EGBL LEGAL REPORT

A Publication of Ehrmann Gehlbach Badger & Lee, LLC | Vol. 13 No. 1, February 2011

Small businesses can benefit from tax changes

by David W. Badger

As businesses prepare their 2010 tax returns, they should be aware of the 2010 Small Business Act, which includes a number of significant tax provisions. These provisions, many of which are in place only for a limited time, touch on items as varied as expensing, bonus depreciation and carryback of general business credits.

Highlights of the Act include:

- For the first time ever, Section 179 expensing can be claimed for certain improvements to real estate. For any tax year beginning in 2010 or 2011, a taxpayer can elect to treat up to $250,000 of certain improvements to qualified real property (which includes qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property) as expensing eligible property. This change applies to property placed in service after Dec. 31, 2009,

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Foulker joins EGBL

EGBL is pleased to announce that Darla A. Foulker has joined the firm as an associate.

Darla concentrates her practice in family law, real estate and estate planning and administration. She routinely handles divorce, custody, support and probate matters, including guardianships, as well as real estate sale and purchase transactions. Darla previously was associated with Ward & Ward and has been practicing in the Dixon area since 2003. She is a member of the Illinois State and Lee County Bar Associations.

Darla earned her law degree from the Northern Illinois University College of Law in 2003, where she graduated fourth in her class. Before attending law school, Darla received her B.A. in English from NIU, where she graduated *magna cum laude.*

Inside

Enforceability of restrictive covenants uncertain after recent court decisions

by Douglas E. Lee

Employers and employees uncertain about the enforceability of restrictive covenants in Illinois now have even more reason to be confused.

On Dec. 3, 2010, the Illinois Appellate Court for the 2nd District – which hears cases arising in Lee, Ogle, and most other counties in Northern Illinois (but not Whiteside, which is in the 3rd District) – issued its decision in *Reliable Fire Equipment Co. v. Arredondo.* In it, the court refused to enforce a restrictive covenant that was part of employment contracts between a fire extinguisher company and its salesmen.

In doing so, the court in rejected a 2009 decision by the Illinois Appellate Court for the 4th District – which hears cases in Central Illinois – in *Sunbelt Rentals, Inc. v. Ehlers,* in which the court had held that restrictive covenants between employers and employees always are enforceable, although courts can scale back covenants that are unreasonably long or cover an unreasonably large geographic area.

While different districts of the Illinois Appellate Court occasionally disagree with each other, disagreements among the justices deciding *Arredondo* leave the law

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Pension law changes can affect long-term care planning

by David W. Badger

People considering long-term care insurance should be aware of a provision of the Pension Protection Act of 2006 that became effective Jan. 1, 2010, which permits Section 1035 tax-free treatment for the exchange of life and annuity policies into long-term care contracts.

Before the amendment took effect, an owner of an annuity or life insurance policy was able to exchange an insurance contract under Section 1035 without tax only if he or she was transferring one life insurance policy for another, an annuity contract for another or a life insurance policy for an annuity contract.

Under the amendment, a person can add a long-term care insurance rider to his or her existing policy, complete a partial Section 1035 exchange and use the proceeds of the exchange to purchase a stand-alone long-term care policy.

Alternatively, a person can exchange a life or annuity policy into a new life or annuity policy with a long-term care rider. The amendment applies only to exchanges of non-qualified policies, that is, policies that are not part of a retirement plan.

Non-qualified annuities with long-term care riders will be treated as tax-qualified long-term care insurance plans, meaning that withdrawals from them will not be taxed as income if the withdrawals are used to pay qualified long-term care expenses. For example, persons will not be penalized if they make withdrawals to pay premiums for qualified long-term care insurance.

One planning opportunity under the amendment allows a person who owns a non-qualified annuity that has grown substantially in value to exchange that annuity for a newer, qualified annuity that contains a long-term care rider and to then withdraw, tax free, the entire value of the annuity for qualified long-term care expenses. A person contemplating such an exchange – or any exchange under the amendment – should seek legal or tax advice to ensure the exchange receives the most favorable tax treatment.

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and tax years beginning after that date. No amount attributable to qualified real property can be carried over to a tax year beginning after 2011, but to the extent an amount cannot be carried over, the code will be applied as if no Section 179 expensing election had been made for that amount.

