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TAX PLANNING OPPORTUNITIES IN A TROUBLED ECONOMY

By **Dennis M. Mitzel**

The past year has brought a steady stream of bad news regarding every aspect of the economy. While the "recession" initially was primarily felt in the business world, it has also greatly impacted financial markets and thus individual investors. Many investors have seen their net worth drop dramatically in the last nine months. While we are all anxiously waiting for some form of recovery, this drastic fall in investment values opens up opportunities to reduce or eliminate estate, gift, and income taxes.

Grantor Retained Annuity Trusts

Individuals wishing to transfer wealth to children or other family members without incurring estate or gift tax may accomplish this result using a Grantor Retained Annuity Trust ("GRAT"). GRATs have been successfully used for a long time, but the current decline in investment values may present an opportunity for individuals to transfer millions of dollars free of estate and gift tax. Best of all, a GRAT is a congressionally approved vehicle for transferring assets to family members.

A GRAT is a transfer of assets into a trust where the transferor (the "Grantor") retains the right to receive specified distributions from the trust for a specified time period. After the time period has run and the distributions have been made to the Grantor, the remainder of the trust is transferred to the Grantor's children or other family members. Internal Revenue Service ("IRS") tables are used to determine the value of the gift of the remainder interest.

A commonly used GRAT is a trust that lasts for only two years. The Grantor receives a payment from the trust at the end of the first and second year. The payment is set at an amount which, after application of the appropriate rate set forth in the IRS table, would reduce the value of the remainder interest to zero.

For example, Mr. Jones transfers $2,000,000 into a GRAT for two years. The trust provides that he will receive a payment of $1,040,000 at the end of Year One and another payment of $1,040,000 at the end of Year Two. The IRS table assumes a growth rate of about 3%, with the result that the remainder amount to be distributed to the children is valued at zero. Because the IRS considers the remainder interest to be without value, there is no taxable gift.

However, if the assets transferred to the GRAT actually increase in value by more than 3%, that excess increase will be transferred to the children at the end of the two year period free of gift tax.

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The excess appreciation will also not be a part of the Grantor's estate at death and thus will not be subject to estate tax.

Mr. Jones transfers stock that was formerly worth $4,000,000 but has dropped in value to $2,000,000. He is hopeful that during the two year trust period, these assets will recover their previous $4,000,000 value. If in fact the assets do recover, Mr. Jones will be able to transfer the increase in the value of the funds ($2,000,000) to his children free of gift tax.

Mr. Jones has taken advantage of a bad economic situation to transfer substantial sums to his children without incurring gift tax. If the assets do not increase in value, Mr. Jones simply will get back the transferred assets and will be in the same position as if no gift had ever occurred. If Mr. Jones dies during the two year term of the trust, the assets will be included in his estate, but that is an acceptable risk and he would be no worse off than if no gift had ever been made.

Although a GRAT is a statutory gift technique that is approved in the Internal Revenue Code, there is some discussion in Washington about requiring a ten year term. The technique would still work, but would not be as effective as when a shorter term is applied. The chances of dying during a ten year trust term would be greater than the chances of dying during a shorter term, negating the savings. As a result, individuals interested in creating a GRAT may need to act soon to take advantage of the opportunity.

Conversion to a Roth IRA

Recent changes in federal tax law, together with the recent downturn in the economy, may also present a unique long term income tax saving opportunity by expanding eligibility and lowering the tax cost of converting a traditional IRA into a Roth IRA. In the past, only individuals with an adjusted gross income of less than $100,000 were eligible to convert. Congress recently modified that rule so that beginning in 2010, there is no income eligibility limit. However, when the conversion to a Roth IRA takes place, income taxes must be paid on all pretax contributions and earnings included in the amount converted.

A traditional IRA holds pretax funds which are subject to income tax as they are withdrawn – usually after retirement. Therefore, although the funds invested in a traditional IRA are not initially subject to income tax, the growth and contributions are taxed as withdrawn.

In contrast, a Roth IRA holds after-tax funds that may be withdrawn without tax. Thus, although income tax is initially paid on the funds invested, all of the contributions and growth are withdrawn from a Roth IRA tax free. Whether conversion of a traditional IRA to a Roth IRA is beneficial depends upon whether it is worth paying some up front income tax to enjoy the future tax free use of the money.

Mr. Green holds a traditional IRA that has recently fallen in value from $400,000 to $200,000. Had he converted his traditional IRA to a Roth IRA when values were high, he would have incurred taxable income of $400,000. At a 28% rate, this would have generated income tax of about $112,000. Mr. Green expects the IRA to recover its value over time. He thus decides to convert the traditional IRA when its value is only $200,000. The tax cost of the conversion will have dropped by 50% – to $56,000. If in fact the IRA, which is now a Roth IRA, regains its former value, the $200,000 in growth and income may be withdrawn by Mr. Green free of tax.

