



WINTER 2009

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INDIVIDUALS

Legislation to Defer Required Minimum Distributions for 2009

Many taxpayers have been hit hard by the sharp decline in the value of their investments. And the consequences are worsened if they are retirees forced to sell in a depressed market to take a distribution as mandated by the tax law. However, on December 23, 2008, the President signed legislation that provides relief with respect to the annual Required Minimum Distribution (RMD) that individual taxpayers over age 70½ must withdraw from their IRAs and qualified retirement plans. As a result of this law change, the RMD for 2009 is waived. The next RMD that must be withdrawn will be for calendar year 2010. This relief applies to lifetime distributions to retirement plan owners as well as to after-death minimum distributions to beneficiaries.

Example. Martha, who attains age 76 during 2009, would have been required to withdraw \$12,500 from her IRA this year. This amount is based on her current age and the balance in her IRA as of December 31, 2008. As a result of the law change, Martha may omit taking any withdrawal during 2009. In 2010, Martha is again required to take a distribution, which will be based on her age of 77 and the balance in her IRA at the beginning of 2010. But no “catch up” of the omitted 2009 distribution is required.

Under current law, taxpayers must start taking RMDs from their retirement plans by April 1 of the year after the year in which the taxpayer attains age 70½. In the case of an employer-provided retirement plan, a special rule allows deferral of RMDs until after retirement. The RMD that taxpayers must withdraw annually is calculated by dividing their beginning-of-the-year account balance by an IRS life expectancy table. RMDs for a particular year (except the

first RMD) must be taken by December 31 of that year. Failure to withdraw the RMD can result in a 50% excise tax on the difference between the required amount and the actual withdrawal.

In the case of an individual who attains age 70½ during 2009 and is first subject to RMD rules this year, the initial withdrawal ordinarily can be electively deferred until April 1, 2010. Under this new legislation, this first RMD is now waived and no distribution is required to be made by April 1, 2010. However, the provision does not change the individual's distribution requirement for calendar years after 2009. Thus, the RMD for 2010 must be withdrawn no later than December 31, 2010.

If the owner of an IRA is deceased, the heirs in some cases are under a requirement to withdraw any retirement plan funds within the 5-year period following death. If the 5-year rule applies to any decedent's account, the new law allows the 5-year period to be determined without regard to calendar year 2009. Thus, for example, the 5-year withdrawal deadline for an account on behalf of an individual who died in 2007 will end in 2013 rather than 2012.

It is important to note that the legislation waives the RMD requirement *only* for 2009. The provision does not apply to a first-time RMD for 2008 that was electively deferred until April 1, 2009, by an individual who attained age 70½ during 2008. There had been some discussion and also press reports that Congress might relieve the RMD requirement for the latter part of 2008, but that did not occur.

Strategies. So now that IRA withdrawals are voluntary during 2009 for those over age 70½, what should be done? For those who do not need to supplement their household account, the general rule will be to avoid the extra taxable income by not taking any IRA withdrawals during 2009. But even those who need the extra cash should consider using other after-tax savings, particularly if they can avoid liquidating IRA investments that are depressed in value (i.e., look to bank CDs and savings that are not deflated). Even modest income filers may find surprisingly large tax savings from this approach: decreasing taxable IRA withdrawals can also decrease the portion of Social Security benefits that are reportable as taxable income.

Example. Art, age 78, would have been required to withdraw \$10,000 from his IRA during 2009. If Art takes no taxable IRA distribution this year, his taxable income decreases by \$15,000, consisting of the \$10,000 of avoided IRA income and \$5,000 of Social Security benefits that are no longer taxable. This saves Art over \$3,000 in federal income tax in 2009. (Social Security benefits "phase-in" to taxability based on the amount of other taxable income, and become reportable at either a 50% or 85% ratio to other taxable income).

On the other hand, there may be some cases where it is efficient to withdraw some taxable IRA funds. The deferred income on IRA accounts will inevitably be taxed someday, whether to the owner or to the owner's heirs. So those retirees with large medical expenses or other

tax deductions should withdraw sufficient taxable IRA amounts to offset those deductions, and possibly also to utilize the lower income tax brackets.

For those with substantial net worth and higher incomes, don't overlook the annual opportunity to remove up to \$100,000 of IRA funds via direct transfer to charity. This provision remains available in the tax law during 2009, even though the RMD rule is waived. IRA funds are taxed harshly in the hands of high net worth individuals. They face both a top rate income tax (currently 35%), and also the 45% estate tax. Using the direct IRA-to-charity transfer is a highly tax-efficient method of meeting your charitable objectives.

Please let us know if we can assist in determining the merits of any voluntary IRA withdrawals, or IRA-to-charity transfers during 2009.

