

tax **IMPACT**

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Looking for the silver lining

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3 ways to soften the blow of estate taxes

Tax Tips

Valuation discounts, 529 plans, and the expanded Work Opportunity Tax credit



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Looking for the silver lining

Tax planning in a troubled economy

Times are tough all over. Real estate prices are depressed, credit is tight and the ups and downs of the stock market are enough to induce motion sickness. Fortunately, the cloud hanging over the economy has a silver lining: It's an ideal time for tax and estate planning. Let's look at several strategies you can use to slash your income tax bill and minimize gift and estate taxes.

Maximizing retirement contributions

If possible, maximize your contributions to IRAs, 401(k) plans and other tax-deferred retirement saving vehicles. Contributions reduce your adjusted gross income (AGI), which not only lowers your taxable income but may also increase deductions that are phased out above certain AGI levels.

For 2009, you can contribute up to \$16,500 to your 401(k) plan (\$22,000 if you are age 50 or older), and, depending on factors such as your AGI and whether you participate in an employer-sponsored retirement plan, \$5,000 to your traditional or Roth IRA (\$6,000 if you are age 50 or older).

Converting to a Roth IRA

If you have a large balance in a traditional IRA, it's a good time to consider converting to a Roth IRA. Why? Traditional IRAs offer current tax deductions and tax-deferred growth, but when you or your heirs

take distributions, the funds are subject to ordinary income taxes. Contributions to a Roth IRA, on the other hand, are nondeductible, but qualified distributions of contributions and earnings are tax free.

Determining which type of IRA is right for you depends on your expected investment returns and whether you're better off paying the tax now or later — your tax advisor can help you do the math. If you would benefit from a Roth IRA, converting an existing traditional IRA may be a good strategy, especially now while many asset values are depressed.

If you have a large balance in a traditional IRA, it's a good time to consider converting to a Roth IRA.

When you do a Roth conversion, you have to pay taxes on the amount you convert. However, if your IRA assets have depreciated in value in recent months, you'll minimize the tax cost while maximizing potential tax-free growth when the economy rebounds.



Keep in mind that Roth IRA conversions are currently available only to taxpayers with a modified adjusted gross income (MAGI) of \$100,000 or less. This income limit is scheduled to disappear beginning in 2010, making this strategy available to all taxpayers. If you believe your MAGI will be under the limit this year, it may be a good idea to lock in current asset values by doing the conversion now.

Advantage of an intrafamily loan

Year	Value of Ruby's investment at the beginning of the year	Growth (6%)	Loan payments	Value at year end
1	\$ 1,000,000	+ \$ 60,000	- \$ 20,000	\$ 1,040,000
2	\$ 1,040,000	+ \$ 62,400	- \$ 20,000	\$ 1,082,400
3	\$ 1,082,400	+ \$ 64,944	- \$ 20,000	\$ 1,127,344
4	\$ 1,127,344	+ \$ 67,641	- \$ 20,000	\$ 1,174,985
5	\$ 1,174,985	+ \$ 70,499	- \$ 1,020,000 (principal + interest)	\$ 225,484

Even if your income ends up being more than \$100,000, you can always undo the conversion (known as “recharacterization”) and reconvert in 2010. In addition, if the value of your IRA declines further after you do the conversion, you can reduce your tax bill by undoing the conversion and then reconverting next year.

Putting RMDs on hold

When you reach age 70½, you have to take annual required minimum distributions (RMDs) from IRAs, 401(k)s and other retirement accounts. Failure to do so results in a tax penalty equal to 50% of the amount you should have withdrawn.

In an effort to provide retirees with relief from the stock market downturn, Congress suspended the RMD requirement for 2009. Unless you need the money for living expenses, consider skipping RMDs this year, leaving more money in your retirement accounts to continue growing tax free.

Harvesting losses

If you're holding poor-performing investments, consider selling them to “harvest” the losses. You can use these losses to offset up to \$3,000 in ordinary income plus any capital gains you recognize this year.

In addition, unused losses can be carried forward to future tax years. Plus, unloading losers also gives you an opportunity to replace them with investments that are expected to yield greater returns.

Giving it away

The struggling economy creates some attractive estate planning opportunities. By leveraging depressed asset values and rock-bottom interest rates, you can

transfer substantial amounts of wealth to your children or other heirs at a minimal tax cost.

A simple strategy is to give assets away. You can minimize gift taxes, for instance, by transferring real estate, stocks or other assets whose values have declined.

Also, there are several estate planning strategies that thrive in a low-interest-rate environment. One of the most effective is the intrafamily loan. To avoid gift taxes on a loan to a family member, you must charge interest at or above the applicable federal rate (AFR). Recently, AFRs dropped to their lowest levels in decades. If your borrower places the funds in investments that outperform the AFR, the money left over after repaying the loan will essentially be a tax-free gift.

