



Bank Tax Institute – S Corporations

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Agenda

- Estate Tax Planning for S Corp Shareholders
- Tax Planning – CFO's Perspective
- Current Tax Issues

Estate Tax Planning for S Corp Shareholders

Agenda

- Overview of Basic Estate Planning Concepts
 - Regular Estate and Gift Tax
 - Generation Skipping Transfer Tax

- Highlights of changes in 2010 Tax Act

- Examples of Estate Planning Techniques
 - Intentionally Defective Irrevocable Trust
 - Grantor Retained Annuity Trust

Estate, Gift and GST Tax: Background

Overview of Transfer Taxes

Recipient	Time of Transfer	
	During Lifetime	Upon Death
Anyone	Gift Tax	Estate Tax
“Skip Person” (grandchild)	Generation Skipping Transfer (GST) Tax	

Tax Laws Applicable Prior to 2010 Tax Act

<u>Year</u>	Applicable Exclusion Against:		<u>Max Rate</u>
	<u>Estate/GST</u>	<u>Gift Tax</u>	
2003	\$1.0 million	\$1.0 million	49 %
2004	\$1.5 million	\$1.0 million	48 %
2005	\$1.5 million	\$1.0 million	47 %
2006	\$2.0 million	\$1.0 million	46 %
2007-8	\$2.0 million	\$1.0 million	45 %
2009	\$3.5 million	\$1.0 million	45 %
2010	(repealed)	\$1.0 million	35 % **
2011 on	\$1.0 million	\$1.0 million	55 %

** = The 35% tax rate for 2010 applies to gift tax only.

Estate and Gift Exemptions under 2010 Tax Act

Applicable Exclusion Against:

<u>Year</u>	<u>Estate Tax</u>	<u>Gift Tax</u>	<u>Max Rate</u>
2006	\$2.0 million	\$1.0 million	46 %
2008	\$2.0 million	\$1.0 million	45 %
2009	\$3.5 million	\$1.0 million	45 %
2010	Optional**	\$1.0 million	35 %
2011	\$5.0 million	\$5.0 million	35 %
2012	\$5.0 million	\$5.0 million	35%
2013	\$1.0 million	\$1.0 million	55 %

** For death in 2010, can choose to either pay estate tax and get stepped-up basis, or not pay estate tax and use carryover basis.

Generation Skipping Transfer (GST) Tax

- A flat rate tax computed at the highest marginal estate tax bracket.
- The tax is imposed on “**taxable transfers**” to “**skip persons**”, which includes related people (two generations lower) and unrelated people (37 ½ yrs younger), as well as trusts created for the benefit of skip persons.
- “Taxable Transfers” include both:
 - Direct Skips
 - Payments from Trusts

Interplay of GST Tax with Gift Tax

Example:

Grandpa gives \$3,600,000 to grandson in 2009

Gift Tax

Value of gift	\$ 3,600,000
Amount exempt	<u>(1,000,000)</u>
Taxable amount	<u>\$ 2,600,000</u>

Gift tax due **\$ 1,155,000**

GST Tax

Value of gift	\$ 3,600,000
Amount exempt	<u>(3,500,000)</u>
Taxable amount	<u>\$ 100,000</u>

GST tax due **\$ 45,000**

\$1,200,000

Total Taxes on \$3,600,000 Transfer

Estate, Gift and GST Tax Changes in 2010:

2010 TRUIRJCA Changes

- **Official title:** Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010
 - Negotiated between President Obama and Republican leadership on December 6th
 - Text of Law released December 9th
 - Passed by Senate on Dec. 15th (81 to 19)
 - Passed by House on Dec. 16th (at 11:58 PM)
 - Signed by President Obama and enacted into law on Friday, December 17th

Estate, and Generation Skipping Transfers

- **Estate Tax is “optional”:**
 - Reinstated retroactively to 1/1/2010, with \$5 million exemption and 35% top rate.
 - Can “opt-out” of retroactive law for deaths during 2010, and use prior law instead.

- **Generation Skipping Transfer Tax**
 - Reinstated retroactively to 1/1/2010, with \$5 million exemption and 35% top rate.
 - Tax rate for 2010 transfers is Zero Percent.

Gift Tax Provisions

■ Gift Tax:

- Rate remains 35% in 2010, 2011 and 2012
- Gift exemption “reunified” with Estate Tax exemption at \$5MM, beginning Jan. 1, 2011

■ Annual Gift Tax Exclusions Continue:

- The **annual** exclusion is still **\$13,000** per donee for present interest gifts in 2010 and 2011; may be indexed for inflation in 2012

Estate Tax: Old Law versus New Law

	2009	2010 (Prior Law)	2010 (New Law)	2011 (New Law)
Top Estate Tax Rate	45%	Repealed	35%, but can “Opt-Out”	35%
Lifetime Exclusion	\$3,500,000	N/A	\$5,000,000 (or “opt-out”)	\$5,000,000*
Tax Basis of Assets Inherited	FMV at Date of Death	Modified Carryover Basis	FMV at DOD, unless elect Opt-Out	FMV at Date of Death
“Portability” Available	NO	NO	NO	Yes

* = Exclusion will be indexed for inflation beginning in 2012

Gift and GST Tax: Old vs. New Law

	2009	2010 (Prior Law)	2010 (New Law)	2011 (New Law)
Top Gift Tax Rate	35%	35%	35%	35%
Gift Lifetime Exclusion	\$1,000,000	\$1,000,000	\$5,000,000	\$5,000,000*
GST – Tax Rate	45%	Repealed	35%	35%
GST – Exemption	\$3,500,000	N/A	\$5,000,000	\$5,000,000

* = Exclusion will be indexed for inflation beginning in 2012

Benefit of Retroactive Implementation

■ **Estate Tax:**

- Full “step-up in basis” can be achieved with \$5 million exemption available
- 35% rate if executor chooses to pay tax

■ **Generation Skipping Transfer Tax**

- Favorable provisions for severances and automatic allocations that otherwise expired on December 31, 2009 are reinstated
- \$5 million exemption can be allocated to transfers into trusts during 2010
- Zero “rate” means no tax on 2010 transfers

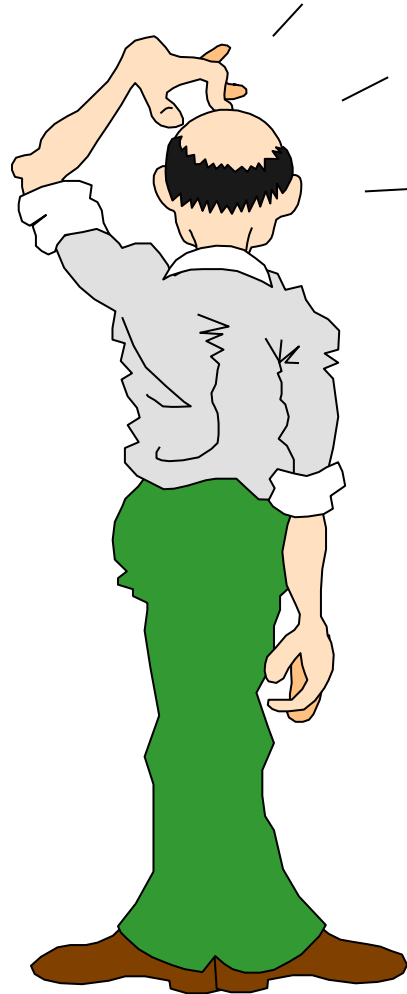
Why Focus on Estate Tax Planning Now?

