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IRS creates global high wealth industry group Increased scrutiny and audit-focus on high-net worth individuals

In a report delivered to the AICPA last October, IRS Commissioner Schulman stated that while many high wealth individuals make use of sophisticated financial, business and investment arrangements with complicated legal structures and tax consequences for valid business reasons, other structures could be attempting to mask aggressive tax strategies. In alignment with this belief, the IRS created the Global High Wealth Industry Group, a new compliance unit focused on high wealth individuals and their related entities.

This is part of a continual effort by the IRS over the past several years to try and reduce the federal

tax gap, which, based on the latest IRS estimates from 2005, is approximately \$345 billion. Of that \$345 billion tax gap, more than 50% relates to underreporting on individual income tax returns. The Global High Wealth Industry Group was created to lower the individual tax gap by targeting taxpayers the IRS deems most likely to have financial and investment arrangements that could conceal tax avoidance strategies.

“Initially, the Global High Wealth Industry Group will divert its resources toward the wealthiest of taxpayers: primarily individuals with tens of millions of dollars of income or assets,” said Jason Uetrecht, PricewaterhouseCoopers Personal Financial Services Director. “This is an obvious starting point for the IRS due to the complex nature of these tax returns and the large volume of information involved. The IRS assumes that these individuals are more likely to have significant tax-related legal structures to investigate.”

“Also, because of the volume and dollars involved with a typical high wealth individual’s tax return, any mistakes that are discovered by the IRS are more likely to result in high dollar amounts of tax modification,” said Uetrecht.

This is the IRS’s latest step in targeting high-net worth individuals. Previously, examinations increased nearly 25% for individuals with income over \$200,000 from 2007 to 2008. Similarly, the IRS has started to initiate more audits from examinations of related returns, such as partnerships and trusts. The Global High Wealth Industry Group takes that approach one step further by evaluating every related return in a family unit and examining the transactions between them.

The global high wealth industry group process

Since these enterprises are complex and may include many different types of tax structures, the Global High Wealth Industry Group consists of specialists and experienced agents, with plans to further grow the group in years to come by adding additional specialists.

The general process followed by the Global High Wealth Industry Group will be to take an individual and examine his or her entire network

of business entities, including trusts, real estate investments, royalty and licensing agreements, revenue-based arrangements, private foundations, privately-held companies and partnerships. There will also be a focus on an individual’s international activities, including international sourcing of income and offshore structures and bank accounts.

The group will identify all of the entities related to a high wealth individual and then ensure the proper income and deduction items are being accounted for at both the entity and individual level. “The IRS feels that looking at all of these entities from a holistic point of view will enable their agents to develop a better understanding of the structure’s goals and objectives,” said Uetrecht. “It will likewise enable them to better assess the risk that certain tax structures pose to tax compliance.”

Estate and gift tax scrutiny

Beyond income taxes, IRS efforts will also focus on the estate and gift tax system. This includes:

- Examining local land real estate records trying to discover unreported gifts that, even if not taxable, may use up part of the unified credit.

- Income tax returns with significant decreases in interest income from year to year, to question if there may have been any gifts not reported.
- Gift tax returns with Grantor Retained Annuity Trusts (GRATs).

“The IRS has found several reoccurring issues with GRATs not following provisions of GRAT trust agreements,” said Uetrecht. “This includes GRATs which are not funded properly, that do not make payments to the grantor and those that sell the asset/business 6-9 months after the transfer to the GRAT for a nominal dollar amount more than the original transfer to the GRAT. Any of these factors could raise questions with the original valuation of the gift.”

Preparing for Increased IRS scrutiny

High-net worth individuals, particularly individuals involved in many different types of tax structures, can expect closer scrutiny from the IRS in the coming years. “In order to prepare for the increase in audits, individuals in this group should focus on compliance and understanding what the IRS will look for,” said Uetrecht. “It’s important that taxpayers who may be subject to these types of audits understand any areas of exposure they may have and plan accordingly.”