For example, Alex loans his daughter, Ruby, \$1 million, during a month when the AFR for midterm loans (more than three years, up to nine years) is only 2%. The loan agreement provides for interest-only payments for four years, with a balloon payment (interest + principal) at the end of the fifth year. Ruby invests the money in assets that yield a 6% return. As the chart “Advantage of an intrafamily loan” above illustrates, after repaying the loan, Ruby ends up receiving more than \$225,000 gift-tax free.

Other tools, such as grantor retained annuity trusts, charitable lead annuity trusts and intentionally defective grantor trusts, also take advantage of low asset values and interest rates, allowing you to transfer substantial amounts of wealth while minimizing or even eliminating gift taxes.

Seize the opportunity

Your tax advisor can help you determine whether these or other tax strategies can help you ease the pain of the recession, but it's important to act quickly. Although these strategies will remain effective even after the economy begins to recover, they may never be as powerful as they are right now. ☺

How to make the most (or least) of business losses

There are many strategies for minimizing your company's tax bill. Not earning enough income to cover your expenses — though effective — isn't the best approach. But for a new company that hasn't yet started turning a profit or a mature business being squeezed by a sluggish economy, losses happen.

No one likes to lose money, but the tax code softens the blow somewhat by allowing you to use a net operating loss (NOL) to offset income in previous or future years. Carrying back an NOL can be particularly beneficial because it can provide you with an immediate tax refund at a time when you may need an infusion of cash.

Do you have an NOL?

The concept behind NOLs is simple: You have an NOL if your business deductions in a given tax year exceed your business income for that year. For most companies, this determination is straightforward.

It becomes more complicated for sole proprietorships because they need to separate business income and losses from personal income and losses. Sole proprietors, for example, don't count personal exemptions, net capital

losses and certain other nonbusiness deductions in determining whether they have an NOL on their individual tax returns.

Should you carry forward or back?

If your business has an NOL, you can use it to offset taxable income in the two tax years preceding the NOL year and claim a refund. For tax years beginning or ending in 2008, the American Recovery and Reinvestment Act of 2009 expands the carryback period to five years for qualified small businesses (defined as businesses having average gross receipts of \$15 million or less applied over the three-year tax period ending with the tax year of the NOL).

For certain losses attributable to casualty and theft, the carryback period is three years. Presidential-declared and certain other disasters allow a five-year carryback for businesses. Unused losses can be carried forward for up to 20 years.

From an economic perspective, it's typically better to carry NOLs back and claim a current refund than to hang on to the losses and use them in later years. In

some cases, however, it may make sense to save your NOLs if you expect them to provide greater benefits in the future. For instance, businesses or business owners likely to move into a higher tax bracket in the near future may want to waive the carryback period.

Does entity type matter?

Business structure has a big impact on your ability to deduct NOLs. If your company is a pass-through entity — such as a partnership, S corporation or multiple-owner limited liability company (LLC) — losses are passed through to the partners, shareholders or members and deducted on their individual tax returns. It's then determined at the individual taxpayer level whether or not an NOL is generated.



Here's where it gets complicated: Individual owners of pass-through entities can deduct business losses only to the extent of their adjusted tax basis, which isn't necessarily the same as the balance in their capital accounts. Also, losses may be limited further by the at-risk and passive loss rules. (See "What about passive losses?" below.)

The rules apply differently depending on the type of entity. Consider basis, for example. Generally, the initial basis of pass-through entity owners is the amount they pay to acquire their interests plus the adjusted basis of any property they contribute to the company. During the life of the business, basis may be increased by the owners' shares of company income, subsequent capital contributions and other factors. Basis may also be reduced (though not below zero) by the share of distributions, taxable losses and other items.

One advantage of the partnership structure is that partners, under certain circumstances, can deduct losses in excess of their investment in the company. That's because their tax basis is increased by certain partnership debt. On the other hand, an S corporation shareholder's basis isn't increased by corporate debt unless the shareholder makes a loan to the S corporation. Thus, S corporation shareholders generally can't deduct losses beyond their company investment.

An LLC member's basis is also increased by business debt, but the at-risk rules make it difficult for members to deduct losses beyond their company investment. Because LLC members enjoy limited liability for company obligation, the portion of their basis attributable to company debt generally isn't considered to be "at risk" unless they pledge nonbusiness property as collateral or otherwise assume personal liability for the debt. There's also an exception for "qualified nonrecourse financing" — loans secured by real estate used in the business and meeting certain other requirements.

What about passive losses?

The ability of pass-through owners to deduct losses may also be limited by passive loss rules. These rules provide that owners can't deduct passive business losses against nonpassive income — such as wages, interest, dividends and capital gains. For business losses to be considered "nonpassive," an owner must materially participate in

What about C corporations?