- **“The Perfect Storm”**

- Current economic conditions
 - Value of assets are still depressed compared to pre-recession prices
- Current interest rates are at historic lows
 - Sales to heirs in July 2011 can be financed at under 2% for “mid-term” (4 to 9-year) notes; rate is under 3.9% for long-term (over 9-yr) notes
- Current political climate
 - Current increase in lifetime exclusion to \$5 million is temporary, and useful estate tax-saving techniques are still under attack from government

Estate Planning Techniques

- QTIP
- Credit Shelter
- **Outright Gifts**
- Crummey Power
- **IDIT (or IDGT)**
- Living Will
- Living Trust
- **GRATS**
- Dynasty Trust



- ILIT
- P.S. 58
- CRAT
- FLP
- SCIN
- NIMCRUT
- GST
- QPRT
- CLUT

Lifetime Gifting Strategies

- Two Methods of Gifting (Control Issues):
 - Outright Direct Gift – Recipient Controls Property
 - (Less of an issue/concern for Non-Voting Stock)
 - Gift to a Trust – Recipient is merely a beneficiary
 - (Trustee manages the asset, and cash received)

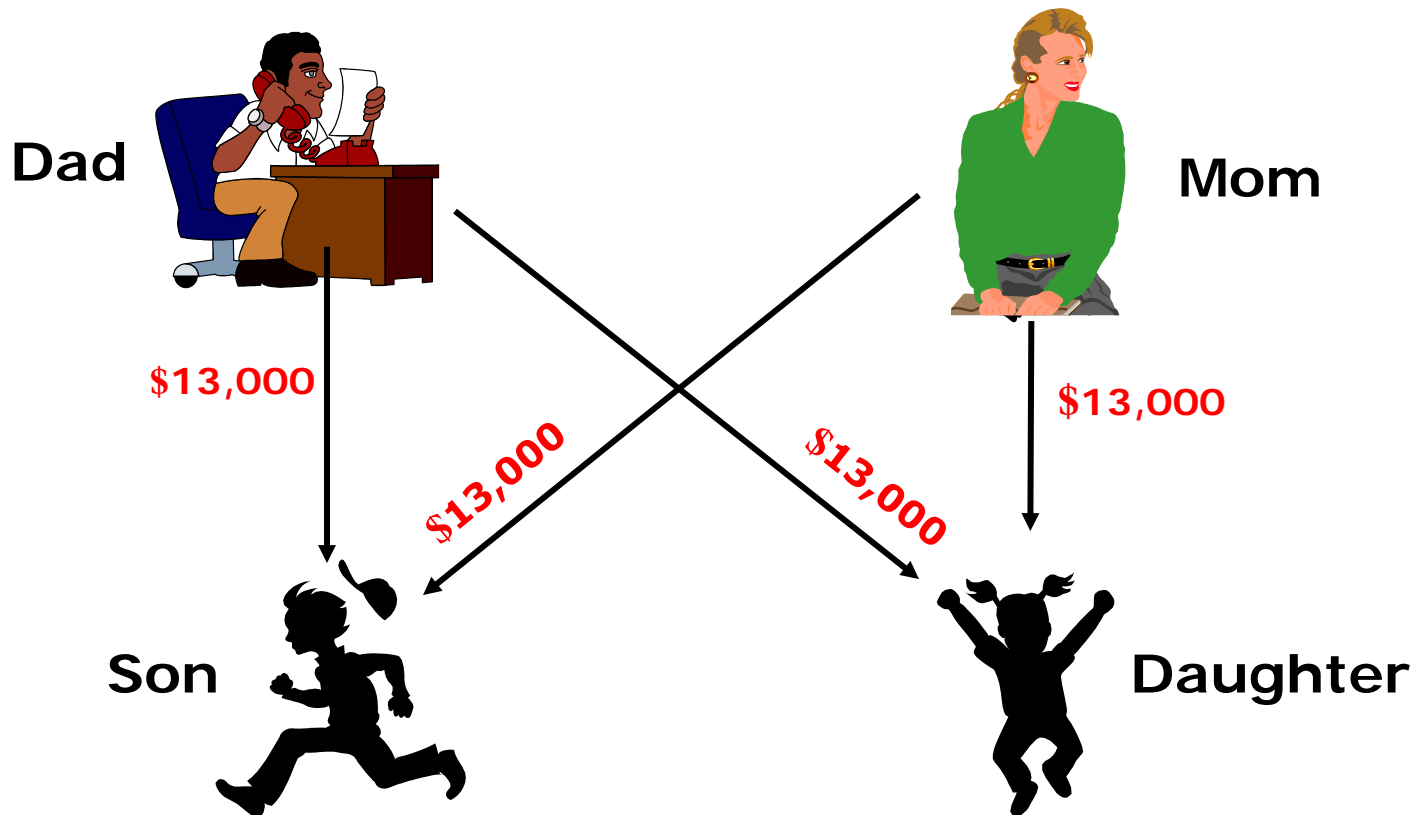
- Two Choices regarding Amount and Timing:
 - Annual exclusion gifting program
 - Lifetime exemption gifting program

Annual Gift Tax Exclusion

- The first \$13,000 of gifts of a present interest made by a donor to each donee in each calendar year is excluded from the amount of the donor's taxable gifts



Annual Gift Tax Exclusion



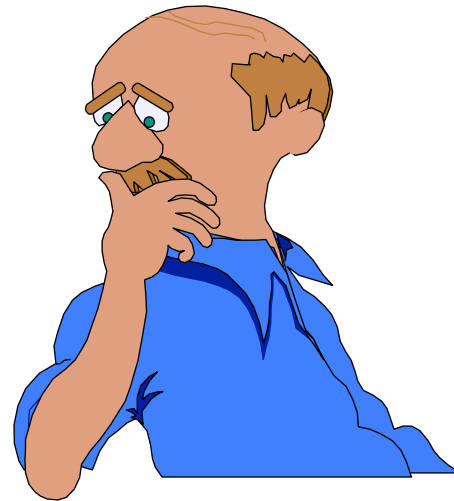
Gifts made = **\$52,000**

Gift tax due = **\$0**

Lifetime Exemption Used = **\$0**

Annual Exclusion Gifting Program

Why?



Potential to transfer significant value that would otherwise be subject to estate tax

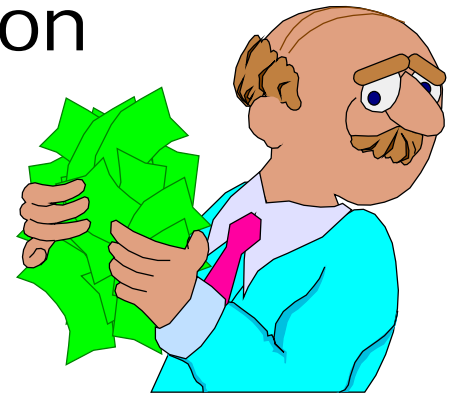
Lifetime Gifting Program (\$52,000 / year)

**Assumes
8% growth**

	<u>Without Gifts</u>	<u>With Gifts</u>	<u>Difference</u>
1/1/10	2,000,000	2,000,000	
2010	2,160,000	2,103,840	
2011	2,332,800	2,215,987	
2012	2,519,424	2,337,106	
2013	2,720,978	2,467,915	
2014	2,938,656	2,609,188	
2015	3,173,749	2,761,763	
2016	3,427,649	2,926,544	
2017	3,701,860	3,104,507	
2018	3,998,009	3,296,708	
2019	<u>4,317,850</u>	<u>3,504,285</u>	<u>813,565</u>
Estate tax:			
55% rate	2,374,818	1,927,357	447,461
35% rate	1,511,248	1,226,500	284,748

Additional Gifting to Use Lifetime Exemption

- Make gifts in a year that **exceed** the \$13,000 exclusion, and thus utilize up to \$5,000,000 of lifetime gift exclusion
- No gift tax due, provided that the cumulative gifts are less than the \$5 million exclusion
- Total gift/estate tax burden will be reduced by removing future appreciation from estate
- Use discounted value of assets if possible



