



Fall 2008

IN THIS ISSUE:

INDIVIDUALS

Extension of the AMT "Patch" to 2008
New Refundable AMT Credit: Relief for the Stock Option Trap
Residential Energy Credit Suspended for 2008
IRA-to-Charity Transfers

BUSINESSES

Health Insurance for S Corporation Owners

ESTATE PLANNING

Estate Tax Exemption Amount Increased to \$3.5 Million
Portability of Spousal Exemptions

INDIVIDUALS

Extension of the AMT "Patch" to 2008

Most middle and upper income 1040 filers are aware of the threat of the Alternative Minimum Tax (AMT). In today's tax environment, most substantive 1040s need to have two tax computations: the regular tax and the AMT. An individual is required to pay the greater of the two calculations.

While the regular income tax rates are indexed for inflation, this has never occurred with the AMT. As a result, Congress needs to constantly increase the amount of income exempt from the AMT in order to prevent the AMT from becoming the prevailing tax for most returns. Had Congress not updated the exemption for 2008, most joint tax returns with income above approximately \$70,000 would have been subject to the AMT!

But, as expected, we received a last-minute AMT "patch" for 2008, increasing the single taxpayer AMT exemption to \$46,200 and the joint filer AMT exemption to \$69,950. The important point to understand is that these increased exemption amounts for 2008 simply preserve the status quo. The AMT exemption was bumped over the 2007 amount only to compensate for the small inflation-indexing that occurred in the regular income tax rates. Stated differently, we will continue to have the same tight relationship between the two tax systems.

21420 Greater Mack Avenue, St. Clair Shores, Michigan 48080 • Fax: 586.772.8100 • 586.772.6715 • www.ghd.com

As a result, taxpayers who have larger deductions in the categories that reduce regular tax, and do not reduce AMT, will essentially face the same probability of incurring AMT as in the past. The types of deductions that tend to subject a 1040 to the AMT include high state income taxes, larger residential real estates taxes (such as from two homes), dependency exemptions, and significant business depreciation.

New Refundable AMT Credit: Relief for the Stock Option Trap

The \$700-billion financial markets rescue bill that Congress enacted on October 3, 2008, also included a number of significant tax relief provisions. One of those provides an important benefit for those who have incurred large alternative minimum tax (AMT) liabilities in the past from the exercise of Incentive Stock Options (ISOs).

When an employee purchases employer stock in an ISO arrangement, AMT is generally triggered at the point of exercise even though no capital gain occurs until the stock is eventually sold. This prepayment of AMT gives rise to a tax credit carryover that was designed to allow later recovery of the AMT against future regular tax. But the complicated interplay of the regular tax and AMT has effectively prevented this recovery. Those who paid AMT on ISO exercises generally found themselves with a large tax credit carryforward that could not be utilized.

Congress took a first step toward a remedy in 2007 by allowing lower income filers to begin a 20%-per-year recovery of the AMT that had been paid more than three years earlier. But for those with Form 1040 income above about \$160,000 single or \$240,000 joint, this credit recovery phased out and could not be utilized.

Now, for 2008, as part of the recent legislation, Congress has made two significant improvements to allow use of these AMT credit carryovers:

- The high income phase-out has been removed, meaning that all taxpayers, regardless of income level, will be able to recover their older AMT payments as a current tax credit.
- Eligible credit carryovers may now be recovered 50% in 2008 and 50% in 2009. Eligible carryovers continue to be defined as AMT that has been paid more than three years prior to the current year.

Example. Lori is an executive in a publicly-traded company and has an ISO plan available. During the years 2000 to 2003, Lori exercised a series of ISOs that resulted in \$120,000 of AMT tax liability in excess of her regular tax. This AMT has been sitting in carryforward status since that time, and only \$10,000 has been recovered as a credit in recent years. The AMT credit relief enacted by Congress

in 2007 did not benefit Lori, as her income exceeded the phase-out range of that provision.

Coming into her 2008 Form 1040, Lori has \$110,000 of over-three-year-old AMT credit carryovers. As a result of the new legislation, Lori will be able to claim a \$55,000 tax credit in 2008 and a \$55,000 tax credit in 2009, so as to fully recover her old AMT prepayments. These tax credits will fully offset any regular tax or AMT that Lori incurs in 2008 or 2009, and become refundable if those credits exceed her actual tax.

