Memo

To: All students planning to sit for the March 2010 CFP® Certification Examination

From: Michael B. Cates, CFP®, Senior Director of Certification Programs

Date: 2/11/2010

Re: Changes to 2010 laws and limits tested on the March exam

As you are aware, the CFP Board recently announced that the March 2010 examination will test 2010 tax laws. This document will detail the differences that we feel you need to be aware of in preparation for the March Board exam.

For a complete list of the annual limits that apply for 2010, go to the College's website at http://cffp.edu/_Rainbow/Documents/2010_AnnualLimits.pdf

Income Tax Planning

The following provisions have expired, and thus are not applicable for 2010:

- The exclusion for up to $2,400 of unemployment compensation benefits received (In other words, the full amount of unemployment compensation benefits are taxable.)
- The adjustment to income for up to $2,000 or $4,000 of higher education expenses (tuition and fees deduction)
- The up to $250 adjustment to income for educator expenses for teachers
- The election to deduct state and local sales taxes in lieu of state and local income taxes
- The deduction for sales and excise tax on the purchase of motor vehicles
- The additional standard deduction for real estate taxes
- The phaseout of overall itemized deductions and personal and dependency exemptions based on AGI
- First-time homebuyers credit (The credit was scheduled to expire on 11/30/2009. The Worker, Homeownership, and Business Assistance Act of 2009, signed into law on Nov. 6, 2009 extended and liberalized the credit. Because this provision was passed within six

months of the March exam, it should not be tested on the exam. Thus, the credit should be treated as having expired.)

- The 50% bonus depreciation provision
- The increased AMT exemption amounts (For 2010, the AMT exemption amounts return to $45,000 for MFJ, $22,500 for marrieds filing separately and $33,750 for single taxpayers.)
- The $500 floor per occurrence for casualty losses For 2010 and beyond, the floor returns to $100.

The Section 179 expense election has been increased to $134,000 for 2010. The property-placed-in-service limitation remains at $530,000.

Taxpayers who claimed a first-time homebuyer credit for homes bought in 2008 must begin repaying the credit in 2010. The credit must generally be recaptured (i.e., repaid) in equal installments over a 15-year period. Recapture is accelerated if the taxpayer disposes of his residence or it ceases to be his and his spouse's principal residence before the end of the 15-year recapture period.

The American Opportunity Tax Credit essentially replaces the Hope tax credit for 2009 and 2010. The maximum annual credit is $2,500 per student. This is calculated at 100% of the first $2,000 of qualified expenses (not room, board, or books) and 25% on the next $2,000. Qualified expenses are tuition, course materials and fees required for attendance or enrollment. The provision applies to the taxpayer, spouse, or dependent for the first through fourth years of college, and in order to qualify, the student must be enrolled on at least a half-time basis for at least one academic period during the year. The AOTC may be elected for a student's expenses for only four tax years, and only for students who have not completed the first four years of postsecondary education as of the beginning of the tax year. As with the Hope credit, an eligible student does not include any individual who has been convicted of any federal or state felony drug offense for possession or distribution. Also, if the student pays the eligible expenses, the parent(s) who claim the child (student) as a dependent are treated as having paid the expenses, and the parent(s) must claim the credit. If the child is eligible to be claimed as a dependent, but is not claimed, only the child (student) may claim the credit. The AGI phaseout ranges were increased to $80,000–$90,000 for single taxpayers or $160,000 and $180,000 for married taxpayers filing jointly.

For alternative minimum tax purposes, the interest on private-activity municipal bonds issued in 2009 and 2010 is not treated as a preference item.

If you have any questions on the changes affecting the Income Tax Planning materials, please contact Mike Cates at 1-800-237-9990, ext. 4832, or by e-mail at mike.cates@cffp.edu.

