

TAXOLUTIONS



►► *ideas on taxes*

NEW BANKRUPTCY REFORM LAW OFFERS GREATER RETIREMENT PLAN PROTECTION

The Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCP) of 2005, signed into law by President George W. Bush on April 20, provides a greater degree of protection in bankruptcy to assets held in tax-advantaged retirement accounts, especially IRAs and Roth IRAs. The law, which will generally require higher-income Americans who file for bankruptcy to repay at least a portion of their debts, will go into effect 180 days after enactment, or on October 17, 2005.

Stiffer Rules for Debt Repayment

Through the application of a means test, BAPCP makes it more difficult for individuals with higher incomes to discharge their financial obligations. Debtors who earn more than the state median income will be required under the new law to file for Chapter 13 bankruptcy, under which debtors must adhere to a plan for repaying creditors over time. Previously, even higher-income debtors were frequently permitted to file for Chapter 7 bankruptcy, under which debtors are freed from repaying all or most of their unsecured debt. The law also mandates credit

counseling from an approved nonprofit credit counseling agency for debtors filing for any form of bankruptcy.

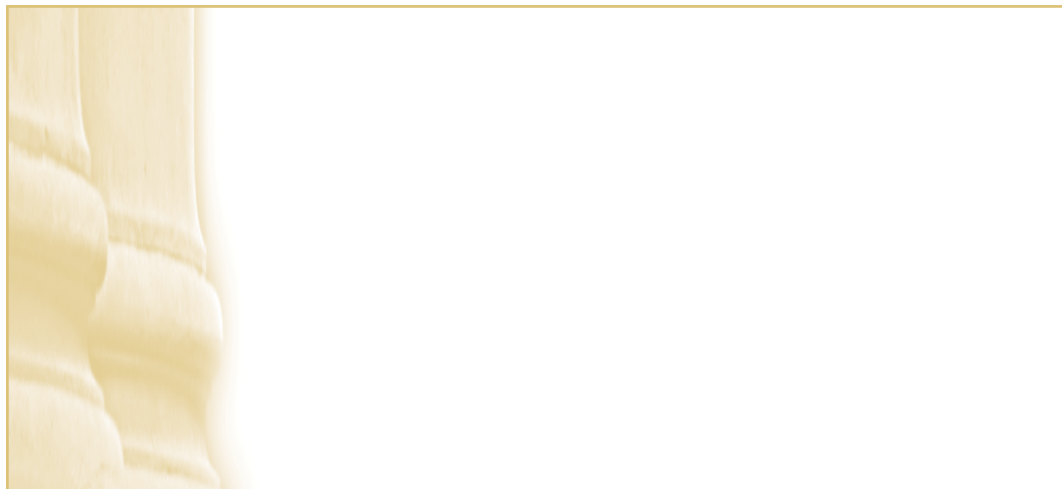
Retirement Accounts Given Creditor Protection

Debtors will gain some relief, however, from a provision of the new law expanding bankruptcy protection granted to retirement savings held in Individual Retirement Accounts (IRAs). Non-rollover assets of up to \$1 million held in tax-favored retirement accounts, including IRAs, are protected under BAPCP in the event of personal bankruptcy. There is

no exemption limit on amounts rolled over to IRAs from qualified plans, including 401(k)s. Funds held in SEP IRAs and SIMPLE IRAs gain unlimited protection from creditors under the legislation, and are not counted toward the \$1 million IRA limit.

Funds borrowed from employer-sponsored retirement, profit-sharing, or stock bonus accounts are not discharged under the new rules. Bankrupt employees with outstanding loans from a company retirement plan can continue to have loan repayments withheld from salary. This may prove helpful for individuals who

►► *cont'd on page two*



►► *cont'd from page one*

NEW BANKRUPTCY REFORM LAW OFFERS GREATER RETIREMENT PLAN PROTECTION

would otherwise be liable to pay taxes on a defaulted loan from a qualified plan.

Education savings held in 529 plans and Coverdell Education Savings Accounts gain some limited protection under BAPCP, provided the beneficiary was a child in the taxable year when the funds were contributed. Contributions made within 720 days of the bankruptcy filing are protected up to a limit of \$5,000, while contributions made within 365 days of the filing are not protected.

Tax Debts Reprioritized

Under the new legislation, debtors with tax obligations will be treated differently than in the past. Previously, debtors who had not filed tax returns in a timely manner were unable to discharge

their tax debt under a Chapter 7 bankruptcy plan, but they were sometimes allowed to do so under a Chapter 13 plan. This loophole, known as the Chapter 13 "superdischarge," was closed by the BAPCP. Under the new law, debtors who failed to file their taxes on time, or who filed fraudulently, will be required to pay their tax debt, with interest, even under a Chapter 13 plan.

In addition, BAPCP awards higher priority among creditors to holders of tax liens on real or personal property of a bankruptcy estate, particularly *ad valorem* tax liens on a bankruptcy estate.

Should You File Now?

Individuals considering filing for bankruptcy may wish to act before

BAPCP goes into full effect in October. In the interim, however, the courts are likely to incorporate in their rulings some of the clarifications contained in the law.

