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THE PLANNER

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A monthly newsletter for Accounting, and Financial Professionals with a focusing on Estate Planning, Elder Law, and Special Needs Persons.

The Planner is a newsletter to inform and educate Accounting and Financial Professionals of the ever changing areas of estate taxes, and elder law to better service their clients.

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Income Tax Planning Concepts in Estate Planning

Estate planning sometimes has income tax effects. All advisors, therefore, should be at least aware of some basics of income tax planning to best serve their clients.

In this issue of The Wealth Counselor, we will examine some of the basics of income tax planning and some of the techniques used in estate tax planning that have income tax impacts.

The Goals of Income Tax Planning

The taxpayer's goal is generally to pay the least amount of income taxes they are legally obligated to pay at the latest possible date. Income tax planning is done to help the client get as close to those goals as the law allows.

Typically, the amount of tax due is reduced by having the income be in a class that has favorable treatment. Favorable rate treatment is granted to long-term capital gains and qualified corporate dividends. Some income is excluded from taxation altogether, such as interest paid by state and local governments, certain gain realized on the sale of the taxpayer's residence, and certain income earned while not living in the United States. The last two are subject to limiting rules and so not always available.

Income tax liability usually arises when an asset changes hands other than by gift or inheritance. However, the tax liability can sometimes be postponed. Examples are certain like-kind exchange transactions and certain installment sales. Sometimes, the fact of an asset changing hands is ignored for income tax purposes because the tax laws treat the transferring party and the transferee as the same taxpayer.

Basic Estate Planning Has No Income Tax Impact

Neither a Will nor a revocable living trust changes a client's income taxes. A Will only takes effect when the client dies and a revocable living trust is classified by the IRS as a grantor trust. Grantor trusts are disregarded for income tax purposes.

Advanced Estate Planning Can and Often Does Have Income Tax Implications.

Advanced estate planning, on the other hand, often involves income tax considerations. Advanced planning involves creation of trusts and/or entities.

Sometimes, advanced estate planning is used to reduce income taxes by shifting income from a taxpayer in a high bracket to a taxpayer in a lower bracket. Irrevocable trusts are often used for this purpose when the "kiddie tax" does not apply. The "kiddie tax," when applicable, imposes the parent's tax rate to the income of the taxpayer's child who is under age 24.

For this donor to donee income tax liability shift to occur, the trust cannot be a grantor trust with respect to the donor. On the other hand, if the trust is a grantor trust, the donor's paying the income tax on the trust's income is not an additional gift. Thus not shifting the tax responsibility can be used to transfer additional wealth to children and grandchildren without using the donor's gift tax exemption.

When an asset is sold, the tax is determined by the amount of gain realized. Gain is generally the difference between the net proceeds of the sale and the taxpayer's basis in the asset. If the taxpayer receives the asset as a gift, the taxpayer's basis is the previous owner's basis plus any subsequent investment by the taxpayer. If the taxpayer received the gift as an inheritance, the basis is the asset's value at the death of the prior owner plus any subsequent investment by the taxpayer. Advanced estate planning, therefore, weighs the estate and gift tax avoided against the increased capital gain that would be due on the recipient's sale of a gifted asset as opposed to an inherited asset.

Some advanced estate planning involves charities. Trusts with charity and non-charity beneficiaries all have income tax effects. Such trusts are characterized as charitable lead trusts (CLTs) if the charity beneficiaries take before the non-charity beneficiaries and charitable remainder trusts (CRTs) if the charity beneficiaries get what is left over after payment to the non-charity beneficiaries. Both CLTs and CRTs can be grantor trusts or non-grantor trusts, depending on what the client is trying to achieve.

Advanced planning with income tax aspects also includes:

- Investing in assets that produce tax-free income;
- Converting ordinary income into capital gain income;
- [a] Defering income for the maximum period of time;
- Accelerating deductions to the earliest possible year;
- Taking maximum advantage of depreciation rules;
- Taking maximum advantage of income exclusion rules;
- Avoiding tax-inefficient business structures;
- Structuring transactions to include some or all of the above.

Deciding which of these techniques should be used in a particular case requires advanced estate planning experience and probably accounting analysis. It is, however, important for every advisor to be at least aware that they exist so that the appropriate team member can be called on when needed.

