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Tax Memo

**PEOPLE ARE RECEIVING
MONEY IN THE MAIL FROM
THE GOVERNMENT!!**

In an attempt to stimulate the economy, Congress and President Bush agreed upon a package of tax rebates and incentives. The centerpiece of the legislation is a rebate equal to \$600 for a single taxpayer, and \$1,200 for married couples filing a joint return. The rebates are generally limited to no more than the individual's "net tax liability." The rebates are increased by \$300 for every dependent child under the age of 17. The rebates are, however, reduced for single individuals with adjusted gross income in excess of \$75,000 and for married couples with adjusted gross income in excess of \$150,000. The reduction is equal to 5% of the excess of their adjusted gross income over the threshold amount. In addition to the rebates, the new legislation includes two new depreciation incentives for business property. First, a *50% bonus depreciation deduction* is available on new equipment that is acquired and placed in service in 2008. This will be a major incentive for the acquisition of new business equipment. Second, the Section 179 expense deduction (which allows a taxpayer to write off

the cost of new equipment) has been increased from \$128,000 to \$250,000.

As an example, if a farmer buys a new \$200,000 combine, the entire \$200,000 cost of the combine can be deducted in the year of purchase. (Of course, he or she would have to take into account any other depreciable property purchased during the year to be careful not to exceed the \$250,000 limit.) These new depreciation rules provide powerful incentives to the acquisition of business equipment. The tax professionals at Bever Dye will be happy to discuss the new depreciation rules if you have any questions.

**CONGRESS APPLIES A ONE
YEAR "AMT PATCH"**

More and more taxpayers are becoming familiar with the Alternative Minimum Tax (or AMT). The AMT is really a parallel income tax system. Taxpayers compute their income under the normal income tax system taking deductions such as real estate taxes, state income taxes, medical and charitable expenses, home mortgage interest, etc. In arriving at their regular tax,

certain credits are also allowable. Then, after computing tax under the regular income tax system, taxpayers are required to compute their tax a second time under the AMT system. Most of their income is the same, but many of the items that are deductible for regular income tax purposes (such as state income taxes) are not deductible for AMT purposes. The tax calculated under the regular tax is compared with the tax calculation under the AMT system, and the taxpayer ends up paying whichever is greater.

This AMT tax structure dates back many years. It was originally enacted as a way to tax certain wealthy individuals who, because of certain deductions they enjoyed (such as accelerated depreciation on tax shelter investments), had relatively modest normal income taxes. As originally enacted, the AMT included an exemption amount and the effect of the exemption was that most taxpayers were well below the income figures which caused an AMT tax to apply. Today, most of the tax shelters that gave rise to the extraordinary deductions have been statutorily eliminated, and the

taxable income of many taxpayers has increased dramatically.

Because the exemption amounts were not set up to adjust automatically to increases in inflation, many taxpayers today who have no exotic investments, but instead simply incur routine deductions such as state income taxes, find themselves paying an unexpected AMT tax. The number of people whose income now exceeds the original exemption amounts is staggering. Congress has dealt with this problem previously. For the years 2000 through 2006, Congress provided for increases in the exemption amounts. The increases expired, and this past December, in a Congressional showdown of sorts, Congress reluctantly agreed to an adjustment in the exemptions to the same exemptions that existed for 2006. However, this is only a one-year "patch." Congress and President Bush (the new president won't be elected and in office in time) will have to deal with this same issue again, probably in late 2008, for the 2008 tax year as well. This issue has big dollar significance, so it is an issue we will want to monitor again as we go through the summer and fall of 2008.

INVESTMENT ADVISORY FEES FOR TRUSTS WILL BE LIMITED

Many trustees seek professional advice regarding the investment of trust funds. A typical arrangement involves a fee to the professional advisor based upon a percentage of the assets under management. When an individual incurs such a fee, that individual's tax deduction for the fees paid is treated as an "other itemized deduction" and all such deductions are subject to a

2% of income threshold before such deductions result in a tax savings on the individual's income tax return. Fiduciaries, however, have maintained the investment advisory fee is incurred because the fiduciary has a duty under the law to prudently invest the funds under their control, and have therefore deducted such fees "above the line." In other words, not subject to the 2% of income threshold. This issue has been the source of litigation in various courts. Recently the Supreme Court ruled in favor of the IRS (*Rudkin v Commissioner*) and it is now clear that such fees paid by a fiduciary to an investment advisor are subject to the 2% of income threshold. In addition, the IRS recently issued proposed regulations which go even further.

Under the new regulations (effective for years beginning in 2008), trustees will be required to allocate a portion of their normal trustee's fees to the investment advisory function role they play. So, for example, a corporate trustee who invests significant liquid assets will probably need to allocate a portion of their fee to the investment advisory role it fulfills. It is clear, under *Rudkin*, that an individual trustee who employs a bank, brokerage firm, or other professional to advise the individual trustee on investments, will be subject to this limitation.

WHAT ARE MY ODDS OF GETTING AUDITED?

No one likes an IRS audit. A common question is "what are my odds of getting audited?" Recently, the IRS provided some statistics on this question, and also noted that more individuals

(particularly the wealthy) will be facing audits in the future. The IRS selected 1.38 million individual returns for examination in the year 2007. Most of those audits were "correspondence audits" largely generated by the IRS matching program. These commonly occur when a third party reporter (such as an employer, bank or other institution issues a 1099 or W-2) issues a tax form that is not easily "matched" by a corresponding entry on an individual's personal tax return. However, the overall number of examinations was up from the prior year by approximately 7%. With respect to high income individuals (those with reported income in excess of \$200,000), the IRS increased the audits on this group of individuals by nearly 30% from the prior year. That does not mean 30% of the individuals were examined. Rather, it means that the number of individuals examined in this income classification increased by that percentage. The IRS did provide more definitive numbers for those reporting an income in excess of \$1,000,000. Nearly one out of every 11 individuals with reported income in excess of \$1,000,000 were examined in 2007. Again, many of those examinations were correspondence exams, and may have been easily and routinely handled.