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Federal estate tax Limbo in 2010

Potential planning opportunities and pitfalls

Contrary to the expectations (and hopes) of most estate planning attorneys and tax advisors, the federal estate and generation-skipping transfer (GST) taxes were allowed to expire at the end of 2009 due to Congressional inaction. Democratic leaders' attempts to extend 2009 estate and GST tax law were stymied by the year-end Senate focus on passing health care reform legislation and disagreements among lawmakers over estate tax policy and other issues. Key lawmakers have suggested the estate and GST taxes may be reinstated retroactively; however, a retroactive tax increase may be politically difficult, especially in an election year. In addition, constitutional challenges are possible. As a result, there is considerable uncertainty about 2010 estate, gift and GST tax law. However, potential planning opportunities may exist during this limited time window, provided the taxpayer is willing to accept the risk of the uncertainty of future legislation and the potential adverse tax consequences that could result.

Current law

As a result of tax law changes enacted under the 2001 Tax Act, the estate and GST taxes are repealed

for decedents dying and generation-skipping transfers made during 2010. (The GST tax is a separate tax that applies, in addition to any estate or gift tax, to transfers to grandchildren or future generations—or trusts for their benefit—and is imposed at the highest estate tax rate. It is intended to replace the estate tax that is essentially avoided at the 2nd/skipped generation.) The gift tax remains in effect during 2010, with a \$1 million exemption amount and a gift tax rate of 35% (down from 45% in 2009).

Also in 2010, the “stepped-up” basis rules for property acquired from a decedent are repealed and a modified carryover basis regime takes effect. Under these rules, each decedent's estate generally is permitted to increase the basis of its assets by \$1.3 million. In addition, the basis of property transferred to a surviving spouse may be increased by an additional \$3 million. When property acquired from a decedent is sold, it generally will be subject to capital gains tax rates.

The 2001 tax law changes are scheduled to “sunset” after 2010 and will be replaced by pre-2001 estate, gift and GST tax law unless Congress acts otherwise. Under this system, a unified graduated rate schedule with a top rate of 55% and a unified estate, gift and GST exemption amount of \$1 million will apply for purposes of determining the tax on cumulative taxable transfers made by a taxpayer through lifetime gift or bequest. Also after 2010, the modified carryover basis regime will be repealed and stepped-up basis will return.

2009 Legislation

Last year, President Barack Obama proposed making 2009 estate, gift and GST tax law permanent for 2010 and beyond. Consistent with this Administration proposal, the US House of Representatives on December 3, 2009, passed H.R. 4154, the Permanent Estate Tax Relief for Families, Farmers and Small Businesses Act of 2009. The bill provides for a top federal estate tax rate of 45% with a \$3.5 million per-person exemption. The House bill also makes permanent 2009 gift and GST tax law.

This bill was projected to reduce federal revenues by approximately \$234 billion over 10 years; however, the estimated cost is not offset and therefore would increase federal budget deficits. To address some House lawmakers' concerns about increasing budget deficits, Democratic leaders included a statutory “pay-as-you-go” (PAYGO) budget requirement to fully offset most new tax cuts or spending. The provision is opposed in the US Senate as it would not apply to permanent extension of 2009 estate tax law and certain other individual tax reliefs scheduled to expire after 2010.

In addition, the House bill faced opposition from Senate Republicans and some Democratic Senators, who favored either repeal or a lower rate and higher exemption. In particular, Senator Blanche Lincoln (D-AR) last year proposed a 35% maximum estate tax rate and \$5 million per-person exemption amount. Given the lack of consensus on a permanent solution, the Senate Democratic

leaders, in the waning days of the 2009 legislative session, tried unsuccessfully to pass a short-term extension of 2009 estate tax law to give Congress additional time to work on a longer-term solution. Because of time constraints and procedural rules, the consent of all Senators was required to pass a short-term extension and Senate Republican leaders objected.