Planning Tip: Remember, there is nothing illegal or improper about rearranging our clients' business affairs to take maximum advantage of all lawful strategies to reduce taxes.

Taxation of Corporations, Limited Liability Companies, Partnerships, and Non-Grantor Trusts

Most corporations, limited liability companies (LLCs), and all partnerships, and non-grantor trusts are taxed differently than individuals. An exception is the LLC owned by an individual or the partnership or LLC owned 100% by a married couple. They will be disregarded for income tax purposes unless the taxpayer owner(s) elect otherwise.

Partnerships, for example, are not taxed at all. They report income and deductions, but the taxes are paid by the partners individually.

Some corporations and LLCs are eligible to elect to be taxed under Subchapter S of the Internal Revenue Code's Chapter 1. They are called S-corporations, and they are treated for income tax purposes very much like partnerships - as pass-through entities. Corporations that do not elect or are not eligible for Subchapter S treatment are taxed as separate taxpayers under Subchapter C. They are called C-corporations.

LLCs can elect to be taxed as corporations, otherwise they are taxed as partnerships or are disregarded. Some are eligible to be taxed as Subchapter S corporations.

Partnerships and LLCs that are taxed as partnerships, have special allocation rules. S-corporation taxation is available only if a number of qualification conditions are met. Some trusts, for example, are not qualified to be Subchapter S owners. Entities in which they own interests, therefore, are ineligible for Subchapter S tax treatment. And with corporations that are not Subchapter S corporations, there are adverse taxation, liquidation and distribution of property issues.

Some Specific Income Tax Planning Techniques

Home Sale Exclusion

Many clients will be able to take advantage of the limited exclusion of gain on the sale of a personal residence. It allows a taxpayer to exclude from income up to $250,000 ($500,000 if filing jointly) of gain, providing the property sold has been the owner's primary residence for two out of the five years preceding the date of sale. This exclusion is also available for residences owned in revocable living trusts and certain irrevocable trusts, including defective grantor trusts.

Planning Tip: Many clients have more than one residence. With planning and a responsive market, a client can use this exclusion every two years to sell multiple properties. For example, sell the principal residence first. Then move into the vacation home, make it the principal residence for two years, then sell it.

Converting Income Taxable Assets into Non-Taxable Assets

IRAs have built-in income taxes. Plus, they are includible in the owner's estate as income in respect of a decedent (IRD). Distributions from an inherited IRA are also taxed when received by the beneficiary (although the beneficiary receives an itemized deduction for estate taxes paid on that income). In taxable estates, the net result is that a $1 million IRA is often only worth about $250,000 net to the beneficiary. There are several solutions to this dilemma. Some are:

Solution #1: Stretch out the inherited IRA as long as possible to offset the double tax. The longer tax-deferred growth will allow it to earn back some of the amount paid in estate taxes. Naming a young beneficiary will provide the maximum stretch out, allowing for more growth over a longer period of time. To make sure this happens, consider a special-purpose trust designed to receive and stretch inherited retirement plan benefits.

Solution #2: Convert the IRA to a Roth IRA. It may make sense to convert and pay the tax now if the IRA assets are expected to increase substantially over the next few years. As with a regular IRA, naming a young beneficiary will provide the maximum stretch out, allowing for more tax-free growth over a longer period of time.

Solution #3: Liquidate the IRA now and pay income tax at the current rates. Then gift the net proceeds to an irrevocable life insurance trust (ILIT) where the trustee can use the money to purchase life insurance. This will work well in 2011 and 2012 when the gift tax exemption is $5 million. Using this approach, a $1 million taxable IRA could be converted to over $1 million in tax-free assets for multiple generations.

C-Corporations

A C-corporation is taxed at a maximum rate of 35%, but, unlike individuals, it has no preferential capital gains rate. Thus, while capital gain income to an individual is taxed at a maximum of 15%, capital gains realized by a C-corporation are taxed at up to 35%. Then, when a C-corporation distributes a dividend to its shareholders, the dividend is taxed at up to 15% on the shareholder's return - thus creating double taxation on the same income. Even worse, if a C-corporation distributes appreciated assets to its shareholders, a deemed sale will have occurred at the corporate level, regardless of whether the corporation has any cash to pay the tax.