If Mr. Green's adjusted gross income is $100,000 or more he would not be eligible to convert in 2009. But he will be eligible to convert to a Roth IRA in 2010.

Of course, actual results cannot be predicted and will vary based on circumstances, including actual investment performance. Nonetheless, this is an opportunity that should be considered by individuals whose large traditional IRAs have dramatically declined in value.

Capturing Capital Losses in a Down Market

Some investors intend to stay in the stock market and simply be patient and hope for a recovery of prices. Other investors will decide to sell those depreciated assets and incur substantial capital losses. As an alternative, investors may remain invested in the market and capture most of the capital losses by selling assets and using the sales proceeds to then purchase the same or similar securities. This strategy generates large capital losses to be offset against capital gains in the current and in future years.

Once the market normalizes, stocks may regain their lost value. Although the value of an entire portfolio may grow dramatically, it is common for an investor to trade only a small portion of that portfolio each year. Thus, although an investor may hope to see a large increase in portfolio value during a recovery, the actual realized capital gains could be a very small fraction of the total increase in value. Capturing capital losses at this time may thus provide capital loss carry forwards that can be spread out over many years. Even if the market fully recovers, captured capital losses could potentially eliminate capital gains for a substantial period of time into the future.

Note that if a capital loss is incurred and the identical security is purchased within 30 days before or after the date of sale, the loss cannot be recognized for income tax purposes. Investors should thus purchase replacement securities outside of this 30 day window or buy

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different securities to replace stocks that were sold. In addition, this tax strategy should not be undertaken without consulting a financial advisor before making specific investment decisions.

Preserving Capital Losses in Trusts

Income tax rules are very different for trusts than for individuals. For most trusts, ordinary income (interest, dividends, etc.) passes through to the trust beneficiaries and is reported on the beneficiaries' own income tax returns. Capital gains, on the other hand, are typically taxed to the trust.

Due to the downturn in the economy, it may now be advantageous for trusts to recognize capital losses since capital loss carry forwards can be generated and used against future capital gains. Like an individual's capital losses, the capital losses currently recognized by a trust may be used to protect the trust from capital gain tax for many years.

For some trusts, current recognition of capital loss is also a way of preserving losses that may otherwise vanish at some time in the future. Some trusts are subject to estate tax at the death of the beneficiary. These trusts typically include marital trusts or trusts over which the beneficiary holds a general power of appointment – that is, the right to direct the transfer of trust assets to anyone. Because these trusts are taxable in the beneficiary's estate, the assets held by the trusts receive an adjustment to basis at the beneficiary's death, in effect, eliminating any accrued capital gains or losses.

In the case of capital gains, this adjustment to basis is a benefit to the taxpayer. In contrast, in the case of unrecognized capital losses, this is a lost opportunity. However, if the loss is actually recognized through a sale, the loss is preserved and any remaining loss will be passed out to the beneficiary at the termination of the trust.

Fiduciaries of marital trusts and other trusts which will be included in a beneficiary's estate should thus periodically review the unrecognized losses in their portfolios and consider a periodic harvesting of these losses. Depending upon the specific investment philosophy of the trust, the assets could be reinvested in similar investments or could be invested in identical assets outside of the 30 day "window" period before or after the sale.

FIRST-TIME HOME BUYER FEDERAL TAX CREDIT EXPANDED FOR 2009

By **Richard R. Zmijewski, Sr.**

Last summer Congress passed the Housing and Economic Recovery Act of 2008 which provided for a $7,500 tax credit for first-time home buyers purchasing homes on or after April 9, 2008 and before July 1, 2009. Unlike most other tax credits that do not require repayment, the $7,500 credit must be repaid over 15 years at $500 each year or when the home is sold, if earlier. On February 17, 2009, President Obama signed into law a new first-time home buyer tax credit replacing the credit enacted in 2008.

Under the American Recovery and Reinvestment Act of 2009 ("ARRA"), first-time home buyers can now take advantage of a tax credit of $8,000 or 10% of the home's purchase price – whichever is less. However, unlike the 2008 tax credit, taxpayers do not have to repay the new credit. Taxpayers can take advantage of this credit for home purchases closing between January 1, 2009 and November 30, 2009. A home purchased by a first-time home buyer will qualify for the credit as long as the home will be used as a principal residence and the buyer has not owned a home in the three years prior to the purchase.

The credit is phased out for taxpayers above certain income levels. Single filers with a modified adjusted gross income ("AGI") between $75,000 and $94,999 and married taxpayers filing jointly with a modified AGI between $150,000 and $169,999 will be eligible for a partial credit. Single and married taxpayers with a modified AGI at or above $95,000 and $170,000, respectively, are ineligible to take the credit.