Outlook

The chairmen of the House and Senate tax-writing committees have said they intend to pass legislation to extend 2009 estate, gift and GST tax law for 2010, possibly on a retroactive basis. However, the timing and outlook for passage of such legislation is unclear. Congress is currently focused on completing health care reform legislation. The longer the estate and GST taxes remain expired, the more difficult it may be for lawmakers to support them retroactively, especially for Members of Congress up for re-election this year. If Congress extends the estate and GST taxes retroactively, it is widely anticipated that there will be legal action challenging the constitutionality.

Existing estate planning documents should be reviewed to ensure that the overall intent and plan of disposition are not adversely affected by the change in law, and that the documents are flexible in response to any potential future law changes.

Some observers point to a 1994 Supreme Court decision permitting a retroactive estate tax law change.

Congress could end up passing legislation that represents a middle ground between complete repeal and retroactive renewal. In addition, any 2010 compromise may be combined with legislation to prevent a return to pre-2001 estate, gift and GST tax policy in 2011 and beyond.

Potential planning opportunities and pitfalls

Unfortunately, no one has a crystal ball to predict exactly what changes Congress will make to the current federal estate, gift or GST tax law, particularly with regard to whether any such changes will be made retroactive to January 1, 2010. However, for taxpayers who willing to accept this risk of uncertainty and the potential adverse tax consequences that could result, planning opportunities may exist. More importantly, existing estate planning documents should be reviewed to ensure that the overall intent and plan of disposition are not adversely affected by the change in law, and that the documents are

flexible in response to any potential future law changes. The following are some general issues to consider.

Review current wills and revocable trusts. In order to avoid any federal estate tax at the first spouse's death, most wills and revocable trusts for married persons direct estate assets in excess of a decedent's remaining estate tax exemption to a marital deduction share, which passes to the surviving spouse (either outright or to a marital trust). The exemption amount then passes either outright to the decedent's children, or more typically to a so-called "credit shelter trust" of which the surviving spouse may or may not be a beneficiary. The amount directed to the credit shelter share is typically defined by formula, such as "the largest amount that can pass free of federal estate tax." As no federal estate tax currently exists, all estate assets under this type of formula would be directed to the credit shelter share and no assets would be directed to the marital share. This could cause unintended and disharmonious results, particularly in cases where the credit shelter share is directed to the decedent's children from a prior marriage. Similar formula provisions may be used for unmarried persons to fund charitable bequests, which could also go unfunded using this type of formula if there is no federal estate tax.

In addition, under the new carry over basis regime, only assets passing to the spouse (either outright or to a marital trust) will qualify for the

additional \$3 million spousal basis adjustment. Thus, if all estate assets pass to the credit shelter trust at the first spouse's death, this special spousal basis adjustment would be lost. Moreover, for taxpayers who reside in or own property in states that have a separate state estate tax (such as New York, Delaware, Maryland and Washington, DC), additional state estate tax may result if the credit shelter trust is funded with an amount in excess of the state estate tax exemption, or if a state-only "QTIP" election is not available for assets passing to a QTIP marital trust.

It may be that a relatively simple codicil to one's will or amendment to one's revocable trust could be executed to cure these potential issues. However, because each situation is different, individuals should consult with their estate planning attorney or tax advisor for a thorough review.

Consider taking advantage of potentially tax-free GST transfers.

With no current GST tax in 2010, it may be possible to make transfers for the benefit of grandchildren and future generations that could be exempt from any current or future GST tax, while also structuring the transfer so that it does not result in any current gift tax. However, given the potential that any reinstatement

Given the current legislative uncertainty, no one can predict the ultimate outcome.

of the GST tax for 2010 could be retroactive, such strategies could result in little or no GST tax savings, while legal fees and other transaction costs are incurred.

