

THE BERNSTEIN REPORT

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Dear Reader,

The Worker, Retiree, and Employer Recovery Act of 2008 suspended the required minimum distributions (RMDs) from defined contribution retirement plans and IRAs for 2009. The law did not give employers and plan sponsors very much time to adjust for the change for this year. The IRS issued Notice 2009-82 (I.R.B. 2009-41) late last month to provide guidance for the impact of this change. Specific problems that were addressed include the need to amend plan documents that otherwise would not permit suspensions and the handling of distributions that were already made in 2009 and would not otherwise be available for a tax-free rollover. The important guidance provided by this Notice includes:

- Sample plan amendments are provided for plan sponsors that permit a choice between receiving and not receiving 2009 RMDs.
- Guidance is provided as to what is (and what is not) treated as the 2009 RMD eligible for the one-year suspension.
- The time period for a beneficiary to choose between a life expectancy payout or a 5-year distribution is extended until the end of 2010 if this decision would normally have to be made in 2009.
- The 2009 RMDs already taken can be rolled over to avoid taxation. The participant has until the later of 60 days or November 30 to complete the rollover. (Again, the guidance must be examined to determine if the distribution included a 2009 RMD).
- Distributions taken as part of a series of substantially equal periodic payments to avoid the 10-percent penalties on pre-age 59^{1/2} distributions are not 2009 RMDs and cannot be suspended under these rules.

This 2009 change to temporarily suspend RMDs will be followed by a change in 2010 to permit conversion of regular IRAs to Roth IRAs regardless of the account holders adjusted gross income. These two changes will provide many individuals who don't currently need to take withdrawals from their IRAs with unique tax planning opportunities. The decisions involve the consideration of several factors and assumptions and should be made with appropriate advice.

Hopefully, our next report will have some details concerning the Health Care legislation and/or estate tax reform. We'll keep you posted.

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?**

SOME IDEAS TO REDUCE TRANSFER TAXES ON YOUR HARD-EARNED WEALTH

When you are ready to pass on all or a portion of your wealth, Uncle Sam looks to get a piece of the pie through the levy of various so-called transfer taxes. These include gift tax, estate tax, and generation-skipping tax. Gift taxes begin to be paid at a 41 percent rate and increase to 45 percent; estate and generation-skipping transfer taxes are imposed at 45 percent. Legislation passed in 2001 repeals the estate and generation-skipping tax in 2010, but not the gift tax. It is the current thinking that the estate tax repeal will not come to fruition, but estate tax reform legislation of some form will be enacted before the end of the year. There are several competing proposals for this reform, but there has not been any action yet to move the bills forward into more serious debate. There is a distinct possibility that permanent reform will be delayed until 2010 and a one-year extension of the 2009 law with the \$3.5 million exemption and a 45 percent maximum rate will be in the offing.

Although we believe that some legislation will be enacted before the complete estate-tax repeal in 2010, it is necessary to continue estate planning since some valuable gift exclusions are available each year. What's more, gifts will generally be indicated for personal objectives rather than (or in addition to) tax savings. A careful understanding of the transfer and income tax rules indicates that lifetime gifts remain an important estate planning technique.

WHY MAKE SUBSTANTIAL LIFETIME GIFTS?

Because there is still a progressive income tax system and a significant estate tax for all years except 2010, gift planning remains essential to reduce transfer and income taxes. There are several reasons to make substantial gifts during your lifetime, including the following:

- To avoid gift, estate, and generation-skipping tax on the appreciation in value of the transferred property
- To avoid state death taxes without paying state gift taxes, because the vast majority of states have no state gift tax
- To take advantage of the exclusions from federal gift tax that are not available under the federal estate tax rules for bequests of your wealth
- To take advantage of the \$1 million gift-tax exemption
- To shift the income tax responsibility for the income earned on the transferred property to the donee, who might be in a lower tax bracket
- To receive valuation discounts for gifts of an interest in, for example, a family business or real estate venture
- To personally witness the joy of the "grateful living" upon receipt of the gifts
- To provide for the needs of less wealthy and/or younger family members
- To test the waters by watching the ability of your children or grandchildren to manage the assets that you provide to them
- To hedge against the possibility that the estate and generation-skipping tax repeals will not occur due to political and budgetary constraints

TOOLS TO MINIMIZE THE GIFT TAX

Here are some important tools that will help you minimize the gift tax:

- **\$13,000 annual exclusion.** During your lifetime, you can make gifts of up to \$13,000 (the annual exclusion is indexed for inflation and is expected to remain at \$13,000 in 2010)

each year to as many different people as you want, and as long as they are "present interest" gifts, they will be excluded from the gift tax. If the donor is married and if his or her spouse is willing to elect to split gifts, the donor can transfer \$26,000 to selected donees.

