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## Basic Tax Review “101”

**For many people, the mere mention of tax is a turn-off: tax is inevitable, painful, incomprehensible, and best handled by competent attorneys and accountants.** There's little incentive to learn about the subject when it is constantly changing, challenging the best of the professionals to make sense of the latest laws. But knowing the basics about tax laws, and their impact on your financial well-being, is really in your best interest not only for your own enlightenment and to understand where your money is going and why, but to enable you to effectively collaborate with your attorney and tax professional to take advantage of the tax laws in your favor, and create a comprehensive estate plan that incorporates both tax benefits and asset protection.

Here in the United States, like in most countries, it is the people who are responsible for supporting their government through income taxation. The calculus is simple: the more income you earn, the more tax you will pay on it. Income takes many forms: money (cash, checks); property in lieu of payment; stocks, bonds; dividends; compensation for services; cancellation of indebtedness; and punitive damages awards all amount to taxable income. Important to calculating an individual's income is how it is characterized by the Internal Revenue Service (IRS).

There are two general classifications of income that the IRS uses: ordinary income, such as wages, salaries, tips, and dividends; and capital income, such as investments like stocks or bonds, and real property, that appreciate in value over time. Ordinary income is taxed at a higher rate than capital income. Some income, within limits, is not regarded as income at all, and is statutorily excluded from gross income. Gifts, inheritances, properly transfers between familial relations, Worker's Compensation, damages awards for personal injuries, and certain bonds (state or local bonds, or federal education bonds) all can be excluded from the gross income calculus. And gross income can be further reduced by making use of statutorily authorized deductions (e.g., business expenses, depreciation, partnership discounts, capital losses, and charitable contributions) that apply to your particular situation.

Generally, a U.S. taxpayer is either a U.S. citizen or a resident alien, or a non-resident alien with U.S.-source income. Any one of these individuals is required to file an annual federal income tax return, based on worldwide income, if it exceeds \$7450 (Based upon single taxpayer status, under age 65 (2002 IRS tax table)). If the taxpayer lives in the U.S., most states require reporting of income and payment of state tax as well. Not only must individuals file annual tax returns, but other entities, like corporations, trusts, and estates must do so as well.

There is an interrelationship between taxation and asset protection; the challenges present, to you the taxpayer, are to protect your assets while alive, and leave them as intact as possible for your survivors. To help acquaint you with the U.S. tax consequences of the various entities and strategies that are used in asset protection, here's an overview.

There are different types of corporations as defined by the IRS. Subchapter C corporations tend to be larger and have public stock, like General Electric. Subchapter S corporations tend to be closely held, with limits on the number and types of shareholders, like the local dry cleaners or a family-owned business. A Subchapter C (C corporation) is treated by the IRS as an individual for tax purposes. It files its own tax return, and is taxed on its earnings at a corporate rate. The owners of the corporation (its shareholders) are taxed on distributions (dividends) as ordinary income. A corporation cannot deduct distributions to its shareholders, but it can deduct capital losses from the sale or exchange of capital assets, to the extent of such similar gains. Shareholders who sell stock are assessed a capital gains tax on profits, which is a significantly lower rate than the ordinary rate that applies to dividend earnings. The double taxation scheme that applies to corporations makes them less desirable from a tax standpoint, but the limited liability (asset protection) accorded to corporations has its

advantages for many.

A Subchapter S (S corporation) is generally not taxed at the corporate level; rather, shareholders report their apportioned shares of the corporation's current earnings on their individual tax returns, regardless of whether earnings have been distributed to them or not.

A partnership enjoys pass-through tax treatment, which means that it pays no income tax itself. Rather, the total partnership income (or loss) passes through to the members to report on their individual tax returns (Form 1040). For tax purposes, members can agree among themselves how to apportion items of income, gain, loss, deduction and credit, subject to IRS Regulation (particularly restricting limited partners' ability to apportion income). Whether or not any distribution is made to a member, the value of the member's interest in the partnership's distributions is taxable.

The **Family Limited Partnership** ("FLP") enjoys reduced taxation on partnership interests because the value of these interests is discounted as a result of the inherent restrictions on transferability among family members. A member can also contribute appreciated assets to the partnership generally without individually incurring a taxable gain, provided the IRS does not regard the partnership as an investment company. Although many people (often husbands and wives) place their personal residence in an FLP for asset protection, it is possible this placement can result in loss of deductions for mortgage interest, as well as loss of favorable capital gains treatment upon the sale of the residence. Therefore, a question remains as to how a taxpayer can take advantage of deductions if the FLP owns the residence.

The **Limited Liability Company** ("LLC"), like an S corporation, is treated like a partnership for tax purposes, so its members report distributions on their individual tax returns. An additional tax benefit of an LLC over a partnership is that, in proportion to the value of the member's interest in the company, the member can take into account his or her share of company losses for tax purposes.

A trust is treated either as a U.S. person or as a non-resident alien (if an offshore trust) for tax purposes, and the trustee must file an income tax return for the trust. Trust beneficiaries are taxed only on income and capital gains distributed to them by the trustee. If a beneficiary is the grantor, he or she is taxed on all income earned by the trust in the reporting year, regardless of whether it is distributed to him or her. Even if a beneficiary has the right to receive all income from the trust, but does not take it, he or she is taxed on all income earned by the trust. A beneficiary must file IRS Form K-1 ("Beneficiary's Share of Income, Deductions, Credits, etc.") along with his or her individual return, indicating how much income or loss must be reported; the form is also included with the trust's income tax return. If a trust distribution is a non-cash asset, its value to the beneficiary is the same as when it was held by the trust; the trust pays taxes on its appreciation. To avoid double taxation of both trust beneficiaries and the trust itself, the trust is allowed a deduction, within limits, for distributions made to beneficiaries.

