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TAX & TRANSACTIONS BULLETIN

Volume I Spring, 2003

President Bush Signs Tax Relief Act on May 28, 2003

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SUMMARY OF "JOBS AND GROWTH TAX RELIEF RECONCILATION ACT OF 2003" ("ACT"), SIGNED BY PRESIDENT GEORGE W. BUSH ON MAY 28, 2003

REDUCE RATES ON CAPITAL GAINS AND DIVIDENDS

1. Reduce Individual Capital Gains Rates

The Act reduces the 10 and 20 percent rates on net capital gains to 5 (zero, in 2008) and 15 percent, respectively, for both the regular tax and the alternative minimum tax. The lower rates apply to assets held more than one year. The lowered rates apply to sales and exchanges occurring (and payments received) on or after May 6, 2003, and before January 1, 2009. The rates for collectibles gain and gain on unrecaptured real estate depreciation remain at 28% and 25%, respectively.

2. Reduce Dividend Tax for Individuals

The Act provides that dividends received by an individual shareholder from domestic and qualified foreign corporations generally are taxed at the same rates that apply to capital gains, for both the regular tax and the alternative minimum tax. Thus, most dividends will be taxed at rates of 5 (zero, in 2008) and 15 percent for dividends received in taxable years beginning after 2002 and before 2009. Dividends from foreign companies whose stock is traded on an established U.S. securities market qualify for the reduced tax rates. [Certain dividends are not eligible for the reduced rates, including (i) dividends received on stock that has not been held for more than 60 days during the 120-day period surrounding the ex-dividend date, (ii) dividends from tax-exempt organizations, and (iii) nonqualifying dividends from regulated investment companies and real estate investment trusts].

BUSINESS GROWTH INCENTIVES

1. Special Depreciation Allowance for Certain Property

The Act provides an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualified property. This special allowance applies for both the regular tax and the alternative minimum tax. Qualified property includes capital assets with MACRS lives of 20 years of less, computer software not amortized under Section 197, and qualifying leasehold improvements. In general, in order to qualify for the 50-percent additional depreciation deduction, the property must be acquired after May 5, 2003, and before January 1, 2005. The property does not qualify if there was a binding written contract for the acquisition in effect before May 6, 2003. Property for which

SUMMARY OF "JOBS AND GROWTH TAX RELIEF RECONCILATION ACT OF 2003" ("ACT"), SIGNED BY PRESIDENT GEORGE W. BUSH ON MAY 28, 2003, (cont'd)

the 50-percent additional first-year depreciation deduction is claimed cannot also receive the 30-percent additional first-year depreciation deduction.

2. Increase Section 179 Expensing

The Act provides that the maximum deductible amount that may be expensed under Section 179 is increased to $100,000 (from $25,000) for property placed in service in taxable years beginning in 2003, 2004, and 2005. Additionally, the phase-out threshold (of the deductible amount) is increased to $400,000 (from $200,000) for property placed in service in taxable years beginning in 2003, 2004, and 2005. The dollar limitations are indexed annually for inflation for taxable years beginning after 2003 and before 2006. Off-the-shelf computer software placed in service in a taxable year beginning in 2003, 2004, or 2005 will be eligible for expensing. With respect to taxable years beginning in 2003, 2004, and 2005, the provision permits taxpayers to make or revoke expensing elections on amended returns without the consent of the IRS.

ACCELERATION OF CERTAIN PREVIOUSLY ENACTED TAX REDUCTIONS

1. Accelerate Increase in Child Tax Credit

The Act increases the amount of the child tax credit to $1,000 (from $600) for 2003 and 2004. After 2004, the amount of the credit decreases to the level provided under current law. For 2003, the increased amount of the child tax credit (up to $400) will be paid in advance, beginning in July 2003, based on the information contained in the taxpayer's return for 2002. The child tax credit remains subject to phaseout under current rules.

2. Accelerate Marriage Penalty Relief

a. Standard deduction marriage penalty relief

The Act provides that the basic standard deduction amount for married taxpayers filing a joint return is double the basic standard deduction amount for single individuals for 2003 and 2004. For taxable years beginning in 2005, the relationship between the standard deduction for joint filers and single filers returns to current law.

b. Accelerate the expansion of the 15-percent rate bracket for married couples filing joint returns

The Act increases the size of the 15-percent regular income tax bracket for married taxpayers filing joint returns to twice the breadth of the 15-percent regular income tax bracket for single returns for taxable years beginning in 2003 and 2004. For taxable years beginning in 2005, the rate brackets return to current law.

3. Accelerate Reductions in Individual Income Tax Rates

a. Ten-percent regular income tax rate

The Act accelerates the increase in the income levels of the 10 percent bracket so that the income levels currently scheduled for 2008 become effective in 2003 and 2004. Consequently, for 2003 the taxable income level for the 10-percent regular income tax bracket for single individuals is increased from $6,000 to $7,000, and for married taxpayers filing a joint return from $12,000 to $14,000. For 2004, these amounts are indexed for inflation. For taxable years beginning in 2005, the taxable income levels for the 10 percent bracket returns to the levels provided under present law.