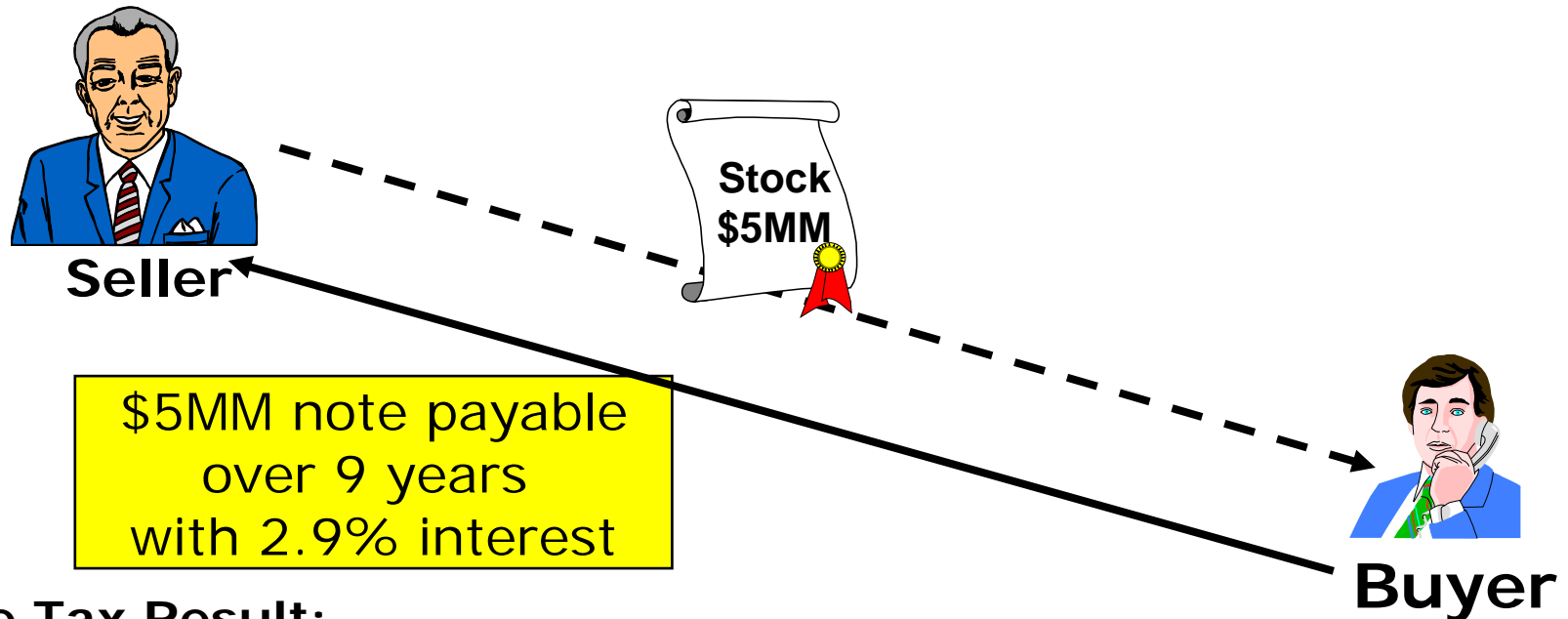
Gift Strategies

- **Discounting opportunities**
 - Minority Interest (a/k/a “lack of control”)
 - What would you pay for 49% of a company?
 - Rev. Rul. 93-12 requires the IRS to ignore “family attribution”; thus minority discounts authorized
 - Lack of Marketability
 - Takes time to find a buyer for a closely-held business
- **Professional valuation is important**
 - “What is a business worth?” (Depends who’s asking)
 - Providing “adequate disclosure” to IRS will start the three-year gift tax statute of limitations

\$1 Million Outright Gift

	<u>Without Gifts</u>	<u>With Gifts</u>	<u>Difference</u>
Jan. 2011	\$10,000,000	\$ 9,000,000	
Estate value at Death	\$30,000,000	\$27,000,000	
Exemption	<u>(5,000,000)</u>	<u>(4,000,000)</u>	
Taxable Amt.	<u>\$25,000,000</u>	<u>\$ 23,000,000</u>	<u>\$ 2,000,000</u>
Estate tax:			
55% Rate	\$ 13,750,000	\$ 12,650,000	\$1,100,000
35% Rate	\$ 8,750,000	\$8,050,000	\$ 700,000

Straight Sale Transaction



Income Tax Result:

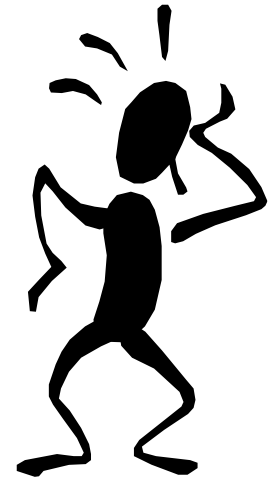
1. Seller pays ordinary rates on interest, and capital gain tax on principal
2. Buyer pays income tax on future profits

Estate Tax Result:

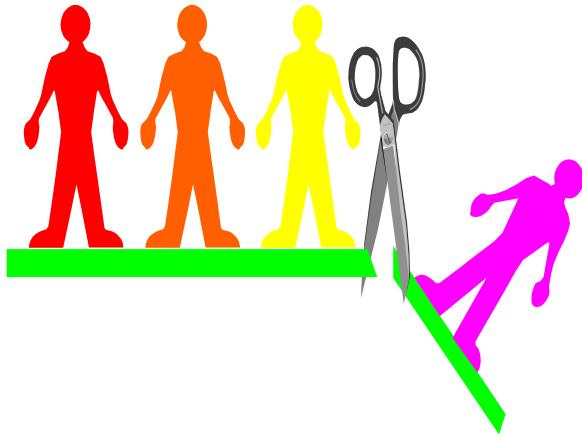
Only remaining note balance (and unspent proceeds) are taxable

Sale to a “Grantor Trust”

- In general, both the income tax and estate tax laws provide that if a taxpayer transfers property to a trust but continues to “control” either the trust or the property, the IRS will simply ignore the existence of the trust
- However, the test for what constitutes “control” is different for income tax purposes than it is for estate and gift tax purposes



