Tax Relief at Every Milestone

At least in the realm of tax law, 2001 may be ending on a better note than it began

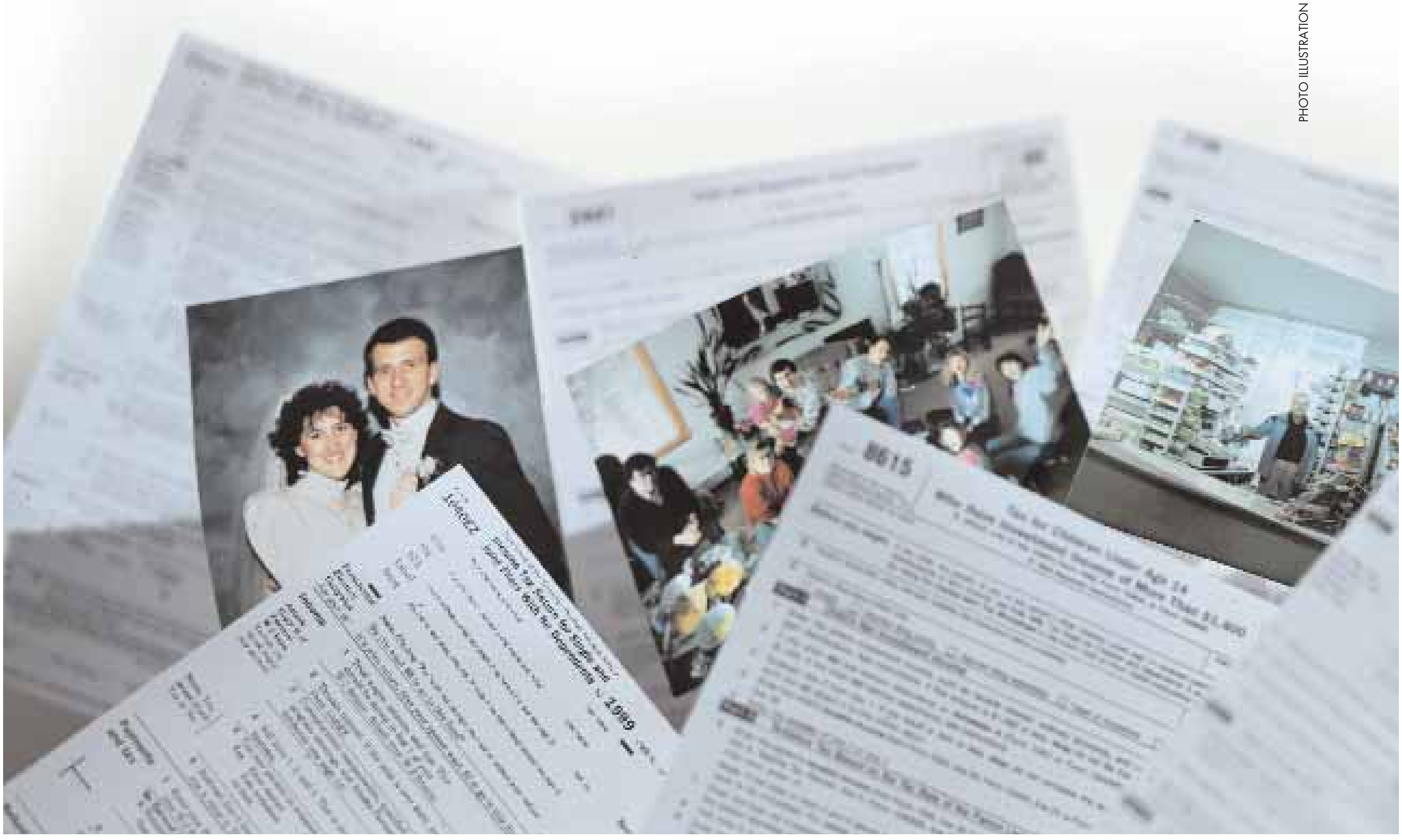

PHOTO ILLUSTRATION BY WAYNE SLEZAK

BY SAMUEL L. BRAUNSTEIN AND CAROL F. BURGER

This program

Begins at 1 p.m. (EST) on Nov. 14 and discusses recent changes in tax law favorable to taxpayers.