Anticipated Tax Changes under Obama's Presidency

In an effort to stimulate the economy, it is expected that President Obama will propose that the following tax cuts for individual taxpayers be enacted early in his administration:

- Tax relief for middle-income taxpayers
- Expanding the refundable earned income credit
- Removing the repayment requirement on the \$7,500 first-time homebuyer credit
- Exempting seniors with less than \$50,000 of income from income tax
- Providing employees with a modest payroll tax credit (rather than a rebate) that would appear in their paychecks (\$500 per individual; \$1,000 per family)

Proposed tax increases for upper income taxpayers apparently will not be enacted in 2009 due to economic conditions, but probably will be deferred until 2010 or 2011. This will likely restore the former 36% and 39.6% tax brackets on taxpayers with adjusted gross incomes of over \$200,000 for single taxpayers and \$250,000 for married taxpayers. In addition, upper income filers may be required to pay increased payroll taxes. Limitations on itemized deductions and personal exemptions (which currently will disappear in 2009) are likely to be reenacted by Congress. Capital gains and dividends will likely also face an increased 20% tax rate (presently 15%) for those with mid or upper level incomes.

With respect to the estate tax, it is likely that the 2009 system will be made permanent (a 45% flat rate tax on a decedent's net worth over the \$3.5 million exemption amount). Further, legislation has been introduced to eliminate the ability to use valuation discounts with respect to transfers of family-controlled businesses and partnerships.

For businesses, the Obama administration is considering the following tax adjustments:

- Possible reduction of the 35% maximum corporate tax rate
- Elimination of the 6% domestic production deduction

- Ending LIFO inventory valuation (*i.e.*, the use of FIFO inventory valuation would be phased in over 8 years)
- Eliminating tax breaks for oil drilling and production activities
- Imposing higher self-employed Social Security taxes on owners of S corporations and partnerships (extending the tax to limited partners and S corporation owners rendering services)
- Allowing companies with net operating losses incurred in 2008 and 2009 (other than those receiving financial bail-out funds) to apply those losses to their prior 5 years for refund of previous taxes, rather than 2 years under current law
- Extending for one year the \$250,000 Section 179 first year depreciation deduction and 50% bonus depreciation that were enacted in the 2008 Economic Stimulus legislation

Many of these items are included in the current economic stimulus proposals recently introduced by Congressional leadership that would provide tax relief of about \$275 billion. Congress and the new President are targeting this legislation for enactment by mid-February.

New Disclosure Rules Facing Tax Return Preparers

As your tax advisor or tax return preparer, our firm is subject to strict rules regarding confidentiality with respect to your tax information. Not only do we adhere to a strict professional Code of Ethics with respect to confidentiality, but the tax law itself imposes significant penalties if a tax return preparer violates disclosure rules. Now, starting on January 1, 2009, there are new IRS regulations that impose significant formality on how we are to respond to client requests for transmitting tax return information to others:

- Tax preparers may no longer send client tax returns or data to a third party, such as a lender, based on a simple verbal or e-mail directive from the client. Rather, clients may authorize such a disclosure or use of tax return data only by signing a consent form that meets strict requirements and contains specific language mandated by the IRS.
- Client names or client lists are considered tax return information and may not be disclosed. For example, if a prospective client were to ask for a reference of several client names, we could not respond to that request without specific written authorization from the existing client.
- Release of tax return information to an affiliated entity of our practice, such as a financial services firm, requires written client consent.

On the other hand, no consent is required if we provide clients with their own tax return information. Thus, it is clearly more efficient to furnish a copy of a tax return directly to the client, who in turn furnishes that data to their lender or attorney or other party.

We recognize the important responsibility that we have to maintain confidentiality with respect to your tax return information, and will continue to adhere to high professional

standards. These new mandates from the IRS, however, will force us to be less responsive to your requests to move your data to third parties, even those with whom we are fully aware that you have a longstanding relationship. We must either secure your formal written authorization using prescribed IRS language that is specific to the request and identifies the recipient, or alternatively, send the data to you for transfer by you to the third party.

529 Plans May Allow Change in Investment Strategy Twice in 2009

The IRS recently issued Notice 2009-1, providing guidance to participants in section 529 college savings plans regarding the restriction on investment direction. The notice implements a special rule allowing investments in a section 529 account to be changed during 2009 on a more frequent basis than under current rules.

In general, a contributor to a 529 plan may not direct the investments, other than to select among different investment strategies designed exclusively by the program when the initial contribution is made. In a 2001 Notice, the IRS acknowledged that there may be situations that warrant changing the investment strategy for a section 529 account. Thus, the Notice states that a 529 program may permit a change in the investment strategy once per calendar year, and upon a change in the designated beneficiary of the account.

