



Advanced Planning Strategies

**Albert E. Gibbons, CLU, ChFC, AEP
President, AEG Financial Services**

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Dear Reader,

The fall Congressional session will include debate over tax changes in several areas. An attempt to make the education tax breaks provided by the 2001 act was defeated in the House of Representatives (Education Affordability Act of 2002). This proposal would have removed the 2011 sunset provision that terminates these tax breaks after 2010. A proposal to remove the sunset of the estate and generation-skipping tax repeal was defeated earlier in the Senate. The passage of the \$1.35 billion tax cut in 2001 required the sunset of these reductions; removal of the sunset provision can be accomplished only with tax increases to offset the cuts or a supermajority vote of both bodies of Congress. An interesting piece of information is that the removal of the sunset would eliminate virtually all the budget surplus currently projected for the second half of this decade.

The IRS reported that it currently audits 6 percent of federal estate tax returns, although all estate tax returns are processed by staff members rather than by computer. Gift tax returns are audited at a rate of one percent. Returns that contain hard-to-value assets, such as a closely held business, or that apply valuation discounts are more likely to be audited. Of course, the larger returns are more likely to garner attention. In 2001, the IRS received 126,000 estate tax returns and over 300,000 gift tax returns. Based on data (1993) evaluated by the Joint Committee on Taxation, 86 percent of the estate tax burden fell on individuals in the over \$200,000 income category. Virtually no estate tax was paid by individuals below the \$100,000 income category. The IRS recently released the revised federal estate and generation-skipping tax return for 2002 that reflects the increased exemption and lower maximum marginal bracket provided by the 2001 act.

A frequent concern for taxpayers, particularly business owners, is the amount of record keeping for tax purposes. Useful information can be found in the recently revised IRS publication "Starting a Business and Keeping Records" (IRS Publication 583). This document can be downloaded free of charge from the IRS web site www.irs.gov. For individuals concerned about estate taxes, the inside report about lifetime gifts should be enlightening.

Knowledge is not power. Only knowledge in use is power.

SOME IDEAS TO REDUCE TRANSFER TAXES ON YOUR HARD-EARNED WEALTH

When you are ready to pass on all or a portion of your wealth, Uncle Sam looks to get a piece of the pie through the levy of various so-called transfer taxes. These include gift tax, estate tax, and generation-skipping tax. For transfers in 2002, the first two begin at a 41 percent rate and increase to 50 percent; the last one begins and ends at 50 percent. Legislation passed last year gradually, over a phase-in period, repeals the estate and generation-skipping tax but not the gift tax. The phase-in period extends to 2009. Full repeal of the estate and generation-skipping taxes currently would last only one year with the reinstatement of estate and generation-skipping taxes in 2011. Congress kept the gift tax on the books to prevent taxpayers from making tax-free gifts to shift income taxes to lower-bracket family members. A careful understanding of the transfer and income tax rules indicates that lifetime gifts remain an important estate planning technique.

RULES DURING THE PHASE-IN PERIOD

The estate and gift tax unified credit shelters taxable gifts or taxable estates of up to \$1 million from tax in 2002. The generation-skipping exemption is indexed for inflation and is \$1,100,000. The gift tax exemption will remain at \$1 million under current law, but the estate tax exemption will rise in three steps between 2004 and 2009. In 2004 when the estate tax exemption is increased to \$1.5 million, the generation-skipping tax exemption will be set identically to the estate tax exemption until repeal of both taxes occurs in 2010. The maximum estate, gift, and generation-skipping tax rate will be reduced gradually. The estate and generation-skipping tax will be subject to a flat tax rate after 2005 (46 percent in 2006 and 45 percent thereafter). Interestingly, the gift tax system will still be subject to initial lower brackets of 41, 43, and 45 percent because its exemption will remain fixed at \$1 million. The gift tax rate is set equivalent to the maximum income tax rate for 2010, the only year that estate and generation-skipping taxes are actually repealed under the current statute.

WHY MAKE SUBSTANTIAL LIFETIME GIFTS?

Because there is still a substantial estate tax for all years except 2010 and a progressive income tax system, gift planning remains essential to reduce transfer and income taxes. There are several reasons to make substantial gifts during your lifetime, including the following:

- to avoid gift, estate, and generation-skipping tax on the appreciation in value of the transferred property
- to avoid state death taxes without paying state gift taxes, because the vast majority of states have no state gift tax
- to take advantage of the exclusions from federal gift tax that are not available under the federal estate tax rules for bequests of your wealth
- to take advantage of the \$1 million exemption
- to shift the income tax responsibility for the income earned on the transferred property to the donee who might be in a lower tax bracket
- to receive valuation discounts for gifts of an interest in, for example, a family business or real estate venture
- to personally witness the joy of the "grateful living" upon receipt of the gifts
- to test the waters by watching the ability of your children or grandchildren to manage the assets that you provide to them
- to hedge against the possibility that the estate and generation-skipping tax repeals will not occur due to political and budgetary constraints

TOOLS FOR MINIMIZING THE GIFT TAX

Here are some important tools that will help you minimize the gift tax:

- **\$11,000 annual exclusion.** During lifetime, you can make gifts of up to \$11,000 (the annual exclusion is indexed for inflation, but is expected to remain at \$11,000 for the next few years) each year to as many different people as you want, and as long as they are "present interest" gifts, they will be excluded from the gift tax.
- **medical and educational expenses.** *In addition* to the annual exclusion gifts, you may pay the medical and educational expenses of family members and others *directly* to the medical facility or educational institution, and such gifts (no matter their amount) will be excluded from the gift tax.
- **unified credit shelter.** The applicable (unified) credit will offset gift taxes during lifetime and/or estate taxes at death that total \$345,800 in 2002. This means that the first \$1 million of taxable transfers during lifetime or at death will be sheltered from payment of gift and/or estate taxes.
- **valuation discount for gifts of minority interests and lack of marketability in property.** This concept can best be illustrated by an example. Let's say a closely held business (Familyco, an S corporation) has a fair market value of \$4,000,000. If its owner (let's call him Freddy) retains 100 percent ownership in the Familyco stock until his death, its value for estate tax purposes would be \$3,900,000. If Freddy is in a 50 percent estate tax bracket, estate taxes on his business will be \$1,950,000.