Co-sponsors

ABA Section of Taxation; Lawyers Division; Judicial Membership and Marketing Division; and Center for CLE.

Registration information

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Changes in the federal tax laws are usually greeted with trepidation rather than anticipation. All too often, the changes result in higher tax bills for individuals and businesses. And sometimes even benefits produced by new tax legislation passed by Congress or regulations issued by the Internal Revenue Service are accompanied by complex reporting requirements or complicated forms that make the tax breaks hardly seem worth the trouble.

In some ways, though, 2001 has been an exception to that pattern. The past year has produced generally good news for taxpayers, much (but not all) of it contained in provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001, an early priority of President Bush that Congress passed at the beginning of the summer.

Any tax legislation that brings rebate checks from the government is bound to be looked on favorably, but there's more to the changes than just that. In effect, the act has something for taxpayers at just about any stage of their lives. Most of the changes are intended to ease tax burdens either through rate reductions or increases in various types of deductions, exemptions and credits.

But true to form, there is even a little dark cloud on the horizon. The act will sunset in 2011, at which time federal tax law will revert back to what it was before the act went into effect. The temporary nature of the changes under the 2001 act is likely to bring on some difficult, long-range tax planning issues. Meanwhile, there is widespread hope that Congress will eventually decide to make at least some of the changes permanent.

While the act has been the most significant tax legislation passed this year, there have been other developments that also could be considered good news for taxpayers—as long as their implications are understood and their provisions applied correctly.

Tax Relief—Really

As part of its name implies, the overriding purpose of the Economic Growth and Tax Relief Reconciliation Act of 2001 is to reduce income taxes in various ways. (As for economic growth, only time will tell, especially in light of events that have buffeted the economy during the second half of the year.)

