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In this issue

Healthcare legislation impact on personal income tax

Report of Foreign Bank and Financial Accounts (FBAR) scrutiny calls for re-evaluating financial-planning needs

Court ruling a consideration in use of LLCs and family limited partnerships

Roth conversions: a unique investment opportunity for 2010

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Healthcare legislation impact on personal income tax

Background

Since inauguration, President Obama has signalled his intent to push through legislation aimed at significantly modifying the nation's healthcare system. On March 23, 2010, the president signed into law the Patient Protection and Affordable Care Act and subsequently, on March 30, signed into law the Health Care and Education Reconciliation Act of 2010. To pay for the healthcare initiatives included in the legislation, these bills significantly increase the tax burden on high-net-worth individuals.

The impact of these tax increases will be compounded if the 2001 and 2003 tax cuts expire in 2011, as scheduled, returning the top two individual income tax rates to 36% and 39.6%, with long-term capital gains taxed at 20%.

The changes

Required healthcare insurance coverage—Effective January 1, 2014, all US citizens will be required to have qualifying healthcare coverage. Failure to have coverage will result in a per-adult penalty of the greater of a flat dollar amount ranging from $95 to $695, or 1% of household income. The 1% penalty will increase to 2.5% in years after 2016. Penalties for uninsured children under the age of 18 will be one-half of the adult penalty.

Increased Medicare/hospital insurance tax—Currently, employers are required to withhold from an employee's earnings 6.2% Social Security tax and 1.45% Medicare/hospital insurance (HI) tax. The Social Security (OASDI) portion of the tax applies to only the first $106,800 of wages, while the Medicare/HI portion applies to all wages, regardless of amount. The recent legislation increases the HI tax by 0.9% to 2.35% on wages earned in excess of $250,000 for married persons filing joint returns, $125,000 for married

persons filing separate returns, and $200,000 for all other taxpayers, for periods beginning January 1, 2013. This increase applies only to the employee portion of the Medicare tax, and not to the employer portion. This increase in the Medicare tax also applies to the Medicare portion of the self-employment tax.

New tax on investment income— The new legislation imposes a 3.8% tax on certain net investment income, effective January 1, 2013. Investment income includes gross income from interest, dividends, annuities, rents, royalties not associated with a trade or business, net capital gain and working capital interests. The law also extends the tax to income from pass-through entities in which the taxpayer does not materially participate. Deductions properly allocable to such income are permitted to reduce the income such that net investment income is subject to the additional 3.8% tax. (Essentially the tax is being levied on the passive and portfolio income.) The tax applies to the lesser of net investment income or the amount by which modified adjusted gross income exceeds the threshold. The threshold amount is $250,000 for married persons filing joint returns, $125,000 for married taxpayers filing separate returns, and $200,000 for single taxpayers. The tax is also levied on estates and trusts but does not apply to distributions from qualified retirement plans, income from active trades or businesses, or earned income that is otherwise subject to Social Security and Medicare taxes.

Changes in health savings accounts— The legislation imposes new limits on the use of health savings accounts (HSAs), flexible savings accounts (FSAs), and Archer medical savings accounts (MSAs). For purposes of all such accounts, the legislation conforms the definition of medical expenses for Schedule A deduction purposes, effectively eliminating the deduction for over-the-counter drugs that are not prescribed by a doctor. This provision is effective for years beginning after December 31, 2010. Furthermore, beginning January 1, 2013 the maximum contribution to an FSA will be $2,500, but this amount will be indexed annually for inflation. In addition, the penalty for distributions from HSA and Archer MSA accounts not used for qualified medical expenses is increased to 20 percent.

Planning opportunities

It is important for all taxpayers to assess their exposure to the new taxes and increased rates. First, the increase in the Medicare tax of 0.9% applies to household taxable wages or self-employment income in excess of $250,000 for married couples filing joint returns. However, your employer is not required to withhold the additional 0.9% if your earnings are not in excess of $200,000. Therefore, if both you and your spouse are employed and your combined wages exceed $250,000, it is possible that your taxes could be under-withheld and that you will owe additional tax. Moreover, where one or both spouses have self-employment income, an assessment should be done to determine the impact of the tax on a household basis.

