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TAXVIEW ON POINT WITH VISION

SUMMER 2006

BREAKING NEWS A Closer Look at TIPRA, Including an Estate Planning Opportunity

On May 17, 2006, President Bush signed into law the $70 billion tax package known as the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA). At first glance, TIPRA appears to deal solely with income taxes, such as the section that spares millions of Americans from the Alternative Minimum Tax (AMT) this year. However, a closer reading suggests that it holds a major new benefit for the estate plans of high net-worth individuals. Prior to TIPRA, only individuals with adjusted gross incomes of $100,000 or less could convert a traditional IRA to a Roth IRA. The new law removes this income restriction, beginning in 2010.

Major Opportunity for Wealth Transfer

This change holds significant potential for those wealthy individuals who may not need all of their IRA funds to finance retirement, opting to transfer wealth to future generations tax-free. While the traditional IRA is built around the concept of tax deferral—individuals get a tax deduction for contributions (up to certain limits) to an IRA, and the account grows tax-deferred until withdrawn upon retirement—the cornerstone of the Roth IRA is that all of the earnings and withdrawals are tax-free, although contributions are not deductible. Furthermore, with a Roth account, individuals are not required to take minimum annual distributions beginning at age 70½ as mandated by traditional IRAs.

The new law will allow individuals to convert all or part of a traditional IRA to a Roth IRA beginning in 2010, pay the income taxes due on the conversion at their regular rate and then let the Roth account grow tax-free until their death. The heirs can then withdraw it over their life expectancies. If left to grandchildren, this could mean tax-free earnings for a period of 70 years or more.

A Roth conversion is not suitable for everyone. For a personalized assessment and evaluation of your tax and estate planning circumstances, contact Jon Persson at jpersson@gellerco.com to determine whether such a conversion is right for you.

AMT, Capital Gains and the "Kiddie Tax"

Other highlights of the new law as it applies to individuals include:

- TIPRA raises the AMT exemption and offers relief for certain personal tax credits. Given that this relief does not extend beyond the current tax year, Congress is expected to consider AMT-related legislation again in 2007.

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- TIPRA extends the top tax rate of 15% on long-term capital gains and dividends through 2010.
- The age limit on the so-called "kiddie tax" is being increased to under 18 years of age from under 14. In light of this change, individuals may want to re-evaluate savings and investment strategies for their children and grandchildren, such as focusing savings on Section 529 Plans rather than Uniform Gifts to Minors Act (UGMA) accounts.

For corporations, TIPRA makes a number of changes, the highlights of which are the following:

- Increased expensing for small businesses (a $100,000 deduction limit and a $400,000 phase-out threshold indexed for inflation) scheduled to expire on December 31, 2007 was extended through 2009. For 2006, up to $108,000 of the cost of the qualifying property can be expensed. This amount is reduced to the extent that the cost of the property exceeds $430,000. Without the extended benefit, the expensing limit would have dropped to $25,000 on a $200,000 cap after December 31, 2007.
- For corporate estimated tax payments due on September 15, 2010, 20.5% shall not be due until October 1, 2010; for those payments due on September 15, 2011, 27.5% shall not be due until October 1, 2011.

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FEDERAL Section 409A Brings Significant Changes to Deferred Compensation Plans

Enacted as part of the American Jobs Creation Act of 2004, Section 409A of the Internal Revenue Code was written to put some teeth into the "constructive receipt" rule that the IRS uses to determine whether deferred compensation is taxable or nontaxable. Although the new law was enacted primarily to curb perceived abuses by highly-paid executives of public companies, it applies broadly to nonqualified deferred compensation (NQDC) plans at both public and private companies. However, there are some exceptions to that broad coverage.

