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# TAX IMPACT

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# DON'T GET CAUGHT IN A DEAD END

*Avoid the AMT trap by knowing your options*

**A**t the height of the late-'90s stock-market boom, incentive stock options (ISOs) made a lot of people rich — at least on paper. But when the bubble burst, many of these overnight tycoons were hit with huge tax bills on income they never received.

The culprit was the alternative minimum tax (AMT). When you exercise ISOs, you don't realize any income for regular tax purposes. But if the options are large enough, they may trigger the AMT. You'll owe taxes on the "bargain element" — the excess of the stock's exercise-date value over what you paid for it — even if the stock's value plummets later on. Let's look at how stock options and the AMT work so you can avoid unintended taxes.



## LOSING VALUE AND PAYING TAXES

In a recent Tax Court case (*Speltz v. Commissioner*), an Iowa couple learned this lesson the hard way. Ronald J. Speltz was earning about \$75,000 per year as a telecommunications company manager. In 2000, he exercised ISOs, paying \$34,000 for stock worth \$750,000. Soon the stock's price began a precipitous descent, and by the end of the year it had lost more than 40% of its value.

In April 2001, Speltz and his wife, who had only a vague understanding of the AMT, were stunned to receive a \$225,000 tax bill. By then, the stock had lost about 60%

of its value. They could have sold the stock and raised enough cash to pay the taxes, with a little profit to spare. But instead they borrowed money to pay a portion of the taxes and held the stock, hoping it would rebound.

**Even if the ISOs trigger the AMT or if the stock's price takes a nosedive, you can reduce or even eliminate the tax by selling the stock during the same tax year.**

Unfortunately, the company ended up in bankruptcy, and by 2002 the stock was practically worthless. The IRS turned down the Speltzes' request for a hardship reduction, finding their income sufficient to pay the taxes.

The consequences for the Speltzes were devastating. They lost their investment and were still responsible for a hefty tax bill.

## UNDERSTANDING STOCK OPTIONS

You can avoid the Speltzes' fate by understanding how employee stock options work. They generally fall into one of two categories: ISOs and nonqualified stock options. Nonqualified stock options are usually structured so that you aren't taxed when the options are granted. Upon exercise, however, the spread between the stock's fair market value and the exercise price is taxable as ordinary income, which is taxed and reported on Form W-2 as wages.

ISOs offer valuable tax benefits, including capital gains treatment when you sell the stock. To qualify as ISOs, options must meet a number of requirements. For example, they must be granted only to employees and be nontransferable, and their exercise price cannot be less than the stock's fair market value when they're granted.

You realize no income when you receive ISOs or when you exercise them (unless the AMT applies). When you

sell the stock, your gain is taxed at the long-term capital gains rates (currently a maximum of 15%), provided you hold the stock until the later of two years after the grant date or one year after exercise. Most employers don't allow you to exercise ISOs within a year after they're granted, so for all practical purposes the holding period is one year from exercise.

If you sell or otherwise dispose of the stock during the holding period, you'll pay ordinary income taxes on gains up to the amount of the bargain element and capital gains taxes on any additional profits. Dispositions for less than the exercise price are treated as capital losses.

### **CALCULATING THE AMT**

The AMT is a parallel tax system originally designed to close loopholes that allowed wealthy people to avoid income taxes. But over the years, it has increasingly drawn middle class taxpayers into its grasp.

Calculating the AMT starts with adding back certain deductions, credits, exemptions and other "preference items," including the bargain element of ISOs, to your regular taxable income. Then the AMT exemption (currently \$40,250 for individuals and \$58,000 for joint filers, but phased out for high-income taxpayers) is subtracted to determine your alternative minimum taxable income. This is multiplied by the AMT rate (26% of the first \$175,000, 28% of the excess), and your tax liability is the regular tax or the AMT, whichever is higher.

When employees exercise ISOs, it's not unusual for their gains to exceed their annual salaries. Even though they're not subject to regular taxes, gains this large can easily trigger the AMT.