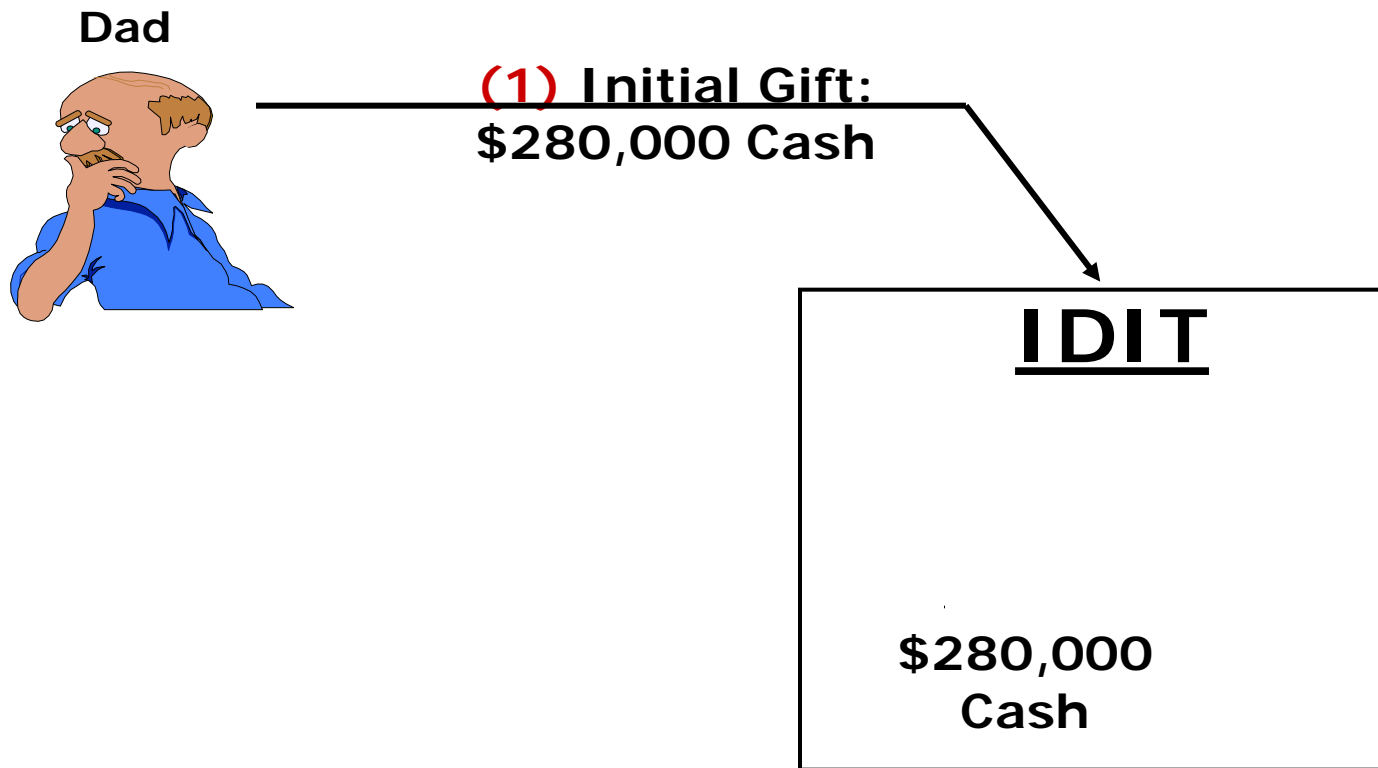
“Intentionally Defective” Trust



- Taxpayers can take advantage of these rules to make the trust **intentionally defective** for income tax purposes
- It still is a valid transfer for legal purposes, as well as for estate and gift tax purposes

Intentionally Defective Irrevocable Trust

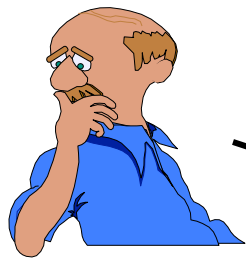
Example:



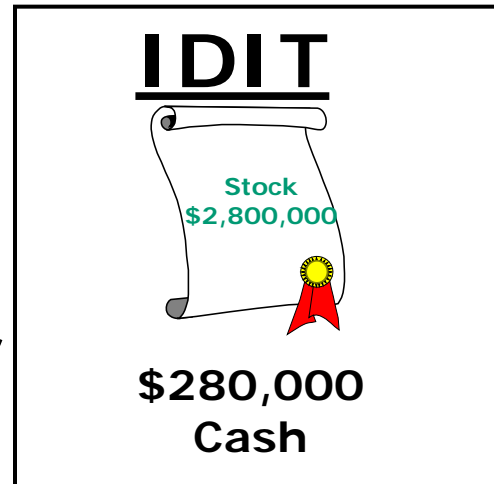
I.D.I.T. Example

Value of Total Company	\$10,000,000
Portion of Stock Sold	<u>X 40%</u>
"Gross" FMV	4,000,000
Valuation Discounts (30%)	<u>(1,200,000)</u>
Net Fair Market Value	\$2,800,000

Dad



(2) Sale
(Income Tax Free)

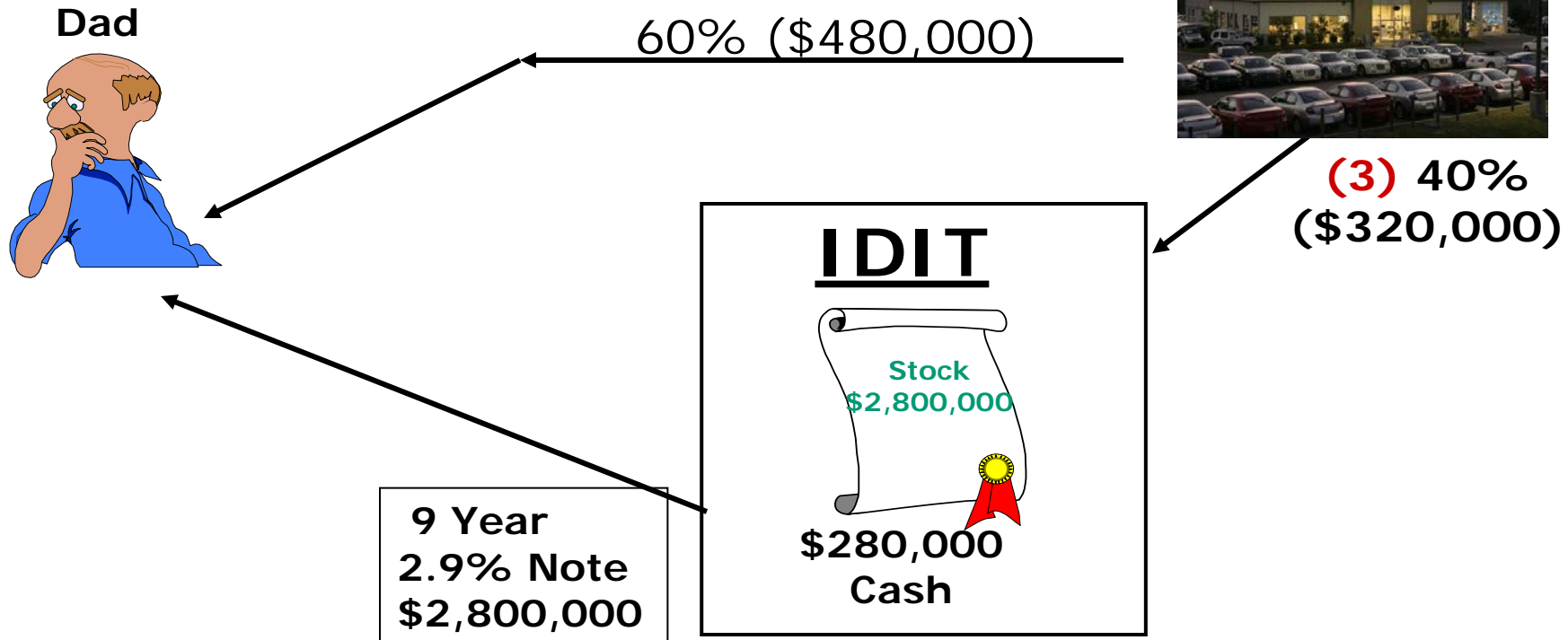


9 Year
2.9% Note
\$2,800,000

Annual Note
Payments:
\$358,000

S Corp Distribution (\$800,000)

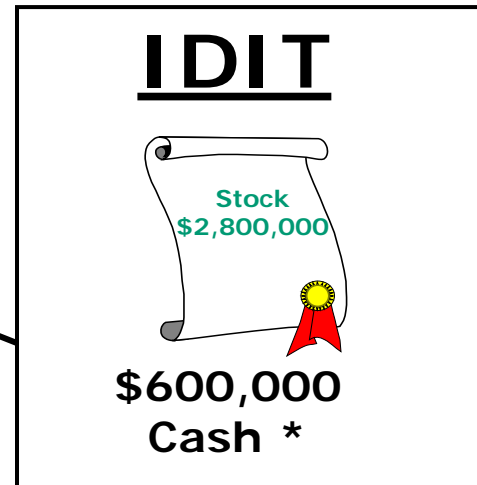
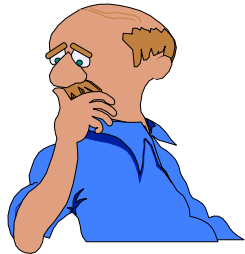
S Corp



