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Estate Tax Repeal - 58 Senate Votes and Counting

By Randall A. Denha, J.D., LL.M.

Leaders in Congress, particularly Rep. Jennifer Dunn (R-WA) and Sen. John Kyl (R-AZ), have repeatedly introduced legislation to make the estate tax repeal permanent. Until now, the estate tax repeal bills have fallen short. Most of the Senate votes have had 56 Senators favoring repeal, 4 short of the required 60 to permanently repeal the estate tax. However, as a result of the 2004 election, the Republican majority increased by 4 votes from 51 to 55 Senators.

So will the estate tax be permanently repealed? Perhaps. Of the 55 Senate Republicans, Sen. John McCain (R-AZ) and Sen. Lincoln Chafee (R-RI) are likely to vote no. They prefer estate tax reform over repeal. That means there are 53 Republican votes for passage. However, there are five Democrats that have been strong supporters of permanent repeal. Sen. Max Baucus (D-MT), Sen. Evan Bayh (D-IN), Sen. Ron Wyden (D-OR), Sen. Ben Nelson (D-NE) and Sen. Bill Nelson (D-FL) all have been steady supporters of estate tax repeal.

That produces 58 seemingly solid votes for repeal. But repeal supporters must find the other two votes. The key votes in the Senate will probably be Sen. Blanch Lincoln (D-AR) and Sen. Mary Landrieu (D-LA). Both Senators Lincoln and Landrieu have regularly voted in favor of permanent repeal. However, both also have expressed support and perhaps preference for the Democratic compromise positions. These Democratic compromise positions have usually involved freezing the estate tax exemption at about \$3 million per estate.

Sen. Kyl will surely be raising the permanent estate tax repeal flag again in 2005. Will it pass? The vote will be very close. However, if the estate tax is repealed, it is likely that the repeal will not take effect until January 1, 2010. Thus, there will be a new President and Congress in place who could decide to

reinstate the estate tax, particularly if the budget deficit continues to grow.

Even if the estate tax is repealed, it will be "replaced" by a capital gains tax. Until 2010, any asset passing from a decedent receives a "stepped-up" basis equal to its date of death value. Therefore, any appreciated property received from a decedent escapes capital gains tax when sold. However, under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), beginning in 2010, the step-up is limited to \$1.3 million per decedent (plus another \$3 million for assets passing to a surviving spouse). Therefore, beneficiaries of large estates could face additional capital gains taxes if and when the inherited assets are sold.

Repeal of the estate tax would *not* apply to the tax on lifetime gifts. Under EGTRRA, the gift tax exemption remains a level \$1 million per donor. However, in 2010 (and thereafter if the estate tax is repealed), the gift tax rate is the maximum income tax rate. The reason for maintaining the gift tax is to prevent persons from transferring income producing assets to avoid or minimize income taxes.

In addition, repeal of the estate tax may not mean the end to state death taxes. Michigan currently has what is commonly called a "pick-up" tax. Michigan's inheritance tax is equal to the maximum amount of federal "state death tax credit". Thus, a resident of Michigan incurs no additional death taxes. However, beginning this year, EGTRRA reduced the maximum amount of the state death tax credit to zero. Therefore, the State of Michigan will no longer receive inheritance taxes.

As of October 24, 2004, 23 states have enacted estate or inheritance tax regimes that will continue to apply after 2010, and Michigan may join that list. Governor

Granholm's budget proposal for 2005 includes a new inheritance tax on estates over \$1 million. The tax rate would be graduated ranging from 4.8% to 16% depending on the size of the estate, but would not apply to family owned farms and businesses.

Finally, repeal of the federal estate tax would not mitigate the need for proactive estate planning. The primary goal of any estate plan is to ensure that the desires of the decedent are fully met. In this respect, tax planning addresses only one aspect of estates planning – maximizing the amount that ultimately passes to the decedent's intended beneficiaries.

In the vast majority of cases, a trust for the benefit of a spouse or children exists for non-tax reasons – namely, the protection of the estate from the beneficiaries themselves, the beneficiaries' creditors, or the beneficiaries' spouses. Certain provisions in these trusts may be motivated by tax planning, but the fundamental estate planning issues – who should receive the estate, when, and how – would all remain the same even if the federal estate tax is repealed.

For more information regarding this topic, please e-mail your requests to Randy at rad@disinherit-irs.com or call Randy at (248) 457-7205.