For example, assets could be transferred to a lifetime "QTIP" marital trust for the donor's spouse, with the remainder passing to a trust for grandchildren at the spouse's death. The gift to the grandchildren could be defined by formula such as "the maximum amount that can pass free of GST tax under applicable law" with any excess amount passing to a trust for the children. Because this lifetime QTIP trust is created when there is no GST tax, there is a possibility that the trust could be grandfathered and exempt from any future GST tax, even if the GST tax is reinstated. In addition, the transfer to the QTIP trust would not result in any current gift or GST tax due to the unlimited marital deduction, provided a timely QTIP election is made on the donor's 2010 gift tax return. However, the trust assets would generally be taxable in the spouse's estate when the estate tax returns in 2011.

In addition, taxpayers implementing a grantor retained annuity trust (GRAT) or charitable lead annuity trust (CLAT) in 2010 may wish to consider including grandchildren as remainder beneficiaries. A GRAT is an estate-freeze strategy, whereby the grantor transfers assets to an irrevocable trust in return for an annuity payable for a term of years equal to the fair market value of the property contributed, plus the IRS's assumed rate of return (Section 7520 rate, which is set monthly

and is currently 3.0% for January 2010). To the extent the GRAT assets appreciate more than the Section 7520 rate, this excess amount passes to the remainder beneficiary and generally avoids taxation in the grantor's estate. A CLAT is similar to a GRAT, except that the annuity is payable to charity. Under pre-2010 law, it was generally not advisable to include grandchildren as remainder beneficiaries of a GRAT or CLAT because the grantor's GST exemption could not be allocated to the transfer until the end of the annuity term, when the assets may have significantly appreciated. However, if no GST tax exists when the GRAT or CLAT is created, the trust could be grandfathered and exempt from any future GST tax. Alternatively, it may be permissible to allocate GST exemption to the value of the assets at the time of transfer, rather than having to wait until the end of the annuity term.

Consider making taxable gifts potentially subject to lower 35% rate.

For those taxpayers who already planned on making taxable gifts and incurring gift tax in 2010, it may be prudent to make such gifts earlier in the year at the current lower 35% gift tax rate (vs. a higher 45% or 55% gift or estate tax rate starting in 2011). It is possible that any reinstatement of the higher 45% gift tax rate could be applied retroactively; however, if gift tax was already expected to be incurred, there does not appear to be much downside to this strategy. There is significant risk, however, in deliberately paying gift tax that would otherwise not have been

incurred absent the potentially lower 35% rate, given that any increase in the gift tax rate may be applied retroactively. This would result in zero gift tax savings and a potentially significant gift tax due.

Conclusion

For a limited time during 2010, it may be desirable to consider undertaking certain estate planning strategies designed to take advantage of the federal estate and GST tax repeal and lower 45% gift tax rate; however, these strategies may come with significant tax risk particularly if they are offered based on a “one size fits all” approach. Given the current legislative uncertainty, no one can predict the ultimate outcome. At a minimum, this a prudent time for individuals to review their current estate plan, and to consult further with their estate planning attorney or tax advisor to ensure that it is consistent with their goals and objectives.

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Planning to sell your residence in 2010? Calculation changes impact real estate capital gains

Signed into law in 2008, the Housing and Economic Recovery Act of 2008 (“HERA”) primarily served as a stimulus package for homeowners. However, this law also included an amendment to existing tax policies for calculating capital gains recognized in selling a residence—a significant change in the process that may impact those who own multiple homes.

This amendment (which went into effect January of 2009) changes the amount of profit you can exclude from the sale of your home. Under the new law, the profit amount is based on a percentage of time during which the house was used as a primary residence. “This was likely included in HERA in order to address a loophole in the system,”

Applying a new ratio

Under the new law, the gain exclusion is calculated based on a ratio:

The aggregate periods of nonqualified use during the period the property was owned by the taxpayer

The period the property was owned by the taxpayer

said Martha Michael, a Director with PricewaterhouseCoopers Personal Financial Services. “Even though this change occurred last year, it has received little coverage and we find there remains a lot of confusion on how this impacts capital gains when selling a residence.”