I.D.I.T. Example

S Corp

Dad



9 Year
2.9% Note
\$2,800,000

*** Cash:**

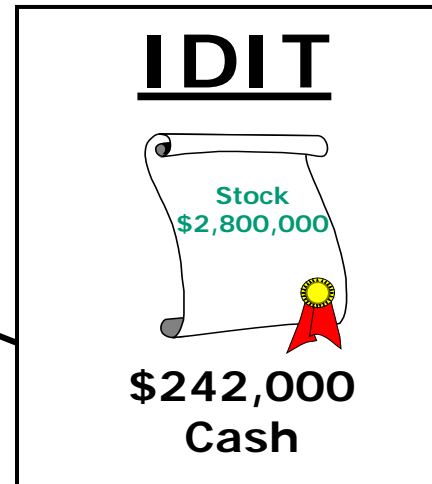
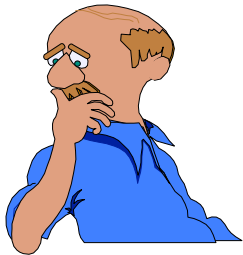
Gift	\$280,000
Dividend	<u>320,000</u>
Total	<u>\$600,000</u>

I.D.I.T. Note Payment

S Corp



Dad



9 Year
2.9% Note
\$2,523,000

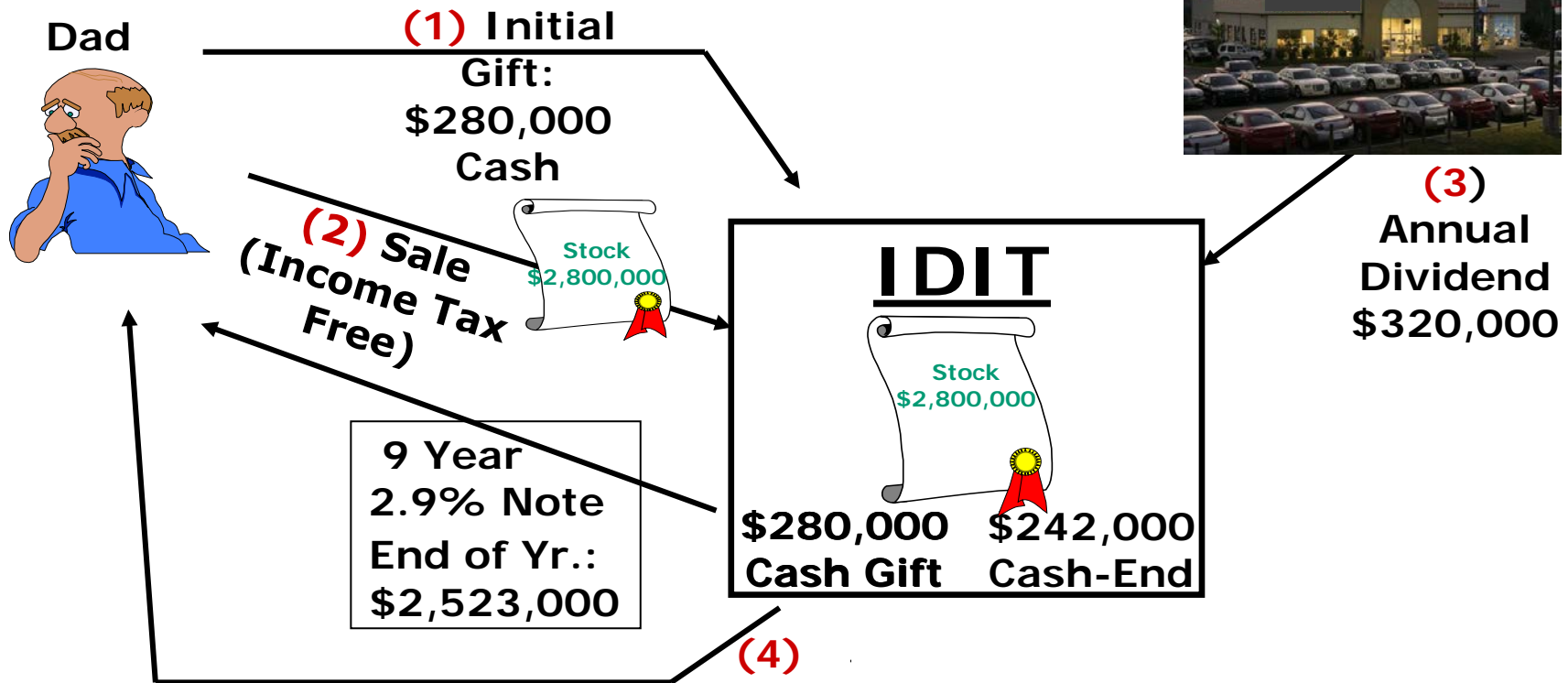
(4)

\$358,000/year
Principal & Interest
(Income Tax Free)

Interest	\$ 81,000
Principal	<u>277,000</u>
Total Pmt.	<u>\$358,000</u>

I.D.I.T. – Summary of Year One

S Corp

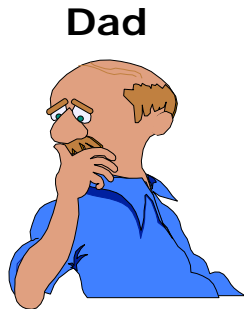


**\$358,000/year
Principal & Interest
(Income Tax Free)**

Interest	\$ 81,000
Principal	<u>277,000</u>
Total Pmt.	<u>\$358,000</u>

I.D.I.T. Income Taxes

S Corp



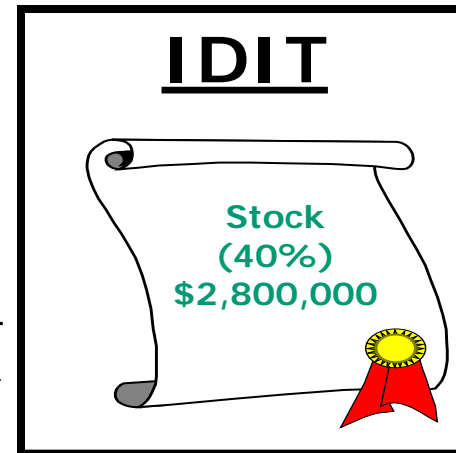
Dad

Dad taxable on S Corp Income:

Directly owned (60%)	\$1,200,000
Owned by IDIT (40%)	<u>800,000</u>
Total	\$2,000,000

Total Profits
\$2,000,000

IDIT Income (40%)	\$800,000
Tax Owed (40%)	\$(320,000)
Cash Received (Note)	<u>358,000</u>
Increase in Cash	38,000



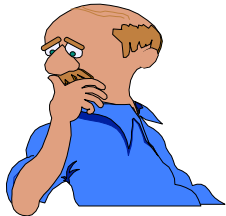
Reduction in Note	<u>(277,000)</u>
Change in Net Worth	<u><u>\$ (239,000)</u></u>

Ultimate
Beneficiaries

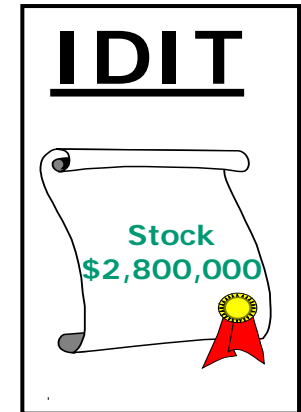
Children / Heirs

I.D.I.T. – End of Year Nine (for 40% Block of Stock)