S-Corporations

An S-corporation is a pass-through entity so there is only one level of tax. Grantor trusts, including revocable living trusts, can be S-corporation shareholders. An irrevocable trust can also be designed so that it is eligible to be an S-corporation shareholder.

Getting Out of the C-Corporation Trap

Many clients form corporations and elect C-corporation

taxation unaware of the problems it can cause in the future because a C-corporation is tax-inefficient. Often the issue only surfaces when there is a real need to get out of the election. Liquidating the C-corporation and re-forming as an LLC (taxed as a partnership) will trigger capital gain on appreciated assets owned by the C-corporation, and shareholders will recognize gain on the receipt of corporate assets. This is not a viable solution unless assets are not appreciated and shareholders have unused capital losses.

A better solution is to liquidate the C-corporation, re-form as an LLC, and make the election to be taxed as an S-corporation. This will eventually eliminate the double taxation. However, a 10-year rule applies, so it is best to get the process started as soon as the problem is detected because any disposition of corporate assets within this 10-year period will result in some double taxation.

Deferring Income Recognition

Any time a client can defer taxes, it is wise to do so unless the tax rate increases. The longer a client can defer the payment of tax the better, because he or she can use and invest that money. Here are some of the opportunities the IRS gives us to defer the tax on income:

Exchange of Insurance Policies (Code Section 1035)

Allows the exchange of a current policy for one with better underwriting or a better product. Often the gain in the current policy is used to partially fund the new policy.

Like-Kind Exchange of Tangible Property (Code Section 1031)

Relinquished tangible property must be of a "like kind" to the replacement property (for example, a herd of cattle cannot be exchanged for a commercial building), and the exchange must occur within certain timing requirements (45 days for identifying and 180 days for acquiring the replacement property). No constructive receipt of cash is allowed in a non-simultaneous exchange, so a qualified intermediary is often used. To completely defer gain recognition, the value of the replacement property must be greater than or equal to the value of the relinquished property, and the taxpayer's equity in the replacement property must be greater than or equal to the taxpayer's equity in the relinquished property. If either is not true, there will be a taxable "boot" that is recognized in the year of the exchange. Tangible property not eligible for a 1031 exchange includes stock in trade or other property held primarily for sale. Intangible property, such as stocks, bonds, notes, other securities or evidences of indebtedness or interest, partnership interests, and certificates of trust or beneficial interests are not eligible for section 1031 exchange deferral.

Certain Corporate Reorganizations (Code Section 368)

Certain corporate reorganizations permit corporations to merge and acquire each other on a tax-free basis, which allows the client to rearrange corporate structure without an immediate income tax.

Installment Sale (Code Section 453)

Generally, if property is sold at a gain and at least one payment is received after the close of the tax year of sale, installment reporting is required unless the taxpayer elects out. There are many specific rules that apply to installment sales.

Charitable Trusts

In the right circumstances, charitable trusts can also provide tax deferral.

Charitable Remainder Trust (CRT)

The grantor retains an annual income stream and the remainder, if any, at the end goes to charity. The annual income stream can be an annuity or a "unitrust": i.e., an amount that is a fixed percentage of the balance of the trust at the beginning of the year. The net present value of the remainder interest when the trust is created must be at least 10% of the value of the initial contribution. The annual distributions can be payable for a term of years, a single life, joint lives or multiple lives.

Tax Deferral with a CRT

A CRT is exempt from income tax because the ultimate beneficiary of the trust is a charity. There will be no capital gain tax when appreciated property is placed in the trust or when it is sold by the trust. Capital gain is eventually taxed as annual payments are made to the grantor, but only after ordinary income has been taxed. Distributions that exceed ordinary income and accumulated capital gains are tax-free. The client also gets a charitable deduction in year one for the present value of the remainder interest.

Conclusion

Income tax planning should be an integral part of the estate planning process. We hope that this review will be useful for issue spotting and serve as a reminder that we need to work together as a team in order to provide the best possible service for our mutual clients.

Special Needs Planning Issues Following Divorce.

Divorce can be complicated, frustrating, disappointing, expensive, along with a whole range of other emotions, as anyone who has endured this type of proceeding can attest. As difficult as the issues can be in a divorce proceeding, can you imagine what happens when divorce involves a child with a disability?

