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TAX, LEGAL & FINANCIAL SOLUTIONS FOR YOUR RETIRED CLIENTS

Tax Court issues favorable FLP ruling

TAX: U.S. Tax Court provides guidance on FLP and FLLC provisions.

By Timothy P. Murphy, Esq.
Guest Contributor

In the past few years, the U.S. Tax Court and various federal Courts of Appeals have issued opinions on Family Limited Partnerships (FLPs) which have been adverse to the taxpayers. Now Judge Chiechi, writing for the U.S. Tax Court, has issued an opinion on FLPs which is favorable to the taxpayer.[1] The opinion goes into great detail on provisions of the Family Limited Liability Company's (FLLC) operating agreement and rejects many contentions put forward by the IRS.

Anna Mirowski died suddenly on September 11, 2001, just a few days following the formation and funding of her FLLC, as well as subsequent gifts of an aggregate of 48% of the FLLC interests therein to trusts for her three daughters. After her death, the IRS asserted an estate tax deficiency of $14.2 million.

Finding significant and real non-tax purposes for the FLLC, the court held the FLLC was viable, the gifts were separate transactions to be respected as such, and that IRS's reliance on prior "bad facts" cases was misplaced.

Background

Anna's husband was a doctor who developed an implantable defibrillator device (ICD) and the patents thereon were the primary basis of the development of the wealth of the Mirowski family.

Upon his death in 1990, Dr. Mirowski, per his Will, left his interests in the patents, the patent licensing agreements and all other assets

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Tax free municipal bonds — look at the options

TAX: A recent decision by the Supreme Court has taxpayers rethinking purchasing state municipal bonds.

By Lynn Freer, EA
Publisher

The U.S. Supreme Court has issued a ruling permitting states to exempt interest on their own bonds from taxation, while taxing residents for interest on bonds issued by other states.[1] This decision overturns the Kentucky Court of Appeals decision that held a statute unconstitutionally violated the commerce clause because it taxes interest earned on bonds issued by other states and their political subdivisions, while exempting interest earned on Kentucky bonds.

The Supreme Court's decision to uphold the state tax-exempt status of municipal bond interest is a relief to state tax officials, as there will be no refund of tax on out of state bonds. It also benefits those states that issue bonds at a lower-than-commercial bond rate because the decision upholds the tax system that currently exists for state tax purposes. Finally, the decision reaffirms the wisdom of investing in single-state municipal bonds.

The ruling also signals a call to rethink the benefits of purchasing state municipal bonds from the taxpayer's state of residence.

Tax benefit recap

In today's market, a California tax-free bond will yield approximately 4%. Ten-year treasury bonds yield only 3.8%. Because the California bond is federal and state tax free, in this scenario it's a better after-tax investment. And to have the same after-tax

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E-mail us:
ecplanner@spidell.com

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How to make the election

Spouses make the election on a jointly filed Form 1040 by dividing all items of income, gain, loss, deduction, and credit between them in accordance with each spouse's respective interest in the joint venture. Each spouse will file a separate Schedule C (Form 1040), **Profit or Loss From Business (Sole Proprietorship)**, or Schedule F (Form 1040), **Profit of Loss From Farming**, and, if otherwise required, a separate Schedule SE (Form 1040), **Self-Employment Tax**.

For tax purposes, the partnership terminates at the end of the tax year immediately preceding the year the election takes effect.

Making the election for a rental real estate business

If a taxpayer and spouse make the election for their rental real estate business as opposed to investment, they must each report their share of the income and deductions on Schedule C or C-EZ instead of Schedule E.[3]

This rule does not apply if the real estate activity is mere joint ownership of property without engaging in a trade or business, or if some other operation would be sufficient to create a partnership.

EXAMPLE 7-5 Rental property: Dan and Maryann also co-own rental property on F Street. This is not a trade or business, and they may report income and expenses on Schedule E.

They also own property that they lease, manage and that is a trade or business. It is owned by the Dan and Maryann partnership. This is a rental trade or business.

Because rental real estate income generally is not included in net earnings from self employment subject to self employment tax, and generally is subject to the passive loss limitation rules, the spouses should enter "Exempt–QJV" on Form 1040, line 58, and not file Schedule SE, unless they had other income subject to self employment tax.

Duration of election

Once the election is made, it can only be revoked with IRS permission. However, the election technically remains in effect only for as long as the spouses filing as a qualified joint venture continue to meet applicable requirements. If the spouses fail to meet the requirements for a year, a new election will be necessary for any future year in which the spouses meet the requirements to be treated as a qualified joint venture.

1 IRC §761(f)
2 IRC §761(f)(2)
3 IRS Publication 553

The effect of reduced Social Security and higher taxes upon the death of a spouse

SOCIAL SECURITY: Retired couples should consider how to maintain their cash flow when one spouse dies and Social Security income drops.

By Richard B. Malamud, CPA, J.D. LL.M.
Guest Contributor

How often does a retired (joint return) couple ask what will happen to their cash flow when one of them dies? How often is that taken into account when doing cash flow projections? Probably not very often.