Dad



	Annual (in '000's)	9 Years
Total Note Pmts Rec'd	\$358	\$3,222
Income Tax Paid	<u>(320)</u>	<u>(2,880)</u>
Net included in Estate	38	342
Stock Rec'd by Heirs ⁽¹⁾		9,900
Net Assets removed from Taxable Estate		<u>\$ 9,558</u>



Ultimate
Beneficiaries

Children / Heirs

(1) Represents 10.6% annual growth in value, undiscounted

Results of Sale to Intentionally Defective Trust

End of 9 Years (in '000's)

	<u>Without Sale</u>		<u>With Sale</u>	
Stock Owned	<u>100%</u>	\$24,800	<u>60%</u>	\$14,900
Beginning Cash	\$280		\$Gifted	
Div's Rec'd (\$800/yr)	7,200	\$480/yr	4,320	
Note Pmts (\$358/yr)	None		3,222	
Taxes Paid	<u>(7,200)</u>		<u>(7,200)</u>	
Cash on Hand		280		342
Gift Made		<u>None</u>		<u>280</u>
Taxable Estate		<u>\$25,080</u>		<u>\$15,522</u>
		\$ 11,286		\$ 6,985
			\$ 4,301	

Assumes 10.6% Growth for Stock, and 2009 Estate tax rates

Benefits of IDIT Technique

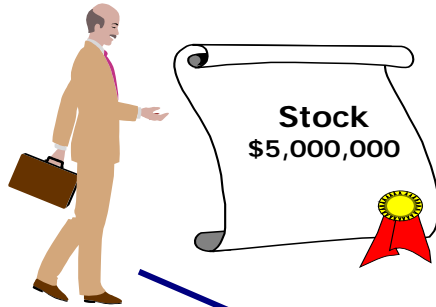
- Selling assets at discounted values
- No income tax on sale, or on note payments
- Any increase in the value of the original asset sold to the trust avoids estate tax
- The value of the note (included in seller's estate) does not appreciate, other than for interest earned on the note
- Grantor pays all income taxes on profits or gains on trust assets, resulting in a further reduction of his estate with no gift tax

Grantor Retained Annuity Trust (GRAT)

- Alternative Technique: useful when transferor has previously utilized all gift tax lifetime exemption
- Transfer assets to an irrevocable trust, in exchange for a series of payments from the trust
- Taxable gift is difference between value of property and the Present Value of the series of payments
- You are treated for income tax purposes as if you still own the assets until all payments are made
- For Estate Tax Purposes, the assets are only taxable if you die before all payments are made as scheduled

Grantor Retained Annuity Trust (GRAT)

Dad



Dad's Estate



\$636,195/yr

<u>GRAT - 9-Year Term</u>	
FMV	\$ 5,000,000
Value of annuity	<u>4,999,984</u>
Taxable gift	<u><u>16</u></u>

If Dad does not live 9 years, stock will be taxed in his estate at FMV. However, the assets will remain in trust, with remaining payments made to Dad's estate

\$ 3,150,543 In 9 years



Child(ren)

Assumes 10% Growth and/or income

Discount rate 2.8% (June 2011)

Tax Planning – CFO's Perspective

“Perfect storm” for transferring bank stock to IDIT

- Low valuations and market multiples
- Low interest rates (mid term AFR rates 1.19% for October)
- Increase in lifetime gift tax exemption from \$1 million to \$5 million (2011 and 2012 only)

Example of IDIT transfer - Assumptions

1. Discounted value of stock	\$ 50,000,000
2. Pretax return on equity	10.0%
3. Assumed annual distribution	50.0%
4. Stock gifted to IDGT	\$ 5,000,000
5. Initial installment note	\$ 45,000,000
6. Interest rate applicable to installment note (mid term AFR for October 2011)	1.19%
7. Term of note (in years)	8.99

IDIT example – Years 1 through 5

(in thousands)

	Year 1	Year 2	Year 3	Year 4	Year 5
Value at the beginning of the year	\$50,000	\$52,500	\$55,125	\$ 57,881	\$60,775
Assumed annual appreciation	5.0%	5.0%	5.0%	5.0%	5.0%
Value at the end of the year	\$52,500	\$55,125	\$57,881	\$ 60,775	\$63,814
Projected pretax net income (10% ROE)	\$ 5,000	\$ 5,250	\$ 5,513	\$ 5,788	\$ 6,078
Projected distribution (50%)	\$ 2,500	\$ 2,625	\$ 2,756	\$ 2,894	\$ 3,039
Interest due on installment note	\$ 536	\$ 512	\$ 487	\$ 460	\$ 431
Funds available to pay down installment note	\$ 1,965	\$ 2,113	\$ 2,269	\$ 2,434	\$ 2,608
Balance of note after payment	\$43,036	\$40,923	\$38,653	\$ 36,219	\$33,612
Cumulative value transferred					\$30,203

IDIT example – Years 6 through 10

(in thousands)

	Year 6	Year 7	Year 8	Year 9	Year 10
Value at the beginning of the year	\$63,814	\$67,005	\$70,355	\$ 73,873	\$ 77,566
Assumed annual appreciation	5.0%	5.0%	5.0%	5.0%	5.0%
Value at the end of the year	\$67,005	\$70,355	\$73,873	\$ 77,566	\$ 81,445
Projected pretax net income (10% ROE)	\$ 6,381	\$ 6,700	\$ 7,036	\$ 7,387	\$ 7,757
Projected distribution (50%)	\$ 3,191	\$ 3,350	\$ 3,518	\$ 3,694	\$ 3,878
Interest due on installment note	\$ 400	\$ 367	\$ 331	\$ 293	\$ 253
Funds available to pay down installment note	\$ 2,791	\$ 2,983	\$ 3,186	\$ 3,400	\$ 3,625
Balance of note after payment	\$30,821	\$27,837	\$24,651	\$ 21,251	\$ 17,625
Cumulative value transferred					\$ 63,820

Location, Location, Location

- For most S Corps, tax distributions are based on the highest effective tax rate of the shareholders
- Shareholders' state of residence is just as important in calculating state taxes as it is for obtaining in-state tuition at state colleges
- The following are factors that can have a dramatic impact on the effective tax rate for the shareholders:
 - States with no individual state income tax
 - Credit for taxes paid to another state for residents
 - State tax incentive programs
 - Unearned Medicare tax contribution set to begin in 2013
 - Return of phased out itemized deductions set for 2013
 - Apportionment of income to states with throwback or no throwback provisions

States with no individual state income tax

Alaska	Tennessee
Florida	Texas
Nevada	Washington
New Hampshire	Wyoming
South Dakota	

Unearned income Medicare contribution

- Beginning in 2013, the Reconciliation Act levies a 3.8% surtax on the lesser of net investment income or income in excess of a defined threshold amount
- The thresholds are \$250,000 for a joint or surviving spouse return, \$125,000 for married individuals filing separately, and \$200,000 for all others
- For estates and trusts, the 3.8% surtax is on the lesser of undistributed net investment income or income in excess of the highest estate or trust tax bracket

Material participation tests

You materially participated in a trade or business activity if you satisfy any of the following tests:

- 1 You participated in the activity for more than 500 hours
- 2 Your participation was substantially all the participation in the activity of all individuals
- 3 You participated in the activity for more than 100 hours during the tax year and you participated at least as much as any other individual
- 4 The activity is a significant participation activity and you participated in all significant participation activities for more than 500 hours
- 5 You materially participated in the activity for any 5 of 10 immediately preceding tax years
- 6 The activity is a personal service activity in which you participated for any 3 preceding tax years.
- 7 Based on all of the facts and circumstances, you participated in the activity on a regular, continuous and substantial basis during the year