Second, the tax on net investment income presents an opportunity to review income-generating activities and the taxpayer's involvement in them. Because the tax is levied on passive activities but not on active trade or business income, you should analyze your participation in the business with your tax adviser to determine if you are active or passive with respect to the activity, or what steps could be taken to become active in the business. With regard to investment income, you might consider accelerating some of this income into periods prior to the effective date of the tax. For example, if selling a stock and realizing a capital gain makes sense from an investment standpoint, doing so before January 1, 2013 will ensure that the gain is not subject to the new 3.8% tax on net investment income.

Conversely, where you can defer deductions, such as investment management fees and investment interest expense, it would be beneficial to pay those expenses after January 1, 2013 so that they reduce the amount of your net investment income that is subject to the new tax.

It is important for all taxpayers to assess their exposure to the new taxes and increased rates.

Report of Foreign Bank and Financial Accounts (FBAR) scrutiny calls for re-evaluating financial-planning needs

Over the last year, the IRS has increased its focus on high-net-worth individuals, along with their tax returns and reporting. Efforts such as the creation of the Global High Wealth Industry Group (which targets taxpayers the IRS deems most likely to have financial investment arrangements that could conceal tax-avoidance strategies), hiring additional IRS agents and specialists, and changes in legislation that impact high-wealth management strategies all point to increased scrutiny of this demographic's finances.

Another aspect of these IRS efforts concerns FBAR, or Report of Foreign Bank and Financial Accounts. These are forms the IRS requires of any US person who has "a financial interest in or signature authority, or other authority over any financial account in a foreign country, if the aggregate value of these accounts exceeds $10,000 at any time during the calendar year." There are no taxes associated with filing a FBAR; it is primarily an information-gathering tool for the IRS.

While FBAR reporting is not a new process, the filing requirements have recently become more complicated, and the related penalties more severe. "The level of detail needed in a FBAR form has made the process more onerous," says PricewaterhouseCoopers' Personal Financial Services Partner Alfred Peguero. "Those who fall under FBAR requirements should be aware that complying with all the FBAR rules is becoming more of a challenge."

Who needs to follow FBAR reporting requirements?

In late February the IRS announced the continued suspension of the requirement for foreign persons (i.e., persons who are not US citizens, US residents, or domestic entities) to file FBARs for calendar years 2008 and 2009. Otherwise, a FBAR is required for each foreign financial account held. This includes private investments in a foreign country, any funds coming from a foreign country, inheritance from family members abroad, and beneficial interests in foreign trusts — essentially the US requires information and taxes on worldwide income regardless of whether the funds have ever been on US soil. "However, the IRS guidance on which particular account aspects need to be reported is not entirely clear, generating a lot of uncertainty in reporting," says Peguero.

Peguero describes one recent scenario: "I worked with a European individual whose spouse is from the US, and even though they've lived outside the US for over ten years, her name is on the accounts and they are subject to FBAR requirements. That caught them by surprise—they didn't realize that's how the system works." Not understanding how FBAR is applied is a common issue for foreign account holders, according to Peguero.

Another situation Peguero describes involves people who have been approached by a tax shelter promoter to keep money off-shore. Those using these services are often incorrectly advised that they do not need to complete FBARs. If you have entered into such a tax-motivated transaction, the penalties are even higher, so it is important to review your reporting requirements and submit the necessary documentation. Honest errors have a tendency to be treated leniently by the IRS.

Challenges and considerations in following FBAR requirements

Timing—According to the IRS, the FBAR must be received by June 30 of the year following the year that the account holder meets the $10,000 threshold on any given day within the calendar year. However, if you have only a signatory interest in a foreign financial account, you are permitted a one-year filing extension beyond the June 30, 2010 deadline, per an IRS policy announced in late February. Those with a financial interest in a foreign financial account must still adhere to the June 30, 2010 deadline. This timing, in addition to the time needed to accurately complete and submit the needed forms, should be taken into account.

A FBAR is required for each foreign financial account held.

Changes in working with foreign banks—Due to increased US scrutiny, some foreign banks and hedge funds are opting to close accounts held by US persons. (The term *US person* covers US citizens, as well as resident aliens, such as holders of green cards.) This is also something to take into consideration if you are planning to open a foreign account: Be aware that some foreign options will be unavailable to US persons as the institution will not want to assume compliance responsibility.

