ADVANCED PLANNING bulletin

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Emergency Economic Stabilization Act
- What We Need to Know 2

Giving Made Easier
- Annual Exclusion Jumps to $13,000 6

Disclaimer Planning
- Used in Clean Up Mode 8

Brief Summaries of other planning and legal developments
- LLC S Elections 10

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Selected Provisions of the Emergency Economic Stabilization Act of 2008

On October 3, 2008, the Emergency Economic Stabilization Act of 2008 was signed into law. Selected provisions are summarized in this article. Each topic includes a summary of current law, the new law, its effective date and observations. Section references are to the Internal Revenue Code.

A. Tax-Free Distributions from Individual Retirement Accounts for Charitable Giving (§ 408(d)(8))

Current Law: Initially enacted as part of the Pension Protection Act of 2006, the ability to do a charitable IRA rollover was to expire at the end of 2007.

New Law: The charitable IRA rollover is now extended to the 2008 and 2009 tax years. An individual, upon attaining age 70½, can make a lifetime gift of IRA funds directly from the IRA to a qualified charity without including the amount in income and, of course, without taking a charitable deduction. The maximum gift is $100,000 per year for each of 2008 and 2009. The transfer must be made by the IRA custodian, meaning that the funds must not touch the individual's hands. The distribution counts as part of the individual's required minimum distribution (RMD). If the IRA has any basis, the contribution is deemed to come first from the taxable portion. If any portion is non-taxable, the individual can count that amount as a charitable contribution and take it as an itemized deduction. The entire payment must be a charitable contribution; if the donor receives a benefit (i.e., a $5,000 donation to attend a dinner where the cost of the dinner is $75), none of the payment qualifies for this treatment. This charitable rollover treatment does not apply to SEP or SIMPLE IRAs nor to qualified plans. Also, distributions must be made to a public charity or conduit private foundation; distributions to a donor-advised fund, charitable remainder trust or supporting organization do not get this treatment.

Effective Date: For distributions in 2008 and 2009.

Observations: Despite our initial reservations about whether IRA custodians would permit individuals to actually take advantage of charitable IRA rollovers, this part of the Pension Protection Act of 2006 apparently proved popular enough that Congress sought to extend it beyond the two year period for which it was initially approved.

This charitable IRA rollover is great for those taxpayers who:

1. Do not itemize since, under old law, they would have included the distribution in income without any deduction. Under the new law, they do not include the amount in income.
2. Itemize because the income exclusion keeps their AGI lower, which translates to a potential increase in itemized deductions and personal exemptions if they are phased out and a lower floor for medical expenses (7.5% of AGI), non-business casualty losses (10% of AGI) and miscellaneous expenses (2% of AGI).
3. Don't need their RMDs. This change will lower their tax liability, and the charitable contribution will lower the account value, which will result in lower future RMDs.
4. Receive social security benefits; it may help to keep their income low enough to decrease or even eliminate the portion of social security benefits that are subject to income tax.
5. Live in states without state charitable deductions; this will lower their taxable income while still allowing them to make charitable contributions.
6. Make charitable gifts greater than the 50% AGI limitation; a charitable IRA rollover will garner a tax benefit without being subject to this limitation.

One word of advice – be sure to comply with all the requirements; failure to do so will result in having taxable income and a charitable contribution as an itemized deduction.

B. Special Rules for Tax Treatment of Executive Compensation of Employers Participating in the Troubled Assets Relief Program (§ 162)

Current Law: None

New Law: The employer's deduction under § 162 for executive compensation paid is limited where the employer sells more than $300 million worth of "troubled assets" pursuant to the Troubled Assets Relief Program established under § 101(a) of the Act.

Effective Date: For tax years ending on or after October 3, 2008.

Observations: The impact of these provisions is likely to be slight. Given that an employer has to be a participant in the Troubled Assets Relief Program to the tune of at least $300 million, the majority of employers can continue to offer executive compensation free from the effect of these rules.

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C. Extension of Exclusion from Income for Discharge of Qualified Principal Residence Indebtedness (§ 180(a)(1)(E))

Current Law: Discharge of debt related to a qualified principal residence is not taxable income under § 108(a)(1)(E) if the debt is discharged before January 1, 2010.

New Law: The Act extends this treatment for debts discharged before January 1, 2013.

Effective Date: Applies to discharges of indebtedness occurring on or after January 1, 2010. (Current law applies to similar discharges occurring before this date.)

Observations: The sub-prime mortgage meltdown has caused (and is expected to cause) countless foreclosures. For taxpayers whose homes are foreclosed upon, this new rule ensures that those taxpayers won't pay a tax for the discharge of indebtedness. The Act merely extends this assistance, which was created in the Mortgage Forgiveness Debt Relief Act of 2007, through 2012. Hopefully, this doesn't mean that we'll be seeing multitudes of foreclosures for the next four years.

D. Non-Qualified Deferred Compensation for U.S. Employees of Foreign Employers (§ 457A)

Current Law: Employees can defer income tax until compensation is actually or constructively received. Employers generally cannot deduct compensation until it is actually paid. Employers pay tax on amounts set aside to informally fund the arrangement. Thus, employers have an incentive to pay the deferred compensation as soon as possible to take the compensation deduction.