- The amount that can be expensed pursuant to Section 179 has increased from $250,000 to $500,000.
- The first-year dollar cap for an automobile depreciation deduction increased from $3,060 to $11,060 for autos and light trucks or vans that are new, were placed in service in 2010 and are qualified property for bonus depreciation purposes.
- When calculating self-employment taxes for tax years beginning after Dec. 31, 2009, but before Jan. 1, 2011, the deduction for health insurance costs of a self-employed taxpayer can be deducted in computing net earnings from self-employment.
- When a subchapter C corporation elects to become a subchapter S corporation, the S corporation is taxed at 35 percent on all gains that were built-in at the time of the election, if the gains are recognized during the recognition period. The recognition period generally is the first ten S corporation years. For tax years beginning in 2009 and 2010, no tax is imposed on the net unrecognized built-in gain of an S corporation if the seventh tax year in the recognition period preceded the 2009 and 2010 tax years. For any tax year beginning in 2011, the Act shortens the holding period of assets subject to built-in gains tax to five years, if the fifth tax year in the recognition period precedes the tax year beginning in 2011.
- For distributions after the Act's enactment date, 401(k), 403(b) and governmental 457(b) plans will be able to permit participants to roll their pre-tax account balances into a designated Roth account. If the rollover is made in 2010, the participant may elect to pay the tax in 2011 and 2012.
- Beginning in 2011, persons who receive rental income from real property are required to file information returns with the Internal Revenue Service and to report payments of $600 or more during the tax year for rental property expenses.

Genetic Information Act creates traps for employers

by Douglas E. Lee

Employers with more productive things to do than collect genetic information about their employees likely have not paid much attention to the federal Genetic Information Nondiscrimination Act (GINA) that took effect in 2008. Recent Equal Employment Opportunity Commission regulations interpreting GINA, however, should cause those employers to take a second look.

GINA, which applies to all employers that employ at least 15 full-time equivalent employees, prohibits employers from discriminating against employees or applicants based on genetic information and from requesting that employees or applicants provide genetic information. While few employers actively engage in genetic testing, the breadth of the new regulations suggests that common workplace occurrences can violate GINA if not handled properly.

For example, a manager showing concern about the health of an employee's family member potentially can acquire employee genetic information. In most cases, any genetic information initially provided would fall within GINA's inadvertent acquisition exception. In these cases, however, managers should not ask follow-up questions likely to elicit further genetic information.

Work-related medical exams also raise concerns. Under GINA and its regulations, these exams must not include requests for family medical history or other genetic information. Moreover, all employees or applicants must be provided the following "safe harbor" notice:

"The Genetic Information Nondiscrimination Act of 2008 (GINA) prohibits employers and other entities covered by GINA Title II from requesting or requiring genetic information of an individual or family member of the individual, except as specifically allowed by this law. To comply with this law, we are asking that you not provide any genetic information when responding to this request for medical information. 'Genetic information,' as defined by GINA, includes an individual's family medical history, the results of an individual's or family member's genetic tests, the fact that an individual or an individual's family member sought or received genetic services, and genetic information of a fetus carried by an individual or an individual's family member or an embryo lawfully held by an individual or family member receiving assistive reproductive services."

Although the medical certification form used to determine eligibility for family and medical leave appears unlikely to elicit genetic information, employers can avoid the risk of violating GINA by also including the safe harbor notice on this form.

Employers also should revise their equal employment opportunity policy statements to include prohibitions against discrimination and retaliation based on genetic information.

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regarding restrictive covenants particularly confusing.

The central issue in these cases has been whether an employer needs a "legitimate business interest" in order to support and enforce a restrictive covenant. Until the 4th District's decision in *Ehlers*, the law was relatively settled that such an interest was necessary. While courts frequently disagreed about when an employer had a legitimate business interest, they generally agreed that the test for analyzing the extent of the employer's interest was whether the employer had a "near-permanent" relationship with its customers, whether the employee would not have had contact with the customers but for his or her employment and/or whether the employee acquired trade secrets or other confidential information during the employment.