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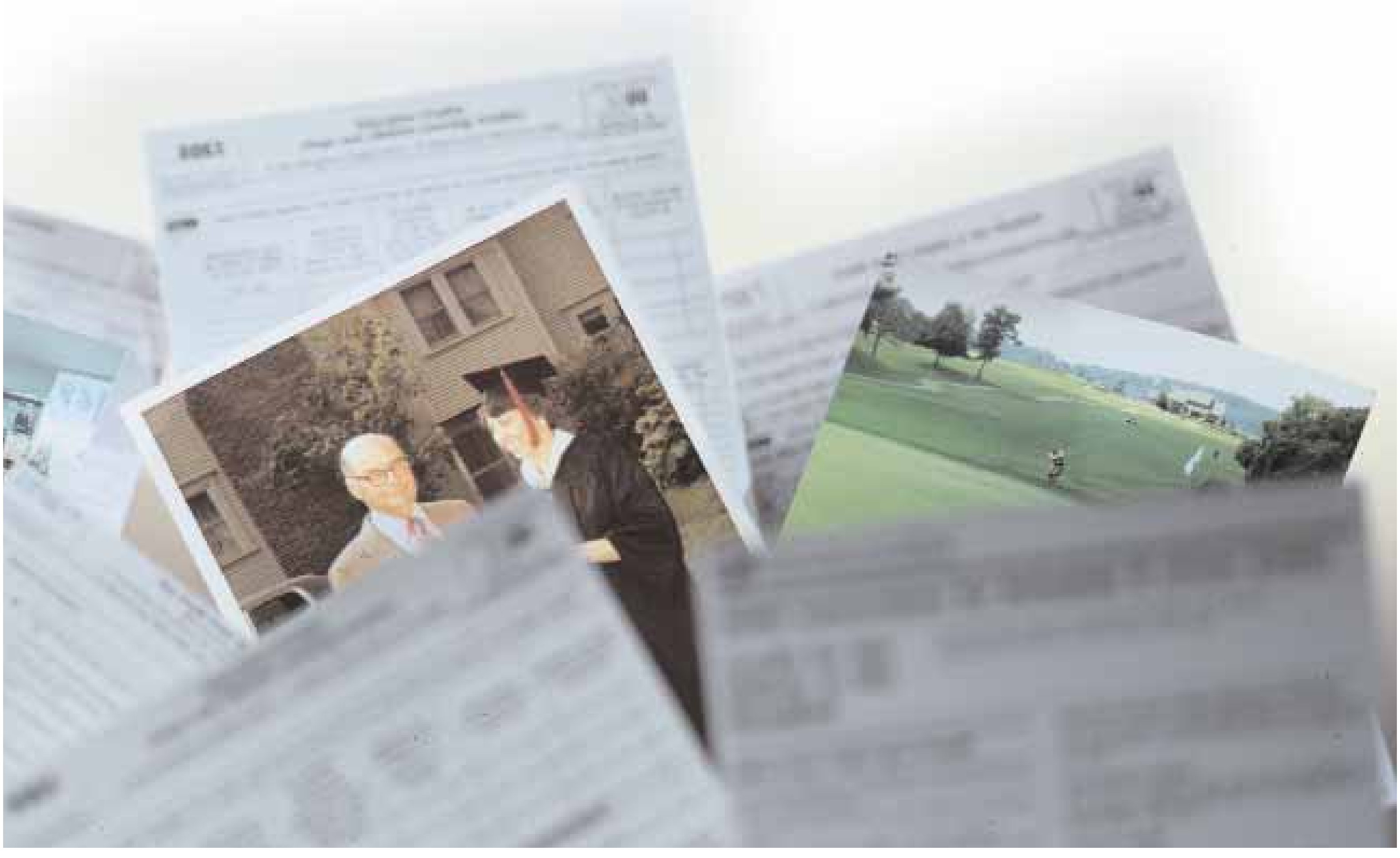
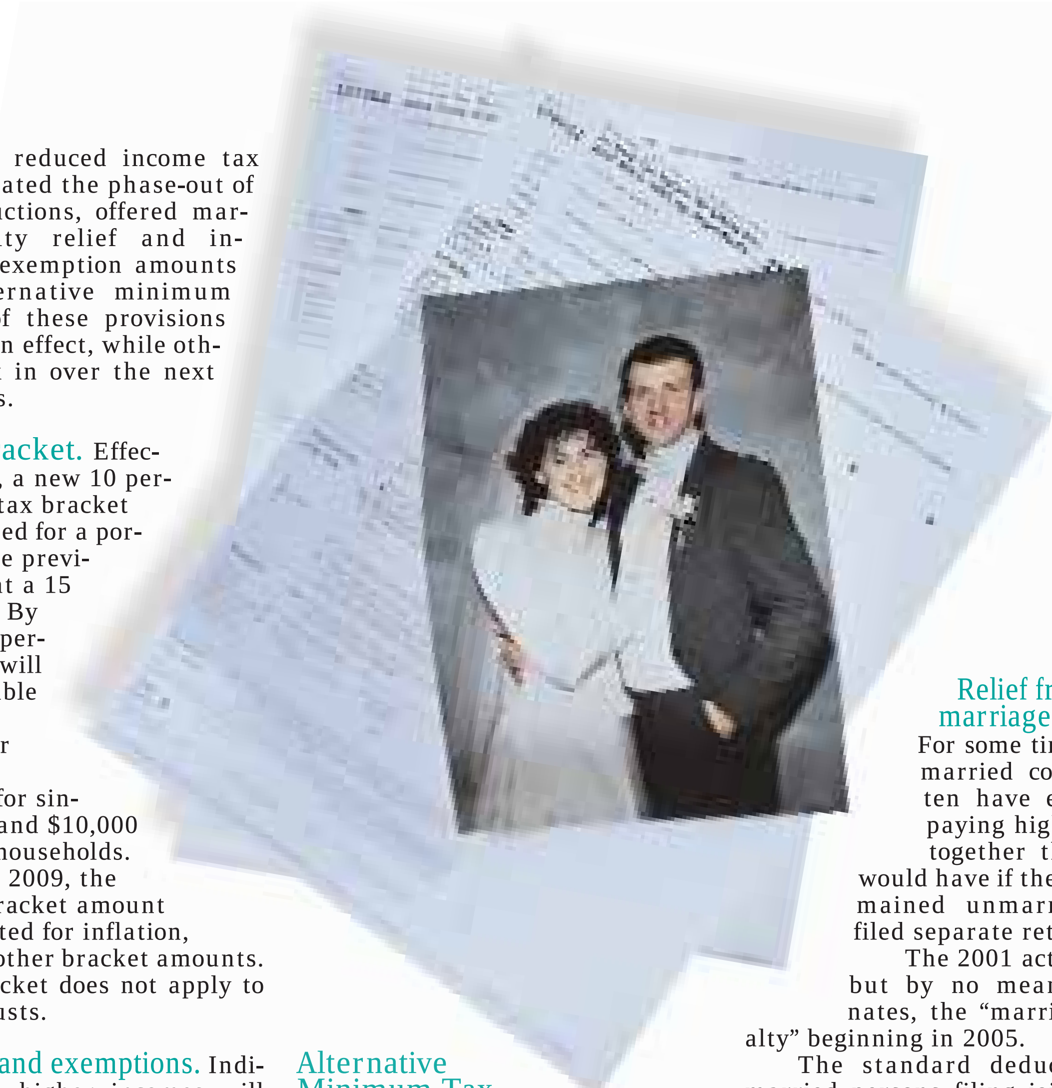