Like the Speltzes, many employees are surprised to learn their AMT liability is fixed on the exercise date, regardless of what happens to the stock's price later. If the price drops, they still owe the AMT based on the exercise-date value. A complicated "AMT credit" may allow them to offset some of this tax liability against future taxes, but that's of little help with the initial outlay.

### **AVOIDING THE ISO TAX TRAP**

The best way to avoid the ISO tax trap is to analyze the AMT implications before you exercise the options. You may be able to escape this tax by spreading your purchases over several years. Even if the ISOs trigger the AMT or if the stock's price takes a nosedive, you can reduce or even eliminate the tax by selling the stock during the same tax year. You'll lose the benefit

## **THE AMT'S GROWING IMPACT ON THE MIDDLE CLASS**

In 1969, Congress discovered that 155 high-income taxpayers paid no income taxes, so it created the alternative minimum tax (AMT). Since then, as a result of inflation, lower regular income tax rates and other factors, an increasing number of middle-class taxpayers are affected by the tax.

Tax preference items that trigger AMT need not be sophisticated tax shelters. On the contrary, some of the most common causes of AMT liability are:

- ⊙ Incentive stock options,
- ⊙ State and local taxes,
- ⊙ Personal and dependency exemptions,
- ⊙ Miscellaneous itemized deductions such as unreimbursed employee business, tax preparation and investment expenses,
- ⊙ Interest on second mortgages,
- ⊙ Medical expenses, and
- ⊙ Private activity municipal bond interest (bonds issued after Aug. 7, 1986).

By next year, 63% of taxpayers with incomes between \$100,000 and \$200,000 will be liable for the AMT, according to the Tax Policy Center. And the AMT will affect "virtually all upper-middle-class taxpayers with two or more kids," the organization predicts, unless Congress changes the system.

of long-term capital gains tax treatment, but you won't end up with a tax bill that exceeds the stock's value.

Another good strategy is to exercise options in early January. At the end of the year, if the stock's value has declined, you can sell it and avoid the AMT trap. If it hasn't, you can continue to hold the stock until you qualify for long-term capital gains treatment. The risk your stock will collapse during that short time is minimal.

### **MONITORING STOCK PERFORMANCE**

ISOs are a valuable compensation tool because they offer employees significant tax advantages. But if they trigger the AMT, the dream of instant wealth can quickly turn into a tax nightmare. If you exercise ISOs, plan carefully and monitor the stock's performance to avoid this stealth tax. 📄

# BENEFITING YOUR STAFF AND YOUR BUSINESS WITH LTC INSURANCE

**M**ore than 50% of Americans will need some form of long-term care (LTC) — such as nursing home, custodial and home care — at some point in their lives, according to the 2004 *MetLife Market Survey of Nursing Home and Home Care Costs*.

But LTC is expensive. The cost of nursing-home care, for example, averages more than \$60,000 a year for a semiprivate room, and that figure is expected to top \$190,000 by 2030, according to the Bureau of Labor Statistics. Many people worry that they won't be able to afford LTC if they need it — either for themselves or for a spouse or parent — or that the expense will deplete assets they had set aside to finance a comfortable retirement or to provide for their children.

LTC insurance is one way you can protect yourself against these risks. And it can benefit your business if you offer it to employees. Not only will your staff appreciate this unique offering, but your business may incur little expense doing so.

## STRENGTH IN NUMBERS

Employer-provided group LTC insurance plans offer big advantages, even if workers pay the premiums. For



one thing, group purchasing power enables employees to obtain discounted premiums, usually 10% to 20%.

Also, many group plans offer “guaranteed issue” coverage. In other words, the policy covers all eligible employees with no medical questions asked. This can enable otherwise uninsurable workers to obtain LTC benefits. Some insurers extend this coverage to employees’ spouses and dependents.