In *Ehlers*, the court held that, under its reading of Illinois Supreme Court precedents, an employer seeking to enforce a restrictive covenant was not required to establish a legitimate business interest. Rather, all the employer had to show was that the employee at one time had agreed to the covenant. While courts still would examine covenants to determine whether their time and geographic restrictions were reasonable, they should enforce all covenants to at least some extent.

In *Arredondo*, each of the justices on the three-member panel wrote a separate opinion. One justice wrote that *Ehlers* was wrongly decided, argued that courts in the 2nd District should apply the legitimate business interest test and concluded that the restrictive covenant at issue was unenforceable. Another justice wrote that *Ehlers* was correctly decided and should be followed in the 2nd District. The third justice wrote that, while the 4th District made some good points about whether the legitimate business interest test was appropriate, an employer needed to have some legitimate interest in order to enforce a restrictive covenant. Not finding that interest in this case, this justice agreed that the covenant at issue was unenforceable.

Given the uncertainties created by these opinions, the law likely will be unsettled until the Illinois Supreme Court decides the issue. Until that time, neither employers nor employees dealing with restrictive covenants can be sure of their rights and responsibilities.

Administration expands definition of 'parent' under FMLA

by Douglas E. Lee

Under an Administrative Interpretation issued by the U.S. Department of Labor, the number of people entitled to leave under the Family and Medical Leave Act after the birth of a child, to bond with a newly placed child or to care for a child with a serious health condition has grown significantly.

In the FMLA, those entitled to leave for child-related reasons are biological or adopted parents, foster parents, step-parents, guardians and persons standing *in loco parentis.* In the Administrative Interpretation, the Department concluded that Congress intended *in loco parentis* to include not only those with day-to-day responsibilities for caring for and financially supporting a child but also those who "assume the responsibilities of a parent," regardless of whether a biological or legal relationship exists with the child.

While it does not appear that the Administrative Interpretation is so broad as to include any adult who agrees to care for a sick child, the Interpretation does extend FMLA coverage to any relative or friend who has assumed "ongoing" responsibility for raising a child. Interestingly, the Department notes in the Interpretation that the FMLA does not limit the number of "parents" a child can have under the Act. Therefore, the fact that a child has two biological parents does not prevent one or more other adults from being *in loco parentis* with the child.

An employer questioning an adult's relationship with a child is entitled to request documentation to support the adult's claim that he or she has assumed ongoing responsibilities related to the child's care.

In Print and At the Podium

In one of **Mr. Lee**'s recent commentaries for the web site of the First Amendment Center, he criticized news organizations for working with Congress to exclude WikiLeaks from coverage under the pending federal shield law. Dozens of sites linked to the commentary, including the sites of filmmaker Michael Moore and the prestigious Thomas Jefferson Center for the Protection of Free Expression. **Mr. Lee** also gave two radio interviews on the topic, one for Media Minutes and one for KUCI at the University of California-Irvine . . . **Mr. Gehlbach**, a member of the Illinois State Bar Association's Legislation Committee, recently presented a paper on new Illinois legislation at a seminar for attorneys in Chicago . . . **Mrs. Heeg** recently served as a panel member of bankruptcy trustees at the U.S. Trustee's annual regional seminar, speaking about new bankruptcy cases affecting chapter 7 trustees . . . **Mr. Ehrmann** has been renamed to the bar of those eligible to handle death penalty cases . . . In recent months, **Mr. Lee** has been quoted in the *New York Times* and the *Washington Post* regarding First Amendment cases . . . **Mr. Gehlbach** recently spoke at a seminar for State of Illinois employees on the essentials of estate planning . . . In November, **Mr. Lee** was quoted extensively in a series published in the Sacramento *Bee* about a trial court's effort to keep secret proceedings and court records in a case . . . **Mr. Lee** has been re-elected president of the board of directors of Open Sesame Children's Learning Centers.