Retirement Planning & Employee Benefits

Most of the numbers are the same for 2010 as they were for 2009:

- $16,500 (and $5,500 catch-up) for all plans that allow employee deferrals except SIMPLEs
- $11,500 (and $2,500 catch-up) for SIMPLES
- 100% of compensation or $49,000 overall limit (employee and employer), does not include $5,500 catch-up
- $195,000 benefit limit for defined benefit plans
- $245,000 limit on includible compensation
- $5,000 limit for IRAs, $1,000 catch-up

These phaseouts are also the same:

- MFJ IRA deductibility if active participant: $89,000–$109,000
- Roth IRA eligibility if single: $105,000–$120,000

These phaseouts were increased by $1,000:

- Single IRA deductibility if active participant: $56,000–$66,000
- MFJ IRA deductibility for the non- active participant spouse: $167,000–$177,000
- Roth IRA eligibility if MFJ: $167,000–$177,000

Vesting

Cash balance plans maximum vesting is now 3-year cliff (Pension Protection Act)

Traditional defined benefit pension plans are the only ones that can potentially have 5-year cliff or 7-year graded vesting (if not top-heavy)

Maximum vesting for defined contribution plans is 3-year cliff or 6-year graded

New for 2010—Roth Conversions

- 10% penalty tax (if under age 59½) does not apply
- Income limitation lifted as of 2010 (MAGI limitation of $100,000 is eliminated)
- Conversions carried out in 2010 – default is for the individual to recognize half of the income from the conversion in 2011, and the other half in 2012 (unless the individual elects otherwise and recognizes all the income from the conversion in 2010).
- An income acceleration rule will apply if the converted amounts are distributed before 2012.
- Assets may be converted to a Roth IRA from traditional IRAs, SEPs, SIMPLEs (after 2 years), and qualified plans.

- Ability to convert is not restricted by age, an individual older than age 70½ could convert to a Roth (and then continue to contribute if they have earned income).
- If nondeductible IRA contributions are involved, then a ratio of non-deductible IRA contributions to the total value of <u>all</u> IRAs must be used – in other words cannot just convert the nondeductible contribution amounts.
- Conversions can be undone (called "recharacterization") – for conversions done in 2010 have until Oct. 15, 2011 to recharacterize (April 15th due date plus 6 month extension).
- Married taxpayers filing separately may convert amounts in a traditional IRA to a Roth IRA.

Sample Scenarios

Scenario 1

- Jane Smith has three IRAs worth a total of $250,000. There is $100,000 each in 2 traditional IRAs, and $50,000 in a SIMPLE IRA. She has made a total of $20,000 nondeductible IRA contributions to the traditional IRAs over the years, and now wants to convert just the $20,000 into a Roth IRA. You would advise her that:

  a. She can convert the $20,000 and not owe any taxes on the conversion.

  b. She can covert the $20,000 and will owe taxes on $18,000 of the conversion.

  c. She can covert the $20,000 and will owe taxes on $18,400 of the conversion.

  d. She cannot convert $20,000, she must convert an entire IRA.

Scenario 2

- John Jones converted his qualified plan into a Roth IRA when the account balance was $75,000 on February 1, 2010. Due to poor investments, on May 1, 2011 the account is worth $40,000. What options, if any, does John have?

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Scenario 3

- Taylor is considering a Roth IRA conversion, and has come to you for your advice. Taylor believes that she will be in a lower tax bracket in retirement, and will most likely need the IRA funds during retirement. Would you advise her to convert or not?

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Answers:

- ***Scenario 1: c is the correct answer, one must take the total of all IRAs, and calculate the ratio based on that amount, in this case we have nondeductible contributions totaling $20,000 and the total value of all IRAs is $250,000. $20,000/$250,000 = .08, so 8% of any***

conversion is nontaxable, and the other 92% would then be taxable. $20,000 conversion x .92 = $18,400 taxable amount. She can recognize $9,200 in 2011, and the other $9,200 in 2012.

