THE BERNSTEIN REPORT

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RICHARD S. BERNSTEIN

JULY/AUGUST 2008

Dear Reader,

Congress has begun to more seriously consider the reform of the federal estate tax. The federal estate and generation-skipping transfer (GST) tax exemptions are scheduled to increase from $2 to $3.5 million per transferor in 2009. The estate and GST taxes are scheduled for repeal for one year only in 2010 under current law. Separate bills were introduced recently in the House and Senate to reform the estate tax and eliminate the total repeal. The Senate version (S 3284) introduced by Senators Carper, Voinovich, and Leahy would extend the $3.5 million exemption (with inflation adjustments) and the maximum rate at 45 percent beyond 2009. The bill included a statement that the change should be made revenue neutral which would require offsetting tax increase provisions.

The House version (HR 6499) introduced by Congressman McDermott is a more complex provision and would set the exemption amount at the current $2 million and have higher tax rates of 50 percent for $5 million estates and 55 percent for over $10 million estates. Both the exemption and rate brackets would be adjusted for inflation. The House bill also restores the state death tax credit, which would reinstate a state estate tax in the majority of states that do not currently have an estate or inheritance tax. The bill contains a simplification provision that would permit the surviving spouse to increase his or her estate tax exemption by the amount of the exemption that was unused by the deceased spouse's estate. Although many prognosticators don't believe that estate tax reform will move forward in an election year, we'll continue to keep you abreast of the proposals.

While this letter was being sent to the printer, Congress worked overtime to get a bill based to address the difficulties with foreclosures and the real estate industry. The "Housing Assistance Tax Act of 2008" also contains revenue-raising provisions and the expenditures are theoretically fully offset. We can't provide all the detail now, but the bill is being sent to the President for signature after overwhelming passage in Congress. Some of the tax benefits include a provision to permit nonitemizers to deduct property taxes in addition to the standard deduction for 2008. This deduction is limited to $500 for single taxpayers and $1,000 for married taxpayers. There is also a first-time home buyer tax credit of $7,500 for home purchases occurring April 9, 2009 to July 1, 2009. One revenue raiser will require credit card issuers to report payments made to merchants to the IRS beginning in 2011.

Cordially,

Richard S. Bernstein

A Second Opinion Costs You NOTHING, But Could Save You MILLIONS!

WHEN IT COMES TO YOUR HEALTH, YOU GET A SECOND OPINION, SHOULD YOUR FINANCIAL WEALTH BE ANY DIFFERENT?

THE ALTERNATIVE MINIMUM TAX (AMT)

"Add On Tax" For Many Taxpayers

Many middle class taxpayers have proven to be wealthier then they think. When the AMT legislation was originally enacted into law in 1969, only a few hundred taxpayers actually paid the additional tax. However, as the definition of AMT preference items has been expanded to include ordinary and commonplace deductions, the number of taxpayers subject to the AMT has skyrocketed. Recent studies indicate that over 4 million taxpayers are subject to the AMT, with middle class families bearing a significant share of the burden. Not only does the AMT create additional taxes, but the AMT also adds significant complexity to the process of complying with federal income tax reporting. In fact, many federal government reports have repeatedly listed the repeal of the AMT as a top priority in simplifying the tax code.

What Are The Tax-Preference Items That Cause AMT Exposure?

The AMT is a complex system and this edition of the newsletter will be limited to an identification of the issues that create exposure to the tax. The AMT calculation starts with a taxpayer's taxable income, which is then modified to reflect the impact of tax-preference (technically adjustments and preferences) items by eliminating or reducing certain deductions. In addition, certain items of tax-exempt income (i.e., certain private activity bond interest) are added-back for the AMT calculation.

Unfortunately, many preferential items are noteworthy since they impact the majority of middle class taxpayers. For individuals that itemize deductions on Schedule A of their Form 1040, the following deductions are eliminated or reduced for the purposes of calculating the AMT:

- State and local income taxes (or deduction for sales taxes)
- Real estate taxes
- Personal property taxes
- Home equity indebtedness (where the loan was not used to purchase, build or substantially improve your home)
- Miscellaneous itemized deductions in excess of 2 percent of adjusted gross income (including unreimbursed employee expenses, the costs of tax preparation, and financial/investment fees)
- Medical expenses in excess of 10 percent of adjusted gross income. Note, however, that for regular tax purposes, a 7.5 percent ceiling applies to medical expense deductibility.

For those taxpayers claiming the standard deduction in lieu of itemizing their deductions, the standard deduction is added back to taxable income in calculating the AMT. In addition, personal and dependency exemptions are not allowable in computing the AMT.

Although there are numerous other tax-preference items, the aforementioned items are typically involved in an average individual tax return calculation.