Deals and Decisions

Mr. Ehrmann has two cases pending in the Illinois Appellate Court, one dealing with whether passive, undistributed income in a revocable trust must be included in calculating child support paid by the beneficiary and one about whether creation of a trust during a marriage creates rights of the spouse that must be recognized in a divorce . . . **Mrs. Considine** successfully represented a client in defending a creditor's action at trial under the Rights of Married Persons Act, which also resulted in an award of attorney's fees to her client . . . **Mr. Gehlbach** recently handled a significant number of farm real estate transactions, including several multi-party exchanges, and also represented a business owner in the successful sale of his business . . . **Mr. Lee** recently represented two clients in the sales of their local businesses . . . As bankruptcy trustee, **Mrs. Heeg** recently liquidated a debtor's various business interests and distributed the sale proceeds to the debtor's unsecured creditors . . . **Mrs. Considine** has uncovered and successfully presented information from Facebook and other websites as evidence in five recent trials centering around family issues . . . **Mr. Ehrmann** has a pending petition for writ of *certiorari* in the U.S. Supreme Court regarding issues of ethics and due process . . . As counsel for a bankruptcy estate, **Mrs. Heeg** recovered for the benefit of creditors certain preference payments the debtor made shortly before it filed bankruptcy . . . **Mr. Lee** recently has successfully represented several clients in hearings before the Department of Employment Security and the Illinois Department of Labor.

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Special Supplement, February 2011

Federal, state tax law changes significantly impact estate plans

by Gary R. Gehlbach

The unlikely compromise between President Obama and Republican Congressional leaders that produced the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 extended income tax reductions that were signed into law by President Bush in 2001 (the Economic Growth and Taxpayer Relief and Reconciliation Act – EGTRRA). The 2010 Act also made significant but short-lived changes to the federal gift and estate tax.

Two weeks later, in a move that was basically unpublished, the Illinois General Assembly reinstated the Illinois estate tax. As had been the case, the Illinois estate tax is again derivative of and a function of the federal estate tax. However, while the federal estate tax now has a $5 million individual exemption, the Illinois estate tax has only a $2 million exemption, which is essentially the same as the exemption in 2009.

To understand these changes in federal and state law, some explanation is necessary.

Illinois QTIP trust

In September 2009 the Illinois estate tax law was amended to provide for a marital deduction for Illinois estate tax purposes, a useful tool for married couples whose taxable estates might exceed the Illinois exemption of $2 million. When the Illinois estate tax was suspended for 2010, however, this planning technique was not needed. Now, with the Illinois estate tax resurrected, it is essential that couples whose combined estates might exceed $2 million consider structuring their estate plans to utilize the Illinois QTIP trust.

Only temporary

While no tax law is ever truly permanent, the estate tax provisions of the federal 2010 Act will automatically expire on Dec. 31, 2012, without further action by Congress. Thus, without further legislative action, the law on Jan. 1, 2013, will revert to that which existed prior to EGTRRA. This would mean a $1 million estate tax exemption and a maximum federal estate tax rate of 55 percent.

EGTRRA for 2010, briefly

Under EGTRRA, the federal estate tax – only for 2010 – was repealed but replaced with the somewhat onerous carryover basis regime, that is, persons receiving property from a decedent who died in 2010 would receive the decedent's income tax basis. However, the executor was allowed to increase the various tax bases of the decedent's assets by a maximum of $1.3 million, so long as no asset would receive a new basis of more than its fair market value as of the date of the decedent's death. (An income tax basis in an asset is generally the cost at which an asset is purchased, less any depreciation deductions allowed, plus any capital improvements. For property received by gift, the recipient generally receives the donor's adjusted income tax basis.)

New changes retroactive to Jan. 1, 2010

With some minor exceptions, the gift and estate tax provisions of the 2010 Act are generally retroactive to Jan. 1, 2010, meaning the new law applies to persons dying after Dec. 31, 2009, but before Jan. 1, 2013. Specifically, the repeal of the federal estate tax for 2010 has been eliminated and the carryover basis rules of EGTRRA have likewise been repealed. Executors of estates of persons who died in 2010 can elect for an estate to be taxed under EGTRRA or under the 2010 Act. However, unless the net taxable estate for estate tax purposes is less than $5 million, the estate is likely to be more favorably treated under the 2010 Act than under EGTRRA.

Exemptions

Under the new law, the exemption for federal estate tax purposes is $5 million per individual or $10 million per married couple, and these amounts are indexed for inflation beginning Jan. 1, 2012. This is a significant increase from the federal estate tax exemption of $3.5 million that applied for decedents who died in 2009.