While the tax credit will be claimed on a taxpayer's 2009 return (filed in 2010), individuals who plan to use the new credit can immediately start benefiting by raising the number of exemptions listed on their W-4 form on file with their employer. By raising the number of exemptions, taxpayers will receive more income each paycheck since a smaller amount will be withheld for federal income taxes (a withholding calculator to help taxpayers determine the appropriate number of exemptions is available on the IRS website at http://www.irs.gov/).

Caution should be used when taking this approach because penalties and interest can be assessed for not withholding enough in income taxes. Taxpayers who decrease the amount withheld should consider the possibility that a home will not be purchased in 2009 and the tax credit will not be used.

Under the ARRA, first-time home buyers in 2009 will benefit from the $500 increase to the credit in addition to not having to repay the credit. For homes purchased between April 9, 2008 and December 31, 2008, the tax credit remains at $7,500 and will have to be repaid over 15 years or in full when the house is sold.

ERISA PENSION PLAN BENEFICIARY DESIGNATION CONTROLS – EVEN WHEN FORMER SPOUSE WAIVED RIGHTS TO PLAN BENEFITS IN DIVORCE JUDGMENT

By **Harvey B. Wallace II**

On January 26, 2009, the case *Kennedy v Plan Administrator for DuPont de Nemours & Company* was decided by the United States Supreme Court. In the Kennedy case, a pension plan participant did not sign a new beneficiary designation form removing his former wife as beneficiary of his pension plan after the divorce. When the pension plan participant died, the plan administrator paid the plan benefits to the ex-wife as the named beneficiary as required by the written document governing the plan. The executor of the deceased participant's estate sued the plan administrator, claiming that the benefits had been improperly paid to the former wife because she had waived her right to those benefits in the divorce decree.

The Court unanimously ruled that the pension plan administrator had correctly distributed the pension plan benefits to the ex-wife. The Court also found that the plan administrator had no duty to take into account the fact that the former wife had given up (or waived) her right to plan benefits in the divorce decree.

In making its decision, the Court's opinion relied on the fact that the Employee Retirement and Income Security Act ("ERISA"), which governed the plan, requires every employee benefit plan to be established and maintained in accordance with a written document. That written document must specify the basis on which payments are to be made to and from the plan. The pension plan administrator was obligated to act in accordance with the documents governing the plan and ERISA provides no exemption from this duty when it comes to paying plan benefits. Therefore, the benefits had to be paid to the named beneficiary – the divorced wife. In doing so, the plan administrator did exactly what ERISA required.

The purpose of this bright line rule is to simplify the administration of plans, to ensure that plan administrators will not be held liable to other claimants for distributing plan benefits to named beneficiaries, and to enable beneficiaries to get plan distributions quickly. In contrast, a less certain rule would result in plan administrators being involved in litigation over the meaning and enforceability of waivers – such as those contained in a divorce decree.

ERISA also requires each pension plan to provide that a beneficiary's right to receive benefits under the plan may not be assigned or alienated – that is, transferred by the named beneficiary to another person. The only exception to this rule is in the case of a Qualified Domestic Relations Order ("QDRO"). A QDRO is a state court domestic relations order that complies with several specific requirements.

Since the divorce decree did not contain the requisite provisions of a QDRO, the Court also addressed the question of whether the ex-wife's waiver of benefits by the divorce decree was an impermissible assignment or alienation of pension plan benefits. The Court concluded that ERISA does not invalidate a non-QDRO spousal waiver. Thus, the Court left open the question of whether a state or federal court action could have been brought against the ex-wife to obtain the plan benefits once those benefits had been paid to her.

In *Sweebe v Sweebe*, the Michigan Supreme Court addressed the question of whether the benefits that have been paid to a designated beneficiary can be recovered through a court proceeding against the beneficiary. In that 2006 case, the executor of the deceased plan participant's estate brought suit against the former wife to recover life insurance proceeds that had been paid to her. The court found that under ERISA, the plan administrator was obligated to pay life insurance benefits to the ex-wife (the named beneficiary) despite the fact that she had waived her right to her former husband's life insurance in the divorce judgment. However, the court also found that once the benefits had been paid to the former wife, ERISA was no longer involved. At that point, the terms of the divorce judgment prevented the ex-wife from keeping the life insurance proceeds. Therefore, the former wife had to pay the life insurance proceeds that she had received to her deceased ex-husband's estate.

However, some federal courts and some courts in other states have reached a contrary conclusion in cases involving similar facts. In addition, the court in *Sweebe* specifically noted that "the case before this court involves a life insurance policy, not pension benefits." As a result, although ERISA plan administrators can no longer be held liable for paying ERISA benefits to a deceased participant's former spouse who is a named beneficiary in accordance with plan documents, other aspects of the law are still unsettled.