In the typical situation in which a couple has some retirement income and Social Security benefits, the retirement income (other than Social Security benefits) often stays the same whether there are one or two taxpayers.

The general rule for Social Security, however, is that when one spouse dies, the surviving spouse will receive the higher of the two spouse's benefits. The effect is to reduce cash flow by the Social Security benefits received by the lower of the two. The average Social Security is approximately $1,082 for the worker and $530 per month for the spouse.

EXAMPLE 7-6 Survivor benefits: One spouse receives $13,000 per year of Social Security benefits and the other receives $6,500 a year. When the first dies, the survivor will receive $13,000 per year in Social Security benefits.

Cash flow analysis

The effects on the survivor's cash flow will be illustrated using the Social Security benefits listed above. The standard deduction will reflect that the taxpayers have each attained the age of 65. The effects will be calculated at three different retirement income levels:

(1) $ 25,000;
(2) $ 50,000; and
(3) $100,000.

The table on the next page illustrates the cash flow and federal and state taxes at each income level and compares the married couple's income and the survivor's income. We have used California tax rates to illustrate the state tax effect.

The most striking facts above are that not only does gross cash flow decrease due to the lower (single) Social Security benefits, but the federal income tax actually goes up. The tax goes up because of the fact that as a single taxpayer, a greater amount of Social Security benefits are taxable than when the couple was married and the tax rates are higher.

The effect of these two items is that cash flow drops between 13% and 19%. That equates to over $700 and up to over $1,000 in decreased monthly cash flow. How many widows or widowers can reduce their expenses by that amount

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Effect on a spouse, *continued from page 10*

each month and retain their current lifestyle?

Those couples who are living on 100% of their income will require the survivor to make some hard choices to keep the same cash flow after expenses. They will either have to invade principal (assuming they have any principal to invade), change their investment strategy to increase after tax cash flow (possibly taking greater financial risk) or reduce expenditures.

Normal reductions

Some of the reductions may occur automatically, such as the lower food and clothing costs, health insurance and medical expenses, and possibly auto insurance as the result of insuring only the survivor. But the major costs, such as rent, utilities, homeowner or renter insurance, and auto expenses may not go down and some individual costs may go up, such as single supplement travel.

About the author

Richard is a professor in the Department of Accounting and Law at CSU Dominguez Hills, where he teaches federal income tax law. You may reach him by phone at (310) 243-2239, fax at (310) 217-6964, or e-mail at: rmalamud@csudh.edu.

Cash Flow	1 Married	1 Single	2 Married	2 Single	3 Married	3 Single
Income	$ 25,000	$ 25,000	$ 50,000	$ 50,000	$ 100,000	$ 100,000
Social Security	13,000	13,000	13,000	13,000	13,000	13,000
Social Security (deceased)	6,500	0	6,500	0	6,500	0
Total Income	44,500	38,000	69,500	63,000	119,500	113,000
Federal Tax	(638)	(2,295)	(6,184)	(9,038)	(18,610)	(22,188)
Net Cash Flow	43,862	35,705	63,316	53,962	100,890	90,812
California Tax	(35)	(376)	(751)	(2,045)	(4,090)	(6,716)
Net Cash Flow	43,827	35,329	62,565	51,917	96,800	84,096
Reduced Cash Flow		(8,498)		(10,648)		(12,704)
Percentage Decrease		-19.4%		-17.0%		-13.1%
Monthly Decrease		(708.17)		(887.33)		(1,058.67)

Paying tax on U.S. savings bonds: now or later

TAX: Consider the long term ramifications when electing to pay tax on bonds in the current year.

By Renée Rodda, J.D.
Associate Editor

Many taxpayers own U.S. savings bonds that were purchased many years ago. They rarely even think about the bonds, except when they make the occasional trip to the safe deposit box. In some cases the bonds were gifts, and in other cases the taxpayers purchased them as safe investments that would accrue interest and wouldn't be taxable until a later date.

The interest may only be deferred until the bond expires (up to 30 years depending on the type of bond). At the end of the bond term, all accrued interest becomes taxable, even if the taxpayer has not redeemed the bond. However, taxpayers may elect to pay the interest as it accrues. This article addresses the election to pay the tax currently, versus waiting until the bond matures or is redeemed.

Pay now or pay later

The interest on U.S. savings bonds is fully taxable for federal income tax purposes. The taxpayer may elect to:

- Defer reporting any interest until the year of maturity, redemption, or other disposition, whichever is earlier; or
- Report the interest each year as it accrues.[1]

The election to pay the tax annually may be made without the IRS's consent. The taxpayer simply reports the current interest income on his tax return each year. If the election is made, however, it applies to all bonds owned by the taxpayer and those acquired in the future.[2] Additionally, all accrued interest must be included in income for the year the election is made.

The election may be revoked, but the IRS must grant permission to make the change.

See **Savings bonds**, *page 12*