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Take Proactive Steps Now in 2012
Before the Window of Opportunity is Scheduled to Close

Tax planning opportunities become considerably less clear after the close of this year. There are numerous political, economic and legislative reasons for this nebulous state of affairs. However, what remains unambiguous is the following. Most financial professionals and clients possess an intuitive understanding this current window of tax planning may be coming to a quick close. In fact, 2012 may very well represent the last chance for affluent clients to take certain steps that may help them attain their financial planning goals. Fortunately, this closing window of opportunity remains sufficiently open to shed light on a number of planning opportunities before year end.

Strategy One-Continue the Tried and True While Considering the New

Legislation passed at the end of 2010[1] established a maximum exemption amount of $5,000,000 per person for transfer tax purposes. (inflation adjusted to $5,120,000 for 2012.) Under current law this exemption is scheduled to return to $1,000,000 at the beginning of 2013. However, it remains unclear what steps, if any, Congress will take to modify the transfer tax laws after this time.

With this as the backdrop, the mantra for affluent clients since January 2011 has been to engage in outright transfers to spousal, dynasty, intentionally defective, grantor retained annuity and other irrevocable trusts arrangements. Split dollar and private finance rollout strategies have also been suggested along with a host of other techniques leveraging the historically high federal transfer tax exemption. And like last year, low interest rates and continual suppressed asset values make these strategies even more attractive.

With this said, the recent Revenue Ruling 2011-28, published in December of last year may be just the necessary push, affluent clients need to take action. In fact, implemented correctly, it arguably propels many of the previously mentioned strategies from good to great.

The main thrust of the ruling describes how an insured who is a grantor of a funded irrevocable life insurance trust may retain the power to substitute assets held outside of

[1] The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010

the trust for life insurance held within the trust IF both of these assets are of equal value. In practice, a grantor/insured can swap “outside” trust assets such as cash, stock or real estate for a life insurance policy owned by the irrevocable life insurance trust. The significance of the ruling is that maintaining this flexibility is not treated as an incident of ownership under the tax law. Clients can wait and see how their future financial situation impacts the ultimate ownership of a life insurance policy. The details of this ruling are beyond the scope of this overview. However, the added flexibility represented by this ruling, may be the impetus behind a client taking final action to set up insurance in a spousal access, dynasty or other trust arrangement.

Strategy 2-Maximizing S Corporation Earnings and Profits

S corporations with earnings and profits (E&P) from previous C corporation tax years are subject to special rules that can complicate tax planning. Many S corporations can remove themselves from these special rules by electing to treat E&P withdrawals as a distribution of a qualified dividend at the current low 15% rate. However there are storm clouds on the horizon. Under current law, beginning in 2013, these type of qualified dividends will be subject to a top rate of 43.4% (39.6% plus the 3.8% healthcare surtax) for higher income earners. This dramatic jump represents a 289% increase in the overall federal tax rate on these distributions.

However, therein lays this opportunity. Like many businesses, S corporation owners have insufficient qualified options to fully provide for their own retirement. At the same time, they have a desire for immediate protection afforded by a life insurance death benefit. Rather than leaving these e&p accounts trapped in the business to face possible exposure to rates exceeding 40%, these owners now have an extra incentive to pull these accounts out as qualified dividends at the low favorable rate. This ‘after-tax’ money can then be used to fund a permanent, personally owned life insurance policy that can be available to finance the owner’s supplemental needs independent of the business.

Wrap-Up

Few months remain to clearly convey the message to clients that they should speak to their tax advisors before this window of opportunity may close. Most financial professionals have come to realize consumers are attracted to the type of opportunity the current law provides. Nonetheless, this knowledge alone, without meaningful communication with a client is ineffective at best. This is the year to align the advisors unique knowledge with the client’s aspirations and goals.

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