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Tax rate

The new federal estate tax rate, applicable for persons dying between Jan. 1, 2009, and Jan. 1, 2013, is 35 percent. This is a reduction from 45 percent, which applied in 2009, and 55 percent, which applied prior to EGTRRA. The Illinois estate tax rate, however, can be as high as 33 percent. For estates exceeding the federal exemption after allowing for a credit for the Illinois estate tax, the combined rate can exceed 60 percent.

Step-up in income tax basis

As noted above, the carryover basis rules applicable for persons dying in 2010 have been repealed (except for those rather large estates that may elect to be taxed under the EGTRRA provisions for persons who died in 2010). This means that, with a few technical exceptions, the income tax bases of assets in which a decedent had an interest at the time of his or her death will no longer apply and the persons receiving the assets from the decedent will receive those assets at the values of those assets as of the date of the decedent's death. That is, the decedent's income tax basis in an asset will be stepped-up to its fair market value as of date of death.

Reunification of gift, estate and GST taxes

As had been the case prior to EGTRRA, the federal gift, estate and Generation-Skipping Transfer tax exemptions and rates have been reunified. For example, the new federal estate tax exemption of $5 million for each individual may be used for lifetime gifts or upon death, or partially or all during a lifetime, with any balance remaining available upon death. Moreover, the gift-estate tax rate of 35 percent will not apply until all of an individual's $5 million exemption has been used. (This exemption is in addition to the annual exclusion amount, which is presently $13,000 per person per year. It is also in addition to qualifying gifts of tuition and medical expenses.) However, for persons who died in 2010, the gift tax exemption of $1 million was not changed.

Portability

A new concept of "portability" was introduced in the 2010 Act. Essentially, this means that, to the extent the first spouse does not use all of his or her gift/estate tax exemption, the balance remaining is available for the surviving spouse. Upon the death of the survivor, she or he may use not only the $5 million exemption but also any part of the prior spouse's exemption that was not used. In multiple marriage situations, a person will only be able to use any remaining exemption amount from his or her last spouse to predecease him or her. However, in order to use any of the prior spouse's unused exemption, the prior spouse's estate must have filed a federal estate tax return to declare how much of the first spouse's exemption was actually used. Couples should note, however, that portability does not apply for Illinois estate tax purposes.

Special use valuation

Since Jan. 1, 1977, qualifying farm families have been able to use "special use valuation" rules to value farmland for estate tax purposes. Under these rules, the land is valued using its income production rather than market value, which results in a significant discount. In 2009, for example, this allowed a qualifying farmer's estate to reduce the estate tax value of farmland by $1 million. While the 2010 Act does not eliminate this estate tax reduction technique, the new $5 million/$10 million exemptions will limit its use.

Impact on estate plans

These changes in federal gift and estate tax laws have the potential to affect virtually all estate plans with any estate tax planning. Therefore, if a current estate plan, especially for married couples, provides that, upon the death of the first spouse, the "tax-sheltered gift" should be transferred to a family trust or to the children or others, the estate plan should be reviewed as soon as possible.

The use of credit-shelter trusts, which are often referred to as family trusts, needs to be reconsidered in light of the 2010 Act. While these trusts might still be desirable at the death of the first spouse to protect against estate tax upon the death of the second spouse arising from appreciation in the value of assets, this advantage should be weighed against the loss of the opportunity for a step-up in basis at the death of the surviving spouse.

As noted above, if a married couple has a combined estate that might exceed $2 million, including provisions for an Illinois QTIP trust to be created on the death of the first spouse should be considered as a way for the surviving spouse to avoid paying any Illinois estate tax on the first spouse's death.

Finally, for those farm families whose estate plans contemplated using special use valuation, these provisions definitely need to be changed. While the typical formula for utilizing special use valuation would work well to maximize the reduction in the value of farmland for estate tax purposes, this same formula is much more costly to administer and involves an income tax that otherwise might be avoided. Therefore, in order to avoid considerably more expense in estate administration and the potential for additional income tax in estate administration, these formulas need to be eliminated.

Conclusion

The 2010 Act is one of the most radical revisions to gift and estate taxation in history. While the changes were welcome, concern will continue that Congress might reverse course in 2013, although in the last 35 years Congress never has reduced the federal estate tax exemption. Moreover, Illinois now has reinstated its estate tax with a $2 million exemption. At least in the short run, the need to review estate plans with any estate tax planning is crucial.