

May 2008

Dear ,

This issue of the WKBK&Y newsletter addresses:

1. Estate Tax Uncertainty: Planning Around an Unknown;
2. Deductibility of FICA Liability for Bonus and Other Payments to Employees Paid in Subsequent Tax Year—IRS Issues Safe Harbor for Accrual Basis Taxpayers;
3. IRS Holds 5-Year Rule Inapplicable to “Designated Beneficiary”; and
4. House Bill Extends Many Expiring Tax Benefits, Provides Alternative Fuel Tax Incentives;

1. Estate Tax Uncertainty: Planning Around an Unknown

With 2010 approaching, practitioners are beginning to wonder what is going to happen to the estate tax thereafter. Next year, the estate tax exemption will rise from \$2 million to \$3.5 million, and in 2010, the estate tax is eliminated altogether (although the heirs of large estates will face higher income tax because they will not be afforded the basis step up at death). In 2011, the law is structured to reset the estate tax to its pre-2002 exemption and tax rate amounts—a 55% top rate with a \$1 million exemption.

Since these changes were implemented, most in the tax community believed that Congress would do something in the interim to mitigate the tax burden from ratcheting back to its higher levels in 2011. There were some intimations of this in 2006, when Republicans pushed to raise the exemption to \$5 million and cut the tax rates on estates to a fraction of what they are now (15% for estates of \$30 million or less and 30% on larger estates). But those proposals have stalled and it is unlikely any changes will come in an election year. The consensus seems to be that the 2009 rules will be continued into the future until after the election, although this issue is on the priority plan in Washington DC.

The uncertainty adds some difficulty to estate planning because practitioners simply cannot say what will happen to the estate tax in the future. In any event, there are steps we can take now to reduce the estate tax burden regardless of what happens to the law in the future.

For one, utilization of the annual gift exclusion amount is still a great way to reduce a client’s estate tax burden. The current exemption amount is \$12,000 per year per donee. If both spouses agree to the gift, then up to \$24,000 can be given to each donee in a year without triggering any gift tax consequences. Hence, the annual gift exclusion will reduce the estate

without triggering any gift tax effects. On a related note, the exclusion amount does not include gifts of tuition and medical expenses made directly to the institution which allows clients to trim their estates even further.

Family entities are also a great tool to obtain liability protection and family succession planning at a valuation discount. It is imperative to structure these entities properly as they are a frequent target for IRS scrutiny. Life insurance trusts are still a great tool to hold insurance and avoid estate tax. By making an irrevocable trust the owner of such a policy, clients can use the annual exclusion to fund the trust to pay the premiums. The client's contributions are a completed gift, assuming the trust is properly structured, and the policy stays out of the decedent's estate when s/he dies. There are also many other techniques that provide multiple advantages that are not discussed herein.

In short, even though the estate tax is up in the air, in the interim practitioners still have available a large arsenal of tools to minimize the estate tax burden. Continuing to use these tools (including the multitude of estate planning tools not mentioned herein) will ensure that a client's estate tax will be reduced no matter what Congress decides to do.

2. Deductibility of FICA Liability for Bonus and Other Payments to Employees Paid in Subsequent Tax Year – IRS Issues Safe Harbor for Accrual Basis Taxpayers

Introduction. The IRS has recently issued a ruling—Rev. Proc. 2008-25—that now provides a safe harbor accounting method for accrual method taxpayers that accrue FICA and FUTA liabilities for year-end bonuses and other compensation that will be paid in the year following accrual. Under the safe harbor, a taxpayer employer is deemed to have satisfied the requirements of the recurring item exception for its payroll tax liability in the same tax year in which all events have occurred that establish the fact of the compensation liability and the amount of the compensation liability can be determined with reasonable accuracy.

Legal Background.

Accrual method taxpayers are entitled to a deduction or credit only if the “all events test” has been met:

- (1) all events have occurred that establish the fact of the liability;
- (2) the amount of the liability can be determined with reasonable accuracy; and
- (3) economic performance has occurred with respect to the liability.
(Regs. § 1.461-1(a)(2)(i).)

Under the “recurring item” exception to the economic performance prong (element (3) above) of the all events test, liability is treated as incurred for a taxable year if: (i) elements (1) and (2) of the all events test are met; (ii) economic performance occurs not later than the earlier of (A) the date on which the employer files a return of the taxable year, or (B) the 15th day of the ninth calendar month after the close of the taxable year; (iii) the liability is recurring in nature; and (iv) either the amount of the liability is not material or accrual of the liability in the taxable year results in better matching of the liability against the income to which it relates than would result from the accrual of the liability in the taxable year in which economic performance occurs.