The act reduced income tax rates, eliminated the phase-out of certain deductions, offered marriage penalty relief and increased the exemption amounts for the alternative minimum tax. Some of these provisions already are in effect, while others will kick in over the next several years.

New tax bracket. Effective for 2001, a new 10 percent income tax bracket has been added for a portion of income previously taxed at a 15 percent rate. By 2008, the 10 percent bracket will apply to taxable income of up to $14,000 for married couples, $7,000 for single persons, and $10,000 for heads of households. Beginning in 2009, the 10 percent bracket amount will be adjusted for inflation, just like the other bracket amounts. The new bracket does not apply to estates or trusts.

Deductions and exemptions. Individuals with higher incomes will benefit from a phased-in repeal of limitations on itemized deductions and personal exemptions.

The limitation on itemized deductions presently requires higher-income taxpayers to reduce their deductions by the lesser of 3 percent of adjusted gross income over a threshold amount (for 2001, for instance, $132,950 for married couples filing jointly) or 80 percent of otherwise allowable deductions.

The limitation on personal exemptions presently reduces the exemption amount by 2 percent for each $2,500 (or fraction thereof) of adjusted gross income for all filers (except $1,250 for marrieds filing separately) over a threshold amount ($199,450 for joint filers and surviving spouses, $166,200 for heads of households, and $132,950 for unmarried individuals).

Under the act, both limitations will be reduced by one-third in 2006 and another one-third in 2008, before being repealed in 2010.

Alternative Minimum Tax. This is one piece of potential bad news, at least for taxpayers in higher brackets. The AMT is intended to offset the advantages those taxpayers derive from substantial deductions that often allow them to minimize their taxes.

Those individuals must figure their taxes using the deductions, then again using the alternative minimum tax, and they must pay whichever amount is higher.

The downside for upper-income taxpayers is that fewer of them will be able to take advantage of the more favorable rules on deductions and exemptions because they will be paying their taxes under the AMT.

The good news for those taxpayers is that income amounts exempt from the AMT will be increased slightly for 2001 through 2004. The exemption amount increases from $45,000 to $49,000 for married couples, and from $33,750 to $35,750 for single filers.

Relief from the marriage penalty. For some time, many married couples often have ended up paying higher taxes together than they would have if they had remained unmarried and filed separate returns.

The 2001 act reduces, but by no means eliminates, the “marriage penalty” beginning in 2005.

The standard deduction for married persons filing jointly will increase over five years, so that by 2009 it will equal twice the standard deduction available for unmarried persons.

In addition, the maximum taxable income in the 15 percent bracket for married couples filing jointly will increase over four years, so that by 2008 it will equal twice the maximum taxable income in the 15 percent bracket for single persons.

Qualified tuition programs. The 2001 act expanded a number of existing education incentives. The act makes the $5,250 exclusion for employer-provided educational assistance permanent and extends it to graduate education. The act also increases the maximum contribution to an education IRA from $500 to $2,000. In addition, the act liberalizes the rules governing qualified tuition programs, also known as Section 529 Plans, which permit individuals to contribute to accounts established by states for the pur-

Distributions from qualified tuition programs are now taxable income to the beneficiary, but they will be excludable starting in 2002.

pose of paying qualified higher education expenses.