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The American Jobs Creation Act of 2004 Toughens the Rules Governing Nonqualified Deferred Compensation Arrangements

By Julius H. Giarmarco, J.D., LL.M..

Under the law before the American Jobs Creation Act of 2004, enacted on October 22, 2004 (the "Act"), the determination of when amounts deferred under a nonqualified deferred compensation arrangement were includible in income depended on the facts and circumstances of the particular arrangement. The timing of the inclusion of nonqualified deferred compensation in income generally depended on whether the arrangement was funded or not. If unfunded, the compensation generally was includible in income when actually or constructively received. If funded, income was includible for the first tax year in which the individual's rights were transferable or not subject to a substantial risk of forfeiture.

For amounts deferred in tax years beginning after 2004, the Act provides specific rules on when income deferral will be permitted. (Section 409A, as amended by Act. Sec. 885) The new rules impose three new key requirements regarding distributions, the acceleration of benefits and deferral elections. These new rules are *in addition* to the existing rules (e.g., constructive receipt, economic benefit and Code Sec. 83). In late December, 2004, the IRS released Notice 2005-1 which provides the first round of guidance on the new deferred compensation rules.

The Act provides that all compensation deferred under a nonqualified deferred compensation plan for the current tax year—and all preceding tax years—will be includible in gross income if at any time during the tax year the plan either: (1) fails to meet the new (i) distribution, (ii) acceleration of benefit, and (iii) election requirements (discussed below); or (2) is not operated in accordance with any of these requirements. (Code Sec. 409A(a)(1)(A)(i)) Failure to comply with the new law either in form or in operation will cause all current and prior deferrals to be taken into income in the taxable year in which the requirements are not met, or if later, when the amounts are no longer subject to a substantial risk of forfeiture. For these purposes, a participant's right to compensation will be

subject to a "substantial risk of forfeiture" if the right is conditioned on the future performance of substantial services. In addition, the participant's taxes will be increased by an amount equal to 20% of the deferrals plus an interest charge based on the period of deferral. The interest rate is the Federal underpayment rate plus one percent.

Distributions Requirements. Generally, this requirement will be met if a nonqualified deferred compensation plan provides that compensation deferred under the plan cannot be distributed earlier than:

- (i) the participant's separation from service (six months after separation from service for key employees of publicly-traded companies);
- (ii) the date the participant becomes disabled (as narrowly defined in the statute);
- (iii) the participant's death;
- (iv) a specified time (or fixed schedule) under the plan as of the date of the deferral of the compensation, but not an event;
- (v) a change in the ownership or effective control of the corporation, or in the ownership of a substantial portion of the assets of the corporation (to the extent provided by the Treasury); or
- (vi) the occurrence of an unforeseeable emergency (as narrowly defined in the statute).

Acceleration of Benefits. The acceleration of benefits requirement will be met if a nonqualified deferred compensation plan does not permit the acceleration of the time or schedule of any payment under the plan, except as provided in IRS regulations (Code Sec. 409A(a)(3)). Any change in the form of distribution that accelerates payments generally will be subject to the rule prohibiting acceleration. Before the Act, "haircut" provisions, allowing a participant to voluntarily take a withdrawal at any time subject to a small penalty were often used to provide greater flexibility with regard to withdrawals. "Haircut" provisions will not be allowed under Section 409A. Plans providing for amounts to be paid upon a change in the employer's financial condition will also violate the new rules. Likewise, distributions at the discretion of the plan administrator will not be allowed.

Election Requirements. Certain election requirements must be satisfied with respect to the initial deferral election and any later election to change the time/form of distribution. (Code Sec. 409A(a)(4)(A)) A nonqualified deferred compensation plan must provide that compensation for ser-

vices performed during a tax year can be deferred at the participant's election only if the election is made: (1) not later than the close of the preceding tax year; or (2) for new participants, within 30 days of initial eligibility. For "performance based compensation" (to be defined by the IRS and Treasury), the deferral election can be made up to six months before the end of the performance period – provided the performance period is at least 12 months.

The time and form of distributions must be specified at the time of initial deferral. A deferred compensation plan can specify how payments are to be made, or can allow participants to elect the time and form of payment at the time of the initial deferral election. Multiple payout events will be permissible, and a plan can allow participants to elect different forms of payment for different permissible distribution events.