If your business is structured as a traditional C corporation, NOLs don't provide any direct tax benefits to shareholders. You can use them only to reduce the corporation's income in previous or future years.

However, if you expect substantial losses in the next few years and you meet the requirements for an S election, you may want to convert the C corporation into an S corporation. S corporations offer several tax advantages over C corporations, including avoidance of double taxation of corporate profits.

One drawback of a C-to-S conversion is the built-in gains tax: The company remains subject to corporate income taxes on built-in gains — generally, this means the excess of an asset's fair market value over its adjusted basis — on sales of assets during the 10-year period following the conversion. The American Recovery and Reinvestment Act of 2009, however, eliminates an S corporation's net unrecognized built-in gain as long as the seventh tax year in the recognition period occurred before the 2009 and 2010 tax years.

Although converting to an S corporation would allow you to pass future corporate losses to your shareholders, it would not allow you to carry forward C corporation losses from this year or previous years and offset them against future S corporation income. Keep in mind that there are basis limitations for S corporation losses.

the business. Disallowed passive losses may be carried forward and offset against future passive income.

The IRS allows owners to demonstrate material participation in several ways. Examples include working for the business for more than 500 hours a year or performing substantially all of the work in the business.

If your business is a pass-through entity and you anticipate an NOL this year, you should determine whether the basis, at-risk or passive loss rules will limit your ability to deduct company losses. If they will, there may be moves you can make to increase your deductions, such as making additional capital contributions, lending money to the company or increasing the number of hours you spend working in the business.

Don't lose out on loss deductions

Losing money is always upsetting. But if you expect your company to lose money this year or if it has suffered a loss in the last few years, don't despair. There are several ways you can use these losses to generate refunds for previous years or cut your tax bill in the future. ☺

3 ways to soften the blow of estate taxes

Reports of the death of the federal estate tax have been greatly exaggerated. True, as of this writing, the estate tax is scheduled for repeal in 2010, but many experts expect Congress to “repeal the repeal” and preserve the tax.

Because the estate tax appears to be here to stay, you and your family need to be aware of the tax-reducing strategies that can be implemented during one’s lifetime and even after one’s death. Here are three postmortem moves an executor can make to reduce an estate’s tax bill.

1. Use the alternate valuation date

Normally, for estate tax purposes, assets are valued as of the date of death. However, an executor can elect to use the alternate valuation date, which is six months later. This strategy may reduce estate taxes if the estate includes property, such as stock or real estate, which declines in value during that time.

Federal tax law allows an executor to elect to value real property based on its actual use, provided several requirements are met.

This irrevocable election applies to all of the estate’s property — it can’t be applied selectively. The strategy is unlikely to be used unless doing so would make the estate’s overall tax burden lower.

2. Use a special-use valuation

If real property used in a family business or farm makes up a significant portion of a decedent’s wealth — 25% or more of the gross estate, subject to certain adjustments — the executor may be able to reduce estate taxes using a special-use valuation.

Typically, real property is valued for estate tax purposes at its fair market value, which in turn is based on the property’s “highest and best use.” Fortunately, federal tax law allows an executor to elect to value real property



based on its actual use, provided several requirements are met.

Among other things, the decedent or other family members must have owned the land and materially participated in the business for at least five of the eight years immediately preceding the decedent’s death. Also, the property must pass to a qualified heir (such as a spouse or child) who materially participates in the business for at least 10 years after the decedent’s death.

3. Defer estate tax payments

If an interest in a qualifying closely held business makes up more than 35% of an estate, the executor can elect to defer the portion of estate taxes attributable to that interest. The estate pays interest only for four years and then pays the tax in 10 annual installments.

Qualifying closely held businesses include sole proprietorships, partnerships and corporations that meet certain size or ownership requirements. The tax code also contains special rules for determining which assets are counted in applying the 35% test.

Consider other strategies

Dealing with the death of a loved one is difficult. In addition to the emotional aspects, there are the financial elements involved in settling an estate. Fortunately, there are a number of strategies, including some not mentioned here, that can be employed after one’s death to reduce the estate tax bite. ☺

tax TIPS

Grab valuation discounts while they last

If you're considering strategies, such as a family limited partnership (FLP), that take advantage of valuation discounts, you may want to accelerate your plans. Congress may consider legislation this year that would limit the ability of families to claim these discounts.

Families are often able to reduce gift and estate taxes by transferring assets — such as limited partnership interests or minority interests in a closely held business — that qualify for valuation discounts for lack of control or lack of marketability. So, for example, the total value for estate tax purposes of an FLP divided among five family members might be substantially less than the value of the FLP's underlying assets.