For those in a position to benefit from larger AMT credit carryovers, it would be important to identify the amounts that can offset both 2008 and 2009 Form 1040 taxes. These credits may allow taxpayers to decrease salary withholding or minimize or eliminate quarterly tax estimates. Please let us know if we can assist in these matters.

Residential Energy Credit Suspended for 2008

The residential energy credit was initially added to the law for 2006 and 2007 (IRC §25C). It allowed homeowners a \$500 lifetime maximum credit for energy-efficient improvements installed in their principal residence such as insulation, doors, windows, and certain energy-efficient appliances (e.g., furnaces, hot water heaters, and central air conditioners). But unlike other expired provisions, Congress did not renew this credit for 2008.

However, it is restored for one year for expenditures made during 2009. To the extent a homeowner has not previously used the full \$500 credit, any home energy-saving expenditures should be deferred until 2009.

IRA-to-Charity Transfers

Since 2006, the tax law has allowed taxpayers over age 70½ to make a direct transfer from their Individual Retirement Accounts (IRAs) to charity without reporting any taxable income on the IRA withdrawal. These withdrawals, which are limited to \$100,000 annually, count toward the required minimum distribution that taxpayers over age 70½ must take from their retirement accounts. The recent "extender" legislation from Congress has renewed this important provision for 2008 and 2009.

Tax Advantages for Making an IRA-to-Charity Transfer

At first glance, the tax advantage of making an IRA-to-charity transfer may not seem obvious. After all, if we take a taxable distribution out of our IRA and subsequently give those funds to charity, it would seem that the reportable IRA income and the charitable deduction are simply a wash in our tax return. But in reality, this rarely has

happened in the past. Here are a variety of illustrations to point out why the new opportunity of a direct IRA-to-charity approach is better.

Lower Income Filers

Many retirees, especially those with modest income, use the IRS standard deduction rather than claiming detailed itemized deductions that include their charitable contributions. Taxpayers who are over age 70½, and who must also make the required annual withdrawal from their IRAs, can use an IRA transfer to fund their normal charitable contributions and avoid the income they otherwise would have been required to take from their IRA and claim on their 1040. Yet they retain the same deductions by claiming the standard deduction.

Example. Al, a retiree, is required to withdraw about \$5,000 per year from his IRA under the minimum distribution rules. Al also regularly contributes \$3,000 to his church, but does not receive any tax benefit because his standard deduction is greater than his total itemized deductions. If Al arranges for \$3,000 of his IRA withdrawal to go directly to his church annually, he will cut his taxable income by \$3,000.

Middle Income Filers

The greatest savings of using the IRA-to-charity transfer accrue to that large group of taxpayers who face the phase-in of taxable social security benefits. Under a complex tax formula, middle income retirees have an increasing portion of their social security benefits brought into taxable income as their other reportable taxable income increases. Adding \$10,000 of extra income can mean as much as \$8,500 of social security benefits becoming taxable! However, reducing IRA withdrawal income by a charitable transfer may also significantly reduce taxable social security benefits.

Example. Bill and Edna are retirees who collect \$30,000 in gross social security benefits, and have \$36,000 of other retirement income (IRA withdrawals, interest and dividends, etc.). At these income levels, they are in the 85% phase-in range on social security benefits. Bill and Edna give \$5,000 to their church annually and claim this as an itemized deduction. If they direct an IRA transfer to their church for this \$5,000 contribution, they will have \$5,000 less of IRA income, but also \$5,000 less of charitable deductions. However, \$5,000 less of IRA income also means that they have \$4,250 (85%) less in taxable social security, saving them about \$1,000 of federal and state income taxes.

Upper Income Filers

Upper income filers are typically claiming itemized deductions, and may not appear to gain an advantage from accomplishing their larger charitable contributions through direct IRA transfers. However, greater income results in many phase-outs of tax deductions and credits (e.g., itemized deductions and personal exemptions) and the likelihood of incurring the Alternative Minimum Tax (AMT) increases. For these reasons, most upper income filers will benefit from direct IRA-to-charity transfers by decreasing the income portion of their return from which these various phase-outs are calculated.

Summary

There are a few rules to watch. The IRA owner must have attained age 70½ by the date of the transfer to charity, and a receipt from the charity is required, just as with any contribution over \$250. Also, the charity must be publicly funded; it cannot be a private foundation or a donor-advised fund. Overall, it seems clear that this IRA-to-charity rule provides tax opportunities for most over age 70½ retirees. If you have any questions about how it may apply to your situation, please let us know.