Another consideration in working with foreign banks is the cost associated with completing the required FBAR forms. Whether you choose to complete them yourself or work with an adviser, this aspect should be taken into account when evaluating the overall cost of the investment.

More countries are agreeing to disclose financial information to the US—Scrutiny in this area is increasing around the world, even in financial markets such as Switzerland that have historically been considered "secretive." The IRS is currently investigating tax shelter havens in the Caribbean and Asia, and will continue to target countries with financial information they want to access.

"There are a number of countries on the list that have agreed to share information with the US," says Peguero. "If people think they won't get caught, it's really only a matter of when financial information is reported to the US Treasury."

Potential consequences of failing to provide a FBAR

"This is not a process you want to put off," says Peguero. "It's time-consuming but needs to be dealt with, given the repercussions that come with *not* reporting your foreign accounts."

The penalties for inaccurate reporting are substantial and include civil and criminal penalties. The government can seize up to 50% of an account's highest value, meaning that one could face penalties exceeding the current account value if there are multiple reporting failures. The severity of the penalty depends on if the failure is considered negligent or willful and whether it is part of a pattern of negligent or willful activity.

Potential penalties include:

- Negligent violation—civil penalty up to $500
- Nonwillful violation—civil penalty of up to $10,000 for each violation
- Pattern of negligent activity—civil penalty for any such violation (not more than $50,000), in addition to other penalties
- Willful failure to file FBAR or retain records—civil penalty up to the greater of $100,000 or 50% of the amount in the account at the time of the violation; criminal penalties up to $250,000 or five years in jail, or both
- Willful failure to file FBAR or retain records of accounts while violating certain other laws—civil penalty up to the greater of $100,000 or 50% of the amount in the account at the time of violation, and a criminal penalty up to $500,000 or 10 years in jail, or both
- Knowingly and willfully filing false FBAR—civil penalty of $100,000 or 50% of the amount in the account; criminal penalty of $10,000 or five years in jail, or both
- Potential civil fraud penalty—75% of the portion of the underpayment of tax liability due to fraud

"If you learn that you were required to file FBARs for earlier years, you should file the delinquent FBAR reports and attach a statement explaining why the reports are filed late," says Peguero. "Penalties might not be asserted if the IRS determines that the late filings were due to reasonable cause. Keep copies for your records of what you send."

The penalties for inaccurate reporting are substantial and include civil and criminal penalties.

Making FBAR filing part of your ongoing wealth management strategy

"If you have foreign accounts, be proactive. You may want to re-evaluate your financial plan to account for FBAR needs," says Peguero. "You're not paying additional taxes—this is a matter of correct reporting."

Peguero adds that pending legislation will likely affect FBAR requirements. "If you opt to work with a financial adviser for your reporting, make sure that person is up to speed on FBAR-related rulings."

Court ruling a consideration in use of LLCs and family limited partnerships

Introduction

In recent years, the use of limited liability companies (LLCs) and family limited partnerships has been a common tool for passing wealth from one generation to the next. A familiar pattern is one in which parents make incremental transfers of ownership in these entities to their children, taking advantage of the gift-tax annual exclusion (currently $13,000 per person in 2010). Such a strategy over time can help reduce payment of—or prevent the need to pay—gift taxes, and many clients automatically think that their transactions will qualify them for the exclusion. While careful structuring of these transactions can result in substantial gift-tax savings, a recent court case should put advisors on notice that the annual exclusion is anything but automatic.

The case

From 2000 through 2002, John and Janice Fisher transferred 4.762% of ownership interests in an LLC to each of their seven children. The major asset of the LLC at the time was undeveloped waterfront land on Lake Michigan. In each of those years, gift-tax returns were filed, claiming annual exclusions as to those transfers. However, upon an IRS audit, a gift-tax deficiency was assessed and the annual exclusions claimed on the gifts were disallowed.

The IRS argued that transfers of LLC interests to the children were not a "present interest" that would qualify for the annual exclusion. Instead, the IRS deemed these gifts "future interests," which the children were not immediately entitled to upon transfer from their parents. Because future interests do not fall under the umbrella of the annual exclusion, the IRS assessed an additional gift-tax liability on the Fishers' gifts.