A report prepared last year by the Congressional Joint Committee on Taxation proposed new rules that would limit discounts by, for instance, aggregating the interests of family members under certain circumstances. ☉

Study up on 529 plans

529 plans have become one of the most popular and effective college savings tools. Contributions to a 529 plan aren't tax deductible, but earnings can be withdrawn tax free as long as they're used to pay qualified higher education expenses, such as tuition, fees, books, supplies and equipment. The American Recovery and Reinvestment Act of 2009 expanded this category to include computers and computer technology (for instance, Internet access); this benefit is only for 2009 and 2010.

A 529 plan requirement is that contributors and beneficiaries cannot direct the investment of the funds in their accounts. Nevertheless, the IRS permits those who



establish 529 plans to select from among several different investment strategies when the initial contribution is made, and to adjust strategies once each calendar year and when the designated beneficiary changes.

In light of recent events in the investment markets and to give account holders greater flexibility, the IRS announced that it would allow two investment strategy adjustments in 2009. If you have a 529 plan, it's a good idea to evaluate its recent performance and determine whether a new investment strategy would be appropriate. ☉

Expanded hiring benefit

If you hire unemployed veterans and “disconnected” youth and they begin work in 2009 or 2010, you may be able to benefit from the Work Opportunity Tax credit. The American Recovery and Reinvestment Act of 2009 added these two categories of workers, which already included:

- ☉ Qualified ex-felons,
- ☉ Recipients of food stamps or Supplemental Insurance Income, and
- ☉ Certain residents of an Enterprise Zone, Empowerment Community or a Rural Renewal County.

The credit is calculated based on a number of factors, such as the number of hours the employees work and first-year wages, and must be certified by a local agency. ☉

Income Tax Planning — The Kiddie Tax

A package of small business tax cuts passed Congress in May and to help pay for them Congress has — again — tinkered with the so-called “kiddie” tax rules. When a child under age 18 has unearned income in excess of a certain amount and does not file a joint return, the kiddie tax may tax part of that income at the parents’ tax rate instead of the child’s tax rate. The Small Business Work Opportunity and Tax Act of 2007 (H.R. 2206) raises the threshold age to under 19 (under 24 if a full-time student).

Congress created the kiddie tax to prevent abuses. It is designed to lessen the effectiveness of intra-family transfers of income-producing property, which shift income produced from such property from the parents’ high marginal tax rate to the child’s generally lower tax bracket, thereby reducing a family’s overall income tax liability.

Unless the parents of a child under the age of 18 make a special election to include the child’s income on a parent’s return, the child’s unearned income is taxed to the child at his or her parents’ top marginal rate. The child is not allowed a personal exemption if he or she can be claimed as a dependent on his or her parents’ return. However, the child can use up to \$900 in 2008 (\$950 in 2009), of his or her standard deduction, to offset unearned income. Thus, only unearned income in excess of \$1,800 for 2008 is taxed at the parents’ top marginal rate.

For many years, the kiddie tax kicked in at under age 14. The Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) raised the threshold age to under age 18. Congress passed TIPRA in May 2006. At that time, it made the kiddie tax changes retroactive to the start of the year.

The Small Business Work Opportunity and Tax Act of 2007 expanded the kiddie tax to apply to children who are under age 19 or who are full-time students under age 24. This treatment applies only to students whose earned income does not exceed one-half of the amount of their support. Unlike TIPRA, the changes in the Small Business Work Opportunity Tax Act of 2007

were not retroactive. The new treatment is effective for calendar year taxpayers in 2008.

Despite the new law, there are some potential tax-saving opportunities. The age cap on the kiddie tax allows you to plan in several ways. You may want to set up a gift-giving program that keeps the child’s unearned income below the \$1,700 threshold until he or she reaches age 19 (or 24). You may also want to wait to transfer property that will produce the most income only starting after the year in which the child reaches 18 (or 23). An investment in raw land with appreciation potential is one example. Some parents buy Series EE bonds for the child and have the child elect to defer tax on the interest as it accrues. Another idea is to buy cash-value life insurance. Inside build-up from the policy generally will accumulate tax-free.

You may also get a modest savings because the first \$900 based on the standard deduction for a dependent is usually tax-free and the next \$900 is taxed at the 10 percent rate. This can add to hundreds of dollars of tax savings. Planning also gets complicated because of different capital gains tax rates. You’ll also need to take into account any alternative minimum tax (AMT) liability. The source of the unearned income also is an important factor. For example, if the child’s income consists entirely of interest and dividends, the parents can elect to include the child’s income in their income.

One more thing: don’t forget that the kiddie tax applies only to unearned income. If you run your own business, you may get some modest savings if your child can legitimately be hired to work in the business.

Of course, careful planning and attention to detail are necessary, not only to achieve the intended tax savings but also to ensure that any action fits in with your overall financial and family goals. Please do not hesitate to call if you would like to explore in greater detail the changes to the kiddie tax rules.

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