On the business side, the IRS took particular interest in two popular business entities; S corporations and partnerships. Audits of both types of entities were up during 2007 by approximately 25%. However, the overall audit coverage for such entities still remains below the audit coverage for individuals.

It appears the increase in audit activity by the IRS is a developing trend and no doubt is partially attributable to increasing pressure from Congress to close the estimated \$300 billion dollar "tax gap," the difference between what taxpayers owe and what they actually pay.

WHAT IS A GRAT AND WHY DO PEOPLE USE THEM?

A GRAT is a grantor retained annuity trust. It is a very useful estate planning technique when taxpayers have appreciating assets in a low interest rate environment. Here's how a GRAT works:

1. A taxpayer transfers a valuable, appreciating asset into an irrevocable trust with an independent trustee (such as a bank, child or trusted advisor).

2. The terms reserve to the taxpayer an annuity payment for a period of years. At the end of the period, the remaining property in the GRAT transfers to the taxpayer's intended beneficiaries (for example, his or her children).

3. Thus, the taxpayer has made a completed gift of the remainder interest in the GRAT. This completed gift must be valued in accordance with the IRS tables which are based upon the current interest rates.

4. But, when the GRAT terminates, and the remaining property in the GRAT actually transfers to the children, there are no transfer tax consequences.

Why is this advantageous? Because if the property actually produces income and appreciation

greater than the assumed rates of return in the IRS tables, the taxpayer is effectively making a gift to his or her children free of the estate or gift taxes.

Let's illustrate: Assume John Doe owns a stock portfolio which is worth \$10,000,000 and has been doing very well. Assume it is producing an income of 4% each year, and it increases in value by 6%. John sets up a three-year GRAT, and reserves in that GRAT an annuity payment of 35% percent of the initial value of the stock he transfers into it. If he transfers in the entire stock portfolio, he will have made a taxable gift of the remainder interest to his children. That taxable gift will be approximately \$500,000 (using current interest rates). He will receive back annuity payments (probably in the form of cash and stock) of \$10,500,000 during the next three years. But, at the end of the period, the GRAT will still have in it assets with an approximate value of \$1,700,000 that will all pass, free of any further tax, to his children. The net estate tax savings will be his estate tax rate (probably 45%) multiplied by the difference between \$1,700,000 and \$500,000, or about \$540,000.

But wait. For many taxpayers it may be much better than for John. Assume Jane Doe owns 100% of the stock of a corporation (Doe Corporation) worth \$10,000,000. Assume it is likewise producing a current income of 4% per year, and that it is appreciating at the same rate as John's stock portfolio, or 6% per year. Finally, assume Jane establishes the same type of GRAT as John. It has a three-year term,

and it reserves an annuity payment to Jane of 35%. But, instead of transferring into the trust all of her stock of Doe Corporation, assume that Jane transfers in 49% of the stock this year; and then next year establishes a similar three-year GRAT, and transfers in another 49% of the stock. (In other words, Jane establishes "rolling GRATs.") Because each GRAT is funded with stock which does not constitute control of Doe Corporation, it is likely that stock can be discounted in value quite significantly. An estimate of the value of 49% of the stock of Doe Corporation would likely result in a value of approximately \$3,500,000 (taking a 30% discount for lack of control and lack of marketability). Therefore, when Jane computes her taxable gift each year, she finds she will be making gifts of approximately \$175,000 to her children. She will receive total payments (stock and cash from dividends) of approximately \$3,700,000 from each of the GRATs, but each GRAT will have stock worth approximately \$600,000 (at its discounted value) or, approximately \$860,000 at its non-discounted value to transfer to the children. The tax savings (based upon the discounted numbers) would be 45% of the difference between \$175,000 and \$600,000 multiplied by two (since there were two different GRATs) or approximately \$382,000 *but, again these figures are based upon the discounted value of the stock, not the gross value before discounts.* By engaging in these techniques, Jane can effectively position her estate to achieve a "lack of control" and "lack of marketability" discount of approximately 30% on the entire value of her stock of the company

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(effectively then, the savings of 45% of 30% of \$10,000,000 - or \$1,350,000 or more).

These are complicated transactions, and for simplicity sake, we've not discussed the income tax issues, or the fact that the taxpayer has to live for the term of the GRAT; or that appraisals may be necessary. And, there may be other ways to achieve similar discounts for lack of control in the case of a closely held business interest. But, very significant transfer tax savings can be achieved in the current low interest rate environment for taxpayers who have appreciating assets and/or the ability to achieve a discount for the value of assets used

to fund GRATs. The tax professionals at Bever Dye will be happy to discuss a GRAT with anyone interested in the technique.

CONFERENCE SPEAKERS

Bever Dye member, Hellen L. Haag, will be speaking at the 2008 KSCPA Financial Planning Workshop on May 12, 2008.

Bever Dye member, Eric J. Larson, will be speaking on ethical issues for CPAs at a Wichita meeting of Cooperative accountants on May 5, 2008.

Bever Dye Professionals

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