Basic Guidelines

The intention of Section 409A is that deferred compensation which is not subject to a substantial risk of forfeiture is includable in the recipient's gross income for the current taxable year unless the NQDC meets specific requirements. The rules potentially affect a wide range of compensation arrangements, including:

- Voluntary deferrals of salary, bonuses, fees or other compensation
- Excess benefit plans
- Supplemental executive retirement plans (SERPs)
- 457(f) plans
- 401(k) wraparound plans
- Phantom stock
- Stock options and stock appreciation rights (SARs) issued at less than fair market value
- Restricted stock units
- Severance plans
- Employment contracts with deferral or severance pay features.

Some Plans Are Not Affected

Compensation arrangements that are not affected by Section 409A include qualified plans, such as 401(k) and 403(b) plans; SEPs and SIMPLE plans; 415(m) plans, such as government excess benefit plans; tax-deferred annuities; stock options and SARs issued at fair market value; 423 employee stock purchase plans; short-term deferrals, such as annual bonuses or other compensation paid within 2 ½ months after the taxable year in which the services were performed; and legitimate vacation leave, sick leave, compensatory time, disability pay and death benefit plans.

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Failure to comply with Section 409A can result in potentially severe adverse federal tax consequences, including triggering (i) a tax liability for deferred compensation prior to its receipt, usually upon vesting; (ii) an additional 20% tax penalty on the amount included in income; and (iii) an interest charge at the current IRS interest rate for underpayments plus an additional 1%.

Section 409A was effective for compensation received after December 31, 2004 subject to the grandfather rules for amounts earned and vested prior to January 1, 2005. The IRS has released proposed regulations regarding the application of Section 409A to nonqualified deferred compensation plans which are to be effective for tax years beginning on or after January 1, 2007. Until then, plans must operate according to a good faith interpretation of Section 409A, and taxpayers can continue to rely on guidance provided in Notice 2005-1, I.R.B. 2005-2, December 20, 2004 as corrected on January 5, 2005.

Part II of this article, to appear in the fall issue of *TaxView*, will further expand on the application of Section 409A.

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STATE & LOCAL Some States Take New Approach to Taxable Income Apportionment

For many years, states that impose a tax on corporate income (only Nevada, South Dakota, Washington and Wyoming do not) relied on an evenly weighted, three-factor formula to determine the taxable portion of income generated by companies with multi-state operations. In a process called the Uniform Division of Income for Tax Purposes Act (UDITPA), the formula looked at property, payroll and receipts to allocate business income.

However, the consensus approach embodied in UDITPA has dissolved over time. Many states—Connecticut, New Jersey (with some exceptions) and New York among them—have adopted formulas that double-weight receipts, for example; Pennsylvania's formula triple-weights them. As of January 1, 2006, only nine states were still using the equally weighted, three-factor formula of payroll, property and receipts, according to the Federation of Tax Administrators.

Three-Factor Formula Phase Out

The changes are part of a larger trend among the states moving away from the three-factor formula in favor of an approach that focuses more closely on receipts. In New York, for example, the multi-factor formula for apportioning income is being phased out over a three-year period, starting with taxable years beginning on or after January 1, 2006 and before January 1, 2007. It will be replaced with a single-factor formula based solely on receipts by 2008.

For companies subject to New York's corporation business franchise tax, the formula consists of a 20% property factor, 60% receipts factor and 20% wage factor in the first year of the phase-out (2006), followed by a 10%-80%-10% formula in the second year (2007). For taxable years beginning on or after January 1, 2008, the formula uses receipts only. For companies subject to the state's bank franchise tax, the percentages are slightly different over the first two years, but also reach 100% receipts in the third year.

Receipts-Only Debate

The trend has not been without controversy. Supporters of the receipts-only apportionment movement argue that it will prompt companies to increase investment in new physical plants and add to in-state payrolls, since doing so will no longer increase their state tax liability. Opponents argue that states will

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lose badly needed tax revenue, and the lion's share of the tax savings will benefit too small a group of companies.