BUSINESSES

Health Insurance for S Corporation Owners

For many years, the tax law has treated more-than-2% owners of S corporations as non-employees with respect to tax-free fringe benefits. The effect has been that the health insurance benefits provided by the S corporation to its owners are not tax-free fringes, but rather must be reported as compensation on Form W-2 to the owner. The owner then claims the 100% self-employed health insurance deduction to offset the extra W-2 income.

Several years ago, the IRS advanced the position that the health insurance policy for the S corporation owner must be in the name of the S corporation. The IRS asserted that the S corporation could not simply reimburse the premium costs if the policy was owned by the individual shareholder.

However, in 2008, the IRS has conceded that it makes no difference whether the health policy is owned by the S corporation or personally by its shareholder-owner. In either case, the S corporation may directly pay the premium or reimburse the owner for that amount. The S corporation must continue to include the premium

payment in the owner's W-2 statement, and the owner then claims the offsetting deduction in Form 1040.

If health insurance premiums during 2008 have been paid individually by an S corporation owner, a key point is to make sure that those premiums are reimbursed by the business before year end.

Caution: Proper inclusion of the health insurance premiums in the W-2 is another critical point. S corporation owners face the risk of the disallowance of the self-employed health insurance deduction if the premium is not properly included in the W-2 wages of the shareholder. Please let us know if your S corporation will need assistance with this before the January 31 payroll filing deadline.

The following examples from IRS Notice 2008-1 illustrate these new rules:

Example 1. For 2008, shareholder Adam obtains a health insurance policy in his own name and makes the premium payments on the policy. The S corporation makes no payments or reimbursements with respect to the premiums. Because the S corporation did not establish a plan providing medical care for Adam, he is not entitled to the self-employed health insurance deduction.

Example 2. For 2008, Lily, Inc., an S corporation, obtains a health insurance plan in the name of the corporation. The health plan provides coverage for shareholder Bea, Bea's spouse, and dependents. Lily makes all the premium payments to the insurance company and reports the amount of the premiums as wages on Bea's Form W-2 for 2008. Bea is allowed the self-employed health insurance deduction.

ESTATE PLANNING

Estate Tax Exemption Amount Increased to \$3.5 Million

In recent years, fewer estates have been subject to the federal estate tax due to changes in the tax law increasing the federal estate tax exemption amount. For 2008, the exemption amount is \$2 million per person, with a flat rate of 45% applying to the amount of the estate in excess of \$2 million. For 2009, the exemption amount will increase to \$3.5 million per person, with the excess continuing to be taxed at the 45% rate. Currently, unless Congress acts, the estate tax is scheduled to expire for 2010, but will be resurrected in 2011 with a much lower exemption amount (\$1 million) and a much higher tax rate (55%).

In 2009, it is expected that Congress will enact legislation that continues the estate tax in its present form. Currently, Senator Obama proposes a \$3.5 million exemption amount with a 45% estate tax rate; Senator McCain proposes a \$5 million exemption amount with a 15% estate tax rate.

Portability of Spousal Exemptions

Both candidates support a change in the estate tax law to allow portability of spousal exemptions. This means that if one spouse dies without having used his or her entire exemption, the surviving spouse would be entitled to use that remaining exemption in addition to the surviving spouse's exemption. The advantage of portability would be that the entire combined exemption amount (\$7 million in 2009) would be available at the second death of a couple, without having to establish marital and credit shelter trusts at the first death. These trusts, which are essential today, are complicated and costly to set up and administer. However, there may be other non-tax reasons why a family may wish to establish such a trust (e.g., protection from creditors, managing investments, holding distributions to younger heirs, dedicating funds for education, etc.).

The following example reflects the benefit of the portability rule:

Example. A husband and wife each have \$3.5 million of assets. In January 2009, the husband dies and leaves his entire net worth to his wife. There is no federal estate tax on the husband's estate because the marital deduction allows a tax free transfer to a surviving spouse. However, his wife now has an estate worth \$7 million and only a \$3.5 million exemption because of the current lack of portability of exemption amounts between spouses. Thus, the benefit of the husband's exemption is lost. If the wife dies in December 2009, her estate can exempt \$3.5 million, but will be taxed at a 45% rate on the remaining \$3.5 million (i.e., \$1,575,000). Portability of spousal exemptions, or a proper credit shelter trust, would have shielded the entire \$7 million from any estate tax and thus saved the family almost \$1.6 million in tax.

Please let us know if we can help you with your estate tax planning needs.