



Advanced Planning Strategies

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Dear Reader,

We have some new tax legislation to discuss in our inside report. The provisions that were left out of the bill are probably as notable as what was included in it. The Senate added significant amendments to the original House provisions (the bill and the conference report are well over 300 pages), but many of the Senate (and some of the House) provisions were not incorporated into the final legislation. Some of the excluded provisions will likely come up for consideration before the end of the year, particularly items that will otherwise expire unless an extension is passed.

Provisions that will be up for debate include (1) a more permanent solution to the alternative minimum tax problem, (2) extension of the federal income tax deduction for state and local sales taxes beyond 2005, and (3) extending several deductions and credits that will expire or have expired. The Senate amendments included the charitable giving incentives that have been discussed for several years. Among the charitable provisions were substantial reform items for foundations and donor-advised funds. There is a possibility that some of these provisions could be incorporated into a major package that encompasses pension reform legislation that has also been discussed previously. Reform of the pension and retirement system is a priority for many in Congress.

A large tax package faces an uphill fight in an election year. Because the legislation already passed contains many tax reduction items, the new legislation would have to follow the so-called "paygo" rules and be revenue neutral. We'll keep you posted about any developments and will provide a timely report of any legislation that passes.

The Tax Foundation reported that the average American celebrated Tax Freedom Day[®] on April 26, which is 3 days later than last year. This is the day that the taxpayer has completed paying annual taxes and begins working for himself or herself. By state, Connecticut had the latest Tax Freedom Day (May 12); Alabama had the earliest (April 11).

Knowledge is not power. Only knowledge in use is power.

THE TAX INCREASE PREVENTION AND RECONCILIATION ACT OF 2005

Congress passed significant tax legislation last month in the form of The Tax Increase Protection and Reconciliation Act of 2005 (HR 4297) (referred to hereinafter as TIPRA). The President signed the bill into law in quick order. We would like to summarize some key components of the legislation for you now.

Extension of Enhanced Expensing Deduction for Small Businesses. For tax years beginning in 2003 to 2007, the amount of expenditures that small businesses may take as a current deduction under Sec. 179 (rather than depreciating) was increased from \$25,000 to \$100,000 by previous tax relief provisions. The \$100,000 (indexed to \$108,000 for 2006) limit is decreased by the amount that the current expenditures exceed \$400,000 (indexed to \$430,000 for 2006). TIPRA extends the increased current expensing limit for tax years beginning in 2008 and 2009.

Extension of Special Reduced Rates on Capital Gains and Dividends. Long-term capital gains and qualified dividends were given a special 15 percent tax rate through 2008. In fact, for taxpayers in the 10 and 15 percent brackets, the rate is 5 percent in 2007 and zero in 2008. TIPRA extends the special rate until the end of 2010. This could enhance the ability to shift the types of income affected by this provision to family members who are subject to these special lower brackets. Note, however, the provision below for the taxation of unearned income of minors.

Relief from Alternative Minimum Tax (AMT). Previous issues of this letter have addressed the AMT problem. The AMT is based on a tax base (the alternative minimum tax income) that exceeds a specific exemption amount (\$58,000 for married filing jointly and \$40,250 for single filers in 2005). TIPRA increases the exemption to \$62,550 for joint filers and \$42,500 for single filers in 2006. The AMT exemption for an estate or trust remains at \$22,500. Note that this provides AMT relief only until the end of this year; more changes may be in the offing, perhaps even before the end of 2006.

In addition, TIPRA extended AMT relief in 2006 for individuals who claim certain nonrefundable personal tax credits such as the dependent care credit, the credit for the elderly or disabled, the lifetime learning credit, the Hope scholarship credit, the credit for certain interest on home mortgages, and certain energy efficiency credits. These credits will be allowable against AMT so that taxpayers who claim the credit will be able to take the full benefit of any such credits used, regardless of AMT. After 2006, only the adoption, child, and saver's credit will be allowable in full without AMT implications. Note that some credits covered by this provision will expire at the end of the year unless extended by new legislation.

Income Limitations Removed for Roth IRA Conversions. Roth IRAs are a popular vehicle because, after funding with after-tax dollars, the future growth and distributions are tax free if the distributions meet the requirements of the law. Previously, taxpayers could convert a traditional IRA to a Roth only if the taxpayer had adjusted gross income of \$100,000 or less. Income taxes would have to be paid on the conversion because it is treated as a distribution from the IRA. TIPRA removes the income limit for Roth conversions beginning in 2010. For a conversion in 2010, the income taxes that result from the conversion can be paid in equal installments in 2011 and 2012 (with a provision to accelerate taxes if a distribution is taken from converted amounts before 2012). If this provision remains in place, there is a possibility that it can have immediate implications because an individual who is ineligible to contribute to a Roth IRA before 2010 could contribute nondeductible amounts to a regular IRA and convert after 2009.

This provision is a revenue-raising item necessary to put the tax legislation in the appropriate balance in the 5-year period. It creates an incentive to accelerate taxes on IRAs to take advantage of the provision but could result in a substantial loss of future tax revenue.