SUMMARY OF "JOBS AND GROWTH TAX RELIEF RECONCILATION ACT OF 2003" ("ACT"), SIGNED BY PRESIDENT GEORGE W. BUSH ON MAY 28, 2003, (cont'd)

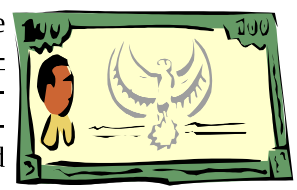
b. Reduction of other regular income tax rates

The Act accelerates the reductions in the regular income tax rates (in excess of the 15-percent regular income tax rate) that were previously scheduled for 2004 and 2006. Consequently, for 2003 and thereafter, the regular income tax rates in excess of 15 percent are 25 percent, 28 percent, 33 percent, and 35 percent. The provision is effective for taxable years beginning in 2003.

c. Alternative minimum tax exemption amounts

The Act increases the alternative minimum tax (AMT) exemption amount for married taxpayers filing a joint return and surviving spouses to $58,000 (from $45,000), and for unmarried taxpayers to $40,250 (from $33,750) for taxable years beginning in 2003 and 2004. Editor's note: the reduction in regular rates may "push" more upper and middle income taxpayers into the AMT, thus increasing a taxpayer's AMT and overall tax liability despite the relief provisions of the Act.

CHARITABLE REMAINDER TRUSTS – TAX PLANNING WITH MARKETABLE SECURITIES



The Charitable Remainder Unitrust ("CRT") is a helpful tool in tax planning for the family. The CRT allows Mom or Dad to accomplish three main goals. First, there is an immediate income tax deduction to the grantor of the CRT equal to the present value of the contribution to Charity. Second, the CRT makes annual cash distributions to Mom or Dad, creating accumulated wealth for them which they can spend or save during their lifetimes and eventually pass on to their children. Third, the CRT ultimately distributes assets to Charity, accomplishing Mom and Dad's charitable goals.

The CRT is tax-exempt, but Mom and Dad are taxed as they receive the annual cash payouts, since these payouts include CRT income (whether ordinary income or capital gain). Because the CRT is tax-exempt, however, and because income realized by the Trust is distributed over time to the beneficiary, the CRT can be used to diversify low basis marketable securities while the resulting tax liability is deferred and spread forward over many years and paid slowly. By selling a low basis stock in a tax-free CRT, Mom and Dad can diversify from a highly-appreciated single stock and receive an investment return on a diversified portfolio of marketable securities at 100% of value (i.e. the portfolio is not reduced due to capital gains tax).

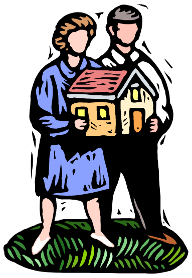
If Mom and Dad sold the low-basis stock outside the CRT, their investment return on the proceeds would be reduced due to the immediate capital gains tax which reduces the portfolio by approximately 15%.

Example 1 – Charitable Remainder Unitrust (Bonds). Mom transfers $500,000 of bonds to a CRT and wishes to receive a unitrust payment of 6% annually. The CRT can provide that she receive 6% of the value of the assets (approximately $30,000) each year. This $30,000 annual payout will be paid first from the Trust's income and then from principal. If the bonds yield at least 6% annually, no principal will be needed to make the unitrust payments. Mom can specify that the annual payment will made to her during her lifetime, and then to Dad for his lifetime. Mom receives four benefits from the CRT: (1) an immediate income tax deduction; (2) the annual cash payouts of $30,000 to her and Dad, which provide a steady stream of income during her and Dad's lifetimes; (3) satisfaction from making a charitable donation at her death; and (4) CRT principal is not subject to Estate Tax for Mom or Dad.

CHARITABLE REMAINDER TRUSTS – TAX PLANNING WITH MARKETABLE SECURITIES, (cont'd)

Example 2 – Charitable Remainder Unitrust (Stocks). Mom transfers a Single Stock worth $1,000,000 (with a low tax basis) to a CRT and wishes to receive a unitrust payment of 5% annually. The CRT can provide that she receive 5% of the value of the assets (approximately $50,000) each year. This $50,000 annual payout will be paid first from the Trust's income and then from principal. The Trustee of the CRT can later sell the Single Stock tax-free, and reinvest the $1,000,000 cash proceeds in a diversified portfolio of stocks and bonds. If the diversified portfolio yields at least 5% annually, no principal will be needed to make the unitrust payments. Moreover, since the CRT is tax-exempt, and since income realized by the Trust can be paid out slowly to Mom, the Trust can be used to immediately diversify low cost investments while deferring the tax liability by spreading forward the taxable distributions to Mom and Dad over many years.