**You can pay LTC insurance premiums for a select group of key executives and offer it as a voluntary benefit to the rest of your staff.**

From the employer’s perspective, group LTC insurance is a valuable benefit it can use to attract and retain quality workers. Your business can:

- ⊙ Pay the premiums itself,
- ⊙ Offer LTC insurance as a voluntary benefit that allows employees to take advantage of group rates, or
- ⊙ Share the cost with workers.

Keep in mind that premiums vary greatly in price because of the type of coverage available, and the insured’s age and state of residence.

Another advantage of group LTC insurance plans is that they aren’t subject to nondiscrimination rules. So, for example, you can pay LTC insurance premiums for a select group of key executives and offer it as a voluntary benefit to the rest of your staff.

## BUSINESS TAX CONSIDERATIONS

When it comes to the tax treatment of LTC insurance premiums, businesses have an advantage. C corporations

**LTC INSURANCE PREMIUM  
DEDUCTION FOR 2005**

Insured's age at close of tax year	Eligible premium deduction
40 or younger	\$270
41 to 50	\$510
51 to 60	\$1,020
61 to 70	\$2,720
71 or older	\$3,400

Source: U.S. Internal Revenue Code

that pay for LTC insurance coverage for employees (and their spouses and dependents) are generally permitted to deduct the entire premium as a business expense, not just the eligible premium amount. What's more, these premium payments are excluded from workers' taxable income and aren't subject to payroll taxes.

Let's look at an example. If Jon operates his business as a C corporation and the corporation pays his LTC insurance premium, the corporation deducts the full \$2,000 premium, none of which is included in Jon's taxable income. Note that this treatment also applies to nonowner employees of partnerships and LLCs, and 2% or less S corporation shareholders.

Partners in a partnership, members of a limited liability company (LLC) taxed as a partnership and more than 2% S corporation shareholders are all considered self-employed for these purposes. Self-employed individuals can deduct 100% of their health insurance premiums — including eligible LTC insurance premiums for themselves, their spouses and dependents — as an above-the-line deduction, which means that there are no floors the expense must exceed to be deductible and it reduces adjusted gross income (AGI).

This is particularly beneficial because AGI determines eligibility for many tax deductions and credits. Eligible premiums are based on the age of the insured. (See "LTC insurance premium deduction for 2005.") In the example above, if Jon is self-employed and between the ages of 51 and 60, he can deduct 100% of the eligible premium (\$1,020). But if Jon is a partner and the partnership pays for his

LTC insurance coverage, he must include the \$2,000 premium in his gross income, but he can deduct 100% of the eligible premium, or \$1,020.

In most cases, benefits paid under a qualified policy are tax free to employees. Keep in mind that these tax benefits are available only to qualified LTC insurance contracts that meet certain standards.

**TAX BENEFITS FOR INDIVIDUALS, TOO**

Individuals are allowed to deduct eligible premiums they pay as medical expenses. Medical expenses are deductible only by those who itemize and then only to the extent the costs exceed 7.5% of AGI.

For example, Patty is 58 years old and owns an LTC insurance policy with a \$2,000 annual premium. Her AGI is \$100,000 and her medical expenses for the year, excluding the LTC insurance premium, are \$7,000. The eligible premium for Patty's age group is \$1,020, bringing her total medical expenses to \$8,020. Patty's allowable medical expense deduction is \$520 [ $\$8,020 - \$7,500$  (7.5% of \$100,000)].

**LONG-TERM BENEFITS**

If you're looking for a unique way to attract and retain employees, consider LTC insurance. It offers significant financial and tax benefits for both you and your staff. Cost and coverage can vary widely for policies, so be sure to shop around for one that meets your business's and workers' needs. 📄



# WHEN DEFECTIVE IS EFFECTIVE

*Incorporating the right “defects” into a trust can save gift and estate taxes*

One of the challenges of estate planning is to minimize your family’s gift and estate tax liability while retaining some control over your wealth. That’s why most estate plans are centered around the use of trusts, which allow you to remove assets from your taxable estate during your lifetime with some strings attached.