Above information per IRS publication 925 *Passive Activity and At-Risk Rules*

Grouping your activities

- You can treat one or more trade or business activities, or rental activities, as a single activity if those activities form an appropriate economic unit for measuring gain or loss under the passive activity rules

- Grouping is important for a number of reasons
 - If you group two activities into one larger activity, you need only show material participation in the activity as a whole

 - If you group two activities into one larger activity and you dispose of one of them, then you have disposed of only part of your entire interest in the activity

Grouping your activities – Appropriate economic units

- The factors you should consider are:
 1. The similarities and difference in the types of trades and or businesses;
 2. The extent of common control;
 3. The extent of common ownership;
 4. The geographical location; and
 5. The interdependence between or among activities, which may include the extent to which the activities:
 - Buy or sell goods between or among themselves;
 - Involve products or services that are generally provided together;
 - Have the same customers;
 - Have the same employees; or
 - Use a single set of books and records to account for the activities.

Grouping your activities – Example 1

- John owns a bakery and a movie theatre at a shopping mall in Baltimore and a bakery and movie theatre in Philadelphia. Based on the relevant facts and circumstances, there may be more than one reasonable method for grouping John's activities. For example John may be able to group the movie theatres and bakeries into:
 - One activity;
 - A movie theatre activity and a bakery activity;
 - A Baltimore activity and a Philadelphia activity; or
 - Four separate activities.

Grouping your activities – Example 2

- Betty is a partner at ABC partnership, which sells nonfood items to grocery store. Betty is also a partner in DEF (a trucking business). ABC and DEF are under common control. The main part of DEF's business is transporting goods for ABC. DEF is the only trucking business in which Betty is involved. Based on the rules, Betty treats ABC's wholesale activity and DEF's trucking activities as a single activity.

Grouping your activities – Rental activities

- In general, you cannot group a rental activity with a trade or business activity; however, you can group them together if the activities form an appropriate unit and:
 - The rental activity is insubstantial in relation to the trade or business activity;
 - The trade or business activity is insubstantial to the rental activity; or
 - Each owner of the trade or business activity has the same ownership in the rental activity, in which case the part of the rental activity that involves the rental of items of property for use in the trade or business activity may be grouped with the trade or business activity.

Throwback rule

- The throwback rule says that if a corporation with facilities in the state has income that is not taxed by any state, then that income is “thrown back” and taxed in the state where the company has facilities.

States with no throwback provisions

Arizona	Minnesota
Connecticut	Nebraska
Delaware	New York
Florida	North Carolina
Georgia	Ohio
Iowa	Pennsylvania
Kentucky	Rhode Island
Louisiana	South Carolina
Maryland	Tennessee
Massachusetts	Virginia

States with throwback provisions

Alabama	Missouri
Alaska	Montana
Arkansas	New Hampshire
California	New Mexico
Colorado	North Dakota
Hawaii	Oklahoma
Idaho	Oregon
Illinois	Rhode Island
Indiana	Utah
Kansas	Vermont
Massachusetts	Wisconsin
Mississippi	

Current Tax Issues

TEFRA Interest Expense Disallowance

- Action on Decision 2010-006
 - Issued December 13, 2010
 - IRS acquiesced “in result only” on *Vainisi v. Commissioner*, U.S. Seventh Circuit Court of Appeals decision reversing the decision of the Tax Court
 - IRS will not apply Section 291 to a QSub bank or an S-Corp bank unless the bank (or any predecessor) was a C-Corp bank in the three immediately preceding taxable years
 - This issue should be effectively resolved pending any future legislative changes

Small Business Jobs Act of 2010

Built-In Gains Tax:

- Effective for S Corp tax years beginning in 2011
- Built-in gains recognition period temporarily reduced from ten years to five years
 - Thus, for 2011 only, the recognition period is the 5-year period beginning with the first taxable year for which the corporation was an S Corp
- American Recovery & Reinvestment Act (ARRA) had previously reduced the built-in gains recognition period from 10 to 7 years, but only if the seventh taxable year in the recognition period preceded either 2009 or 2010
- See chart on next slide

Small Business Jobs Act of 2010

Built-In Gains Tax:

- Including overlap of ARRA provision

Tax year converted to S Corp	BIG Tax applicable for 2009?	BIG Tax applicable for 2010?	BIG Tax applicable for 2011?	BIG Tax applicable for 2012?
2001	NO	NO	N/A	N/A
2002	NO	NO	NO	N/A
2003	YES	NO	NO	YES
2004-2006	YES	YES	NO	YES
2007 or later	YES	YES	YES	YES

Small Business Jobs Act of 2010

Built-In Gains Tax:

- When ARRA was enacted in 2009, the AICPA S Corporation Technical Resource Panel requested clarification from Treasury on a number of issues related to the BIG Tax suspension
- For example, an S Corp which converted from a C Corp to an S Corp in 2002 has a built-in gain from a sale of property in 2009, but has no taxable income in 2009 or 2010
 - Absent ARRA, the built-in gain would be suspended and treated as a built-in gain in the subsequent tax years – i.e., 2011
 - Since the built-in gain was generated during a suspension year, will it now be subject to BIG Tax in 2011?
- Is there a similar impact from suspension of 2011 built-in gains under the Small Business Jobs Act?

Job Creation Act of 2010

- Extends the tax cuts enacted by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) an additional 2 years – through December 31, 2012
- This includes the enhanced capital gains and dividends tax rates in the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA)
- Plus, for tax years effective after Dec. 31, 2012, higher-income taxpayers will be subject to an additional 0.9% Medicare tax on earned income above \$250,000 (married filing joint) and a 3.8% Medicare tax on the lesser of net investment income or modified AGI in excess of \$250,000 (married filing joint)
 - Investment income will include S Corp pass-thru income for passive investors in an active trade or business

Individual Tax Rates – Impact of “Sunset” in 2013

Income Type	Pre-2013 Rates	Post-2012 Rates
Ordinary	35.0%	39.6%
Dividends	15.0%	43.4% [^]
Capital Gains	15.0%	20.0% [*]

[^] Includes 3.8% additional Medicare tax on net investment income

^{*} 18% capital gains rate for assets held over 5 years

C Corp vs. S Corp Tax Benefit Analysis

Impact of Post-2012 Rate Increases:

	<u>C CORP</u>	<u>S CORP</u>
Pre-tax income	\$ 1,000,000	\$ 1,000,000
Corporate level income tax	\$ (340,000)	\$ N/A
Tax distribution @43.4%	<u>\$ 0</u>	<u>\$ (434,000)</u>
After-tax income	\$ 660,000	\$ 566,000
Capital retention	<u>\$ (500,000)</u>	<u>\$ (500,000)</u>
Additional dividend	\$ 160,000	\$ 66,000
Income tax @39.6% dividend rate	\$ (63,000)	\$ N/A
Add'l Medicare tax @3.8% rate	<u>\$ (6,000)</u>	<u>\$ N/A</u>
Net cash to shareholders	\$ 91,000	\$ 66,000
Benefit from increase in basis	<u>\$ 0</u>	<u>\$ 90,000</u>
Total return to shareholders	<u>\$ 91,000</u>	<u>\$ 156,000</u>

Net benefit from S election = \$65,000

NOTE: Assumes all shareholders are in 39.6% tax bracket and are passive investors (i.e., additional 3.8% Medicare tax applies). The tax benefit of the stock basis adjustment is equal to 18% multiplied by the net basis increase of \$500,000 (not discounted for future value). Amounts are rounded to nearest \$1,000.