- ***Scenario 2: John should consider a recharacterization, and "undo" his conversion, which caused him to be taxed on $75,000 for an account that is now worth only $40,000. John has until Oct.15, 2011 (if he applies for an extension) in order to carry out the recharacterization. He could then do another conversion at some point if he wants to. When the market value of an account is down is an opportune time to carry out a conversion.***
- ***Scenario 3: Generally, conversion makes sense if the tax rate is lower at conversion rather than at withdrawal – in this case the tax rate is anticipated to be lower at withdrawal than conversion, so you would advise Taylor not to convert.***

Traditional IRAs

Prior to 2010, taxpayers could distribute up to $100,000 tax-free from a traditional IRA to a qualifying charity This provision has expired for 2010.Key employee is the same in 2010 as in 2009:

- was a greater-than-5%-owner
- greater than 1% ownership *and* compensation > $150,000 (not indexed)
- officer *and* compensation > $160,000 in 2010

Highly compensated employee lookback amount was raised to $110,000 from $105,000:

- compensation exceeding $110,000 in 2009, where 2009 is the lookback year for 2010 *and*, if employer chooses, also in top-paid group (top 20% of *eligible* employees)
- In 2010, the compensation amount is still $110,000 (which will be the lookback amount in 2011)

New for distributions in 2010:

- 401(k) plans must now offer a direct rollover option to beneficiaries (result of the Worker, Retiree, and Employer Recovery Act of 2008 – WRERA)
- Prior to 2010: 401(k) plans only had to offer a lump sum distribution option

Social Security

- Social Security wage base remains at $106,800 for 2010
- Amount needed for a quarter of coverage increased from $1,090 to $1,120
- Reduction in earnings from age 62 to year prior to FRA remains at $1 for every $2 over $14,160
- Reduction in earning in FRA year remains at $1 for every $3 over $37,680
- Percentages of Social Security subject to taxation thresholds are still the same:
  - Single $25,000–$34,000
  - MFJ $32,000–$44,000

Medicare

- Part A deductible raised to $1,110 from $1,068 for first 60 days, then a $275 (was $267) per day coinsurance for the next 30 days
- Part B annual deductible is now $155 (was $135.00)
  - coinsurance is still 20%
- Part D (drugs)
  - deductible is now $310 (was $295)

Health Savings Accounts (HSAs)

- Self coverage (single) deductible must be at least $1,200 (was $1,150), and family deductible must be at least $2,400 (was $2,300)
- Self coverage (single) limit for contributions in 2010 is $3,050, and the family contribution limit is $6,150

COBRA Subsidy

COBRA continuation of coverage assistance offered under The American Recovery and Reinvestment Act of 2009 (ARRA) should be treated as having expired at the end of 2009. Technically, the provision was extended and liberalized by the Department of Defense Appropriations Act of 2010, signed into law on December 19, 2010. The Act extended the subsidy to apply to terminations occurring through February 28, 2010, and increased the maximum period for receiving the subsidy an additional six months (from nine to 15 months). Because this extension was passed within six months of the March examination, it should **not** be tested.

Transportation Benefits

Tax-free transportation benefits are limited to $230 per month (up from $120) for commuter highway vehicles or transit passes. Employer-provided parking is excluded from income up to $230 (same as 2009) per month.

Standard Mileage Rates

- business use: 50 cents per mile (was 58.5 cents)
- charitable use: 14 cents per mile (unchanged, not indexed)
- medical or moving use: 16.5 cents per mile (was 27 cents)

If you have any questions on the changes affecting the Retirement Planning & Employee Benefits materials, please contact Jim Pasztor at 1-800-237-9990, ext. 4839, or by e-mail at jim.pasztor@cffp.edu.

Estate Planning

2010: The Shift from Estate Tax to Income Tax

The EGTRRA legislation in 2001 repealed the estate tax for 2010. However, in order to comply with the Congressional Budget Act of 1974, EGTRRA also provides that all provisions of, and amendments made by EGTRRA would not apply to estates of decedents dying, gifts made, or generation-skipping transfers, after December 31, 2010. The Internal Revenue Code (IRC) would thereafter be applied and administered as if the provisions and amendments of EGTRRA had not been enacted (Act Section 901(b)). This "sunset provision" will thus reinstate the estate tax as it existed prior to EGTRRA on January 1, 2011, absent intervening legislation. Many people thought such new legislation would come long before 2010, but it has not.