In response to the recent condition of the financial markets, the IRS has agreed to provide more flexibility to the current rule. The IRS noted that the present inability to change investment strategies more frequently may interfere with preserving the value of the account. Thus, Notice 2009-1 modifies the prior guidance and permits a change in the investment strategy selected for a section 529 account twice per calendar year *for calendar year 2009 only*, as well as upon a change in the designated beneficiary of the account. Section 529 programs and their participants may rely on this notice pending the issuance of final regulations by the IRS.

Section 529 plans have several unique tax features that are important to recognize:

- *Income tax.* The investment earnings grow within the account on a tax free basis, and distributions are also tax free if used for the higher education costs of the beneficiary. Starting in 2008, the “kiddie tax” system imposes the parents’ tax rate on the investment income of college-age students, and negates the former strategy of building up college savings funds in the title of the child. As a result, accumulating investments in a tax free 529 plan is now clearly the most efficient method of saving for higher education.
- *Estate tax.* The creation of a 529 account is considered a gift to the beneficiary, such that the account is not part of the estate of the donor. But the donor may continue to control the account and the investment decisions, as well as the decisions on the timing and amount of distributions to the student-beneficiary. This makes 529 plans

ideal vehicles for grandparents who wish to reduce their taxable estates through gifts to grandchildren, but would have concerns about outright, unrestricted cash gifts.

- *Gift tax.* A special gift tax rule allows a donor to use up to five years of annual gift exclusions when funding a 529 plan. Thus, under the current gift exclusion of \$13,000, a parent or grandparent could immediately place \$65,000 in a 529 plan for each child or grandchild. This shifts the assets immediately into nontaxable status, and jump-starts the child's higher education fund. Further, if any child or grandchild's account is larger than needed for their education costs, it is permissible to shift funds to the 529 plan of another family member of the same generation without further gift tax implications.

Please let us know if we can advise on how a 529 plan can benefit your situation.

BUSINESSES

Information Reporting for Employer-owned Life Insurance Contracts

It is not unusual for a business to acquire insurance on the life of an employee. Often, this occurs to provide a source of funds to buy-out the equity of an employee-owner in the event of an untimely death. In other cases the insurance is key person protection. In the past, life insurance death benefits have been tax free if collected by an employer. But new tax law and IRS regulations threaten this exemption in some cases.

The IRS recently issued regulations (Reg. §1.6039I-1) that require employers to file a tax schedule disclosing information on employer-owned life insurance contracts ("EOLI contracts"). An EOLI contract is a life insurance contract issued after August 17, 2006, that is owned by an employer engaged in a business who is a beneficiary of the policy and which insures the life of an employee. The regulations apply to tax years ending after November 6, 2008.

The regulations relate to a change in the tax code that occurred in 2006. Under this law, the death benefits from an EOLI contract in excess of premiums paid represent taxable income *unless* the employer complies with certain notice and consent requirements (IRC §101(j)(2)). Life insurance death benefits remain tax-free if the employer notifies and secures the written consent of the employee to the insurance prior to placement of the policy, and the policy is for a typical business need such as key person protection or funding a buy-sell agreement.

In addition, every employer owning one or more EOLI contracts issued after August 17, 2006, must file a return with the IRS on Form 8925, "Report of Employer-Owned Life Insurance Contracts." This form discloses the status of the EOLI policies owned by the employer.

The new IRS regulations address only the information reporting on Form 8925. They do not address the requirement under IRC §101(j)(2) that an employer must notify and secure the employee's written consent *prior to* the issuance of any EOLI policy issued after August 17, 2006 in order to receive tax-free death benefits. The IRS is considering publishing guidance that will address these requirements.

In the interim, employers who obtain new EOLI contracts should be certain to comply with the employee notice and consent requirements of the new law. Employers who maintain EOLI contracts issued after August 17, 2006, without the proper consent may wish to document that their employees have since been notified and consent to the EOLI contracts (although there is not yet any guidance by the IRS that such documentation will constitute acceptable notice and consent). Alternatively, they should consider exchanging the old EOLI contracts for new EOLI contracts after complying with the new notice and consent requirements.

New 15-Year Realty Depreciation Periods

Business buildings and improvements to those buildings are generally depreciable over a 39 year recovery period for tax purposes. There have been two significant exceptions in the past: Leasehold improvements to the interior of a building, and restaurant building improvements.

But now, as of 2009, there are two significant changes:

- All restaurant buildings, new or used, as well as improvements to those buildings, qualify for a 15-year recovery life
- Retail property interior improvements qualify for a 15-year life, if the improvements are made to a structure that has been in business use for more than three years, and the space is then used for the retail sale of tangible goods

These three categories of 15-year property (interior leaseholds and interior retail improvements and restaurants) all have some specific eligibility rules, including a difficult "related party" prohibition on general leasehold improvements. Please let us know if you have any questions.

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