



Advanced Planning Strategies

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October 2003

Dear Reader,

The Charitable Giving Act of 2003 passed the House of Representatives by a whopping 408 to 13. The Senate has a similar version known as the CARE bill, which will be taken up with the House bill in joint conference. The House bill, which is estimated to cost \$11.5 billion over 10 years, would take effect in 2004 and provide the following tax benefits:

- Permit a charitable income tax deduction by taxpayers who do not itemize deductions of up to \$1,000 for married joint filers. To provide an incentive to make contributions, no deduction is allowed until the charitable contributions exceed \$500 for the tax year (the numbers are one-half for single filers).
- Increase deductible corporate contributions to 20 percent, phased in fully by 2012.
- Permit tax-free contributions from an individual's IRA or Roth IRA to qualified charitable organizations or charitable remainder trusts, pooled income funds, or charitable gift annuities once the donor attains the age of 70 1/2. This provision would not apply to funds in employer-provided SIMPLE IRAs or SEPs. The Senate version of the bill would permit such contributions after age 59 1/2.
- Make charitable contributions of property by S corporations more attractive by limiting the shareholder's reduction in income tax basis to the amount of the property's cost basis.
- Revise certain rules for private foundations. The provision would simplify some of the penalty or excise taxes attributable to private foundations. However, the bill contains an unattractive feature that would exclude some administrative expenses for the purposes of determining the minimum 5 percent payout from private foundations.

We will report to you provisions of any charitable bill as soon as enacted. On another note, the IRS released 101 pages of final regulations and accompanying explanations concerning split-dollar life insurance at the time this letter was written. For certain split-dollar life insurance plans (known as "equity split dollar") in effect before January 28, 2002, the ability to avoid income tax on the participant's rights to the equity expires at the end of this year. The tax avoidance is accomplished by rolling the policy out of the agreement to the insured or changing the tax accounting of the plan.

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 2003, the first two begin at a 41 percent rate and increase to 49 percent; the last one begins and ends at 49 percent. Legislation passed in 2001 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 2003. The generation-skipping exemption is indexed for inflation and is currently \$1,120,000. 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 TO MINIMIZE 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 2003. 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 is used primarily with family limited partnerships or family limited liability companies. In these techniques, transfers of limited interests can be significantly discounted below the value of the proportionate share of the underlying property owned by the entity if the limited owner cannot control the activities of the entity, force liquidation, or freely transfer the ownership interest. The discount is also available to transfers of closely held corporate stock if the transferred stock has 50 percent or less of the voting power and is subject to transfer restrictions. Finally, marketability discounts are also available for transfers of joint undivided interests (such as a joint interest in real estate).

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 PROVIDES GUIDANCE FOR PRIVATE PLACEMENT VARIABLE LIFE INSURANCE PRODUCTS

In a pair of recently published revenue rulings, the IRS examined the taxation of private placement variable life and annuity products (Revenue Rulings 2003-91, 2003-33 IRB 347 and 2003-92, 2002-33 IRB 350). Private placement insurance products are designed to include a private placement investment element. The investment is held by the insurer in a segregated asset account divided into sub-accounts held just for purchasers of such variable products. The policyowner specifies premium allocations to the sub-accounts and can make changes in the allocation to different sub-accounts a limited number of times per year. All investment decisions concerning the sub-accounts are made by the insurer and investment advisor. The policyowner cannot choose or recommend particular investments or investment strategies for a sub-account. Nor can the policyowner communicate directly or indirectly with the company's investment officer or advisor. Under this scenario, the IRS in the first ruling indicated that the policyowner did not possess sufficient incidents of ownership to be treated as the owner of the investment assets. Thus, the life insurance or annuity products holding such variable investments will provide protection from the potential current income taxes associated with the internal investments.

In the second ruling, the sub-accounts hold interests in nonregistered partnerships. However, the partnerships are also available for purchase by individuals other than the purchaser of the variable life insurance or annuity products. The investments of the partnership were hedge funds that have significant income tax implications. Under this scenario, the policyowner is treated as the owner of the hedge funds in the sub-accounts and must include any interest, dividends, or other income derived from the investment element in current income.

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*



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