Again, to comply with the Congressional Budget Act of 1974, the revenue lost by repeal of the estate tax for one year had to be partially paid for by enacting a new tax that would apply during 2010 only. Congress chose to use the federal income tax for this purpose. EGTRRA denies beneficiaries of a decedent who dies in 2010 the automatic step-up in income tax basis to the value used for estate tax purposes that existed under the now-repealed estate tax. Instead, such beneficiaries take the decedent's basis in the asset received, or fair market value (FMV) of the property at the decedent's death if less—known as "carryover basis"—thus receiving an asset subject to much more capital gain (assuming a capital asset—see IRC Section 1221) upon subsequent sale than would have been true with the old automatic step-up in basis.

However, to soften this potential increased income tax burden on estate beneficiaries, EGTRRA also empowers the personal representative of an estate, under prescribed circumstances, to increase the decedent's basis for assets going to any estate beneficiary by not more than $1.3 million in the aggregate, but not to exceed the property's FMV at the time of death (subsequently called the "$1.3 million basis increase"). EGTRRA also empowers the personal representative of an estate, under prescribed circumstances, to increase the decedent's basis for assets going to a surviving spouse by not more than an additional $3 million in the aggregate, but not to exceed the property's FMV at the time of death (subsequently called the "spousal property basis increase").

If the decedent was a nonresident noncitizen, the PR is empowered to increase the decedent's basis in estate assets only by an aggregate of $60,000 regardless of the beneficiary's identity.

The $1.3 million basis increase figure can be increased by the amount of any capital loss carryover of the decedent under IRC Section 1212, the amount of any net operating loss carryover under IRC Section 172 that would be carried from the decedent's last tax year to a later year but for the decedent's death, and any losses that would have been allowable under IRC Section 165 if the property acquired from the decedent had been sold at its fair market value immediately before the decedent's death. These amounts are allowed to increase the $1.3 million basis increase amount even when the increase is applied to assets other than those that generated the losses.

Eligibility Requirements for Basis Increase

There are two basic requirements for property to be eligible for either the $1.3 million basis increase, or the spousal property basis increase. The first requirement is that the property be owned by the decedent at the time of death. Not surprisingly, this requirement includes all property that would have been included in a decedent's gross estate under the estate tax in existence for 2009 with a few notable exceptions. These exceptions are:

- *Income in respect of a decedent (IRD) property.* While IRD property was in a decedent's gross estate for estate tax purposes, it was not entitled to a step-up in income tax basis. With the shift to income tax, and the emphasis on the basis of assets, this exception preserves the former rule that IRD assets cannot get a step-up (increase) in basis.
- *Property acquired by the decedent by gift or for less than full and adequate consideration in money or money's worth within three years of the decedent's death.* This exception does not apply to property acquired from a spouse during such period unless spouse also acquired the property during such period by gift or inter vivos transfer for less than full and adequate consideration in money or money's worth. This exception is designed to prevent people from giving property to a person who is going to die simply to get an increase in basis prior to sale after receiving the property back from the decedent. In effect, it lengthens the former rule regarding reverse gifts from one to three years. However, since the three-year rule may not apply to property received from a spouse, the old rule—that at least one year must elapse between the date of completion of the gift and the decedent's death in order to be eligible for an increase in basis from the PR—still applies.
- *Property in which the decedent held a general power of appointment at death.* Remember, the holder of such a power does not have actual title to the property over which the power is held.
- *Stock in foreign investment companies and foreign personal holding companies.*

An interest in property held in the decedent's sole name, or as a tenant in common (TIC) is deemed to be property owned by the decedent at death, as is the decedent's share of property held in joint tenancy with right of survivorship (JTWROS), tenancy by the entirety (TBE), and community property (CP). The decedent's interest in property held concurrently with others is determined in the same manner as under the estate tax in effect for 2009.