Previously, distributions from these plans were taxable income to the beneficiary to the extent of earnings, as though they were annuities, except to the extent they qualified for the Hope Scholarship or Lifetime Learning Credit under Section 25A of the Internal Revenue Code.

Under the act, effective for distributions made after Dec. 31, 2001, distributions used to pay for qualified higher education expenses will be excludable from the beneficiary's income.

There are benefits to donors as well. Contributions to the plan are considered gifts and qualify for the $10,000 annual gift tax exclusion available for each named beneficiary. And under an especially favorable rule, a donor may contribute as much as $50,000 in a given year for each named beneficiary ($100,000 between spouses) and treat the contributions as being made ratably over five years.

The act also lets private institutions establish prepaid tuition programs, although distributions from the programs will not be excludable from income until 2004.

Death to the Estate Tax

Some of the most welcome provisions in the tax relief act relate to estate taxes, which have long been widely despised as a form of double taxation on individuals and their estates. However, the bad news is that, while the estate tax will be totally repealed after Dec. 31, 2009, all of its provisions will go back into effect after Dec. 31, 2010. This creates the odd situation that the extent to which these changes are beneficial will depend on the timing of one's death.

In general terms, the act increases the amount exempt from estate taxes and generation-skipping transfer taxes and reduces the maximum estate tax rates from 2002-2009. Both taxes will be repealed in 2010 (and replaced with complicated carryover basis rules), only to be reinstated—with a $1 million exemption amount and today's tax rates—in 2011. The gift tax is not scheduled to be repealed.

On Jan. 1, 2002, the estate and gift tax exemption amount will increase to $1 million per person; the maximum tax rate will be reduced from 55 percent to 50 percent; and the 5 percent surcharge on estates of more than $10 million will be eliminated. The maximum tax rate is scheduled to be reduced by an additional 1 percent each year through 2007, when the rate will be 45 percent. The estate and generation-skipping transfer tax exemptions (but not the gift tax exemption) are scheduled to increase to $1.5 million on Jan. 1, 2004; to $2 million on Jan. 1, 2006; and to $3.5 million on Jan. 1, 2009.

This would be a good time to advise clients to review their estate plans to make certain that the increased exemptions do not distort the intended plan.

For example, a client who prepared a will on the assumption that the estate tax exemption at the client's death would be $675,000—the current exemption amount—might have left the estate tax exemption amount to his or her children and the balance of the estate to his or her spouse. If the exemption amount increases to $3.5 million, or even $2 million, the client might determine that the children are receiving too large a share of the estate at the expense of the spouse.

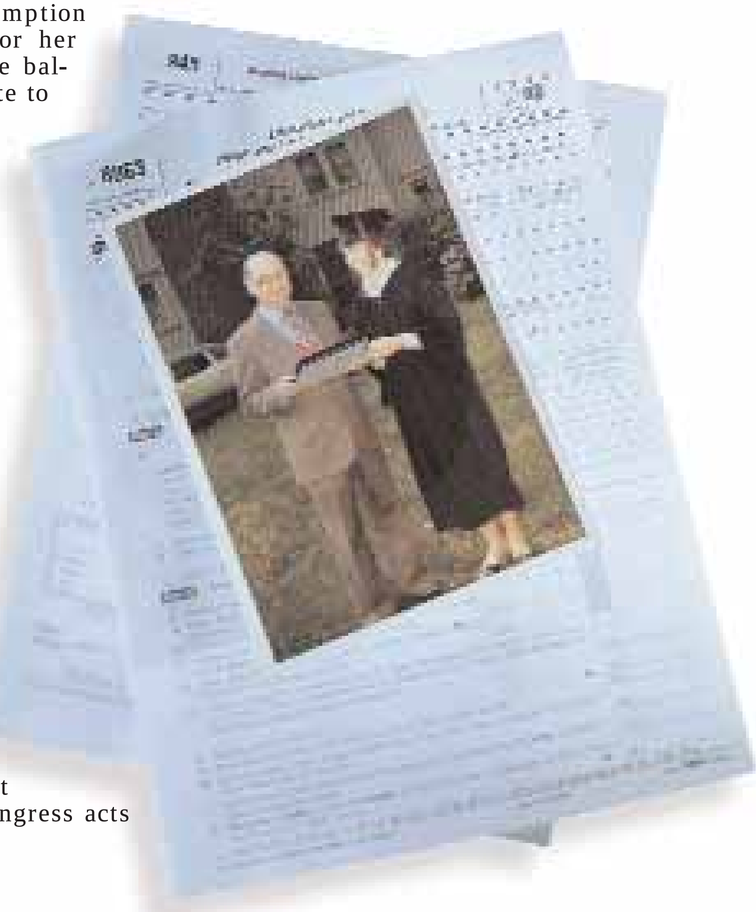
Clients and practitioners also should keep in mind that estate plans will have to account for the fact that—unless Congress acts otherwise—the law will revert at the beginning of 2011 to what it was before the 2001 act went into effect.

