospital insurance tax on all compensation income. IRC Sec. 3101(b)(6).

Approach 3: If you're personally liable under state law for LLC obligations then distributions to you as a member will be subject to employment taxes to the extent of your share of income. Liability for debts may refer to liability created under the operating agreement. The concept is that if you're personally liable, your position is analogous to that of a general partner in an LP who has personal liability. Since a general partner is liable for SE taxes, then under this reasoning, so should you.

Approach 4: If you participate in the LLC business for more than 500 hours per year, all your distributions will be subject to SE tax. The flaw in this is that you may in fact participate for well over 500 hours, but that does not negate the possibility that a significant, even predominant, portion of your return is really a return on capital invested in the LLC, not compensation for services. Proving a return on capital, and documenting your actual hours, may solve part of the problem.

Approach 5: If you have authority to make contracts on behalf of the LLC under state law all your distributions are subject to SE tax. Perhaps your operating agreement should expressly preclude you from being able to contract.

Approach 6: If you can be a member in a manager managed LLC, not work more than 500 hours (and document that fact), not be liable for any LLC debt, and prohibit your right to contract for the LLC in the operating agreement, there should be little issue of SE tax.

Approach 7: If you like to ride in the front seat of the front car of a roller-coaster, consider the following:There is an argument some commentators have advanced based on Private Letter Ruling 9452024 that by analogy to the passive loss limitation rules a member in an LLC should be treated as a limited partner. This means no SE tax.

Approach 8: Managers are usually analogous to general partners, but merely because you are a manager should not necessarily determine that all compensation is subject to SE tax. But, your LLC operating agreement (analogous to a shareholders' agreement) can restrict your endeavors to provide an argument to limit SE tax.

Approach 9: Distributions subject to SE tax should be limited to the amount of the distributions that is reasonable compensation for the services you actually provide. Use compensation studies, industry data, etc. to corroborate this. A concern in applying this approach is that the law has characterized as all LP distributions as being subject to SE tax regardless of services. Earnings from a partnership that owned oil and gas leases, managed by an agent, were characterized as earnings from self employment for a partner in spite of the modest involvement he had. Rev. Rul. 58-166, 1958-1 CB 324.

Approach 10: Return on capital arguments can be used. Demonstrate that a portion of the distribution to you is a return on capital invested (e.g. value of equipment) and not payment for services subject to employment taxes. PP

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...INSURANCE TRUST CHECKLIST.

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ny, etc.).

Step 4: Your trustees should take a signed copy of your trust (with the TIN on it) to a bank and open a trust bank account. Deposit a nominal amount to get the account started (usually an amount is listed on the last page or schedule of the trust - deposit that amount). It should be a check written by you (the grantor) to the exact name of the trust. If a premium is due soon, you write a separate check for an amount sufficient to cover those costs. The best account is usually a non-interest bearing free checking account. No interest, no income tax reporting.

Step 5: Be sure the insurance is issued in the name of the trust. If existing insurance is being transferred to the trust, contact your insurance agent and request a written estimate of the value of the insurance policies being transferred, the balance of any loans outstanding, the amount of the policy which can be borrowed against, and the documents to complete the transfer. The value of the policies is important so you can plan to avoid any gift tax cost on making the transfer. This is usually complicated and should be worked out at a meeting with your estate planner or CPA, and your insurance agent. You have to survive 3 years after the transfer of an existing policy to the trust for the proceeds not to be taxed in your estate.

Step 6: Your insurance trust probably includes a demand or Crummey power to qualify your gifts to the trust for the annual $12,000 gift tax exclusion. Each time a gift is received by the Trust, the trustees should send the beneficiaries a formal notice of the amount of gifts made in total and for the credit of that beneficiary. The beneficiaries must sign and return these notices for the trustee to hold in the trust files. This is like the commercials on TV cautioning you not to try it at home. Have your estate planner, CPA, or insurance agent, walk you through the first ones. The calculations are not obvious and the entire concept defies logic. Even if the estate tax is repealed, or won't affect you, you need to continue these procedures if they are in your trust.

Step 7: Your trustees should pay for the insurance premiums using checks on the trust bank account made payable to the insurance company. Note the policy number and trust TIN on the check. If you have more than one trustee, ask the lawyer who drafted the trust if all trustees need to sign all checks and deposits. Some trusts permit one trustee to handle limited administrative tasks alone, many don't.

Step 8: Ask your CPA if you need to file a tax return. Many insurance trusts are "grantor trusts" (meaning the income is reported on your return) but the trust might still file its own Form 1041 indicating that.

Step 9: Meet annually with at least one of your advisers to be sure that you are properly administering your trust. Your adviser should review trust bank accounts to be sure they are set up properly, insurance policies to be sure they are in the trust, Crummey notices to be sure they are done correctly, monitor your plan to evaluate the appropriateness of the coverage and plan, and periodically get a review of the insurance policy (in force illustration), review trust administration issues, etc.

Failing to follow up on not monitoring your trust, could jeopardize any or all of the significant benefits. PP

RECENT DEVELOPMENTS

Piercing the Corporate Veil: Almost every business is organized as a corporation or LLC to prevent lawsuits from reaching your personal assets. If the business gets sued, all assets of the business might be at risk, but your house shouldn't. However, in some situations, the courts have pierced the corporation's protection and let claimants get personal assets, like your house. This is called "piercing the corporate veil". In a recent case, a group of NY doctors got quite close to tasting this bitter pill. Although they escaped by the skin of their teeth, the case teaches some valuable lessons. Since litigators are looking at this case for guidance in how to pierce through corporations in future cases, you should look at this case for how to shore up yours. Cherkasets v. Gordon, 21 AD3d 856 (1st Dept. 2005). These lessons apply to more than doctors, and the concepts should apply to other states and LLCs as well. Be sure your corporation is adequately capitalized. If you have multiple corporations don't let them share each other's assets as if they were their own. Example, you and your partners have a medical practice corporation and surgical-center LLC. Don't let the medical corporation pay for expenses of the surgical-center. Don't have surgical-center equipment find its way into your medical practice office without a lease. Minimize overlap of ownership, officers and directors. This is probably impossible for many family businesses, or real estate developers owning many properties. Common office space and addresses should be minimized. Again, a difficult or impossible task for many. Observe all corporate formalities: signing in corporate name, issue stock, hold annual meetings, etc. Keep transactions between your different entities arm's length (what you would pay a stranger). Don't let one entity guarantee or pay another entity's debts. Each entity should stand independently as a profit center. Never use funds for personal purposes. Don't commingle personal or other entity funds.

Tax Increase Prevention and Reconciliation Act: See www.laweasy.com for an analysis PP