

Tax Planning Ideas for 2010 and 2011

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Significant uncertainty exists related to tax planning for 2010 and beyond. Much of the uncertainty stems from laws enacted in 2001 and 2003, which made significant changes to individual income tax brackets, capital gains tax rates, and estate taxes. However, without Congressional action, many of the changes enacted in 2001 and 2003 are scheduled to expire in 2011 and be replaced by less generous provisions in place prior to 2001 and 2003.

Current individual income tax brackets range from 10 to 35 percent, and are scheduled to revert to a range of 15 percent to 39.6 percent. Capital gains rates generally stand at 15 percent, but are scheduled to increase to a 20 percent rate. Qualified dividend income currently taxed at capital gain rates of 15 percent could be subject to ordinary rates as high as 39.6 percent. And, last but not least, there is currently no federal estate tax, but the estate tax is scheduled to “reappear” in 2011 at rates as high as 55 percent and federal gift tax rates would rise from 35 percent to a 55 percent maximum.

Consider techniques to accelerate income and to defer deductions

- Take distributions out of IRAs, assuming no penalty for early withdrawal.
- Defer charitable gifts until 2011.
- Recognize long term capital gains in 2010.
- Pay estimated state taxes in Jan., 2011 rather than Dec., 2010.
- Consider electing out of the installment reporting method for 2010 sales.
- For sales prior to 2010 that are reported on the installment method, consider a disposition of the installment contract to accelerate gain into 2010.
- If possible, consider making a section 83(b) election on restricted stock.
- Consider exercising nonqualified stock options.
- Consider electing out of deferred comp deferrals in 2010, and double up on the deferral amount in 2011.
- For shareholders of a closely held/closely controlled C corporation with earnings and profits (E&P), consider a dividend distribution to take advantage of low dividend tax rates in 2010.

Always consider the impact of AMT on anticipated 2010 and 2011 tax liabilities. Also, with respect to deferring itemized deductions until 2011 (such as ideas 2 and 4 above), also consider that President Obama has proposed a potential 28 percent limit on itemized deductions for taxpayers in the two highest tax brackets.

Evaluate a Subchapter S election

The top individual tax rate and the tax corporate tax rate are currently the same at 35 percent. However, the top individual tax rate is scheduled to increase in 2011, while the top corporate tax rate is currently scheduled to remain at 35 percent. The potential rate spread suggests a careful analysis be made to consider terminating an entity’s S election.

Remember, future distributions to shareholders from the C corp will be treated as taxable dividends, to the extent of C corp E&P. The tax rate on dividends is expected to increase after 2010 and is currently scheduled to revert to ordinary income tax rates. Also, consider the five-year limitation on re-electing S status after termination of an S election.

Absent an election to terminate Subchapter S status, existing S corporations with undistributed C corporation E&P should consider distributing the E&P (taxable as a dividend) to take advantage of the lower rates on taxable dividends in 2010.

Partial stock redemption by senior family member of corporate stock

Most likely a partial redemption of corporate stock by a member of a family corporation will be treated as a dividend (assuming E&P) due to family attribution rules. But this may be an opportunity to pull excess cash out of the corporation at the current dividend rates (15 percent) to the senior member only with the net effect of transferring ownership to the younger generation without incurring a gift tax or using any estate and gift exemption.

Carefully consider a Roth IRA conversion

Consider a Roth IRA conversion, and electing out of the opportunity to spread the tax liability evenly over two years (2011 and 2012). Instead, consider paying all the income tax on the converted amount in 2010. This may be less costly, based on lower current tax rates. Admittedly, a Roth conversion reported in 2010 could push a taxpayer into a higher tax bracket, and splitting the tax evenly over 2011 and 2012 could be appealing as a result. On the other hand, taxpayers already in the highest tax brackets should consider the possibility of higher tax brackets in 2011 and beyond.

An alternative consideration for Roth conversions would be a conversion plan over five years to spread income out over the five-year period (again, electing out of the two-year spread opportunity for amounts converted in 2010), taking conversions only to use up lower marginal tax brackets. Obviously, this strategy makes sense only for taxpayers subject to marginal rates below the top tax rate. A potential downside to this strategy is appreciation of the IRA account before the conversion in future years may result in greater amounts subject to tax at conversion, decreasing the benefit of a five-year conversion versus a lump sum conversion in 2010. Again, a careful analysis of the Roth conversion should include a projection of future conversion amounts, the time value of money and anticipated future tax rates.

Estate & Gift tax considerations

With the estate tax and generation skipping transfer (GST) tax currently repealed for 2010, but scheduled to be reintroduced in 2011, there are a number of planning opportunities for consideration in 2010.

- Make taxable gifts in 2010, to be taxed at the lower 35 percent tax rate. The rate is scheduled to increase to 55 percent in 2011.

- Make a gift to “Skip Persons” in 2010 to avoid the GST. The rate is scheduled to go up to 55 percent in 2011.
- Certain estate planning transactions are sensitive to interest rates that are established each month by the IRS. The interest rates, in turn, are based on market interest rates for debt obligations issued by the U.S. Government. One rate that is used for several estate planning transactions is known as the Section 7520 rate. The 7520 rate for transactions in October of 2010 will be 2 percent. October’s rate matches the all time low set in early 2009.