(Regs. § 1.461-5(b)(1).) Tax liabilities are deemed to satisfy prong (iv). (Regs. § 1.461-5(b)(5)(ii).)

Historically, the IRS treated FICA and FUTA taxes for accrual method taxpayers as incurred only in the taxable year in which the compensation giving rise to the liability was paid. (See, e.g., Rev. Ruls. 69-587, 74-70.) That position was challenged in Eastman Kodak Co. v. United States, 534 F.2d 252 (Ct. Cl. 1976), wherein the Court held that FICA taxes on compensation accrued in a year but paid in a subsequent year are not established because of the uncertainty whether an employee would reach the payroll tax ceiling at the time of payment in the following year in which the compensation is paid. In this case, the Court allowed a deduction for FICA taxes with respect to “year-end” compensation paid in the first week of the subsequent tax year because it was certain that the FICA ceiling would not be reached, however for bonus payments which were payable on March 15 of the second year, the Court held that payment of FICA taxes was not certain because of the possibility that the employees could receive a raise such that they would have reached the applicable ceiling.

Rev. Proc. 2008-25.

The Revenue Procedure recognized Kodak, but also addressed the facts that there is no longer a ceiling limitation with respect to the Medicare portion of FICA and that the ceiling limitations have increased significantly since 1964, when the events relating to Kodak occurred. Accordingly, for administrative convenience to avoid further controversy, the IRS will not challenge a taxpayer’s use of the safe harbor method of accounting for payroll taxes on compensation in these circumstances.

3. IRS Holds 5-Year Rule Inapplicable to “Designated Beneficiary”

Introduction.

The IRS recently issued PLR 200811028, which holds in relevant part that a named IRA beneficiary is generally not subject to the 5-year rule where the IRA owner dies prior to the “required beginning date”.

Facts.

Taxpayer is the sole beneficiary of Decedent’s IRAs—IRA X and IRA Y. Decedent died in 2002 at age 66 and did not take and was not required to take any distributions from the IRAs prior to his death. The terms of IRA X provide that where the required distribution has not commenced prior to the owner’s death, the balance of the IRA must be distributed to the owner’s non-spouse designated beneficiary over his/her life expectancy beginning in the year following the year of the owner’s death. The terms of IRA Y similarly provide that if the IRA owner dies prior to the required beginning date, a non-spouse beneficiary may receive distributions over his life expectancy beginning no later than the end of the calendar year following the year of the owner’s death. Both IRAs provide a non-spouse beneficiary with the option of receiving required distributions in accordance with the 5-year rule.

Taxpayer did not take any distributions in 2003 or 2004 but in 2005 took a distribution from the IRAs equal to the aggregate required minimum distributions for years 2003, 2004 and

2005. In 2007, Taxpayer paid the additional excise tax for failure to timely receive required minimum contributions for tax years 2003 and 2004. Taxpayer did not elect the 5-year distribution rule.

Law.

Code sections 408 and 401 provide that an IRA owner is required to begin receiving distributions in the calendar year following the year in which the owner turns 70 ½. If an IRA owner dies before this required beginning date, in general the entire IRA interest must be distributed within 5 years of the owner's death (the "5-year rule"). However, if an IRA or any portion thereof is payable to a designated beneficiary upon the death of the IRA owner, then the IRA must be distributed to the beneficiary over his life expectancy. These minimum distributions (calculated pursuant to mortality tables published in the Regulations) must commence not later than the year following the year in which the IRA owner died.

Code section 4974(a) imposes an excise tax equal to 50% of the amount by which a taxpayer's minimum required distribution for a taxable year exceeds the amount actually distributed during the taxable year.

The explanatory provisions accompanying the final Regulations on section 409 provide that absent a plan provision or an election of the 5-year rule, the life expectancy rule applies in all cases in which the IRA owner has designated a beneficiary prior to his death.

Issue.

Whether Taxpayer's failure to timely take the 2003 and 2004 required distributions from either IRA (or both) requires that Taxpayer take distributions in accordance with the 5-year rule.

Analysis.