Since non-profits are not concerned with taking deductions and are not concerned with paying tax on informally-funded assets, a non-profit's employee with a § 457(f) plan (an ineligible plan) is taxed on the entire amount when there is no longer a substantial risk of forfeiture, regardless of when that amount is actually paid.

Similarly, employers in low or no tax foreign jurisdictions are not concerned with deductions nor tax on informally-funded assets. However, the rules that apply to non-profits do not apply in any similar fashion to U.S. employees of employers in low or no tax foreign jurisdictions.

New Law: The apparent gap with respect to U.S. employees of employers in low or no tax foreign jurisdictions is now dealt with by new § 457A. This new

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statute provides that non-qualified deferred compensation of "non-qualified entities" (defined below) is not taxed to the employee while a substantial risk of forfeiture exists. When the substantial risk of forfeiture ceases, the entire amount is included in the employee's gross income. A substantial risk of forfeiture exists only if the employee's right to the compensation is conditioned upon the future performance of substantial services – a definition which is identical to that of §§ 83(f)(1) and 409A(d)(4). For this statute, non-qualified deferred compensation means the same thing that it does under § 409A. A non-qualified entity includes foreign corporations (unless most of their income is connected to a U.S. trade or business or taxed in a foreign jurisdiction) and foreign and domestic partnerships (unless certain exceptions are met).

Effective Date: For amounts deferred based upon services performed on or after January 1, 2009.

Observation: The statute mimics the rules for ineligible § 457 plans: the entire amount is included in the employee's income when there is no longer a risk of forfeiture regardless of when actually paid. The statute targets deferred compensation arrangements established for managers of off-shore hedge funds located in low or no tax foreign jurisdictions. Absent this statute, employers in these jurisdictions have little or no incentive to pay out the deferred compensation.

E. Alternative Minimum Tax Patch Extended (§ 55(d))

Current Law: The Alternative Minimum Tax (AMT) exemption was $66,250 for a married couple filing jointly ($44,350 for single individual) in 2007, dropping to $45,000 ($33,750 if single) in 2008.

New Law: The higher exemption of $66,250 ($44,350 if single) is extended through 2008. In 2009, the exemption falls back to $45,000 ($33,750 if single).

Observations: Raising the exemption is the main tool used by Congress to reduce the number of people that pay AMT. Instead of raising it permanently, Congress raises it on a year-by-year basis.

Effective Date: For 2008.

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Giving More Made Easier: Annual Exclusion for Gifts Increased to $13,000 in 2009

Dad and Mom are married and have two children, Son and Daughter. Dad wants to give money to Son and Daughter. As of January 1, 2009, Dad can give $13,000 gift tax free (and without using any of his $1 million gift tax exemption) to each child (or anyone, for that matter) in each calendar year by using the annual exclusion.[1]

To qualify for the annual exclusion, the gifts must be of a present interest, meaning Son and Daughter must be able to immediately use, possess, or enjoy the gifts or the income they produce, without any restrictions. Let's say that Dad decides not to give the children outright gifts of cash but would prefer that the money be held in trust. Dad sets up an irrevocable trust and names Mom as trustee, and Mom, Son and Daughter as trust beneficiaries. Dad gives the money to Mom, as trustee, who decides to use it to pay for the first premium on some life insurance. See Having Your Cake and Eating It Too: The Spousal Irrevocable Life Insurance Trust, *Advanced Planning Library, 2005.*

Dad's gift to the irrevocable trust will not be of a present interest unless Son and Daughter, as the trust beneficiaries, have an immediate, unrestricted right to withdraw amounts equal to the value of the gift. This withdrawal right is commonly referred to as a Crummey power. By giving Son and Daughter these powers, up to $26,000 of Dad's gift qualifies for the annual exclusion.

Dad can actually contribute more than $26,000 to this trust and stay within the annual exclusion amount by using Mom's annual exclusion. This is known as gift splitting. To do this, Dad files a gift tax return, on which Mom consents to Dad using her annual exclusion. Once elected, gift splitting applies to all gifts made by either Mom or Dad (other than to each other) during the calendar year. By gift splitting, Dad can give up to $52,000 of his money to the trust per year and stay within the annual exclusions.

Even though Mom's annual exclusion is used, she has not made a gift of her money. This is important because if Mom gives her money to a trust of which she is a beneficiary, the trust assets are included in her estate.[2] Mom's role as trustee does not cause estate inclusion as long as distributions she can make to herself are for health, education, maintenance and support and as long as she cannot make distributions to discharge her legal obligations, such as making distributions for the support of Son and Daughter.

Could Dad increase his annual gift to the trust from $52,000 to $65,000 if Mom has a Crummey power, too? Dad could, but it creates a problem for Mom. When Mom does not withdraw the $13,000, she's treated as if she gave some of the assets back to the trust. Her gift is the amount that exceeds the greater of $5,000 or 5% of the value of the assets out of which the power can be satisfied (generally, all of the trust assets). When Mom gives assets to a trust of which she is a

[1] The annual exclusion was $11,000 from 2002 through 2005 and $12,000 from 2006 through 2008.
[2] Treas. Reg. § 20.2041-3(d)(1); § 2036(a)(2).