Pension plan participants seldom intend to bestow pension or other benefits on their ex-spouses at death. However, when divorce judgments and beneficiary designations are inconsistent, conflict can result. In order to avoid future uncertainty and litigation, divorced plan participants should always follow through and change beneficiary designations to delete former spouses as named beneficiaries. Similarly, if a divorcing non-participant spouse wishes to preserve rights in a participant's benefits, a QDRO should be prepared making clear that those rights continue after divorce.

INDIVIDUAL TAXES AND THE AMERICAN RECOVERY AND REINVESTMENT ACT OF 2009

The American Recovery and Reinvestment Act of 2009 (the "ARRA") was signed by President Obama on February 17, 2009.

In addition to expanding the credit for first-time home buyers (as explained in the article on page 3), major provisions affecting individual taxpayers include –

- Creating a refundable "Making Work Pay" tax credit during 2009 and 2010 of 6.2% of earned income of up to $400 for single taxpayers and $800 for married taxpayers filing jointly.
  - The credit begins to phase out for single taxpayers with an adjusted gross income ("AGI") of $75,000 and at an AGI of $150,000 for married taxpayers filing jointly. Many taxpayers will receive the credit through an increase in their paychecks as a result of decreased withholding.
- Making a one-time payment of $250 to retirees, disabled individuals, and Social Security and Supplemental Security Income recipients receiving benefits from the Social Security Administration. Railroad Retirement beneficiaries and veterans receiving disability compensation and pensions from the Department of Veteran's Affairs will also receive a $250 payment. The one time payment reduces any "Making Work Pay" tax credit.
- Allowing a one time $250 refundable tax credit to certain government employees who are not eligible for Social Security. The one-time credit reduces any "Making Work Pay" credit.
- Temporarily suspending federal income tax on the first $2,400 of unemployment benefits received in 2009.
- Expanding eligibility for the refundable child tax credit by lowering the earned income threshold to $3,000 (from $8,500 in 2008).
- Creating a $2,500 higher education tax credit. The credit is available for the first four years of college and is based on 100% of the first $2,000 of tuition and expenses (including fees and course materials) paid during the tax year and 25% of the next $2,000 of tuition and related expenses paid during the tax year. Forty percent of the credit is refundable.
  - The credit begins to phase out for single taxpayers with an AGI of $80,000 and at an AGI of $160,000 for married taxpayers filing jointly.
- Allowing computers and computer technology to qualify as qualified education expenses for Qualified Tuition Plans (529 plans) for the 2009 and 2010 tax years.
- Allowing taxpayers to deduct state and local sales and excise taxes paid on the purchase of a new automobile, light truck, SUV, motorcycle, or motor home attributable to the first $49,500 of the purchase price. Both taxpayers who itemize and taxpayers who use the standard deduction will be allowed to take the deduction. However, a taxpayer who deducts state and local sales taxes instead of state and local income taxes will not be allowed to take the deduction.
  - The deduction begins to phase out at an AGI of $125,000 for single taxpayers and at an AGI of $250,000 for married taxpayers filing jointly.
- Increasing the Alternative Minimum Tax ("AMT") exemption amount for 2009 to $46,700 for single individuals, to $70,950 for married taxpayers filing joint returns, and to $35,745 for married taxpayers filing separately. The ARRA also allows personal nonrefundable credits to offset the AMT and regular tax. This "patch" prevents an increase in the number of taxpayers subject to the AMT.

FIRM NEWS

Sheryl A. Laughren has joined the firm as a shareholder. Sheryl practices in the areas of labor and employment law, civil litigation, alternative dispute resolution, and nonprofit law. In recognition of her achievements in employment and labor law, Sheryl was designated a Michigan Super Lawyer in 2006, 2007, 2008, and 2009.

Leland Prince was recently appointed by Mayor David Landry to the nine member Novi, Michigan, City Planning Commission. The appointment is for the term ending June 10, 2010. The Commission holds public meetings twice each month and is responsible for preparing the Novi Master Plan for Land Use. Leland's practice focuses on commercial and civil litigation, labor and employment law, and corporate law.

Randolph M. Wright was recognized in Michigan Super Lawyers, Corporate Counsel Edition 2009 for his knowledge and experience in International Law. Randy actively assists clients in creating business relationships worldwide, with concentration in the United Kingdom, European Union, and the Russian Federation. He also assists foreign companies in establishing a presence in the US market. Randy is also a 2006 and 2008 recipient of the Super Lawyer designation for his expertise in business and corporate law.

Thomas M. Sullivan was elected as the Assistant General Bowling Chairman at the Detroit Athletic Club for the 2009-2010 Bowling Year. Tom will succeed to the position of General Bowling Chairman for the 2010-2011 Bowling Year.

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