



# Advanced Planning Strategies

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The so-called extenders legislation was not passed at the time this letter was written. There is also energy legislation that includes tax provisions and the House and Senate currently have different versions of the proposals. The Senate is deliberating over a tax package that includes extending the increased credit against AMT (an over \$60 billion price tag) while eliminating or freezing some tax breaks for oil and gas companies. The Bill would potentially include disaster relief provisions for the recent hurricanes. President Bush has promised to veto the legislation if it contains tax increases.

The House is considering a bill to provide an incentive for moving children from foster homes into adoptions (Fostering Connections to Success and Increasing Adoptions Act—HR 6893). The bill is likely to be merged with a Senate version of the legislation. The bill contains a restricted definition of “qualified child” for tax purposes. The child must be either younger than the individual claiming the tax benefit or disabled. The benefit cannot be claimed by another if the parent of the child is eligible to claim the child. It is quite possible that this legislation will have been enacted by the time this letter is printed.

The tax code is likely undergo significant change after the election. The federal debt will undoubtedly limit what can be done. The federal debt ceiling would be raised to \$11.3 trillion by the government’s action to provide security as a result of the crisis in the banking industry. With respect to the extenders legislation referred to above, 41 provisions expired at the end of 2007 that would have to be renewed. An additional 21 provisions expire in 2008. A significant number of provisions created by the tax cuts in 2001 and 2003 will expire between 2010 and 2014. We’ll outline some of the more significant expiring provisions for you in an upcoming letter.

## Special Report

Congress passed The Emergency Economic Stabilization Act of 2008 after our letter was approved for production and distribution. President Bush signed the Bill on the same day the House approved it. In addition to the financial rescue plan (A/K/A the Troubled Assets Relief Program (TARP)), the Bill included many tax provisions including some extensions of expired or expiring tax provisions. Some important tax provisions that were enacted include:

- An increased AMT exemption for married taxpayers filing jointly of \$69,950 for 2008 (the exemption would otherwise have dropped to \$45,000)
- An extension of the charitable IRA rollover provision permitting up to \$100,000 of qualified charitable distributions per year from a regular or Roth IRA for individuals over age 70 ½ in 2008 and 2009.
- An extension of the research tax credit for 2008 and 2009.
- An extension of the special 15-year cost recovery for qualifying restaurant or leasehold improvements for 2008 and 2009.
- An extension of the New Markets Tax Credit applicable to investments or loans with respect to small businesses in economically distressed areas through 2009.
- An extension of the deduction for energy efficient commercial buildings through 2013.
- An extension of the residential energy efficient property tax credit through 2016.

*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 to be paid 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 (which are viewed as inevitable for 2009), 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 applicable 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 since some valuable gift exclusions are available each year. What's more, gifts will generally 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 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 donees" 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 your lifetime, you can make gifts of up to \$12,000 (the annual exclusion is indexed for inflation and is currently forecast to increase to \$13,000 in 2009) 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

### Interest Paid by Estate On Deferred Estate Taxes Treated As Nondeductible Personal Interest

An estate was granted an extension of time to pay estate taxes under the provisions of IRC Sec. 6161. This provision is available to an estate that demonstrates reasonable cause for requesting an extension. Examples of reasonable cause include (1) the estate includes assets in several jurisdictions that are not immediately available to the executor, (2) the estate has assets that cannot be collected without litigation, (3) the estate has assets that will not be received until the future and provide insufficient cash to pay the taxes, (4) the estate includes illiquid assets that cannot be converted to cash in the current market without substantial loss, and (5) the estate does not have sufficient cash to pay the taxes, satisfy claims against the estate, and provide an allowance for the decedent's widow and dependent children. The extension could be for as much as 10 years if undue hardship is demonstrated.

In this case, the deferred taxes accrued interest and the executor attempted to deduct the interest on the estate's income tax return (Form 1041). The IRS held (Chief Counsel Memorandum 200836027) that the interest accrued on the deferred estate taxes was nondeductible personal interest. IRC Sec. 163(h) provides six specific exceptions as non-personal interest. The IRS reasoned that interest under another estate-tax extension provision (Sec. 6163) was specifically made deductible and the exclusion of Sec. 6161 from the exceptions indicated clear Congressional intent that the interest in this case be treated as nondeductible personal interest.

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. Securities and Investment Advisory Services offered through Capital Analysts Incorporated, Member FINRA/SIPC. AEG and CAI are independent non-affiliated entities.

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for the future*



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