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May 13, 2010

***RE: Federal Tax Developments***

Dear Clients:

Health care reform and employment incentive legislation passed by Congress in the first quarter of 2010 contains several significant tax law developments. This letter summarizes those developments that may affect your estate and financial planning.

**GRAT Limitations.** H.R. 4849, which passed the House of Representatives on March 24, could be the beginning of the end for the short-term Grantor Retained Annuity Trust ("GRAT"). At present, a taxpayer may establish a "zeroed-out" GRAT in which the remainder has no taxable value so that no taxable gift occurs. Although the estate tax was suspended for 2010, the gift tax remains. A zeroed-out GRAT preserves a taxpayer's \$1.0 million lifetime gift tax exemption for other transfers.

The House Committee on Ways and Means stated that "such uses of GRATs for gift tax avoidance are inappropriate." The House bill requires that GRATs have a term of at least 10 years, compared with the current two-year minimum. This requirement increases the "mortality risk" of a GRAT: if the grantor dies during the trust term, all or part of the trust assets will be included in the grantor's estate for estate tax purposes. The House bill would, however, apply only to GRATs established after enactment.

Clients who are concerned about the scheduled reinstatement of the estate tax in 2011 and beyond should act swiftly. In particular, a GRAT may appeal to clients who expect that a liquidity event, such as a sale, may occur in the foreseeable future, or who expect depreciated assets to recover during the GRAT term.

**Estate planning uncertainty.** Congress remains remarkably silent regarding the estate and generation-skipping transfer tax regime. Because of changes to the income tax basis rules for property acquired from a decedent in 2010, non-spouse beneficiaries could

actually face a higher tax on wealth transfers if their loved one dies in 2010. The suspension of the estate tax this year may be more than offset by a higher realization of capital gain due to a carry over basis. Nevertheless, no legislative proposal is on the "front burner."

**Annuitizing** retirement plan payments. The Departments of Labor and Treasury are currently reviewing approaches to enhance the retirement security of participants in employer-sponsored retirement plans and IRAs. The preferred approach appears to be arrangements that provide a lifetime income stream after retirement. The government's concern is that many employers no longer provide fixed lifetime pensions but rather provide 401(k) plans. These plans shift the investment risk to employees, causing them to be responsible for the adequacy of their savings at the time of retirement and for the management of those assets to last through life expectancy.

**Moratorium on selective enforcement of tax shelter penalty.** The IRS will continue to suspend through May 31, 2010 its efforts to collect penalties of \$100,000 per individual and \$200,000 per entity for each failure to make special disclosures with respect to a "listed transaction", or a reporting position "substantially similar" to a listed transaction. Listed transactions are high profile tax avoidance strategies, typically used in connection with syndicated limited partnerships that the IRS has identified for special reporting requirements. The suspension applies when the annual tax benefit from the transaction is less than \$100,000 for individuals or \$200,000 for other taxpayers.

**Audit Percentages.** The IRS has issued its annual data book. A total of 138,788,744 individual income tax returns were filed in calendar year 2008; 1,425,888 (1%) were audited. For business returns (other than farms) showing total gross receipts of \$100,000 to \$200,000, 4.2% of returns were audited, For business returns (other than farm returns) showing total gross receipts of \$200,000 or more, 3.2% of returns were audited. For returns showing income between \$200,000 and \$1 million, the audit percentage of returns not showing business activity was 2.3%, compared with 3.1% for returns showing business activity.

**Like-kind exchange relief for certain users of Qualified Intermediaries.** In general, no gain or loss is recognized on the exchange of "like-kind" property held for productive use or for investment. A taxpayer may use a qualified intermediary (QI) to complete a deferred like-kind exchange. Federal tax regulations allow the QI to complete the sale and receive the sales proceeds, and to purchase replacement property that is ultimately transferred to the taxpayer. Many QIs went bankrupt in the recent recession, creating problems for exchanging taxpayers. The IRS has now granted special "safe harbor" relief for taxpayers who are unable to complete a timely like-kind exchange because their QI entered into bankruptcy or receivership.