The court's ruling

The United States District Court for the Southern District of Indiana ruled in favor of the IRS, upholding the assessment. Citing precedent from other federal cases, the court defined a present interest as the unrestricted right, without postponement, to the immediate use, possession or enjoyment of the property. More importantly, the court stressed that for a gift to be considered a present interest, the transferee must have the right to a substantial, present economic benefit upon receipt of the gift. The court ruled that the Fisher children did not realize any present economic benefit upon transfer of the LLC interests.

While careful structuring of LLC and family limited partnership transactions can result in substantial gift-tax savings, a recent court case should put advisors on notice that the annual exclusion is anything but automatic.

The court looked to the operating agreement of the LLC when giving its reasoning. First, the agreement put forth many contingencies before any of the Fisher children could receive distributions of capital from the company. In fact, such distributions were at the complete discretion of the LLC general manager. In addition, the operating agreement restricted the children's ability to freely transfer their LLC interests to others. Even though the children owned their LLC interests outright, the restrictions placed on their ownership did not entitle them to "immediate economic value," which is the hallmark of a present interest.

Lastly, the Fishers argued that their children's mere right to use and enjoy the lakefront property would qualify the gifts as a present interest. The court was unmoved by this argument, pointing out that enjoyment of the property, without more, did not demonstrate any immediate economic value.

Lessons from the decision

Many families look to the use of LLCs as a flexible way to transfer ownership and maintain control during the older generation's lifetime. They are great vehicles for holding real estate, such as a vacation home or other family homestead. However, the decision in the Fisher case should give estate planners pause when drafting operating agreements and imposing restrictions on the younger generation. Such limitations could come with a price: the loss of the annual exclusion.

Roth conversions: a unique investment opportunity for 2010

A sound financial strategy encompasses the key elements that contribute to your overall financial health, including tax planning, insurance, portfolio management and investment planning. This strategy should be reviewed on a periodic basis to take into account any changes in market conditions or your individual situation. One such change arrived for 2010: As a result of the Tax Increase Prevention and Reconciliation Act of 2005, high-income taxpayers now have, for the first time, the option to roll over traditional IRA accounts into Roth IRAs.

What is the difference between a traditional IRA and a Roth IRA?

An IRA (individual retirement account) provides an individual with a tax-deferred or tax-free method for retirement savings. While there are many types of retirement savings plans available, the most common are the traditional and Roth IRAs; the main differences between the two are whether your contributions are pre-tax or post-tax, and whether you have a minimum-distribution requirement. Both allow a portfolio of stocks, bonds, mutual funds and other assets owned by the account holder to accumulate in a tax-advantaged manner.

Under a traditional IRA, the account is created and the account holder may receive an upfront tax deduction upon contribution. The account holder pays taxes only when funds are withdrawn. Under a traditional IRA, the account holder is subject to minimum-distribution requirements: You can begin withdrawing funds at age 59½ without penalty for early withdrawal but, beginning at age 70½, are required to take minimum distributions.

With a Roth IRA, the account holder contributes after-tax dollars, but the income and growth are not subject to tax when distributed, provided that the distribution satisfies a five-year holding period and takes place after the account holder reaches age 59½ (or on account of death or disability, or to meet first-time homebuyer expenses). The minimum-distribution rules that apply to traditional IRAs do not apply to Roth IRAs, which means that after the account holder reaches age 70½, the account can continue to grow tax-free.

For both traditional and Roth IRAs, you are limited to how much you can contribute on an annual basis. Traditional and Roth IRA account holders can both contribute up to $5,000 for 2010 (with a $1,000 catch-up contribution allowed if you are over 50). Contributions to the Roth IRA are subject to income limits, and those income limits may not allow any of the $5,000 to be contributed. Although there are no income limits for traditional IRA contributions, there are income limits (combined, if you are participating in another retirement plan) to determine how much of your contribution is deductible. A Roth contribution is never deductible, since it is made with after-tax dollars.

What is the change to Roth IRAs in 2010?