- **Medical and educational expenses.** In addition to the annual exclusion gifts, you may pay the medical and educational expenses of family members and others directly to the medical facility or educational institution, and such gifts (no matter their amount) will be excluded from the gift tax. These expenses include tuition to educational institutions, regardless of the level of education. The allowable medical expenses include any that would be deductible (ignoring the limitation on itemized deductions) against federal income taxes. For example, a parent or grandparent could pay the health insurance premiums for adult children or grandchildren without gift tax implications.
- **Credit (exemption) shelter.** The gift tax credit will offset gift taxes during lifetime that total \$345,800. This means that the first \$1 million of taxable transfers during lifetime or at death will be sheltered from payment of gift taxes.
- **Valuation discount for gifts of minority interests and lack of marketability in property.** This concept is used primarily with family business entities such as limited partnerships or family limited liability companies. In these techniques, transfers of limited (noncontrolling) interests can be significantly discounted below the value of the proportionate share of the underlying property owned by the entity if the limited owner cannot control the activities of the entity, force liquidation, or freely transfer the ownership interest. The discount is available to transfers of closely held corporate stock if the transferred stock has 50 percent or less of the voting power and is subject to transfer restrictions. Finally, marketability discounts are also available for transfers of joint undivided interests (such as a joint interest in real estate).
- **Grantor-retained annuity trusts (GRATs).** This type of gift permits the grantor to make an irrevocable transfer to a trust while retaining a fixed amount for a specified term of years. The remainder will pass to family members or to a family trust. The GRAT is a great wealth transfer technique in a period of low interest rates, such as 2009, due to the method of calculating the remainder gift. There has been some discussion by the Treasury and Congress to somewhat limit the use of GRATs, so time may be of the essence.

TAX COMPLIANCE FOR GIFTS

Gift tax returns are required and are due at the same time as income tax returns in the year following the year of the transfer under these circumstances:

- A transfer is made to an individual other than the donor's spouse, it exceeds the \$13,000 annual gift tax exclusion (IRC Sec. 2503(b)), and it is not excluded by the exemption for transfers with respect to medical or tuition expenses (IRC Sec. 2503(e)) of the donee.
- A transfer is made to a qualifying charity that is less than the donor's entire interest in the property (for example, a charitable remainder trust).
- A transfer is made and the donor's spouse elects to split the gift for the purposes of increasing the annual exclusion from \$13,000 to \$26,000 per gift.

A 3-year statute of limitations following the filing of a gift tax return applies to the initiation of an IRS audit of the return. IRS regulations (Treas. Reg. Sec. 301.6501(c)-1(f)) describe substantiation requirements to ensure the protection of the statute of limitations. The gift tax return will have the statute's protection only if it is substantiated with enough information to give the IRS sufficient details of the nature of the transaction. A memorandum, including a complete description

of the property, should be filed with the return to explain the form of the transfer. The relationship between the transferor and transferee must be disclosed. It is important to include valuation methods, particularly if hard-to-value property is transferred. If valuation discounts are taken, the supporting information should provide justification for the discount based on the facts and circumstances of the case. The substantiation rules also permit the submission of an appraisal by a qualified appraiser in lieu of requiring the donor to submit this voluminous substantiation with the return. For most gifts involving hard-to-value property and/or valuation discounts, the taxpayer will use a qualified appraiser. Note that the IRS has neither the staff nor the budget to audit the increased volume of gift tax returns. An appropriately substantiated gift tax return that is not overly aggressive will have a high likelihood of passing through the system without significant examination. With respect to the timing of gifts, a gift is complete in the tax year that the gift is delivered to the donee with no strings attached. A gift made by check is completed for tax purposes when the check is presented for payment by the donee.

RECENT CASES AND RULINGS

ESTATE SCORES HUGE VICTORY IN FAMILY LIMITED PARTNERSHIP CASE

In a rather complicated case (there were 96 paragraphs identifying the fact pattern), the decedent's estate owned a family limited partnership (FLP) that was created, but not actually funded before the taxpayer's death. The FLP certificate was filed with the state (Texas), as were the Articles for a Limited Liability Company (LLC) that was to serve as the general partner of the FLP. Applications were made for tax identification numbers for the entities, but were not yet received at the time of the decedent's death. A great deal of correspondence described the intended transfers by the decedent to the entities and to family members who were to succeed in ownership of the LLC.

The court concluded that under state law, the intent to make the partnership the owner of property was sufficient to treat the partnership as the owner of the property (*Keller v. United States*, 104 AFTR 2d 2009-6015). Thus, the FLP was treated as validly formed and funded prior to the decedent's death and the intended and documented transfers to family members of decedent were also respected. The Court concluded that the decedent had legitimate nontax reasons to form the FLP (notably, protection of assets from divorces of her children). Ultimately, the assets contributed to the FLP were discounted over 47 percent as a result of the application of the lack of marketability and lack of control discounts.

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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