Age Limit for Tax on Unearned Income of Minors (Kiddie Tax) Increased to 18. Rules currently provide that unearned income of a minor who has not attained age 14 before the end of the tax year be taxed at his or her parent's highest marginal tax rate. In some instances, the parent can elect to report the child's dividend or interest income on the parent's return. This applies in 2006 to the child's unearned income above \$1,700. TIPRA increases the threshold age to 18 beginning next year. Obviously, this creates an additional concern for planning the appropriate gifts to minors (and how such gifts are invested). This provision does not apply to income from a disability trust for a special needs minor as defined in the Social Security Act. This is another revenue increase provision and, unlike the tax relief provisions discussed earlier, the change is permanent.

RECENT CASES AND RULINGS

CHARITABLE DEDUCTION FOR DONATION OF CLOSELY HELD STOCK REDUCED FOR MINORITY DISCOUNT

The taxpayers donated 45 percent of the outstanding stock of a closely held corporation to a charitable foundation. The donation was actually a type of charitable donation known as a bargain sale, and the taxpayers received \$90,000 in return for the stock. Concurrently with this donation, another 45 percent shareholder and the remaining 10 percent shareholder likewise contributed their stock to the foundation. The 45 percent interest was valued at \$810,000, and the resulting charitable deduction taken on the income-tax return was \$720,000 (\$810,000 less the \$90,000 consideration received for the donation).

The court first heard testimony about one underlying asset of the corporation, a submersible barge, and made some initial adjustments that reduced the value of the asset well below the appraisal the taxpayers used. Another important issue was the determination of the appropriate discount for the lack of control the 45 percent interest represented. A minority discount is generally appropriate when valuing an interest in a closely held corporation that does not provide the shareholder with the ability to control the corporation. The taxpayer argued that no discount should apply to the value of the donated 45 percent interest because the foundation ultimately received 100 percent control as a result of the three donations. The IRS attempted to apply a 22 percent discount. The court followed some precedent and determined that the minority discount could be significantly reduced if the transaction was part of a prearranged plan by minority interest shareholders to transfer the controlling interest by "marching in lockstep." The court determined the appropriate discount to be 10 percent in this case. The allowable donation deduction was reduced to \$339,300 as a result of the adjusted value of the key asset and the minority interest discount. (*Koblick v. Commissioner*, TC Memo 2006-63)

RESTRICTIVE TRANSFER AGREEMENT ESTABLISHES ESTATE TAX VALUE OF STOCK

The decedent owned some assets in her estate (notably some stock in a closely held bank and some farmland) that created a valuation dispute between the estate and the IRS. A conservator had managed the decedent's affairs for several years prior to her death. Her stock in the bank had been the subject of exchanges and acquisitions over time and was the center of disputes between her children. The stock was subject to several restrictive transfer agreements that would obligate her estate to sell at an agreed price. The agreement also contained typical first-offer provisions while she was alive. As a result of the sale of the bank and the exchange of stock for stock in the acquiring bank, a new transfer

agreement was considered in 1994 with a fixed buyout price for her stock of \$118 per share plus 6 percent compounded annually until her death. Because expert testimony indicated that the price was too low, the conservator failed to get court approval to sign the agreement.

A family settlement agreement was reached in 1995 and approved the court's restriction of the price to \$118. The stock would be used to fund the share of the estate one son held (through a trust). The trust would be funded with the stock at the value of \$118 per share, and the son (or his trust) would be required to buy the remainder held by the estate at the same price. The son would also have to consent to lifetime transfers. The conservator and the other heirs felt the agreement was in their respective interest to remove the risk of holding a large block of closely held stock and to provide liquidity for the decedent's estate. The son holding the rights to the stock later entered into an agreement with the bank to sell at a substantially higher price due to some speculative rights that had become more valuable.

A restrictive transfer agreement between family members has to meet several requirements to establish the estate tax value of property at the price in the agreement. First, the agreement must be binding on the parties at a fixed and ascertainable price. The agreement did state that the share provided to the son and his purchase of any remaining stock was binding on all parties at \$118 per share. In addition, the son had to consent to any transfers made prior to the decedent's death. Second, the agreement must have a bona fide business purpose. The court determined that this requirement was satisfied by the purposes of (1) mitigating the risk of the future value of holding a minority stake in a closely held business and (2) improving the liquidity position of the owner's estate.

The third and often difficult requirement is that the agreement cannot be a device to transfer the property to a member of the decedent's family for less than full and adequate consideration. The court felt that this was satisfied because the decedent received the consideration of removing the speculative risk of future litigation with parties outside of the family over the stock's value. In addition, the other family members agreed to the price with the son after acrimony, indicating an arm's-length negotiation where there would be no intent to transfer property for less than full and adequate consideration.

Finally, the agreement must be comparable to similar agreements entered into by persons in an arm's-length transaction. In this instance, the court found that an appropriate valuation appraiser had considered several comparables and that the agreement entered into by the parties was at arm's length. Notably, the conservator, not the decedent, entered into the agreement bound by the fiduciary duty to act in the decedent's best interest with parties who were not acting in concert with each other. (*Amlie v. Commissioner*, TC Memo 2006-76)

This letter prepared, with the help of a nationally recognized tax authority, intends to promote interest in more comprehensive tax and estate planning. References are intentionally brief. If a topic interests you, you should investigate it more thoroughly with your qualified tax advisor. Effective tax and estate planning should involve competent advisors in relevant law, accounting, trusts, life insurance and investments. The knowledge and experience of each in their specialties can make the difference between a wealth transfer that works as intended and one that does not. Please seek competent counsel to determine and satisfy your individual needs.

***Positioning our clients
for the future***



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