Previously, a taxpayer could sell their primary residence and use the full exclusion—\$250,000 for a single taxpayer and \$500,000 for a married taxpayer—for the capital gains tax on the sale of the home. The taxpayer could then convert another owned home (such as a vacation home or rental property) into a primary residence by meeting the residency requirement (living in the residence two out of five years). The owner(s) could then sell this second home as the primary residence and again could use the entire exclusion on the sale.

In short, all that was previously necessary to qualify for this exemption was for the taxpayer to own and occupy the home as a principal residence for an aggregate of two of the five years before selling.

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This ratio greatly alters the resulting gain amount. For example:

A married couple purchases a vacation home on January 1, 2009 for \$250,000. Two years later the couple moves into the vacation home and uses it as their principal residence. On January 1, 2013 (two years after moving into the vacation home and making it their primary residence), the couple sells the home for \$700,000. They make a profit of \$450,000.

“Under the old law, the taxpayers would be able to exclude the entire \$500,000 gain since they had lived in the home for two out of five years. Under the new law, they will only be able to exclude one-half of the gain as the ratio is applied,” said Michael. The calculation is illustrated below:

$$\frac{2 \text{ years}}{4 \text{ years}} \times \$450,000 = \$225,000$$

“They will be required to pay capital gains tax on the remaining \$225,000, which is a significant change if this couple were unaware of the new calculation in place,” said Michael.

Determining Occupancy and Nonqualified Use

The new law prevents taxpayers from excluding the gain on the sale of a home attributed to periods of “nonqualified use,” which refers to any period after 2008 when the residence was not used as a primary residence. Short, temporary absences for vacations or seasonal absences are counted as qualified use, even if the taxpayer rents out the property during these periods. (An absence of an entire year will not be considered a temporary absence.) There are several important exclusions when it comes to nonqualified use, the most notable being:

- Any period before January 1, 2009.
- The 5-year period after the last date that the residence is used as a principal residence.
- Any period (not in excess of 10 years) during which the taxpayer is on military duty.
- Any period of temporary absence (not in excess of 2 years) resulting from a change of employment. The change of employment test is satisfied if the taxpayer’s new place of employment is at least 50 miles farther from the residence sold than was the former place of employment. If there is no former place of employment, the distance between the taxpayer’s new place of employment and the residence sold must be at least 50 miles.
- Any period of temporary absence (not in excess of 2 years) resulting from a change of health. For health circumstances, the primary test will be satisfied if the reason for the sale is to obtain, provide,

or facilitate the diagnosis, cure, mitigation, or treatment of disease, illness, or injury.

- Any period of temporary absence (not in excess of 2 years) resulting from unforeseen circumstances. Examples in this case include involuntary conversion; damage to the home from disasters or acts of terrorism; death; loss of employment allowing the taxpayer to receive unemployment compensation; change of employment resulting in the taxpayer’s inability to pay housing costs and living expenses; divorce; legal separation; or multiple births from a single pregnancy. “Other reasons exist, but these are the most common when it comes to ‘unforeseen circumstances,’” said Michael.
- The exclusion will also not apply to the extent the gain is attributable to depreciation allowed for rental or business use of the residence for the periods after May 6, 1997.

Another key aspect in determining your gain exclusion is the question of proving residency. How people prove residency can vary from one state to another, and this has always been a gray area with the IRS. If a taxpayer used more than one residence, the one occupied for the majority of the time is generally considered the principal residence. However, there are also a number of factors that support residency. “The greater number of these factors you can use in support of your residency claim, the better,” said Michael, “so it is important to keep records to support your case.” Examples of these factors include:

- Where the taxpayer spends the majority of their time each year
- The principal place of abode of the taxpayer's family members
- Place of employment
- Address listed on the income tax return(s)
- Address on driver's license and auto registration
- The taxpayer's mailing address for bills and correspondence
- Voter registration
- Banking relationship(s)
- Membership in religious and/or recreational organizations

All of these factors contribute to determining your residency status, and, coupled with any periods of nonqualified use, should be taken into account if you are planning to sell a residence in 2010.

