

TAX WARRIOR

Roger V. Bennett
942 Enterprise Dr., Suite A-1
Sacramento, CA 95825
WWW.TAXWARRIOR.NET
(916)646-1876
(800-770-1876)

WINTER 2008 NEWSLETTER

February 17, 2008

DANGER OF LABELS IN ESTATE PLANNING

Marketing people like to put catchy labels on products. People become comfortable with a product label and buy it. This marketing approach spills over into estate planning. This creates a false sense of security. With law firms patenting tax planning techniques, descriptive labels can attract unwanted attention from law firms attempting to enforce their patent rights.

A recognized label on an estate planning technique creates a flag if the IRS learns how to take it apart. It creates an even greater problem if the IRS designates it as a "listed transaction". (See our Fall 2007 Newsletter)

Estate planning vehicles should not be "one size fits all". It should be tailored to your specific estate and family situation. It should not have a designer label. Fancy names and opinion letters saying the technique is wonderful does not protect you against penalties and interest in the event of an IRS audit. (See IRS Circular 230) Be careful of labels!

WEALTH TRANSFER OPPORTUNITIES

The failing real estate market provides opportunities for greater wealth transfer to reduce Federal Estate Taxes (FET). A popular technique is an Intentionally Defective Grantor Trust (IDGT). This is a description, not a label! An Irrevocable Trust normally files and pays its own taxes under Rules concerning irrevocable trusts in the Internal Revenue Code (IRC). If a rule is violated, tax attributes fall on the creator of the Trust, or the Grantor. Violating these rules means tax attributes and the ownership of the assets for income tax purposes remain with the Grantor. Intentionally violating one of these rules in the formation of the Trust can be desirable for FET purposes. Property placed in the Trust is valid for Estate and Gift Tax purposes, however, it is still owned by the Grantor for income tax purposes. The potential for wealth transfer is greater than a Family Limited Partnership, which is limited by the Gift Tax Rules. With interest rates and values falling, this is a wonderful opportunity to sell real property to an IDGT. Increases in values on the real estate are outside of the Grantor's estate for estate tax purposes.

This technique has been available and used since the early 1980's. With approval of an IDGT by the Internal Revenue Service in a public revenue ruling in early 2007 (Revenue Ruling 2007-13), it has become a much more attractive option.

NEGATIVE EQUITY FAMILY RESIDENCES

Family residences with negative equity creates a dilemma with your Revocable Living Trust. The normal desire is to have all your assets, including the family residence, in the Trust. This reduces probate costs and the transfer costs upon the death of the creator of the Trust.

If the value of the house is significantly below the amount owed on the house, consideration should be given to deeding the house out of the Trust. If the residence is upside down by \$100,000.00 and the estate is worth \$500,000.000, the Trustee has a decision of paying \$100,000.00 to save the house or let it go into foreclosure. If the house is outside of the Trust, the decision to let the house go into foreclosure is an easier one. A foreclosure normally involves a Notice of

Default on the house, with the house going back to the lender. Lenders do have the option of a judicial foreclosure which would result in the recovery of the difference between the mortgage and the value of the house from the estate. With significant estate assets, this is an attractive option to a lender who may already have a number of foreclosed houses. This is a repeat of the economic situation of the early 1990's with houses deeded out of revocable trusts for planning purposes.

ALTERNATIVE MINIMUM TAX (AMT) PATCH PASSED

In December, the AMT patch was passed by Congress *without offsets*. There were no revenue enhancers to balance the tax cost of the patch. It is a tax reduction for those with AMT issues.

WEALTH TRANSFER PROJECTIONS

The failure to have enhancers with regard to the AMT patch is an indication Democrats are not too concerned about maintaining the so called "*pay as you go*" rules for tax legislation. There is also not a big push in Congress to repeal the Federal Estate Tax. This may have to do with a study by the Boston College Social Welfare Research Institute Report issued in 2003 estimating that over the first 50 years of the 21st century, between 41 trillion and 136 trillion dollars in wealth will pass. An article last year indicated these numbers are conservative. If you want to know why Congress is not in a hurry to repeal the Estate Tax, just do the math. Those are very, very large numbers.