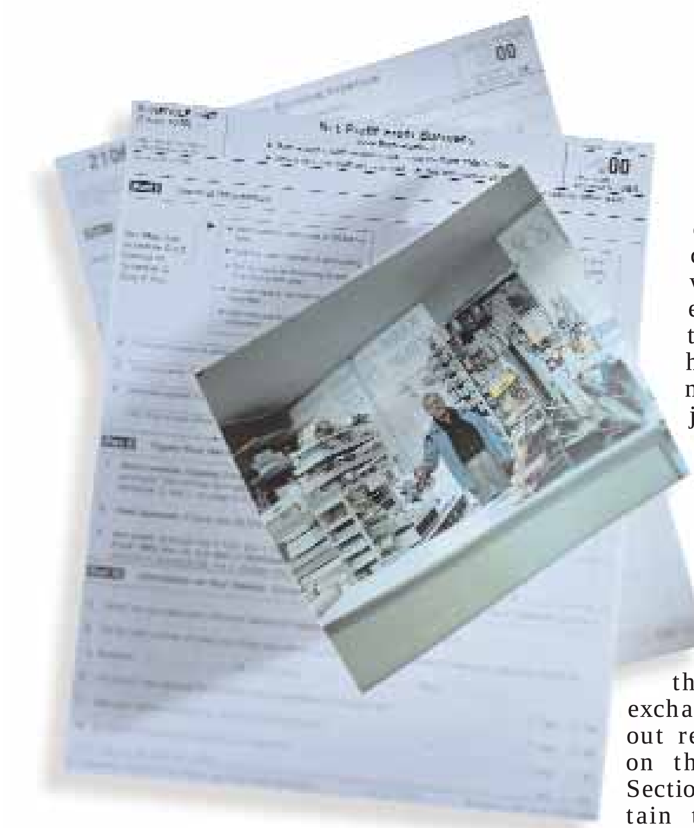
Not all the good news on the tax front was produced by the act. A number of other developments that may be welcomed by taxpayers have also taken shape in the past year or more as a result of legislation and regulatory actions. Some of those developments are discussed below.

Relief for Innocent Spouses

Under Section 6013 of the Internal Revenue Code, a husband and wife may file a single income tax return jointly even though one of them has neither gross income nor deductions. Filing jointly does not always bring a lower tax bill, but most married couples do file joint returns, at least partly because it's easier and amounts to something of an informal reaffirmation of marriage vows.

The problem with such uncompromising and undying allegiance to the joint return is found in IRC §





6013(d)(3): If a joint return is made, "The tax shall be computed on the aggregate income and the liability with respect to the tax shall be joint and several." Thus a spouse with no income or deductions can be entirely liable for the tax of the other spouse solely because he or she filed a joint tax return. (A hold harmless clause in a divorce settlement or decree is not binding under IRC.)

To prevent obviously inequitable treatment of a spouse who was unaware that there was an inaccurate entry on a joint return, there is now a provision available for giving the innocent spouse relief.

IRC § 6015 provides for different types of relief from joint and several liability, sets forth specific rules that must be met to grant relief, provides for a proportional allocation of a deficiency between estranged or former spouses, and gives the IRS discretion to grant relief to taxpayers who may not otherwise qualify.