For example, property held in JTWROS, TBE, and CP between spouses is deemed to be held half by each spouse without regard to contribution, with the exception that property held in JTWROS by spouses prior to 1977 can use the contribution principle that applies to JTWROS property between nonspouses. Property held in TIC is deemed to be held equally unless otherwise stated regardless of the identity of the tenants. As was true for estate tax, the surviving spouse's interest in property held as CP is also deemed to be owned by the deceased spouse at death, thus preserving the possibility of a 100% step-up in basis for such property.

Property transferred by the decedent to a qualified revocable trust is deemed to be owned by the decedent at death. A qualified revocable trust is a trust in which the grantor has retained the right to revoke, and must recognize all income owned by trust assets. The property of any irrevocable trust in which the decedent retained the right to alter, amend, or terminate the trust, is also deemed to be owned by the decedent at death. Note that with both types of trust mentioned in this paragraph, the grantor will not have paid gift tax when the trust was funded, as the retained rights prevented the gift from being complete.

Finally, there is some uncertainty about whether irrevocable trusts in which the decedent retained other rights such as the right to income, the right of use, or the right to vote contributed stock would be deemed to be owned by the decedent at death. The grantor would have paid gift tax on at least part of such property when the trust was funded. The language of the applicable IRC section (§1022) seems broad enough to argue that such property should be deemed to be owned by the grantor/decedent at death, but it is not clear that such a result was intended. Because we are talking about property that is eligible for a basis increase, it is likely that the IRS would argue that Congress did not intend for such property to be eligible for a basis increase.

The second major requirement to be eligible for either the $1.3 million basis increase or the spousal property basis increase is that the property must be acquired from the decedent. Such property includes:

- property acquired by bequest devise, or inheritance;
- property transferred from a qualified revocable trust (described above);
- property transferred by the decedent to any trust over which the decedent retained the power to alter, amend, or terminate the trust;
- property that would have been included in a decedent's gross estate under either Sections 2036 and 2038 is likely deemed to have been received from the decedent; and
- any other property passing from the decedent by reason of death to the extent such property passed without consideration.

Qualified Spousal Property

Property that is eligible for the spousal property basis increase is known as qualified spousal property, and is classified either as outright transfer property or qualified terminable interest property (QTIP). Outright spousal property includes any interest in property acquired by a surviving spouse from the decedent that does not constitute a terminable interest, or an interest that is to be acquired for the surviving spouse, pursuant to directions of the decedent, by his executor or by the trustee of a trust. An interest passing to the surviving spouse that is conditioned upon a survival period not exceeding six months, or that would terminate only as a result of a common disaster resulting in death of the decedent and surviving spouse (simultaneous death) and such termination does not in fact occur in either circumstance.

QTIP property includes property in which the surviving spouse has a qualifying income interest for life, i.e., the right to all income, payable at least annually for life, or a usufruct (life estate) interest in the property for life. Also, no person can have a power over the property to appoint any part of the property to any person other than the surviving spouse (except a power exercisable only at or after the death of the surviving spouse).

While the previous paragraph describes the basic elements of a QTIP trust, it is important to remember that QTIP property can also exist outside of trust, such as when the donor's spouse is given a life estate in property with the remainder interest in the same property to someone else. It should also be noted that no QTIP election is necessary or possible for QTIP property to qualify for basis increase. When there was an estate tax, the QTIP election was made to get the marital deduction to keep some or all of the QTIP assets from being subject to estate tax in the decedent's estate. Since we are not concerned with estate tax in 2010, no election is necessary.

Return Filing Requirements

The PR must file a "Large Transfer" return (no form number currently assigned) pursuant to IRC 6018 for all estates where the value of property, other than cash, exceeds $1.3 million at the same time as the decedent's final income tax return (unless a later date is specified by regulation). Each recipient of estate property must receive a statement from the PR within 30 days after the return is filed containing all information on the return regarding assets received from the decedent. The return must report the following as to each asset:

- the name and TIN of the recipient of each asset,
- an accurate description of each asset,
- the adjusted basis of such property in the hands of the decedent, and its FMV at the time of death,
- the decedent's holding period,
- sufficient information to determine whether any gain on the sale of the property would be treated as ordinary income,
- the amount of basis increase (adjustment) allocated to the property, and
- such other information as the IRS may by regulations prescribe.