Designing an effective trust is a delicate balancing act. You want to retain as much power as possible over the assets without drawing them back into your estate. So why would you create a trust that’s intentionally defective?

If you incorporate the right “defects” into a trust, you create an intentionally defective grantor trust (IDGT). This allows you to make additional tax-free gifts without using any of your \$11,000 annual gift tax exclusion or \$1 million lifetime gift tax exemption.

## **GIVE A TAX-FREE GIFT**

When creating an IDGT, you reserve certain powers in the trust document that cause the trust to be defective for income tax purposes but not for gift and estate tax purposes. Examples include the power to borrow trust funds without adequate security or reacquire trust assets by substituting other property of equal value.

**Last year, the IRS issued a revenue ruling confirming that payment of an IDGT’s taxes is not a taxable gift.**

The IDGT works as follows: You make a gift to the trust and the trust, in turn, purchases assets from you. Because the trust is defective for income tax purposes, there is no tax on the sale. Further, as the grantor, you pay the taxes on any trust income, even though the income stays in the trust. This is true for as long as the trust is defective.

Keep in mind that the trust defect can be “cured” at any time. But once you do that the trust is responsible for its own tax.

## **LOOK AT THE SAVINGS**

A planning technique that increases taxes may seem counterintuitive, but paying the trust’s income taxes is



the equivalent of a tax-free gift to your heirs. Let’s look at an example.

Suppose you transfer \$500,000 to an irrevocable trust for the benefit of your children. The trust generates an 8% return and pays federal and state income tax at an effective rate of 40%. In 20 years, the trust grows to \$1.277 million.

But if you design the trust to be an IDGT, you pay the income taxes each year, allowing the trust assets to grow and compound tax-free for the trust beneficiaries. By year 20, the assets are worth \$2.33 million, providing your children with more than \$1 million of added assets without generating further gift or estate taxes or using any additional exemptions.

## **COMPLY WITH RECENT IRS GUIDANCE**

Last year, the IRS issued a revenue ruling confirming that payment of an IDGT’s taxes is not a taxable gift.

The ruling also permits an IDGT to give the trustee discretion to reimburse the grantor for income taxes paid without triggering estate or gift taxes. This can be a useful feature in the event the grantor has trouble making the tax payments.

If the trustee is required to reimburse the grantor or the IRS finds there was an express or implied promise to do so, the trust assets may be brought back into the grantor’s estate.

## **TAKE CARE WITH DOCUMENT DRAFTING**

An IDGT can be an effective tool for making tax-free gifts without tapping your annual gift tax exclusion or lifetime gift tax exemption. Just be sure that the trust documents are drafted carefully. Otherwise, you may have unintended estate tax consequences. ■

## CAN BANKRUPTCY PROTECT IRA ASSETS?

Money you have in a 401(k) or other qualified retirement plan is protected against creditors' claims in bankruptcy. But what about IRAs?

Contrary to popular belief, the Supreme Court's recent decision in *Rousey v. Jacoway* did not extend to IRAs the same protection afforded qualified plans, which are excluded from the bankruptcy estate. Rather, the Court held that traditional IRAs may be entitled to a bankruptcy exemption for "retirement assets." (It's not clear whether the ruling applies to Roth IRAs.)

To qualify for the exemption, you still need to prove that IRA funds are "reasonably necessary" to support you and your dependents. Plus, the decision is irrelevant in states that have opted out of the federal exemption — and only some of those states offer creditor protection for IRAs.

After *Rousey* was decided, President Bush signed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which provides for uniform treatment of IRAs in bankruptcy. Effective for bankruptcy filings after Oct. 16, 2005, both traditional and Roth IRAs are entitled to the same protection as qualified plans, up to a \$1 million limit.