If, during lifetime, Freddy transfers one-third of his Familyco stock to each of his children, Jim and Jenny, and retains one-third for himself, the fair market value of the gifts to his children will be *less* than \$1,300,000 each. This is because he has transferred a minority interest in Familyco to each of them. A minority interest lacks control over business decisions, cannot force Familyco's liquidation, and lacks marketability. As a result, Familyco's fair market value will be discounted. A 35 percent discount (which is not unusual) would result in a gift tax value of \$845,000 for each gift. Through gift splitting with Freddy's wife, Farah, and the application of each of their applicable (unified) credits, there would be no gift tax payable. Furthermore, at Freddy's death, he would own a minority interest in Familyco, and the same 35 percent discount should apply to the value of his one-third interest for estate tax purposes. The combined discount for the two lifetime gifts and the transfer at death totals \$1,365,000. In a 50 percent tax bracket, that translates into at least a \$682,500 savings in gift and estate taxes! More if Familyco appreciates in value between the date of the gifts and Freddy's death.

TAX COMPLIANCE FOR GIFTS

Gift tax returns are required and are due at the same time as income tax returns in the year following the year of the transfer under the following circumstances:

- A transfer is made to an individual other than the donor's spouse, it exceeds the \$11,000 annual gift tax exclusion (IRC Sec. 2503(b)), and it is not excluded by the exemption for transfers with respect to medical or tuition expenses (IRC Sec. 2503(e)) of the donee.
- A transfer is made to a qualifying charity that is less than the donor's entire interest in the property (for example, a charitable remainder trust).
- A transfer is made and the donor's spouse elects to split the gift for the purposes of increasing the annual exclusion from \$11,000 to \$22,000 per gift.

A 3-year statute of limitations following the filing of a gift tax return applies to the initiation of an IRS audit of the return. IRS regulations (Treas. Reg. Sec. 301.6501(c)-1(f)) describe substantiation requirements to ensure the protection of the statute of limitations. The gift tax return will have the statute's protection only if it is substantiated with enough information to give the IRS

sufficient details of the nature of the transaction. A memorandum should be filed with the return to explain the form of the transfer and provide a complete description of the property. The relationship between the transferor and transferee must be disclosed. It is important to include valuation methods, particularly if hard-to-value property is transferred. If valuation discounts are taken, the supporting information should provide justification for the discount based on the facts and circumstances of the case. The substantiation rules also permit the submission of an appraisal by a qualified appraiser in lieu of requiring the donor to submit this voluminous substantiation with the return. For most gifts involving hard-to-value property and/or valuation discounts (such as demonstrated in the example above), the taxpayer will use a qualified appraiser. Note that the IRS has neither the staff nor the budget to audit the increased volume of gift tax returns. (It currently estimates a one percent audit rate for gift tax returns.) An appropriately substantiated gift tax return that is not overly aggressive will have a high likelihood of passing through the system without significant examination.

RECENT CASES AND RULINGS

IRS PERMITS EXTENSION OF TIME FOR LATE ALLOCATION OF GENERATION-SKIPPING TRANSFER (GST) TAX EXEMPTION TO TRUSTS

An important provision of the 2001 tax act was the ability of transferors to request relief for late allocations of the GST exemption (currently \$1,100,000) where the transferor and his or her advisers failed to make the allocation on a timely filed gift tax return. This relief was provided in large part due to the belief that the GST was overly complex and created compliance difficulties. In a series of private rulings (Ltrs. 200236004, 200236016, 200236019, and 200236020), the IRS granted extensions to make allocations necessitated by the failure of taxpayers and qualified tax advisers to make timely allocations of GST exemptions. The initial failure to allocate included such reasons as the mistaken belief with respect to the need to report GST transfers under \$10,000, the misunderstanding concerning the need to allocate the exemption for both halves of gifts split between spouses, and the failure to recognize a taxable termination event for a trust. Perhaps this relief provision will make GSTT compliance more preparer friendly in the future.

This letter prepared, with the help of a nationally recognized tax authority, intends to promote interest in more comprehensive tax and estate planning. References are intentionally brief. If a topic interests you, you should investigate it more thoroughly with your qualified tax advisor. Effective tax and estate planning should involve competent advisors in relevant law, accounting, trusts, life insurance and investments. The knowledge and experience of each in their specialties can make the difference between a wealth transfer that works as intended and one that does not. Please seek competent counsel to determine and satisfy your individual needs.

*Positioning our clients
for the future*



Albert E. Gibbons, CLU, ChFC, AEP
AEG FINANCIAL SERVICES
1288 Valley Forge Road, #53
Phoenixville, PA 19460
Tel. (610) 917-8940
Fax. (610) 917-8962
Email. algibbons@algibbons.com
Web: www.algibbons.com