Transactions that should be considered given the current 7520 rate environment include Grantor Retained Annuity Trusts (GRATS), Charitable Lead Annuity Trusts (CLATS), Installment Sales to Grantor Trusts, and intra-family loans. Installment sales and intra-family loans use different interest rates (known as the Applicable Federal Rates), but these rates are also near the all-time low. If you already have an intra-family loan or installment sale to a grantor trust, you should consider refinancing. It should be noted that a low interest rate environment is not favorable for qualified personal residence trusts or charitable remainder annuity trusts. However, many individuals may want to establish a QPRT to take advantage of the current low values on residential real estate.

A. GRAT – A grantor retained annuity trust (GRAT) is an irrevocable trust designed to transfer the appreciation on assets contributed to the trust with minimal or no gift tax consequences. GRATs are commonly used with assets expected to appreciate significantly over the time frame established as the term of the trust. GRATs pay an annuity to the grantor for a period of years. At the end of the term, any assets remaining in the GRAT pass to the trust’s remainder beneficiaries, often the grantor’s children. To avoid incurring a gift tax liability, the GRAT must be “zeroed-out.” This means the trust must be structured to return the maximum possible annuity to the grantor, equal to the present value of the assets contributed plus the assumed earnings rate (the 7520 rate). At the end of the trust term, only the appreciated value will pass tax-free to the remainder beneficiaries. When the 7520 rate is low, the GRAT containing high-performing assets can transfer significant wealth to the trust’s remainder beneficiaries. Finally, with significant discussion in Washington around extending the minimum GRAT term to 10 years, now is an ideal time to consider a GRAT.

B. CLAT – A charitable lead trust (CLT) is a type of trust under which the charitable beneficiary receives an annual payment for a designated term and the non-charitable beneficiaries receive the remainder of the property in the trust at the end of the charitable term. The term of the charitable interest can be a set number of years or for the life (or lives) of a designated individual(s). The interest of the charitable beneficiary can either be defined as a fixed annuity (Annuity Trust) or as a fixed percentage of an annually reappraised value of the trust (Unitrust). Upon the establishment of a CLT, the donor will be deemed to make two gifts: one for charity and one to the donor’s family. The amount of the gift to the donor’s family equals the difference between the value of the assets contributed to the CLT and the present value of the payments to the charitable beneficiary. While the gift to charity is tax-free, the gift to the donor’s family is subject to estate or gift tax. The current low interest rate environment increases the present value of the annuity thereby reducing the taxable gift.

C. Installment Sale to an Intentionally Defective Grantor Trust – This strategy involves a sale for an installment note to an intentionally defective grantor trust (IDGT). The value of the asset is “frozen” at the value of the note received in the sale so that future appreciation in the value of the asset sold to the IDGT will be transferred to the beneficiaries of the IDGT without gift or estate tax. Structured properly, the sale is not recognized for tax purposes (i.e., there is no taxable gain) because the grantor and the trust are treated as the same entity. However, the transaction is effective for gift and estate tax purposes and, assuming the sale is for fair market value, the value of the asset sold will not be includible in the grantor’s estate at his or her death. If the grantor dies during the term of the note, the value of the note will be includible in his or her estate. The note must provide for interest on the outstanding balance of the note using the appropriate Applicable Federal Rate (AFR). To the extent assets subject to the installment sale outperform the AFR, the growth will inure to the benefit of the IDGT. Because the IDGT will not have to pay federal income taxes, the likelihood of growth in excess of the AFR is further enhanced.

As a final note, many of these strategies are significantly enhanced when funded with an interest in a family controlled entity that may support significant discounts for lack of marketability and control. A number of proposals have suggested that Congress may attempt to enact legislation to substantially reduce discounts in the context of intra-family transfers. As a result, 2010 may mark the end of significant discounts on intra-family transfers. Therefore, anyone considering a significant transfer of a family controlled entity should act soon to take advantage of the existing “estate freeze” provisions contained in sections 2701 through 2704.

Small Business Jobs Act of 2010

The Small Business Jobs Act enacted in September 2010 included the following provisions, among others, that may impact tax planning.

1. Extending 50% bonus depreciation for qualifying assets purchased in 2010.
2. Increased Section 179 dollar limit to \$500,000 and investment limit to \$2,000,000.
3. Allows self employed individuals to deduct cost of health insurance in calculation of self employment tax
4. Reduction in S corporation built in gain recognition period.
5. Percentage gain that may be excluded increased to 100% for qualified small business stock acquired after 9/27/2010 and before 1/1/2011.
6. Increased carryback of general business credits for eligible small businesses.
7. Taxable rollovers from Pre tax retirement account to Roth accounts

Due to the amount of changes and planning opportunities that exist from a personal and business perspective, you may want to consult a tax professional to review your unique situation.

The above should not be considered a complete or comprehensive list of potential planning ideas or opportunities. There are other potential planning ideas, particularly with respect to estate and gift tax planning, which are somewhat complex and are not well suited for discussion here.

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