It should be remembered, however, that innocent spouse relief is only available for certain types of taxes: income (including self-employment), penalties, additions to tax and interest.

Although IRC § 6015 provides workable and understandable rules whereby innocent spouses may be granted appropriate relief from their joint return obligations, another alternative also exists under Section 6013 of the code: that the return was signed under duress. If duress can be established, courts have held that the return is not considered to be joint, and the spouse who signed it in that state may be relieved of joint and several liability.

Limited Liability Companies

A useful tax-planning tool is the ability to make exchanges of property without recognizing gain or loss on the transaction. Under Section 1031 of IRC, only certain types of property are covered by the rule, and they must be exchanged for like kinds of property. If other types of property or money (nonqualifying property) are included in the transaction, at least a portion of any gain realized must be recognized (referred to as "boot").

Until recently, it was unclear whether nonqualifying property under Section 1031 included a legal entity that has become increasingly common in recent years: the limited liability company.

Legislatively created in many states, the limited liability company is a noncorporate business entity that gives an owner essentially the same degree of protection against potential financial exposure as a corporation. LLCs generally have the ability to choose how they will be taxed under the "check the box" rules: sole proprietorship, partnership, or S or C corporation.

Limited liability companies can be a part of 'tax-free' property swaps.

The question of whether the prohibitions contained in IRC § 1031 regarding nonqualifying types of property precluded a "tax-free" exchange of property involving an LLC was recently addressed by the IRS in Letter Ruling 200118023, issued on Jan. 31, 2001. (Since this was a private letter ruling, it cannot be formally cited as a precedent by parties other than those who requested it.)

The letter ruling described a situation in which there was an exchange of qualifying property (investment real estate) for an interest in a single-member limited liability company that held like-kind property (investment real estate).

In that limited circumstance, the ruling held, the acquisition of the LLC itself would be treated as the acquisition of qualifying like-kind replacement property to the extent that the LLC's property at the time of the transaction consisted of qualifying like-kind property. Any other property held by the LLC would be taxable as boot.

While the ruling is not definitive, its importance, and the use of its rationale by practitioners, should be far-reaching. Lawyers will remember it in structuring tax-free exchanges of qualifying property and maintaining the degrees of protection from financial exposure that many clients desire.

Family Limited Partnerships

The intense interest among lawyers and their clients in family limited partnerships as effective vehicles for asset protection and management of family property and businesses shows no sign of abating.

One advantage of family limited partnerships is that they allow mom and dad to maintain control of the partnership as general partners. The children normally are designated limited partners, and interests in the partnership can be transferred to them over time through gifts and other means, often saving income taxes. In that way, mom and dad can pass the torch without giving up the controls until it is appropriate and at the same time reduce their taxable estates.

A great deal of attention has been devoted to the ability to obtain "discounts" in the value attributed to interests in FLPs for estate tax purposes. An issue that has not been given the attention it deserves is the method of determining an appropriate discount for gift tax purposes (which may not always be hand-in-hand with estate tax planning goals since a grantor may live for a considerable amount of time subsequent to the transfer).

For such purposes, it should be remembered that valuation discounts attributable to interests in FLPs (whether by gifts or otherwise) are usually the result of contemplated transfers of limited partnership interests in the FLP.

Because of the restrictions associated with limited partnership interests, there is a corresponding reduction in the value of such an interest, as opposed to an actual ownership interest in the assets that comprise the assets of the partnership.

Finding an appropriate value for a limited partnership interest in an FLP (and thereby, the appropriate "discount") continues to be a problem. The courts have consistently sought to ascertain the price a willing buyer would pay a willing seller for the subject limited partnership interest (as opposed to acquiring an interest in the underlying assets owned by the partnership), where neither the buyer nor the seller is under a compulsion to buy or sell and both have reasonable knowledge of the relevant facts of the transfer.

It is important to determine at the start of the process how the value/discount will be used—to determine, for instance, an arm's-length sales price, the value for gift tax purposes, or the value for estate tax purposes. An appraiser would be extremely hard-pressed to arrive at any meaningful valuation of a limited partnership interest without first establishing such parameters.