As more and more middle class taxpayers fall prey to the AMT, they quickly discover that the promised tax relief under recent legislation was a mirage. One study by the Urban Institute-Brookings Institution Tax Policy Center projects that about 30 million taxpayers will be subject to the AMT within the next few years, as compared to the 4 million or so taxpayers currently paying

the additional tax. In addition, the Congressional Budget Office (CBO) predicted that the AMT could impact as many as one in five taxpayers by the year 2010, including virtually all married couples with incomes between $100,000 and $500,000. This phenomenon has also been accelerated by the reduction of maximum individual tax rates (39.6 to 35 percent) and the implementation of a 10 percent bracket. As a result of the Bush Administration's tax rate changes, the overwhelming number of taxpayers are in a 25 percent bracket or lower (over 95 percent according to the IRS's most recent tax data report). However, the AMT tax rates of 26 percent and 28 percent are not indexed for inflation. As a result, the AMT rates become the effective tax rates for many taxpayers.

Recent Developments

The December 2007 Tax Technical Corrections Act liberalized the AMT refundable credit for tax years beginning prior to 2013 by providing that an individual's AMT refundable credit amount for a tax year is the greatest of (1) $5,000; (2) 20 percent of the long-term unused minimum tax credit or (3) the AMT refundable credit amount, if any, for the prior tax year before any reduction by reason of adjusted gross income. This change gives the taxpayer an AMT refundable credit amount of at least $5,000 for a tax year, provided the individual's long-term unused minimum tax credit is at least $5,000. This law will allow taxpayers to more effectively utilize long-term unused credits under the AMT.

In addition, December's Tax Increase Prevention Act of 2007 retroactively implemented an AMT "Patch," increasing the AMT exemptions for yet another year (e.g., $66,250 for a married couple filing a joint return). Furthermore, the late 2007 legislation extended the nonrefundable personal credits as an offset against the AMT for 2007. However, barring any new and real legislation, the AMT exemption amounts will revert to the significantly lower AMT Exemptions of 2000 (e.g., $45,000 for a married couple filing jointly) for 2008 tax returns filed next April. Although several Congressional leaders are seeking yet another AMT "Patch" for 2008, there are others who are seeking repeal of the AMT. However, the potential loss of revenue resulting from an AMT repeal is staggering. The Joint Conference Committee on Taxation has reported that repealing the AMT would deprive the government of $611 billion in revenue over the next decade. A tax reduction of that magnitude would require offsetting tax increases, most likely through an overhaul of the system. Since 2008 is a general election year, another AMT "Patch" is more likely to occur this year than a repeal of the AMT.

Recent Cases and Rulings

Corporate-Owned Life Insurance (COLI) Didn't Reduce or Increase Accumulated Adjustments Account (AAA) in S Corporation

An S corporation acquired key person life insurance coverage on the life of a key employee. The corporation was the policyowner, paid all premiums, and was the designated beneficiary under the policy. S corporations maintain an account, known as the AAA, that tracks items of previously taxed undistributed income in the corporation. The AAA is a corporate account and is not apportioned among shareholders. The AAA is generally not increased by items of income that are exempt from tax. In addition, the AAA is not reduced by nondeductible expenses related to tax-exempt income. The calculation and maintenance of the AAA is provided by Treas. Reg. Sec. 1.1368-2.

IRC Sec. 101(a) generally exempts life insurance proceeds paid at the death of an insured from gross income. Unfortunately, this general rule does not apply in some cases of employer-owned life insurance. However, IRC Sec. 101(j)(2) preserves the tax exempt status if the insured was a director or a highly compensated employee at the time the contract was issued, which applied in this case. The IRS held (Rev. Rul. 2008-42, 2008-30 IRB) that (1) the premiums paid by the S corporation did not reduce the AAA and (2) the death benefits of COLI exempt from income taxes do not increase the AAA.

Interests in Restricted Management Account (RMA) Not Discounted for Gift or Estate Tax Purposes

An individual deposited marketable securities and cash into an RMA with a 5-year duration. The bank indicated that the purpose of the account was to enhance the portfolio's performance in part because the risk of withdrawal prior to the end of the term was prohibited by the restrictions of the account. All income and dividends were retained for reinvestment. The RMA permitted transfers to certain family members or trusts with the proviso that the transferee be bound by identical restrictions on withdrawal. The owner of the account made a gift of one-sixth the account to her child in year 1. The original account owner died in year 4 just after extending the term of the RMA to 7 years.

The IRS held (Rev. Rul. 2008-35, IRB 2008-29) that the gift of a portion of the account and the remaining account held by the estate would be valued without any discount for the restrictions on withdrawal. The analysis indicated that the account holder held all interests in the property at the time of the gift and of the remaining account at the time of death. The bank has no interest in the assets. The IRS reasoned that the account owner did not change the nature of the assets and the restrictions related primarily to the performance of the account. It was further determined that the RMA did not change the price at which a willing buyer and willing seller would exchange the underlying assets in the account. The IRS also briefly indicated that IRC Sec. 2703 which normally applies to family buy-sell agreements would cause the restrictions to be ignored for the purposes of determining value.

This Tax Letter is intended to assist you to conserve your estate and to protect the interests of your family and business associates. Estate planning involves the joint services of a competent Trust Officer, Attorney, Accountant, and Life Underwriter. The experience and advice of each is generally essential.

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