Prior to 2010, high-income taxpayers (defined as single people with an adjusted gross income over $120,000 and married people with an adjusted gross income over $176,000) were not permitted to establish and contribute to Roth IRAs. Taxpayers with an adjusted gross income greater than $100,000 were also not allowed to convert existing traditional IRAs into Roth IRAs. In 2010, high-income taxpayers will be allowed to convert existing IRAs into Roth IRAs, since the income limitation will no longer apply to conversions.

However, Roth IRA contributions are still subject to the income limitations, so during 2010, if someone is married and filing jointly, he or she can contribute $5,000 ($6,000 if the contributor is 50 years or older) to a Roth IRA only if his or her modified adjusted gross income is below $166,000. If his or her married adjusted gross income is between $166,000 and $176,000, he or she can contribute a reduced amount to the Roth IRA, and if his or her married adjusted gross income exceeds $176,000, he or she cannot make contributions directly to the Roth IRA.

Benefits of converting to a Roth IRA

- Distributions from a Roth IRA are generally income tax-free for accounts in existence for at least five years.
- Required minimum distributions do not apply to Roth IRAs, unlike traditional IRAs and other qualified plans.
- Payment of income taxes upon conversion reduces the taxpayer's gross estate.
- Taxpayers can pay the income tax on the conversion with non-IRA funds for tax-free benefits during their lifetime (as well as an income tax-free legacy to heirs). When comparing a Roth IRA to a traditional IRA of the same amounts, take into account that the Roth IRA dollars are after-tax dollars that will grow income tax-free, as opposed to the traditional IRA dollars, which will be subject to the income tax at ordinary rates when distributions are required. As a result, the payment of the income tax upon the conversion from other funds outside the converted IRA is considered to be the equivalent of a one-time lump sum contribution to the Roth of the tax liability amount.
- Taxpayers converting in 2010 have until October 15, 2011 to undo (re-characterize) the conversion if the Roth IRA assets and investments converted declined in value. This allows the taxpayer to avoid paying the income tax on the higher IRA value.
- Roth IRA conversions are beneficial in an environment of rising taxes and down financial markets.
- Roth IRA conversions are attractive for taxpayers who are currently taking their required minimum distributions, but do not necessarily need the funds. Once the IRA is converted, the minimum-distribution requirement will no longer apply; however it will apply upon the owner's death. (Inherited Roth IRAs are subject to required distributions by the beneficiaries over their life expectancy or by depleting the Roth IRA by December 31 of the fifth anniversary of the date of death.)
- Taxpayers with expiring tax attributes (such as large charitable contribution deductions, large alternative minimum tax credit carryovers and net operating loss) in the current year should consider the impact on the tax liability upon conversion.

Planning ideas for consideration

Conventional tax-planning wisdom indicates that income taxes should be deferred as long as possible. However, this thinking may not be the case with a Roth IRA conversion, so additional planning ideas should be considered:

- Convert early in the year to start the once-in-a-lifetime five-year holding period qualifying Roth IRA distributions for tax-free treatment.
- Paying for the income tax on the conversion with funds outside your IRA is the equivalent of making an additional lump-sum contribution to the Roth IRA equal to the tax liability paid.

- Convert your IRA into multiple Roth IRAs, separated by asset classes. This allows flexibility to re-characterize the Roth IRA with the lowest investment returns by the tax return deadline (including extensions).
- High-income taxpayers can start a nondeductible IRA and contribute on an annual basis the allowed maximum ($5,000 in 2010; $6,000 if the contributor is 50 years or older), then elect to convert these amounts to a Roth IRA each year.
- Consider converting your IRA in 2010 to take advantage of a special rule allowing the taxpayer to spread the tax liability between 2011 and 2012, as opposed to paying the full tax liability in 2010. However, future possible tax rate increases may make it more advantageous to pay all taxes in 2010.
- Partial conversions can also be considered, as a Roth conversion is not necessarily an all-or-nothing option.
- Taxpayers unwinding their Roth IRA conversion in light of the turbulent stock market can re-convert after meeting certain deadlines.
- The tax-free accumulation of income in a Roth IRA is particularly attractive for younger taxpayers, as sheltering years of earnings in this manner can lead to enormous compounding.

The minimum-distribution rules that apply to traditional IRAs do not apply to Roth IRAs, which means the account can continue to grow tax-free after the holder turns age 70½.

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