In conjunction with valuations for gift tax purposes, a primary focus under the "willing purchaser/willing seller" test generally applied by the courts should be on the value of the property transferred—not on the value of transferred property in hands of the eventual transferee. Further, extreme care should be given to structuring transfers of property to the FLP in exchange for interests in the FLP to ensure that such contributions do not result in unintended taxable gifts to the "other partners."

Remember, it is the intended gift of limited partnership interests (with appropriate discounts in value) that is the goal. Two recent cases that address the valuation/gift tax issues with discounts are *Estate of W.W. Jones II v. Commissioner*, 116 T.C. 11; and *Knight v. Commissioner*, 115 T.C. 36.

IRAs and Retirement Plans

Earlier this year, the IRS issued new proposed regulations to simplify the mandatory distribution requirements that apply to qualified retirement plans and individual retirement accounts.

Under the new rules, beneficiary designations that were once irrevocable when the account holder reached the age of 70½ may now be changed after that point. In many cases, the new regulations also reduce required distributions during the owner's life, allowing the assets to grow on a tax-deferred basis for a longer period of time.

The new rules, like their predecessors, require the owner of a qualified retirement plan account or IRA to begin taking minimum distributions by April 1 of the calendar year following the later of 1) the calendar year in which the account owner attains age 70½; or 2) the calendar year in which the account owner retires from employment with the employer maintaining the plan.

The second option does not apply to IRAs or to owners of more than 5 percent of the company maintaining a retirement plan.

Now, with one exception, the amount of an account owner's annual minimum distribution during his or her lifetime is no longer based on the person the owner selects as his or her designated beneficiary. Instead, minimum distributions are based solely on the account owner's age.

To make that determination, the account owner divides the balance in his or her account at the end of the prior year by the number set forth in an IRS-published table next to the owner's age. The table is based on the deemed joint life expectancy of the owner plus someone 10 years younger than the owner, which was the longest possible payout under the old rules when the designated beneficiary was anyone except the account owner's spouse. So as not to disadvantage account owners with spouses who are more than 10 years younger, an exception to the new rules provides that in such cases the account owner may take minimum distributions over the actual joint life expectancy of the account owner and the account owner's spouse.

An account owner's designated beneficiary is still important for determining how quickly distributions must be made after the account owner's death, and a designated beneficiary may only be an individual, including someone who is the beneficiary of a qualified trust.

Under the new regulations, however, the determination of the designated beneficiary is not made until Dec. 31 of the year after the year of the account owner's death. That allows for post-death planning, such as dividing an IRA into separate accounts or cashing out selected beneficiaries such as charities.

If an account owner dies before his or her required beginning date and there is no designated beneficiary, the account must be distributed in full by the end of the fifth calendar year after the year of the account owner's death.

If an account owner dies after his or her required beginning date and there is no designated beneficiary, the account may be distributed over the account owner's remaining life expectancy at death, reduced by one year each year thereafter.

If there is a designated beneficiary other than the spouse, the account may be distributed over the designated beneficiary's life expectancy, regardless of whether the account owner died before or after the account owner's required beginning date.

If the sole designated beneficiary is the surviving spouse, and the account owner died before reaching age 70½, the spouse has the option of deferring minimum distributions until the year in which the account owner would have reached age 70½, and naming his or her own designated beneficiary in case he or she dies in the interim.

If the account beneficiary is a trust, the spouse will be considered the sole designated beneficiary only if all distributions from the account to the trust must be redistributed to the spouse. This is likely to require some tinkering with standard marital trust language.

A spouse who is the beneficiary of an account has the additional option of rolling the account over into an account in his or her name, in which case he or she may defer distributions until his or her own required beginning date, and name his or her own designated beneficiary.

To be eligible for the spousal rollover, the spouse must be the sole beneficiary of the account and must have an unlimited right to make withdrawals from the account.

Just how good the tax news is from 2001 remains to be seen, as taxpayers and their counsel apply some of the new provisions to their own cases, and legislators weigh the merits of further changes. Particularly in the case of the 2001 act, which expires in a decade, it will be up to Congress to decide whether this year's good news in tax law will be permanent or just a passing fancy. ■