### **There are several subcategories of trusts:**

**Non-grantor trusts**, generally irrevocable, give the grantor no rights to distributions. The trustee must file IRS Form 1041 for the trust for each year that the trust has any taxable income of more than \$600, as well as Form K-1.

For **Grantor trusts**, where the grantor or his or her spouse is also a trustee of the trust, no income tax return need be filed for the trust. Instead, the grantor reports all trust income on his or her income tax return (or joint return). States might have different reporting requirements, so check your own state's rules. Where neither the grantor nor his spouse is trustee of the trust, a separate trust tax identification number should be obtained, and a Form 1041 filed, but no taxes are paid by the trust. Instead, the trustee attaches a statement to the 1041 indicating income received by the trust will be reported on the grantor's individual (or joint) tax return.

An individual can create a **Bypass trust** ("credit shelter trust") for the benefit of his or her family members during their lives; they can receive income or principal as distributed by the trustee. Upon the death of any beneficiary, trust assets would

not be taxed to his estate because he did not create the trust, had no control over it, and could not withdraw the principal.

A **Qualified Terminable Interest Property** trust ("QTIP trust") is another tax-free way for an individual to transfer assets to a spouse. It can be set up during the grantor spouse's lifetime (as an *inter vivos* trust), or upon the grantor's death (as a testamentary trust). To qualify for the marital deduction, the surviving spouse must be the sole beneficiary of all income, and has no power during his or her life to give the trust property to another. In addition to tax savings, the QTIP trust avoids probate, and can provide creditor protection for the donee -spouse. (For a non-U.S. citizen spouse, a qualified domestic trust, or "QDOT," provides similar benefits.)

The *Crummey Trust* (named for the brave individual who challenged the IRS to allow the trust) allows each beneficiary the right, or power, to annually withdraw an amount equal to the annual tax-free limit of \$12,000.

Exercising such *Crummey* powers must be done within a certain period of time, after which the amount cannot be withdrawn. Consequently, for those beneficiaries who choose not to use their *Crummey* powers of withdrawal, a lot of money can accumulate gift-tax free over several years.

Estate taxes are assessed upon the value of an individual's property at death. An individual's estate may include for example:

- the value of jointly held assets (*with someone other than spouse*),
- life insurance (*if the individual was the owner of the policy, or if the proceeds were payable to his or her estate*),
- properly held in revocable trusts,
- retirement plan proceeds, and
- assets held in the individual's own name.

The marital deduction provides that there are no estate taxes for the portion of the estate that passes to the surviving spouse. However, upon the surviving spouse's death, the entire estate will be taxed for amounts over the statutory maximum. In 2002, the tax-free amount of property that any individual can pass to others over his or her lifetime is \$1 million. Property in excess of this amount is subject to a maximum 55% federal estate tax, and most states tax the estate as well. Estate tax liability applies to the entire estate, regardless of where it exists, for deceased U.S. citizens or residents.

Gift taxes are imposed (by federal law and some state laws) on transfers of property from one individual (the donor) to another (the donee) for less than its fair market value. It seems counterintuitive that the donor should pay tax on a gift that he or she makes for another's benefit, but it's an efficient way for the IRS to raise tax revenue. Under IRS Section 2503, every individual is allowed a \$12,000 per year, per donee exclusion to the gift tax rule, as long as the gift is of present interests in property; husbands and wives together can gift \$24,000 per donee per year. A donor can give an unlimited amount for medical care and for tuition payments on behalf of a donee, but these gifts must be paid directly to the medical provider or education institution in order to qualify for gift tax exclusion.

Gifts made in excess of the statutory maximum allowance per donee must be reported on IRS Form 709, which is filed along with the donor's income tax return. A donor or estate owner can, over his or her lifetime, take the maximum of combined estate and gift allowances, up to \$1 million in 2002. This \$1 million lifetime credit is reduced by all of those gifts made during an individual's lifetime, for estate tax purposes.

Gifting is a very attractive strategy to reduce your overall taxable income, and in certain situations, it can move you into a lower tax bracket. In order to take advantage of the gift tax exclusion, the gift must be complete, meaning that the donor relinquishes all control of the property. It is not a complete gift if the donor transfers it to his revocable trust (since he can change the trust and reclaim the gift). However, certain trusts can receive gifts tax-free, like spousal support trusts (for example, QTIP or DOT trusts) or irrevocable trusts that empower a beneficiary to withdraw his or her gift (up to \$12,000 per beneficiary per year, or \$24,000 if made by husband and wife). The latter type of trust is known as a *Crummey* trust, previously discussed. Finally, under the federal taxing scheme, spouses can make unlimited gifts to each other (recall the marital



deduction for estates), but there may be local tax implications affecting spousal gifts.

Now that you have a basic understanding of the various tax consequences that flow from different entities, you are better prepared to join your attorney and tax professional in developing an asset protection plan that fully serves your particular needs for today, as well as protects your assets for the future.

**This article is designed to introduce you to the importance of asset planning and the need to protect your wealth. It is published as part of general information series for visitors to our web site. If you need to pursue an asset protection strategy, make sure you do it with the assistance of a professional.**

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