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Recent court case addresses LLC transfer taxes LLCs carry the same wealth transfer advantages as more traditional limited partnerships

While limited partnerships are a commonly applied wealth management tool, LLCs have been gaining in popularity for the added flexibility they often offer in transferring interests—despite the valuation transfer issues that may arise with an LLC over a limited partnership. However, a recent court case involving the valuation of transfers of LLCs ruled in favor of the taxpayer and should encourage a closer look at LLCs as an option to limited partnerships.

The case

In July of 2000, Suzanne Pierre, a New York resident, set up a single-member LLC as part of her estate planning strategy. As she was not treating her LLC as a corporation, she did not file a corporate income tax return for the LLC. That same month, Pierre also created two trusts for her son and

granddaughter. In September, she transferred \$4.25 million in cash and marketable securities to the LLC, then transferred the entire LLC interest into the two trusts she created. The transfers to each trust were structured as a gift of a 9.5% interest and a sale of a 40.5% interest in exchange for a promissory note.

Pierre had obtained an appraisal of her LLC, which valued the membership interest at 30% discount below their fair market value due to the lack of marketability and control. On her gift tax return, Pierre reported the gifts to the trusts as gifts of membership interests in the LLC, valued at \$256,168 for each 9.5% interest. Pierre did not report the transfer of the 40.5% interest on a gift tax return as it was a sale formalized by two promissory notes of \$1,092,133 each. All values included a 30% discount determined by an independent appraiser.

The IRS argued that, because Pierre elected to treat the LLC as a disregarded entity under the check-the-box regulations, the transfers should have been treated as transfers of the underlying assets as opposed to transfers of the LLC membership interests. In short, the IRS did not believe Pierre's transfers were entitled to the valuation discount and valued the reported gifts at \$403,750 per trust.

A recent court case involving the valuation of transfers of LLCs ruled in favor of the taxpayer and should encourage a closer look at LLCs as an option to limited partnerships.

What the court decided...

In a 10-6 split, the court in this case held that, for gift tax purposes, an individual's transfer of membership interests in an LLC shall be valued as a transfer of member interests in the LLC rather than a transfer of the underlying assets. Therefore, the transferor may discount the value of the transfer through the use of valuation discounts for lack of marketability and control (much like with a limited partnership).

In finding for Pierre, the court reasoned that under New York state law, she did not have a property interest in the underlying assets because the LLC was recognized as an entity separate and apart from herself. While the check-the-box regulations govern how a single-member LLC will be taxed for Federal income tax purposes, they do not apply to "disregard the LLC in determining how a donor must be taxed under the Federal gift tax provisions on a transfer of an ownership interest in the LLC." To find otherwise would be to "require that Federal law, not State law, apply to define the property rights and interests transferred by a donor for valuation purposes under the Federal gift tax regime." The majority reasoned this was an inappropriate interpretation and that the purpose of the language "for Federal tax purposes" was "to cover the classification of an entity for federal income tax purposes" and not to alter the federal gift tax valuation regime.

Implications of this decision

This decision allows LLCs the same valuation discounts enjoyed by limited partnerships for transfer tax purposes. This may prove useful in a wealth transfer context as taxpayers strive to pass wealth and entity control from one generation to the next. LLCs have many advantages that partnerships do not, including limited liability and less stringent member agreements. If they also share the same wealth transfer advantages, LLCs may well become the transfer vehicle of choice for business succession and estate planning purposes.

Also, this case shows that the Tax Court continues to take issue with disregarded entities and their incidences of taxation. The decision suggests that there are distinctions between income and transfer taxation and as such, different layers of tax treatment exist within a single entity.

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