Small Business Lending Fund

- Treasury authorized to invest up to \$30 billion in eligible institutions → banks with less than \$10 billion in total assets
- Banks can convert TARP securities/debentures into the new program
- Securities have a 10-year term
- Preferred stock – Initial dividend rate is 5%, but reduced to 1% if small business lending increases by 10% or more
 - After 4½ years, the dividend rate increases to 9%
- Senior Securities – Similar to TARP, S Corps receive debentures instead of preferred stock → no second class of stock
 - Rank senior to common stock (and any other class of equity)
 - S Corp banks participating in the program as of Sept. 27, 2011 = **47**

Small Business Lending Fund

- Interest rate on S Corp debentures grossed up using the highest marginal federal income tax rate for individuals (35 percent)
 - Thus, the interest rate would initially be 7.7% - same as initial interest rate on TARP debentures
 - Higher interest rate based on S Corp banks receiving a tax deduction for the interest payments on the debt
 - Interest rate reduced to 1.5% if small business lending increases by 10% or more
 - After 4½ years, the dividend rate increases to 13.8% for all lending levels
 - See next slide for interest rate adjustment table
- Advantages over TARP debentures
 - No warrants
 - No dividend restrictions
 - No compensation restrictions

Small Business Lending Fund

The interest rate will be adjusted to reflect the amount of an Issuer's change in Qualified Small Business Lending from the Baseline, based on the following schedule:

Increase in Qualified Small Business Lending over Baseline	Interest Rate Following Investment Date		
	First 9 Quarters	Quarter 10 to Year 4.5	After Year 4.5
0% or less	7.7%	10.8%	13.8%
more than 0%, but less than 2.5%	7.7%	7.7%	13.8%
2.5% or more, but less than 5%	6.2%	6.2%	13.8%
5% or more, but less than 7.5%	4.6%	4.6%	13.8%
7.5% or more, but less than 10%	3.1%	3.1%	13.8%
10% or more	1.5%	1.5%	13.8%

*For the first nine quarters, the interest rate will be adjusted quarterly

Uncertain Tax Positions

- Applicable corporations must file Schedule UTP if 2 conditions are satisfied:
 1. The corporation has taken a tax position on its U.S. federal income tax return for the current or a prior tax year
 2. The corporation recorded a reserve with respect to that position in audited financial statements
- For 2010, applicable corporations are corporations that meet ALL of the following criteria:
 - File Form 1120, 1120-F, 1120-L or 1120-PC
 - Assets equal or exceed \$100 million
 - Issued audited financial statements
 - One or more tax positions that must be reported on Sch. UTP
- **S Corps required to file Schedule UTP for 2011??**

Proposal to Tax “Large” S Corps

- Treasury developing a proposal to levy corporate taxes on flow-through businesses (including S Corps) with more than \$10 million in annual gross income or deductions
- Not intended to lead to a tax increase, but rather an attempt to address a widely acknowledged information gap resulting from difficulty matching tax returns of flow-through businesses with their owners’ returns
- Proposal does not address impacts to the flow-through owners – for example, would shareholders be given a credit against their personal income tax liabilities for taxes paid at the corporate level?
- Would likely impact most S-Corp banks with assets of \$150 million or more
 - As of June 30, 2011, per FDIC website, this would include approximately 900 S-Corp banks on a stand-alone basis (i.e., not including smaller S-Corp banks that may be part of a multi-bank holding company structure)

Code Section 6045B Reporting Requirements

- Requires issuers of stock and securities to report actions undertaken by the issuer that affect a holder's per-share basis in such securities
- Reporting is made to the owners of the applicable securities and to the IRS
- The ultimate goal is to provide owners of such securities with information needed to calculate the impact of the action on the basis of their securities
- Any organizational action that impacts the basis of the securities must be reported, including (but not necessarily limited to):
 - Mergers and tax-free reorganizations
 - Stock dividends
 - Stock splits
 - Non-dividend distributions
- The reporting must include identification of the affected securities and a detailed description of the impact the organizational action has on the basis of the securities

Code Section 6045B Reporting Requirements

- Reporting is required on two fronts:
 1. Reporting to each holder of record by January 15th of the year following the calendar year in which the organizational action was executed; and
 2. Reporting to the IRS within 45 days following the organizational action or, if earlier, January 15th of the year following the calendar year in which the organizational action was executed
- Special rule for S Corps – Both reporting requirements above are met if the corporation reports the effect of the organizational action on a timely filed Schedule K-1 (Form 1120S) for each shareholder and timely furnishes copies of these schedules to all proper parties
 - Thus, for calendar year S Corps, the Form 1120S must be filed with the IRS, and Schedule K-1's provided to the shareholders, by March 15, 2012 (or extended due date)
- Substantial penalties apply for non-compliance – \$100 for each IRS return and each shareholder statement (i.e., Sch. K-1), subject to separate \$1.5 million-per-year maximums

Allocations of Income and Expense

- Reg. Sec. 1.1368-1(g) election available when, during any 30-day period:
 1. Shareholder disposes of 20% or more of company's outstanding stock;
 2. Company redeems 20% or more of its outstanding stock from a shareholder; OR
 3. Company issues new stock equal to or greater than 25% of the company's previously outstanding stock to one or more new shareholders
- Election causes shareholders to be allocated the income and expense that corresponds to their stock ownership as if the year consisted of two tax years (or more depending on the number of applicable transactions during the year)
- Benefit of election is that the seller will not be allocated income after the shares are transferred and buyer will be allocated losses incurred after the transaction date (i.e., a portion of these losses will not be allocated to the seller)
- All shareholders who held stock in the company during the taxable year must consent to the election
- See Tax Adviser, December 2010

Private Letter Ruling 201017019

- Release Date April 30, 2010
- S Corp shareholder agreement required a company to make payments to its shareholders based on each shareholder's pro-rata share of taxable income for a given tax year to ensure that the shareholders had sufficient funds to pay income taxes on their respective share of the company's income
- Company sought a ruling on a discretionary payment provision, allowing the company to assist its shareholders in paying additional tax liability resulting from an increase in taxable income or a decrease in creditable foreign taxes
- Company believed it was more efficient and equitable to base distributions under the discretionary payment provision on the shareholders' interests during the taxable period to which the adjustment relates, rather than the shareholders' interests at the time the distributions are made
- IRS ruled favorably – the discretionary payment provision, and distributions made pursuant to it, did not cause the company to have more than one class of stock

David E. Watson, P.C. v. United States

- District Court of Iowa, Dec. 23, 2010
- Reasonable compensation case involving a sole shareholder of an S Corp
- Shareholder was an employee of a successful accounting firm typically working 35-40 hours per week
- The following factors should be considered in assessing reasonable compensation:
 - Nature of the S Corp's business
 - Employee qualifications, responsibilities, and time devoted to business
 - Compensation compared with non-shareholder employees or amounts paid in prior years
 - What comparable businesses pay for similar services
 - Compensation as a percentage of corporate profits and compared with distributions
- See Tax Advisor, August 2011

Santa Clara Valley Housing Group, Inc. v. U.S.

- District Court of California, Sept. 21, 2011
- Warrants issued by an S Corp to its shareholders constituted a second class of stock
- Case involved a tax strategy later declared an abusive tax shelter
- Warrants were in direct violation of the provisions of Reg. Sec. 1.1361-1(l)(4)(ii)
 1. They constituted equity or otherwise resulted in the holder being treated as the owner of the stock; AND
 2. A principal purpose of issuing the warrants was to circumvent the rights to distribute or liquidate proceeds conferred by the outstanding shares of stock
- As a result, the taxpayer's S election terminated as of the date of the issuance of the warrants

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Questions??