Two Member LLC Provides Family Protection from Personal Liability – LLC is Disregarded Where Owned by Community Property Spouses



The Single Member LLC is a valuable tax and estate planning tool because it is "disregarded" for federal income tax purposes. Since the Single Member LLC is disregarded, it does not exist for federal income tax purposes and its items of taxable gain and loss flow directly to the Single Owner. The Single Member LLC is thus taxed like a branch or division, and requires no separate return nor tax filings. In special situations a Two Member LLC may also be "disregarded" (see PLR 199911033, in which a Two Member Disregarded LLC completed a like-kind exchange).

Revenue Procedure 2002-69 extends the favorable treatment of "disregarded" tax status to Two (2) Member LLCs which are owned solely by spouses as community property owners. This situation typically would occur where the spouses at some point lived in a community property state (e.g. Wisconsin) and transferred community property assets to an LLC owned by them. The IRS has ruled that where husband and wife own the LLC as community property, the LLC is disregarded for federal income tax purposes. As a result, the LLC is not required to file a Partnership Tax Return on Form 1065. Instead, the LLC operates as a direct flow-through branch or division (i.e. without the complications of the partnership tax rules). The spouses are treated as owning the LLC assets directly for federal tax purposes, although the LLC still provides the benefits of state-law creditor protection and asset protection / asset management.

Revenue Procedure 2002-69 provides an additional Tax, Estate Planning, and Liability Containment technique for spouses owning community property assets. Single Member LLCs are often used by a spouse to hold his or her separate property. The Single Member LLC protects the assets from creditors, without imposing any tax consequences or tax filings. Revenue Procedure 2002-69 now extends these advantages to Two Member LLCs for spouses owning community property assets. This new ruling would appear to apply equally to spouses currently living in a community property state, as well as spouses who moved from such a state to a common law state but retained some assets in community property form.

One last point: the IRS has indicated it may extend Revenue Procedure 2002-69 to spouses who own LLCs as non-community property. This treatment would be consistent with established tax principles treating married couples as a single economic unit, and would provide an abundance of new planning opportunities. For instance, the Two-Member Spousal LLC should be exempt from the Diversification Rules of Code Sections 721 and 351, meaning that the spouses could consolidate their investment assets tax-free even if they diversified their portfolios. The spouses would not have to file a Partnership Tax Return (Form 1065) and should avoid State-level entity taxes, such as the Illinois Replacement Tax on partnerships and LLCs.

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Properly Structured Buy-Sell Agreement Can Minimize Income and Estate Taxes

Business owners typically use a Buy-Sell Agreement to accomplish several important goals. First, upon the death of an owner the Buy-Sell Arrangement will provide the surviving owners with continued control of the business. Second, the Agreement is often funded with life insurance to create a liquid cash payout for the family of the deceased owner. Third, the Agreement may assist in creating a ceiling in the value of the business for estate tax purposes.

A Buy-Sell Agreement is often structured as a Cross Purchase (rather than as a Redemption). In a Cross Purchase the surviving owners buy the equity interests in the business from the deceased owner's estate / trustee. The Cross Purchase Buyout enables the surviving owners to take a stepped-up Tax Basis in their purchased shares, and also is more flexible in avoiding estate tax on the insurance proceeds. [Contrarily, a Redemption Agreement, where the business entity effects the buyout, has distinct disadvantages including: (a) the Redemption structure may trigger the "Transfer for Value" rules, resulting in income taxation of the life insurance proceeds; (b) Life Insurance proceeds owned by the business entity may be subject to Estate Tax at the owners death due to attribution; (c) C Corporations are subject to an additional Alternative Minimum Tax on their receipt of life insurance proceeds; (d) the Redemption distribution impairs the entity's capital pool, especially if the insurance proceeds only represent a down payment on the buyout; (e) a Redemption can be recast by the IRS and taxed as a dividend at ordinary income rates instead of favorable capital gains (although the new Tax Act may reduce this last risk)].

To obtain the best possible economic and tax result, careful planning is essential to a proper Buy-Sell Agreement. One technique which appears to work quite well is a Cross Purchase using a limited liability company (LLC). In Private Letter Ruling (PLR) 9309021, the IRS approved a Cross-Purchase Arrangement using an LLC. Although the LLC had no business activities other than holding the insurance, the Arrangement was <u>exempt</u> from the "Transfer for Value" rules. In PLR 9309021, the LLC owned the insurance policies and administered the Buyout. This arrangement avoids the "Transfer for Value" rules, and permits the surviving owners to obtain a Stepped-Up Tax Basis in their purchased shares. The arrangement also reduces administrative costs since only one (1) policy is needed for each owner, and <u>the LLC allows the owners to have equal co-control and co-management over the policies</u>. The owners make capital contributions to the LLC which then pays all premiums on the policies. Upon the death of an owner, the cash insurance proceeds are collected by the LLC. The LLC then distributes the cash proceeds to the surviving owners, who are required to use that cash to purchase the equity interests in the business from the estate / trustee of the deceased owner at an agreed purchase price. The end result is that the deceased owner's estate / family receives a cash payout, and the surviving owners control and own all shares in the business.

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