While the single-factor formula for apportioning income should simplify state tax preparation and reduce total tax liability for many multi-state businesses subject to New York's corporation business franchise tax (Article 9-A) or bank franchise tax (Article 32), it will not completely eliminate the use of the three-factor formula. Businesses may still need to use the formula to apportion capital or franchise taxes. In addition, the presence of property or payroll in a state remains the standard for determining nexus (the physical presence that triggers the requirement to file an income tax return in that state), despite the lessening role these factors play in calculating a company's tax liability once nexus has been established.

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INDIVIDUAL Basic Estate Planning Techniques: Trusts
Part 5 in a Series

Trusts can play an important role in estate planning. A trust is a legal agreement between two parties: the creator of the trust, or the grantor, and a trustee, who administers the trust. All trusts share certain common characteristics, but they offer a wide range of flexibility and can be used to achieve a variety of different objectives in an estate plan. The five key elements of every trust are the grantor, the trust property, the trustee, the beneficiary and the intent of the trust.

A trust that is created by a will is called a testamentary trust, and property can only pass into it through the probate court process. If you create a trust during your lifetime, you are described as the trust's grantor or settlor, and this type of trust is called a living or inter vivos trust. A living trust avoids the costs and delays associated with the probate process, but requires funding (e.g., the transfer of assets into the trust during your lifetime) and can have tax implications that should be discussed with an estate-planning specialist.

Trustees and Beneficiaries

The trustee may be one or more individuals—including a spouse or child—or a corporate trust company, bank or other professional manager. Outside trustees are sometimes named in order to avoid putting a spouse or child in the position of potentially having to mediate disagreements among heirs who may also be relatives.

The beneficiary is the person or persons who are to receive the benefits and advantages of the property transferred to the trust. A trust can have multiple beneficiaries, as well as contingent beneficiaries, and a beneficiary may also serve as a trustee. A trust is most often used as a vehicle to hold and manage property for the benefit of the creator and his or her beneficiaries during the creator's lifetime and for the benefit of the heirs after the trust creator's death.

Revocable vs. Irrevocable Trusts

A living trust may be revocable or irrevocable. A revocable trust can be amended or revoked by the grantor after it has been created, while an irrevocable trust cannot be changed or canceled. A revocable trust automatically becomes irrevocable upon the death of the grantor.

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While either type of trust can be structured to accomplish similar objectives, such as managing property and other assets, irrevocable trusts are generally more effective for avoiding or minimizing federal estate taxes. Revocable trusts are sometimes favored if avoidance of probate court is the primary objective.

Trust Property and Intent of the Trust

The trust property is the subject matter of the trust. A funded trust is one in which the trust property has been transferred to the trust. An unfunded trust is one in which the trust has been set up and the property is set to be transferred at a future date.

Assets may be transferred to a trust during the lifetime of the grantor or after death through the will, by gift or by beneficiary designation (as with an inherited IRA). The intent of the trust is the underlying motivation or purpose to set up the trust. The intent may include several objectives and may change over time.

Advantages of a Trust

Trusts have been popular as estate-planning tools among the very wealthy for many years, but the advantages they offer are often relevant to those of more modest means. For example, parents of young children can use an inter vivos or testamentary trust to provide for their children's financial security should both parents die before the children are old enough to manage their own financial affairs.

Among the objectives trusts can be used to achieve are:

- Minimizing or avoiding the expense, time and public nature of probate proceedings.
- Maximizing tax-efficiency in the conveyance of assets to beneficiaries.
- Securing the financial future of minor children or other dependents unable to care for themselves.
- Providing for continuity of business ownership.
- Assigning management of financial affairs in the case of incapacitation.
- Distributing assets to children from a previous marriage.
- Consolidating assets held in multiple jurisdictions.
- Protecting assets from creditors, malpractice claims and divorce actions.

Common types of trusts include bypass or credit shelter trusts, grantor trusts, marital deduction or qualified terminable interest property (QTIP) trusts, charitable remainder trusts (CRTs) and irrevocable life insurance trusts. Future articles in this series will take a more in-depth look at some of these trusts.

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