The cap doesn't apply to rollovers from qualified plans, however, so it's a good idea to keep rollover contributions in separate IRAs. 📄

## NEW ROTH 401(K) IS HERE AT LAST

Beginning in 2006, employers may give their employees the opportunity to make Roth deferrals to their 401(k) accounts. This provision, which also applies to 403(b) plans, was added by the 2001 tax act but doesn't take effect until next year.

The Roth 401(k) is an attractive option for many workers — particularly those who don't qualify for a

Roth IRA because of income restrictions. As with Roth IRAs, Roth 401(k) contributions are made on an after-tax basis but qualified distributions of contributions and earnings are tax free.

Whether Roth or pretax contributions are better depends on a number of factors, including whether an employee expects his or her tax bracket to be lower, higher or the same during retirement.

Keep in mind that, if you decide to permit Roth 401(k) contributions, you'll need to amend your plan and you'll incur additional expenses. 📄



## GET A QUICK CORPORATE TAX REFUND

If your corporation overpays its estimated taxes this year, you're entitled to a quick refund of the excess payment. The requirements: Payments must exceed \$500 and 10% of your expected tax liability for the year. You can request a quick refund only after the close of your tax year by filing Form 4466. The IRS is required to act on your request within 45 days.

A quick refund can help ease cash flow pressures on corporations that suffer large losses during the fourth quarter, lowering their expected tax liabilities. For example, ABC Inc., a calendar-year corporation, anticipates a tax liability of \$100,000 for 2005. During the first three quarters of the year, it pays a total of \$75,000 in estimated taxes. In the fourth quarter, however, ABC suffers a large loss that reduces its expected tax to \$25,000. On Jan. 2, 2006, ABC files a request for a quick refund of \$50,000, which it receives in February. 📄

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## *Certified Public Accountants*

**W**ith the complexity and continuous changes in tax rates and laws, strategic and proactive tax planning is the key to consistently minimize the amount of income, estate and other taxes your business or family pays. Formulating effective tax strategies for corporations, business owners and high net-worth individuals is an important component of MBAF's portfolio of client services. Our team of tax specialists has extensive experience with federal and state tax issues regarding the taxation of individuals, corporations, S corporations, partnerships, and Estate Planning.

Morrison, Brown, Argiz & Farra takes great pride in offering comprehensive tax counseling to preserve wealth, optimize taxes and maintain state and federal compliance. We offer much more than standard compliance work. Our goal is to work closely with our clients to make sure that they are taking advantage of the many tax planning strategies available. We also want to ensure that they are in compliance with income tax laws and assist in preparing all necessary tax returns.

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- Tax planning for individuals, corporations and non-resident aliens
- Identification of opportunities to minimize or defer income, estate and gift taxes
- Timely completion and thorough understanding of all tax reporting requirements
- Coordination of correspondence with tax authorities
- Timely advice on acquisition-related tax issues
- Coordination of personal and business tax issues with a focus on minimizing global taxes
- Representation in tax controversies

Sincerely,



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Bakhai is regarded in the professional community as one of the best tax minds in South Florida. He deals with such topics as the tax benefits of LLCs, year-end tax planning, and qualified subchapter S subsidiaries, the innocent spouse relief provision under Section 6015, and IRS regulations on valuing and substantiating charitable contributions.



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Raul focuses his practice on international tax services with an emphasis on financial institutions. He has exceptional depth of knowledge in cross-border transactions and investments, income tax treaties and foreign tax credits.



**Santiago Pujals, CPA**

Santiago's expertise includes tax planning, sales and use tax consulting, and representation of clients during examinations by the Internal Revenue Service and Florida Department of Revenue. He also provides senior counsel to MBAF clients on tax planning issues, with an emphasis on state and local taxation (SALT).



**Barry I. Ross, CPA**

Barry brings over 40 years of experience handling sophisticated foreign and domestic transactions, including acquisitions and mergers, public and private debt and equity financing, complex tax cases, estate planning, litigation and valuations.