This issue of The ElderCounselorTM focuses on one case study to illustrate how much more difficult the issues can be when a child with a disability is involved in the marital split, and how important it is to have someone knowledgeable in government benefits and special needs planning issues participate in the proceedings

The Facts

Consider the following situation: Husband and wife divorce in 1996, when their child, who is disabled, was 4 years old. The husband was ordered to pay approximately $2,800 per month in child support (considered to be about three times an ordinary child support order based upon his assets and income) for the life of the child. While it is unusual to see lifetime child support payments, and the award was larger than is customary, the husband agreed to this primarily because of the guilt he felt around the divorce. He also knew that his daughter was disabled and would require as much help as possible.

Fourteen years later, in 2010, the daughter turns 18 years old. The husband has since remarried and had another child. He feels he can no longer continue to make child support payments at the current level, and in fact his current wife now assists him in making these payments each month.

The husband wishes to seek a modification of the child support award, and he hires the attorney that handled his divorce years earlier to file the court papers seeking a downward modification of child support payments. The theory behind seeking this downward modification of child support payments is twofold. First, the husband would like to argue that since his daughter has just turned age 18, she can now qualify for Supplemental Security Income (SSI) benefits. Second, his daughter could receive services through a Medicaid waiver program, but her income from the child support payment could prevent her from qualifying. Therefore, the husband would like to know if establishing a court-ordered special needs trust to receive the child support payments would protect the child support payments from being counted as income to the daughter.

Can the Daughter Qualify for SSI?

During the course of the proceedings, the wife appears to be the only person testifying as to the question of whether her daughter can qualify for SSI benefits and the utility of creating a special needs trust for her daughter. According to the wife, her daughter cannot qualify for SSI benefits due to the so-called deeming rules, pursuant to which a parent's income and assets are deemed to be available to the child for purposes of determining the child's eligibility for SSI benefits. The husband argues that the wife should apply for SSI for their daughter, but she refuses to do so, citing the deeming rules as an obstacle to her daughter's eligibility, and arguing that her own work income and $400,000 in assets will result in a denial of eligibility.

Without expert testimony, the court may have determined that the daughter was not eligible for SSI benefits, based solely on the testimony of the wife, who had apparently "done her own research on the issue." In fact, the deeming rules stop when a person turns age 18 under CFR Sections 416.1165 and 416.1851, and their daughter could qualify for an SSI benefit of up to $674, plus any additional state supplement. With this testimony now on the record, the husband is able to argue, credibly, that his daughter is entitled to a monthly SSI benefit of $761 and, if she were to avail herself of this benefit, then this increased income should be taken into account by the court in evaluating husband's request for a downward modification of the original child support payment.

Can a d4A Trust Hold the Daughter's Income?

The second major issue in this case pertained to the daughter's income surplus for Medicaid purposes. As a Medicaid recipient, daughter's income (solely in the form of child support payments she received from her father) could have prevented her from receiving Medicaid benefits as an adult. The husband wanted the court to order the creation of a self-settled special needs trust under 42 USC Section 1396p(d)(4)(A) (often referred to as a "d4a trust"), and have the child support payments irrevocably assigned into the newly established trust, thereby eliminating any surplus income.

Unfortunately, the husband and wife could not agree on the establishment of a d4A trust. The wife questioned whether such a trust could legitimately receive child support payments. She also testified that she may move to a different state to be with family, and that such a move would require a payback to the first state, reducing available trust funds that would be needed to care for her daughter. What the wife didn't realize was that under the Social Security Program Operations Manual System (POMS) Section SI 01120.200G(1)(d), an irrevocable assignment of child support payments (i.e., as a result of a court order), is not income for SSI purposes, and therefore would not count for purposes of determining daughter's SSI or Medicaid eligibility, or the amount to be received under either program.

In addition, there is no such requirement for payback when a Medicaid recipient and d4a trust beneficiary moves from one state to another, a point that was made through expert testimony. The only time payback to any state would be required is when the disabled daughter dies.

The Lesson Learned

The issues in the case study above make it clear that when a child with a disability becomes part of a divorce proceeding, difficult issues arise that warrant the expertise of elder law and special needs planning attorneys. Matrimonial or family law attorneys will very likely not possess the expertise needed to address these issues.

Please contact us if you would like additional information on any of the topics addressed in this newsletter or if you would like to discuss a specific issue.

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