Assets held in traditional IRAs have already been granted protection from creditors as a result of a recent Supreme Court ruling. In the case of *Rousey v. Jacoway*, the justices held that IRA savings, including funds rolled over from 401(k) accounts, may be exempted from a bankruptcy estate provided the funds are needed to support the debtor and his or her dependents. Assets held in Roth IRAs would be unlikely to receive similar protection based on this ruling, but Roth IRA savings will be explicitly shielded from creditors when BAPCP goes into effect this fall. ■

EXERCISE CAUTION WHEN EXERCISING INCENTIVE STOCK OPTIONS

Compared with other forms of compensation, incentive stock options (ISOs) can provide executives and other employees with substantial tax breaks. If held for a certain period of time, shares purchased as ISOs may escape all taxes other than the relatively low long-term capital gains rate of 15%. But as many "paper millionaires" discovered, exercising ISOs can be very risky, especially if the employee fails to weigh all the potential tax consequences before cashing in.

When you exercise ISOs, there are no taxes due immediately. Instead, the entire gain, including the spread and any additional appreciation, is taxed at long-term capital gains rates, provided the employee does not sell the shares until at least two years after the option was granted, and one year after the date of exercise. The gain would lose its qualified status only if these holding period requirements were not met.

Sometimes, however, exercising and then holding ISOs into the next tax year can carry a very substantial hidden sting. When calculating tax liability, the spread between the grant price and the market value must be added as a "preference item" on the Alternative Minimum Tax (AMT) worksheet. If the amount you would pay under the AMT were higher than your regular income tax, you would be required to pay the AMT.

Under the AMT, people are taxed at rates of 26% and 28% on the amount of their taxable income above the exemption amounts. For 2005, these are \$40,250 for single filers or heads of household, and \$58,000 for joint filers. The AMT exemptions phase out gradually at higher income levels.

Some employees who held onto their companies' shares for more than a year

after exercising ISOs have found themselves in the unfortunate position of owing more in AMT taxes than their shares were actually worth.

Suppose, for example, an employee exercised an incentive option to buy 1,000 shares in his company at his grant price of \$25 a share, at a time when the shares were trading at \$175 on the open market. On paper, his gain would be \$150,000. If he decided to hold the shares for at least a year in hopes of minimizing his taxes and enjoying additional appreciation, the AMT could be triggered and he would become liable to pay the AMT on his \$150,000 gain.

This tax burden might not feel too onerous if, after a year, he were able to



►► *cont'd on page three*

►► *cont'd from page two*

EXERCISE CAUTION WHEN EXERCISING INCENTIVE STOCK OPTIONS

sell the shares at a price of \$185. But if his company's share price were to fall dramatically before he sold his stock, to \$35 a share, his gain will have shrunk to \$10,000, but the IRS would still demand AMT payment on his original spread of \$150,000. To help offset his losses, he can claim an "AMT credit" in future years. But many taxpayers who have found themselves in this situation have been forced to borrow money to pay

the IRS, arrange payment plans, or even declare bankruptcy.

Fortunately, there are ways to reduce the chances of falling into this trap, including:

- Selling shares immediately after exercising ISOs;
- Exercising ISOs incrementally;
- Exercising ISOs at a time when the share price is unusually low;

- Exercising ISOs early in the year;
- Taking other steps to reduce your chances of having to pay the AMT; or
- Choosing not to exercise the options.

The most appropriate strategies for you will depend on your personal financial and tax circumstances. For specific guidance, please give us a call. ■

GRATs: A PLANNING TOOL FOR BUSINESS SUCCESSION

For today's business owner, continuation and estate planning go hand-in-hand. Without proper tax strategies, the time, hard work, and money you've invested in your business could yield little more than a significant tax bill for your heirs. Fortunately, with careful planning, there are numerous ways of reducing your family's tax burden while keeping your business intact.

Gifts Review

Currently, you are annually allowed to give assets valued up to \$11,000 to each of your children or grandchildren (or anyone else, for that matter) without incurring a tax penalty. A married couple can transfer assets worth \$22,000 this way every year—\$11,000 per adult. Making gifts qualifying for this annual gift tax exclusion can help lower your estate's taxable value and minimize estate taxes. In 2005, estates with values exceeding \$1.5 million are subject to estate taxes, which can reach as high as 47%.

Above and beyond the annual gift tax exclusion, every individual has a lifetime gift tax exemption of \$1,000,000. For many business owners, this amount is not enough to transfer an entire business; furthermore, using the lifetime gift tax exemption will reduce what you can transfer tax free at death. Thus, in order to substantially reduce your tax liabilities, further planning options must be explored.

Is a GRAT for You?

For many estates, a trust is a cost-effective method of making gifts and can often facilitate intergenerational transfers. The grantor retained annuity trust (GRAT) in particular enables you to gift a substantial amount, while retaining an income interest for a specified period of time. This significantly minimizes your gift tax liability or entirely eliminates your exposure. GRATs are especially useful if a business or estate assets will appreciate in value.