If a nonqualified deferred compensation plan permits elections to be made (after the initial election) to delay a payment or change the form of payment, the plan must require that the election cannot take effect until at least 12 months after the election is made. Moreover, if the election is not made on account of death, disability, or unforeseen emergency, the plan must require the first payment to be deferred for at least five years from the date on which the payment would otherwise have been made. Finally, the plan must also require that any election related to a payment made at a specified time, or under a fixed schedule, cannot be made less than 12 months before the date of the first scheduled payment. (Code Sec. 409A(a)(4)(C))

For purposes of new Section 409A, a "nonqualified deferred compensation plan" is any "plan" that provides for the deferral of compensation, other than: (1) a "qualified employer plan" and (2) any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. (Code Sec. 409A(d)) According to Notice 2005-1, Section 409A will *not* apply to nonqualified stock option plans in which the strike price is at least equal on option grant to the option stock's fair market value—provided the plan has no deferral feature other than the option holder's future right to exercise the option.

The term "plan" includes any agreement or arrangement, including an agreement or arrangement that includes one person. (Code Sec. 409A(d)(3)) The Committee Report provides that Section 409A's application is *not* limited to arrangements between an employer and employee. Thus, a deferred com-

pensation arrangement with a single corporate director or other independent contractor may be subject to Section 409A.

As noted at the beginning of this article, the new rules for deferred compensation arrangements are effective for amounts deferred in tax years beginning after 2004. Amounts deferred in tax years beginning before 2005 are subject to the provisions if the plan is materially modified after Oct. 3, 2004. Notice 2005-1 provides that a plan adopted before December 31, 2005 will satisfy the new rules if (1) the plan is operated in good faith compliance with the provisions of the Act and the Notice during the 2005 calendar year (i.e., the "transition period"), and (2) the plan is amended on or before December 31, 2005 to conform to the provisions of the Act.

Notice 2005-1 also provides that a plan adopted before December 31, 2005 may be amended to allow a participant during all or part of the calendar year 2005 to terminate participation in the plan or cancel a deferral election without causing the plan to fail to conform to the new rules. However, this amendment authorization is effective only if the amendment is made on or before December 31, 2005, and the amounts subject to the termination or cancellation are includible in the income of the participant in the calendar year 2005 or, if later, the taxable year in which the amounts are earned and vested.

In summary, many existing deferred compensation arrangements will need to be amended by year end to avoid potentially adverse income tax consequences to the individuals covered by such arrangements.

For more information regarding this topic, please e-mail your requests to Julius at jhg@disinherit-irs.com or call Julius at (248) 457-7200.

Trust-Owned Annuities

By Thomas P. Cavanaugh, J.D.

In the past few years, there has been a significant increase in the number of nonqualified annuity products sold. The popularity of annuities is due in large part to the tax deferred nature of the product since earnings on the premiums are generally not subject to income tax until distributions are made. However, annuity contracts owned by "non-natural" persons (e.g. cor-

porations, partnerships and trusts) are not treated as annuity contracts for federal income tax purposes. Thus, the earnings on such contracts are taxed annually as ordinary income received or accrued by the owner of the contract during the taxable year. Code Sec. 72(u). This presents a problem for donors wishing to make gifts of non-qualified annuities, but wishing to "wrap" such gifts in trust to protect their donees from their inability, their disability, their creditors and their predators – including divorced spouses.

The IRS has privately recognized several exceptions to the non-natural owner rule. In PLR 9639057, for example, the IRS ruled where (i) a trustee's duties were limited to purchasing an annuity contract as directed by the beneficiary; (ii) the trustee held legal title to the annuity contract for the beneficiary's sole benefit; and (iii) the trustee was not able to exercise any rights under the annuity contract unless directed to do so by the beneficiary, that the trustee was acting as agent for a natural person. Further, where the trustee of an irrevocable trust had the power to select an annuity settlement option or to terminate the contract, the annuity was still considered to be owned by a natural person. PLR 199933033. The IRS has also ruled that an employee-grantor secular trust that purchased an annuity contract should be treated as a natural person, presumably because a secular trust is a grantor trust of which the employee is considered the owner for federal income tax purposes. PLR 199905015.

In a recent series of substantially identical private letter rulings, the IRS has ruled that a non-grantor irrevocable trust may be viewed as an agent for the beneficiaries. PLRs 200449011 through 200440917. These rulings shed additional light on what the IRS considers an "agency relationship" between the trustee and the beneficiary. Following are the pertinent provisions of each trust involved in the rulings:

1. The beneficiary was entitled to withdraw specified percentages of the trust principal upon attainment of ages 30, 35 and 40.
2. Any amounts not withdrawn remained in a separate trust for the sole benefit of the beneficiary, and such trust could continue beyond the beneficiary's 40th birthday.
3. Any distributions from the trust must be in the form of distribution of an annuity contract or annuity contracts in kind.