The IRS reasoned that the structure of the statutory language and the explanatory language accompanying the Regulations clearly reflected that the "default" rule for designated beneficiaries was the life expectancy rule rather than the 5-year rule. Since both IRA X and IRA Y provided that the 5-year rule was elective by Taxpayer and because Taxpayer did not make such election, she was entitled to receive distributions in accordance with her life expectancy pursuant to the Regulations' mortality tables. Taxpayer made this calculation for years 2003, 2004 and 2005, took the required distributions, and in 2007, paid the 50% excise tax attributable to her failure to take the 2003 and 2004 distributions. Accordingly, the IRS held that Taxpayer could continue to take distributions pursuant to the mortality tables based on her life expectancy and that she was not subject to the 5-year rule.

WKBKY Takeaway.

Rather than withdrawing the entire IRA fund in 5 years, this ruling allowed Taxpayer to withdraw the fund over 52.4 years (Taxpayer's life expectancy). This enabled Taxpayer to defer tax on the earnings for a considerable period of time.

This ruling also illustrates the importance of obtaining tax advice. Here, Taxpayer was required to receive three years' worth of distributions in one year, which very well could have had the effect of increasing Taxpayer's marginal income tax rate for 2005 as well as potentially reducing her deductions any AGI-based phase outs. In addition, Taxpayer had to pay a 50% excise tax on her failure to take distributions in 2003 or 2004—in effect, Taxpayer had to pay over a year's worth of distributions to the federal government as a penalty for failing to timely receive distributions.

4. House Bill Extends Many Expiring Tax Benefits, Provides Alternative Fuel Tax Incentives

Introduction.

On May 21, 2008, the House of Representatives passed H.R. 6049, the “Renewable Energy and Job Creation Act of 2008,” which includes a one-year extension of the IRA charitable rollover and a plethora of other tax extenders along with a number of renewable energy incentives.

Some of the extenders in the bill include one-year extensions (apply to tax years ending in 2008 but not beyond) on the deduction for state and local sales tax, deductions for education expenses, deduction for educator expenses, allowing non-itemizers to deduct a portion of property taxes, and an expanded child tax credit for low-income taxpayers. Some of the renewable energy incentives include an extended investment tax credit for solar energy, extended credits for biomass, geothermal, hydropower and wind energy. The bill also includes incentives for coal electricity plants to reduce carbon dioxide emissions, incentives for biodiesel and cellulosic biofuels, credits for hybrid and electrical cars and energy-efficient construction credits.

Highlights.

One of the more noteworthy provisions is the extension of the \$100,000 per taxpayer gross income exclusion for distributions of IRA proceeds to qualified charities. Rather than recognizing the distribution as income and allowing for a concomitant itemized deduction for the contribution, as would usually be the case, the provision changed the law so that the charitable distribution to a qualified charity would be excluded from gross income altogether to the extent the distribution does not exceed \$100,000. Because this provision provided for exclusion, a separate deduction was not allowed for the same contribution because that would have allowed a double benefit. Previously set to expire at the end of 2007, the bill changes the expiration of the applicable provision to December 31, 2008.

Another important extension is the extension of the basis adjustment to S corporation stock for S corporations making charitable contributions of property. The Pension Protection Act of 2006 amended Code section 1367 to provide that an S corporation shareholder's basis would be reduced by the shareholder's proportionate share of the contributed property's *basis* (rather than the contributed property's fair market value) in the property. As summarized in our January newsletter, this provision was added to make S corporation treatment more consistent with treatment of individual taxpayers, who get the full benefit of a fair market value charitable deduction (in most situations). H.R. 6049 would also extend this provision for an additional year (through 2008).

The bill also gives non-itemizing taxpayers the benefit of up to an additional \$350 (\$700 for married filing jointly) deduction for state and local real property taxes paid by the taxpayer in the current year. This is substantially less than the amounts we had seen in other bills before Congress.

Outlook.

The bill was introduced in the House on May 14, and passed (by vote of 263-160) in fairly short order—May 21. The Senate also seems positive toward the bill—Finance Committee Chairman Baucus has spoken positively about H.R. 6049. Many of the extenders in H.R. 6049 are renewed annually, so even if this bill is ultimately not passed, we will doubtless see many of the same extenders in subsequent bills.

We hope that you find these items of interest to you. If you need further information or would like to discuss a particular issue, feel free to call any one of the lawyers listed below. We will get you to the right person.

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