



Advanced Planning Strategies

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The recent Congressional elections could have a significant impact on future tax reform. It is unlikely that there will be any immediate efforts to make the tax cuts provided by the 2001 and 2003 tax acts permanent. In fact, some officials have indicated that major tax reform will not be a priority until 2009. Charles Rangel, the incoming Ways and Means Committee chairman, has stated that he will not attempt to eliminate any of the tax reductions prior to their expiration. However, it is probable that action will be taken on many of the items set to expire in 2010 or 2011 well before the expiration dates. Obvious targets for reform are the alternative minimum tax (AMT), marriage penalty, deduction for state and local sales taxes, and federal estate and generation-skipping transfer tax. The current increased exemption for AMT will expire at the end of 2006, and the state and local sales tax deduction has not yet been reinstated for 2006.

We have discussed the benefits of using funds from IRAs or qualified retirement plans to make charitable donations at death. These are generally the most efficient assets to fund intended charitable bequests because the funds in such accounts or plans are otherwise subject to income taxes in addition to any estate taxes that apply if funds are left to family members. However, there is a right and wrong way to accomplish these charitable bequests. The best method is to designate the charity as the beneficiary of the IRA or retirement plan on the beneficiary designation form to the extent of the intended charitable bequest. A recent case resulted in immediate income tax to a trust where the IRA was payable to the trust and the trustee had the discretion to fund pecuniary (fixed-dollar amount) bequests to charity with IRA proceeds. (Chief Counsel Memo 200644020)

The IRS released the final inflation adjustments for 2007. The gift tax annual exclusion will remain at \$12,000, but the maximum reduction for the estate tax value of real estate used in a farm or closely held business will increase to \$940,000. The gift tax (super) annual exclusion for gifts to a noncitizen spouse will increase to \$125,000. For long-term care insurance premiums, the amounts eligible for deduction as a medical expense in 2007 will be \$290 for individuals up to age 40, \$550 for ages 41 to 50, \$1,110 for ages 51 to 60, \$2,950 for ages 61 to 70, and \$3,680 for ages over 71.

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 2006, gift taxes begin at a 41 percent rate and increase to 46 percent, estate taxes are imposed at 46 percent, and the generation-skipping tax is imposed at 46 percent. Legislation passed in 2001 repeals the estate and generation-skipping tax in 2010, but not the gift tax. Absent further legislative changes (which are viewed as inevitable), the repeal of the estate and generation-skipping taxes would occur only in 2010; the taxes would be reinstated in 2011, with rates and exemptions as if the 2001 laws were in place. Congress kept the gift tax on the books to prevent taxpayers from making tax-free gifts to shift income taxes to lower-tax-bracket family members.

Although most prognosticators believe that some estate tax reform will be enacted before the complete repeal in 2010, it is necessary to continue estate planning because some valuable gift exclusions are available each year. What's more, gifts will often be indicated for personal objectives rather than (or 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 taxes 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 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:

- **\$12,000 annual exclusion.** During lifetime, you can make gifts of up to \$12,000 (the annual exclusion is indexed for inflation but will remain at \$12,000 for 2007) 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. If the donor is married and his or her spouse is willing to elect to split gifts, the donor can transfer \$24,000 to selected donees.

- **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 can 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 is used primarily with family business entities such as limited partnerships or family limited liability companies. In these techniques, transfers of limited (noncontrolling) 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 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. 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 \$12,000 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 \$12,000 to \$24,000 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. It must disclose the relationship between the transferor and transferee. 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. With respect to timing of gifts, a gift is complete in the tax year that the gift is delivered to the donee with no strings attached. A gift made by check is completed for tax purposes when the check is presented for payment by the donee.

RECENT CASES AND RULINGS

PROPOSED TREASURY REGULATIONS APPLY HEAVY HAND TO PRIVATE ANNUITIES

Proposed regulations were issued on October 18, 2006, revoking the long-standing income tax treatment of annuities received in exchange for property. (Rev. Rul. 69-74, 1969-1 C.B. 43 was revoked.) No distinction is made in the new rules between private and commercial annuities. The proposed regulations (Prop. Treas. Reg. Secs. 1.72-6(e) and 1.1001-1(j)) remove the income tax deferral traditionally applied to transactions in which an annuity is received in exchange for property. For transactions entered into after October 18, 2006, the seller will be treated as receiving an amount equal to the fair market value of the annuity and will recognize gain for income tax purposes immediately at the time of the exchange. The payments received from private annuity transactions entered into before the effective date will continue to be taxed under the old rules that spread gain recognition over the life expectancy of the seller.

Under an exception for certain nonabusive transactions, the old rules will apply to annuities received in exchange for property for transactions entered into before April 19, 2007, if (1) the issuer of the annuity is an individual, (2) the obligation under the annuity contract is not secured directly or indirectly, and (3) the property received for the annuity is not subsequently sold or disposed of during the next 2 years. This subsequent disposition would include a transfer to a trust or to an entity, even if solely owned by the transferor. Thus, a private annuity transaction involving a sale to a junior generation family member would continue to provide income and estate tax advantages as long as the exchange occurs no later than next April 18 and the buyer keeps the property at least 2 years. The new rules also provide an exception for charitable gift annuities.

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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