BANKRUPTCY SUSPENDS IRS COLLECTION LIMITATION TOUGH BREAK!

A taxpayer may file bankruptcy on income taxes more than three years after the due date for the return, plus extensions, or more than two years after actual date of filing, whichever is later. A taxpayer filed a Bankruptcy Petition "within" the three year rule. (No discharge of the taxes!) The Petition tolls the running of the ten year collection limitation, from the date of the bankruptcy petition to the date of discharge, plus 6 months. (26 U.S.C. Section 6503(h)(2)). (See tax court opinion, *Severo vs. Commissioner of Internal Revenue Service, 129 T.C. No. 17*. (Special thanks to Aristides G. Tzikas, Esq., Sacramento, California)

TAX PREPARER PENALTIES

More penalties in the tax code are directed toward accountants and other tax preparers. Between these concerns and Sarbanes/Oxley legislation drawing accountants into large corporations, fewer people are choosing accounting and tax preparation as a career. Considering the headaches, problems, and potential penalties, writing computer game software sounds like more fun. Congress needs to address this issue and find a balance. Many accounting firms are feeling the pinch of more work and less competent help available to help them.

KNIGHT CASE, SUPREME COURT UNANIMOUS ON 2% FLOOR

The Circuit Courts were divided on whether trust advisory fees are subject to the 2% floor under IRC Section 67(e). The Sixth Circuit held they were fully deductible, the Fourth and the Second held they were subject to the 2% floor. The Supreme Court ruled they were subject to the 2% floor. Now an accounting has to be made for trust advisory fees and fees and costs which are necessary for the maintenance of the assets of the Trust. (See Fall 2007 Newsletter)

The original issue seemed to be directed toward investment advisory fees. What is an investment advisory fee? If you hire a broker to determine the proper rental value of real estate in a Trust, is that investment advice and the fees subject to the 2% floor? You now have additional bookkeeping and must determine which expenditures are fully deductible trust administration fees and which are investment advisory fees. It comes down to the issue of intent. That's wonderful. Now the IRS has a free shot in issuing regulations to create a broader net to bring more fees in a trust administration subject to the 2% floor. This in turn creates more litigation, appeals, more accounting and legal costs, and possibly litigation costs with the Internal Revenue Service if the fees are large enough. This increases costs to your trust after you have died.

We are into 2008 which means that all trust advisors must be working with the accountant to determine which advisory fees are what. The IRS is working to provide interim guidance on filing fiduciary returns for the 2008 filing season.

DEDUCTION OF PRE-PAID MORTGAGE INSURANCE PREMIUMS

The Tax Relief and Healthcare Act of 2006 provides treatment of qualified mortgage insurance premiums paid or accrued in 2007 for qualified mortgage insurance contracts as deductible qualified residence interest. (See IRS Notice 2008-15 for guidance). If you have questions, call your accountant or check the IRS website for a copy of the Notice.

SHOPPING FOR LIFE INSURANCE

Previous newsletters have dealt with tax and structural issues for life insurance. This segment addresses a practical approach to purchasing insurance.

First step in shopping for life insurance, determine the need for the insurance. Second, quantify the amount of insurance to satisfy the need. Quotes based on that need may result in sticker shock. Panic results in the purchase of the cheapest policy covering that amount of insurance or no purchase of insurance. Not a good business or investment decision. Step three should be, assess your business or personal budget to determine the money available to pay annual insurance premiums. Then shop for the best insurance policy for that amount of premium regardless of the face amount. If the need is one million and all you can afford is a \$700,000.00 policy, at least you have handled 70% of the problem.

Term insurance is not always the best. Most agents sell level premium term insurance. This means level annual premiums over the life of the policy. You overpay on the front end and pay less on the back end. If you only need coverage for less than five years, you are overpaying. Understand the various options and assumptions in the policy. Each has an affect on the face amount, life of the policy, and the cash surrender value.

This Newsletter is not intended as legal or tax advice.

“Pursuant to requirements set forth in U.S. Treasury Regulation Circular 230, Section 10.35, you are informed that this communication and any advice contained in it, is not intended or written to be used and cannot be used for the purpose of avoiding tax penalties that may be imposed under the Internal Revenue Code.”