Advanced Planning Strategies

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Dear Reader,

It is likely that the "Working Families Tax Relief Act of 2004" (H.R. 1308) will be signed into law by the time you read this letter. This bill was passed by Congress at the end of last month and extends many of the tax-relief provisions that were due to expire by the end of the year. The provisions in the bill include the continuance for 2005 until 2010 of the (1) $1,000 per-child tax credit, (2) expanded 10 percent income tax bracket, and (3) marriage penalty relief provisions related to the standard deduction and the size of the 15 percent income-tax bracket. The relief act also provides an increased alternative minimum tax (AMT) exemption for 2005. The AMT will continue to be a problem and will be a topic of further debate in the upcoming years because estimates indicate that a growing number of middle-class taxpayers will be subject to the AMT unless some permanent relief is enacted.

Additional legislation (H.R. 1057) would make the adoption tax credit and the exclusion for employer-paid adoption assistance permanent. One problem for any tax relief is the growing deficit and the statutory limit on the national debt, currently capped at $7.38 trillion. This limit will probably be reached before the election and would require action by Congress to raise the ceiling.

The IRS has responded to the hurricane disasters with several relief provisions. Taxpayers within the disaster areas have until December 20 to submit certain tax returns and payments. Extensions have been provided for filing Form 5500 for certain types of retirement plans. In addition, for retirement plans affected by the storms, contributions currently due are postponed until October 15, 2004 (IRS Notice 2004-62). Finally, the IRS will allow owners of low-income housing to permit temporary residence to individuals displaced by the hurricanes without imposing the normal income limitations (IRS Notice 2004-66).

Some estimates of the inflation-indexed figures for 2005 have been reported. The wage base for Social Security is forecast to be $89,400. The final numbers are generally identical or extremely close to the estimates. We typically receive all the final numbers by mid-November and will report them as soon as they are available.

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 2004, gift taxes begin at a 41 percent rate and increase to 48 percent, estate taxes range from 45 to 48 percent, and the generation-skipping tax is imposed at 48 percent. Legislation passed in 2001 gradually, over a phase-in period, repeals the estate and generation-skipping tax but not the gift tax. Repeal of the estate and generation-skipping taxes currently would occur only in 2010; the taxes would be reinstated 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 gift tax credit (exemption) shelters taxable gifts of up to $1 million for all future tax years (or until the next change in the law). The exemption against estate or generation-skipping tax is $1.5 million for 2004 and 2005. These exemptions increase to shelter $2 million for transfers in 2006 to 2008 and $3.5 million in 2009. The maximum estate, gift, and generation-skipping tax rate is also reduced over time. The top bracket drops to 47 percent in 2005, and the estate and generation-skipping taxes 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 remains 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 progressive income tax system and a significant estate tax for all years except 2010, 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 year or two) 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.
- **credit (exemption) shelter**. The gift tax credit will offset gift taxes during lifetime that total $345,800. This means that the first $1 million of taxable transfers during lifetime or at death will be sheltered from payment of gift 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 these 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, including a complete description of the property, should be filed with the return to explain the form of the transfer. 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, 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

GIFT TAX PAID ON GIFTS MADE MORE THAN 3 YEARS PRIOR TO DEATH IS EXCLUDED FROM GROSS ESTATE

The gross estate of a decedent includes the gift tax paid on gifts made during the 3-year period ending on the decedent's date-of-death (IRC Sec. 2035(b)). Thus, gift tax paid on earlier gifts escapes estate tax, providing an advantage of timely lifetime gifts over taxable transfers at death. In this instance, the taxpayer elected to split gifts with her spouse, and the couple made taxable gifts and filed a gift tax return to pay the required tax. The taxpayer died 3 years to the day after the transfers; the executor filed the estate tax return listing the gifts as adjusted taxable gifts but excluding the gift tax previously paid from the gross estate.

The IRS held (Ltr. 200432016) that the 3-year period includes the day of the transfer because the wording of Sec. 2035(b) requires a different result than the typical statute of limitations rules that apply to tax returns. The term year is defined as a calendar year in this instance. Thus, for example, a decedent who dies on December 31 would not have to include the gift taxes paid as a result a gift made 3 years prior on December 31 in his or her gross estate for federal estate tax purposes.

Positioning our clients for the future

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