With a GRAT, you can put all or part of your company's stock into an irrevocable trust that pays you (the business owner) a fixed income for a specified number of years. Since the trust is irrevocable, once you place stock or other assets into the trust, they are there for good, or until the GRAT terminates and the assets pass to your designated beneficiaries.

Assets transferred to the trust are considered a gift for gift tax purposes. GRAT gifts do not qualify for the annual exclusion because the beneficiaries have a future interest, not a present interest, in the gift. Since you retain an income interest, the gift's value is discounted, reducing your total gift tax liability. However, any income is taxed to you as the grantor.

An applicable federal interest rate determines your annuity (the income you receive as a percentage of assets transferred) value. GRATs are generally

most attractive when interest rates are low, because your annuity can be lower to equal the transfer value. This, in turn, means the remaining assets have no present value, which minimizes your gift tax cost. At the end of the trust term, any asset appreciation benefits your beneficiaries.

For estate planning purposes, the assets pass to your beneficiaries (outright or in trust) without inclusion in your gross estate. Remember: while reducing your estate tax liability and possibly building wealth for your heirs, a GRAT also locks in a guaranteed income stream for yourself for a fixed time period.

A Word of Caution

There may be one major drawback to using a GRAT: If the grantor dies before the trust term expires, then the trust's full value falls back into the grantor's estate. It is important to plan for a trust term you expect to outlive. Given this risk, older grantors may wish to specify shorter terms, or set up several trusts of varying durations (this is known as "laddering").

Business owner estate planning is a multifaceted endeavor. Advance planning and carefully considered tax-efficient strategies can help maximize the transfer of wealth to your heirs. For specific guidance, consult your tax professional. ■

UGMA/UTMA TRANSFERS TO 529 PLANS

Prior to the popularity of 529 college savings plans, many people saving for their children's education opted for either a Uniform Gifts to Minors Act (UGMA) account or a Uniform Transfers to Minors Act (UTMA) account, depending on their state of residence. For investors looking to enjoy the tax benefits 529 plans offer, it is possible to fund these savings plans with assets from an UGMA or UTMA; however, the rules governing the custodial account still apply.

The custodian of an UGMA or UTMA has the right to manage assets in the interest of the child, and may choose to transfer money to a 529 plan, provided the minor is named as the beneficiary of the 529 plan. The UGMA or UTMA custodian will be considered the owner of the plan until the child, upon reaching

the age of majority (legal adult age, generally 18 or 21), becomes the owner. Until that time, the custodian makes investment decisions.

Earnings in a 529 plan have the potential to grow *tax deferred*, and withdrawals made for qualified higher education expenses are federally *tax free*. Under a "sunset provision," certain federal tax benefits associated with 529 plans are scheduled to expire on December 31, 2010, unless Congress enacts further legislation.

An UGMA or UTMA is irrevocable and if funds are invested to a 529 plan, when a child becomes the owner, he or she becomes entitled to make the money management decisions. 529 plans do not stipulate that funds must be used for education; however, if funds are not used to pay for qualified education expenses,

earnings will be subject to a 10% federal income tax penalty, as well as ordinary income tax.

As you consider investing UGMA/UTMA assets in a 529 plan, familiarize yourself with some of the potential risks. It is important to note that assets in a 529 plan could impact the beneficiary's ability to qualify for grants and student loans. ■



Cash, Castles, Future Compensation—What's the Value of Your Estate?

Although you may not own a castle, do you know which of your "treasures" will be included in your estate? Federal estate taxes can take a large chunk out of the assets you hope to leave your heirs—as much as 47% in some cases. Federal estate taxes will generally be due if the sum of your net taxable estate at your death exceeds your individual estate tax exemption (\$1,500,000 in 2005).

Regulations relating to the taxation of property owned at death contain a catch-all definition stating that the "gross estate of a decedent who was a citizen or resident of the United States at the time of his death includes the value of all property—whether real or personal, tangible or intangible, and wherever situated—beneficially owned by the decedent at the time of his death." What does this mean? The first step in

understanding the potential implications of the federal estate tax is to understand some of the major items that may comprise your estate:

- *Personal assets.* Personal property, savings, real estate, retirement plans, and the proceeds of any life insurance policies are included in your estates.
- *Rights to future income.* Rights to future income, such as rights to payments under a deferred compensation agreement or partnership income continuation plan, may be includable in your estate. These rights are commonly referred to as "income in respect of a decedent (IRD)" and may be includable at their present commuted value.
- *Business interests.* Likewise, interests in any business you own at death, whether as a proprietor, a

partner, or a corporate shareholder may be includable in your gross estate.

- *Social Security benefits.* The value of Social Security survivor benefits received as either a lump sum or a monthly annuity is not includable in your gross estate.

Stay Current

Estate planning can help *minimize* estate taxes and *maximize* the amount you transfer to your heirs. It is important to accurately inventory your estate to project your potential liabilities, and then to perform periodic reviews to make sure your plan is up to date. By developing strategies early on, you can make the most of your tax-saving opportunities and help ensure that your beneficiaries receive your assets according to your wishes.