Selected Effects of the 2010 Basis Increase Rules

Although hardly an exhaustive list here are some selected effects of the 2010 basis increase rules:

- Valuation is still important; basis adjustment cannot exceed FMV.
- Estates may try to increase FMV as much as possible in order to allocate as much basis adjustment as possible if the estate is clearly in excess of $1.3 million. This position could cause valuation disputes with the IRS.

- If FMV of all estate assets is very close to $1.3 million, estates may want to hold down FMV to avoid filing a return, and to receive full basis increase for all estate assets. This position could cause valuation disputes with the IRS.
- More assets may be left to a surviving spouse to qualify for the $3 million spousal property basis increase.
- Low basis assets may be left to a spouse, with high basis assets to nonspouse beneficiaries.
- QTIP trust property may not be eligible for the $1.3 million basis increase in the estate of surviving spouse, as remainder beneficiaries would not have received such property from the surviving spouse.
- There are no deductions for debts of the decedent, administrative expenses, state death taxes, or theft or casualty losses.

The Gift Tax

Any changes in the federal gift tax required by EGTRRA for 2010 are set forth in Module 4.

The Generation-Skipping Transfer Tax (GSTT) in 2010

EGTRRA also repealed the GSTT (Act Section 501(b); IRC Section 2664) for 2010. No alternate plan or tax was put in place for 2010.

What to Expect in 2011

Estate Tax. As stated at the beginning of this section, because of the sunset provisions of EGTRRA, the federal estate tax will be reinstated effective January 1, 2011, absent intervening legislation. If this reinstatement because of EGTRRA's sunset provisions actually occurs, the estate tax provisions that will be different from those described in Module 3 for 2009 are:

- an applicable exclusion amount of $1 million (the same as the gift tax applicable exclusion amount) rather than $3.5 million in 2009.
- an applicable credit amount of $345,800 (the same as the gift tax credit amount) rather than $1,455,800 in 2009.
- The gift and estate tax rates will also be unified as they were prior to 2001, with a top regular rate of 55% (rather than 45% in 2009).
- The deduction for state death taxes that began in 2005 as a result of EGTRRA will revert back to a credit against estate tax owed, as was the case prior to EGTRRA. This credit will be the lesser of the death taxes actually paid or an amount derived from a federal table.

Gift Tax. The sunset provisions of EGTRRA will also restore the federal gift tax to the provisions that were in effect for this tax prior to EGTRRA. The pre-EGTRRA provisions that would be different from the gift tax described in Module 4 are:

- The maximum gift tax annual exclusion will continue to be indexed to inflation as it has been in prior years, and may be different from the $13,000 figure in 2010.
- Gift tax rates will return to what they were before EGTRRA, and will again be the same as estate tax rates with a top rate of 55% rather than 35% that existed in 2010.
- The gift tax applicable exclusion amount will be $1 million, and the gift tax applicable credit amount will be $345,800 (rather than $330,800, as was the case in 2010).

GSTT. The GSTT will be revived using the same provisions as were in effect before EGTRRA. The pre-EGTRRA provisions that would be different from the GSTT described in Module 5 are:

- One major change in this law from the tax as it existed in 2009 is that the GSTT exemption available to every person will no longer be tied to the estate tax exclusion, but will revert to an inflation indexed base amount of $1 million plus cumulative inflation since 1998 to the next lowest multiple of $10,000. This change will result in a much smaller exemption than existed in 2009 ($3.5 million).
- Because the rate of tax for taxable generation-skipping transfers is the highest estate tax rate in effect for the year of the transfer, such transfers will be taxed at 55% rather than 45%, which was the highest estate tax rate in effect for 2009.
- The deemed allocation rules of Section 2632, which automatically allocate a transferor's GSTT exemption, will no longer apply to lifetime indirect skips as they did in 2009.

If you have any questions on the changes affecting the Estate Planning materials, please contact Gregg Parish at 1-800-237-9990, ext. 4833, or by e-mail at gregg.parish@cffp.edu.