



Advanced Planning Strategies

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

October 2007

It's beginning to look like tax legislation is going to be delayed somewhat by politics. The key issues that have to be addressed are the AMT reform and several lapsing provisions that will require Congressional action to be extended. The primary bottleneck is generally the Senate, where 60 votes might be necessary to advance significant tax cuts. The AMT has been mitigated for several years for many taxpayers by temporary increases to the exemption. Some Democrats have indicated a preference to eliminate the AMT, which would require offsetting tax increases in other areas. This type of action might pass the House, but that is unlikely in the Senate. We will probably not see any dramatic changes, but the debate might delay the further extension of the increased exemption.

Other major items that are expected to be addressed (but probably not until after the 2008 election) are the repeal/reform of the federal estate and generation-skipping taxes and the tax cuts mostly from the 2001 and 2003 legislations. These items were not permanent and will sunset if not extended or reformed. The changes to the estate tax have provided some interesting results. Since 2001, the amount of property exempt from taxes at death has risen from \$675,000 to \$2 million, while the maximum rate has dropped from 55 percent (60 percent if a surcharge applied) to 45 percent. From 2001 to 2005 (the latest year of IRS published statistics), the number of returns filed has been more than cut in half (from 108,071 to 45,070). However, the total tax revenue has declined by less than \$2 billion, an 8 percent decrease.

In a news release (IR-2007-157), the IRS and Treasury indicated that employers will have until December 31, 2008, to revise plan documents to bring affected benefit plans in compliance with the regulations under Section 409A, released earlier this year. These regulations, which primarily affect nonqualified deferred compensation plans, created a great deal of commentary and are difficult to understand and apply in some circumstances. This relief applies only to plan document revision and does not delay the effective date of the regulations.

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. Gift taxes begin at a 41 percent rate and increase to 45 percent; estate and generation-skipping transfer taxes are imposed at 45 percent. Legislation passed in 2001 repeals the estate and generation-skipping tax in 2010, but not the gift tax. Absent further legislative changes (viewed as inevitable), the repeal of the estate and generation-skipping taxes currently would occur only in 2010; the taxes would be reinstated in 2011, with rates and exemptions that would be in place 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-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, in general gifts are indicated for personal objectives rather than (or in addition to) tax savings. A careful understanding of the transfer and income tax rules shows 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 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 is not expected to increase above \$12,000 in 2008) 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 if 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 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 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. 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 \$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. 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. 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

TAX COURT HOLDS PROCEEDS RECEIVED IN DISPUTE CONCERNING OWNERSHIP OF LIFE INSURANCE POLICY TO BE ORDINARY INCOME

The taxpayer founded and was CEO of a bank. Under an employment agreement, the bank acquired and was named policyowner of a \$1 million life insurance policy on the taxpayer's life. Ultimately, the policy was made payable to the taxpayer's spouse. The taxpayer subsequently resigned from his employment and as a director of the bank. A dispute arose over issues related to the taxpayer's employment agreement and a suit was filed. Among the items disputed was the failure of the bank to transfer title to the policy to the taxpayer. The case was settled and \$500,000 of the settlement proceeds was allocated to the dispute over the life insurance policy.

The taxpayer attempted to report the life insurance component of the settlement as a sale of the policy to the bank. The gain would be offset by the basis in the policy (i.e., the amount of premiums paid by the bank that were taxable to the taxpayer). The taxpayer also divided the proceeds from the life insurance into components of \$181,343 of cash surrender value and the remainder representing other policy attributes. The court found that there was no evidence presented indicating any basis in the policy or any particular cash surrender value. Nor did the court find that this transaction represented a sale or exchange of the policy. The holding simply determined that the proceeds were an extinguishment of the employment claim and taxable as ordinary income (*Eckersley v. Commissioner*, TC Memo 2007-282). The discussion concerning the absence of a sale or exchange did not include the court's view of the tax treatment in the event of a sale or exchange of a policy.

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