



Advanced Planning Strategies

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Dear Reader,

It appears that the tax amendments discussed over the summer have been somewhat postponed by the hurricane relief for the Gulf states. Some of these tax proposals will certainly be revisited during the fall since there are tax-relief provisions that are scheduled to expire. Action will probably be taken to expand relief from the alternative minimum tax (AMT) that we discussed in a main article of a recent letter. In addition, the deduction for state and local sales tax enacted last year will expire with the 2005 tax year unless extended by Congress. Even if this extension is not passed by the end of the year, it could be passed next year retroactive to the beginning of 2006, so it would be prudent to keep the appropriate receipts.

Congress had completed tax relief related to Hurricane Katrina at the time this letter was written. The Senate and House passed the “Katrina Emergency Tax Relief Act of 2005” after some substantive amendments from initial mark-ups of the legislation. Initially, many of the charitable contribution provisions in prior tax proposals that we’ve discussed in past were included, but they were later dropped. For example, a provision to permit tax-free withdrawals from IRAs for contributions to charities did not make it through to conference.

Provisions included in the final bill are to

- permit penalty-tax-free withdrawals up to \$100,000 from retirement plans for victims in a federally declared natural disaster
- permit full income-tax deductions for casualty losses for affected taxpayers
- increase limits for income tax deductions for charitable contributions made by individuals between August 28 and the end of the year
- increase mileage rate for charitable use of automobiles
- increase corporate deduction limits for contributions to Katrina relief efforts
- provide incentives through work opportunity tax credits for hiring employees inside the hurricane disaster area. In addition, there is a tax credit for small employers in a disaster area for retaining employees.

We’ll provide more details of some of the interesting provisions in an upcoming letter.

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 2005, gift taxes begin at a 41 percent rate and increase to 47 percent, estate taxes range from 45 to 47 percent, and the generation-skipping tax is imposed at 47 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.

Although the Senate promised a vote on the acceleration of the estate tax repeal this fall, the problems caused by Hurricane Katrina delayed other legislation for now. It appears that estate tax reform with further changes to the exemption amount and maximum rate are more likely than full repeal in the near future. In either event, lifetime gifts will continue to serve many objectives in addition to tax savings. A careful understanding of the transfer and income tax rules indicates that lifetime gifts remain an important estate planning technique.

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 provide for the needs of less wealthy and/or younger family members
- to gauge the ability of children or grandchildren to manage 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 and is expected to increase to \$12,000 for 2006, based on some preliminary estimates) 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. These expenses include tuition to educational institutions, regardless of the level of education. The allowable medical expenses include any that would be deductible (ignoring the limitation on itemized deductions) against federal income taxes. For example, a parent or grandparent could pay the health insurance premiums for adult children or grandchildren without gift tax implications.
- **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 can best be illustrated by an example. Let's say a closely held business (ESSCO, an S corporation) has a fair market value of \$3 million. If its owner (let's call him Dave) retains 100 percent ownership in the ESSCO stock until his death, its value for estate tax purposes would be \$3 million. If Dave is in a 47 percent estate tax bracket, estate taxes on his business will be \$1,410,000.

If during lifetime, Dave transfers one-third of his ESSCO stock to each of his children, Peter and Sheila, and retains one-third for himself, the fair market value of the gifts to his children will be less than \$1 million each. This is because he has transferred a minority interest in ESSCO to each of them. A minority interest lacks control over business decisions, cannot force ESSCO's liquidation, and lacks marketability. As a result, ESSCO's fair market value will be discounted. A 30 percent discount (which is not unusual) would result in a gift tax value of \$700,000 for each gift. Through gift-splitting with Dave's wife, Doris, and the application of each of their applicable (unified) credits, there would be no gift tax payable. Furthermore, at Dave's death, he would own a minority interest in ESSCO, and the same 30 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 \$900,000. In a 47 percent tax bracket, that translates into at least a \$423,000 savings in gift and estate taxes! More if ESSCO appreciates in value between the date of the gifts and Dave's death. Although the discount for lack of control seems unusual in a circumstance where the family owns 100 percent of the company, the IRS has sanctioned the discount in this type of setting (Rev. Rul. 93-12, 1993-1, C.B. 202).

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

IRS PROVIDES SAMPLE CHARITABLE REMAINDER UNITRUST (CRUT) FORMS

The IRS recently issued a series of Revenue Procedures (Rev. Proc. 2005-52 to 59, I.R.B. 2005-34) that provide sample trust agreements and alternative language for CRUTs to comply with IRC Sec. 664. The samples include both living and testamentary trusts for one or two lives or a term of years. The language contained in the samples meet with IRS approval. The IRS will generally issue letter rulings on individual trusts only if the taxpayer uses a form that deviates substantively from the samples. These documents were long awaited because the previous sample forms were issued in the early 1990s and were obsolete due to several legislative changes to charitable trusts.

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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