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beneficiary, she has estate inclusion.[3] The same estate inclusion goes for Son and Daughter but since trust assets will normally be distributed outright to them at some point, we're not as concerned with that issue.

To avoid this estate inclusion problem for Mom, the trust should limit her right to withdraw from the trust to the greater of $5,000 or 5% of the value of the assets out of which the power can be satisfied (often referred to as a 5x5 power). By limiting Mom's withdrawal power to the 5x5 amount, Dad can make an additional $5,000 annual exclusion gift, for a grand total of $57,000 of annual exclusion in 2009 without creating estate inclusion problems for Mom.

A larger annual exclusion translates into more tax-free giving. Be careful though; gifts to existing trusts can only take advantage of the $13,000 annual exclusion if the trust document gives the Crummey beneficiaries the right to withdraw that amount.

[3] Id.

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Using a Disclaimer to Mop Up a Taxation Mess
Private Letter Ruling 2008-40-023 (October 3, 2008)

Background: What happens when you discover that Grandmother's estate plan creates unexpected taxation – and she is already dead? This recent Private Letter Ruling serves as a reminder that the timely and proper use of a disclaimer can be used to "clean up" an unexpected estate tax mess.

Facts: Grandmother dies, leaving a spouse, four daughters, two stepchildren, and ten grandchildren, seven of whom are minors. In her will, Grandmother gives some stocks and bonds to a trust for her ten grandchildren. The residue of her estate passes to her spouse. The daughters petition the court to enable them, as conservators for their minor children, to disclaim a fraction of each minor grandchild's interest in the trust. The amount to be disclaimed is the amount that would have been subject to the generation skipping transfer tax. The three adult grandchildren plan to disclaim their fractional interests as well. The guardian ad litem for the minor grandchildren recommends that the petition be granted. The court approves the disclaimers, conditioned on the executor obtaining a favorable letter ruling from the I.R.S.

Rulings requested:
1. Are the disclaimers qualified disclaimers?
2. Do the disclaimed assets, which will pass to the surviving spouse, qualify for the estate tax marital deduction?

Rulings:
1. The disclaimers are qualified disclaimers as long as they are valid under state property law.
2. The disclaimed assets, which pass to the surviving spouse, qualify for the marital deduction.

Analysis: The family wants qualified disclaimer treatment so that the grandchildren will not be making gifts of the disclaimed property. At first blush, the proposed disclaimers look like they meet the requirements that the disclaimer be:

1. Irrevocable;
2. In writing;
3. Delivered within nine months of the death or the date on which a disclaimant reaches age 21 (whichever is later); and that
4. No benefits were received by the disclaimant from the disclaimed property; and
5. The interest passes without any direction from the disclaimant.[4]

So, what could get in our way? First, can one disclaim a portion of a beneficial trust interest? Yes; however, the disclaimed portion must be a fraction of each and every substantial interest or

[4] § 2518(b).

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right owned by the disclaimant and must extend over the entire term of the disclaimant's interest.[5] The proposed disclaimers comply.

Second, can a minor, even through a conservator, disclaim? In this case, state law authorizes a conservator to disclaim on behalf of a minor with court approval, which the conservators obtained.

Third, are the disclaimers valid under state property law? The ruling properly refuses to rule on this since it's not a federal law issue.

Having concluded that the disclaimers were qualified disclaimers as long as they are valid under state law, the ruling confirms that the property disclaimed passes directly from Grandmother to the surviving spouse and qualifies for the marital deduction.

Observation: Wow! Grandmother's estate, faced with potential double taxation (estate tax and generation skipping tax), now owes no amount for either tax. Quick thinking and timely action, through the use of a disclaimer, cleansed an otherwise very messy and costly tax situation.

[5] Treas. Reg. § 25.2518-3(b).

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Advanced Planning Bulletin – November 2008

Limited Liability Companies and S Corporation Elections
Private Letter Ruling 2008-39-003 (September 26, 2008)

An LLC was granted an extension of time to make two elections – first, whether to elect corporate status and second, whether to make an S election, resulting in the LLC being taxed as an S corporation. While the extension of time isn't interesting, it's a convenient time to recall how LLCs are taxed. To begin with, an LLC with more than one member must choose to be taxed as a corporation or a partnership. Historically, almost all LLCs have chosen to be taxed as partnerships to avoid the double taxation that accompanies C corporation status. It now appears some LLCs (including the one in this ruling) are electing to be taxed as corporations and then making an S election.

Why do this when double taxation is avoided simply by choosing partnership status? It's the payroll tax. Partnership income is subject to it and S corporation income is not. In an S corporation, only salaries are subject to payroll tax.

Two things to remember:

1. Salaries must be reasonable, which means that an S corporation cannot unreasonably depress a salary to decrease its payroll tax; and

2. The LLC document might have been drafted with partnership taxation in mind, so it must be reviewed to ensure it doesn't contain anything that would blow the S election.

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