4. While the beneficiary was living, no distributions of the annuity contract could be made to anyone other than the beneficiary.
5. Upon the beneficiary's death, the trust was to be distributed to the beneficiary's issue.

In addition, the taxpayer seeking the rulings represented that the trusts were not grantor trusts, that all of the beneficiaries were natural persons, and that the beneficiaries were not employed by the trusts.

Even though private letter rulings cannot be relied upon by anyone other than the taxpayer who obtained the ruling, they are indicators of the IRS' position on certain matters. When using irrevocable non-grantor trusts to purchase a non-qualified annuity, care must be taken to draft the trust agreement to "mirror" the terms of the trusts in the PLRs described above.

For more information regarding this topic, please e-mail your requests to Tom at tpc@disinherit-irs.com or call Tom at (248) 457-7218.

Charities: A Primer, Part III

By Salvatore J. LaMendola, J.D.

Now that a choice of format (corporation or trust) for the new 501(c)(3) organization has been made, and appropriate organizational documents put into place, recognition of 501(c)(3) status from the IRS is the next step in the setup process. Two items are worth noting at this point: First, the new organization can proceed with operations (including receiving donations) right away. There is no need to delay activity until official IRS recognition of 501(c)(3) status is obtained. (This recognition comes by what is known as a "determination letter" from the IRS.) As long as the application for recognition of exemption under Section 501(c)(3) (Form 1023) is made within 27 months of inception, such recognition, whenever granted, relates back to the date of creation of the new organization. In other words, the new organization is considered to have 501(c)(3) status from day one. Thus, donations made to the new organization at the end of the year are still deductible to the donor in the year made, even though the determination letter may come in a later year.

The second important item to note is that 501(c)(3) status is not granted or denied on

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the basis of any discretion exercised by the IRS. Rather, any organization that meets the applicable standards is entitled to 501(c)(3) status. Form 1023 is designed merely to collect sufficient information to allow the IRS to determine that the applicable standards have been met. There are two key requirements for a new organization in this regard. First, it must show that its purposes have been sufficiently limited to exempt purposes by its organizational documents and that its assets will be permanently dedicated to such exempt purposes. Second, it must show that its activities will be in furtherance of its exempt purposes. Said another way, to satisfy the second requirement, it must certify that it will *not* do any of the following: (i) participate in the political campaigns of candidates for office; (ii) use its assets to unjustly enrich insiders; (iii) substantially further non-exempt purposes; (iv) operate for the primary purpose of conducting an unrelated trade or business; (v) engage in activities that are illegal or that violate public policy; and (vi) attempt, in a substantial

way, to influence legislation.

Another important determination is made by the IRS at this point that is worth mention: Whether the new organization will be considered to be a public charity or a private foundation. Both public charities and private foundations are 501(c)(3) organizations. The presumed status of each applicant submitting a Form 1023 is that it is a private foundation. To obtain recognition as a public charity, the new organization must successfully rebut this presumption by demonstrating on the Form 1023 that it is able to meet certain tests entitling it to public charity status.

The next (and final) installment of this series will focus on filings that are required of a new 501(c)(3) organization by state (Michigan) law.

For more information regarding this topic, please e-mail your requests to Sal at sjl@disinherit-irs.com or call Sal at (248) 457-7204.

You're Invited!

MARK YOUR CALENDARS

March 1 and March 2, 2005

We will be conducting a four hour seminar entitled "Current Topics in Wealth Transfer Planning" to be held on the above dates.

These seminars will be held at the Michigan State University Management Education Center, from 8:00 am. to 12:00 pm. Registration begins at 7:30 am.

Four (4) CE credits are available for attending the course.

Within the next few weeks you will receive an invitation in the mail to attend this **free** seminar. The invitation will explain how you can register for this seminar.

Seating is limited and will be on a first come, first served basis. We will try to accommodate your first choice of dates.

This newsletter is designed to provide accurate (at the time of printing) and authoritative information with regard to the subject matter covered. It must not be used as the basis for legal or tax advice. In specific cases, the parties involved must always seek out and rely on the counsel of their own advisors. Thus, responsibility for modifying and guiding any party's action with respect to legal and tax matters is placed where it belongs - with his or her own advisors.

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