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Before the Year Ends

Basic tax planning practice dictates that one should always review his or her affairs and consider taking certain steps before year-end. Planning for 2008 is no exception. This year, however, the volatile economic times may require consideration of additional planning opportunities.

Maximize your annual exclusion gifts

In 2008, every individual may give anyone else up to \$12,000 free of gift tax by using the annual exclusion. Gifts can be made outright or to custodial accounts, to trusts for minors and to certain other types of trusts so long as the donee has the right to enjoy the gift immediately. If annual exclusion gifts are made to several donees, it is possible to shift significant value from the donor's estate to the next generation each year free of tax. Splitting gifts with a spouse may double the amount a person can give under the exclusion. Any gifts that are not completed in 2008 (such as uncashed checks) are ineligible for this year's annual exclusion, and therefore the exclusion will be partially wasted. Of course, another round of annual exclusion gifts may be made in 2009, when the exclusion amount increases to \$13,000 per donee.

Use depreciated assets for gifting

The recent drop in the value of stocks and real estate may make them more attractive for gifting. For gift tax purposes, property is valued at its fair market value. So, lower values mean more assets may be given away for the same tax cost.

Also, for income tax purposes the general rule of thumb has always been

to give away assets with a high basis, because the donee normally takes the donor's basis in the gifted property. Retaining low-basis (that is, highly appreciated) assets until death, when the assets will receive a "step up" in basis equal to their date-of-death value, minimizes the amount of capital gains the donee must eventually recognize.

However, this concern over the gift recipient's future capital gains is diminished in a world where fewer assets have built-in appreciation. As a result, donors may find themselves with more funding options for their gifting.

It is important to keep in mind, though, that the recipient's new basis in the gifted property will equal the *lesser* of the donor's basis or the property's fair market value at the time of the gift. This means that if the value of a depreciated asset subsequently rebounds, a portion of the donor's basis may be lost as a result of the gift. Therefore, it will usually be best to give away depreciated assets that nevertheless are worth more than the donor's basis.

Rethink funding of charitable gifts

Charitable giving is also entitled to year-end consideration, since deductions against 2008 income must be completed before the end of 2008. However, taxpayers may wish to rethink using depreciated stock or cash to fund their gifts to charity this year.

Perhaps a more tax-efficient source of funding would be the donor's individual retirement account (IRA). The popular "charitable IRA rollover" rules, which

expired at the end of 2007, were recently extended to 2008 and 2009. Once again, anyone age 70½ or older may make a direct trustee-to-charity transfer of up to \$100,000 from his or her IRA to a public charity (but not a private foundation, a supporting organization or a donor-advised fund), without having to include the distribution in his or her income for the year. The distribution/contribution also counts against the taxpayer's required minimum distribution for the year.

Offset earlier capital gains

Another year-end planning consideration is to accelerate the realization of capital losses into 2008 if doing so will help offset earlier capital gains. Of course, there are holding periods, wash sale rules and other factors to be considered before selling any capital asset, but such planning may help make a taxpayer's capital gain transactions more tax efficient in this volatile economic market.

In sum, the basics of year-end planning for 2008 are the same — complete annual exclusion gifts and make charitable contributions before the end of the year, and offset earlier capital gains with losses where possible — but the standard rules regarding the appropriate assets to give away may have shifted. On the bright side, many more assets can be transferred in 2008 for the same tax cost, which will hopefully result in much greater wealth finding its way into the hands of donees in the long run.

North Carolina has repealed its gift tax effective January 1, 2009. Therefore, anyone potentially subject to North Carolina gift taxes should consider delaying taxable gifts until after 2008.

Are You a Fiduciary?

Many individuals serve as fiduciaries. Some serve as trustees of trusts created by a family member or friend or as executors of their estates. Others serve as trustees of a charitable trust or as directors of a charitable corporation. Most realize that their fiduciary roles subject them to certain duties. While the exact standards may vary from state to state, all fiduciaries must generally act with prudence and reasonable diligence.

When investments are performing well, few will complain that a fiduciary is not meeting the required standard of care. However, "prudence" and "diligence" may take on new meanings in a world where investment values can swing by 10 percent in a day, and almost 50 percent in a year. Of course, no one fiduciary can be expected to have a perfect crystal ball, but it becomes increasingly important for trustees and other fiduciaries to take steps to illustrate that they have acted with prudence, and to document their diligence.

For example, a trustee should monitor trust investments regularly and seek advice when needed. He or she should document any decisions and their rationale. If the trustee decides to liquidate an account, he or she should document the reason. If the trustee decides not to diversify investments, he or she would be well-advised to obtain the beneficiaries' consent and a written release agreement that would hold him or her harmless against future claims. Even if a decision proves to have been wrong in hindsight, careful documentation of the steps

that led to the decision may provide valuable protection for the fiduciary.

Beyond standard diligence, fiduciaries should consider other possible effects of dramatic market changes. For example, North Carolina law limits the use of charitable endowment funds that are currently worth less than their historic cost. Many states, including Virginia, have eliminated this historic dollar limitation, but charitable trustees and directors should check for any limitations or requirements that apply in their state.

As another example, the trustee of a trust that provides only for distributions of trust income to the current beneficiary may wish to consider an equitable adjustment or conversion to a unitrust if income has been significantly reduced. (See page 3, "When Income Is Not Enough," for more information on these options.)

Obviously, the current volatile financial markets will leave many trust and estate beneficiaries disappointed, and many charities struggling to remain solvent. This cauldron of unhappy people will undoubtedly result in lawsuits against fiduciaries who are struggling to cope with the difficulties as best they can. The reward for serving as a fiduciary, often a favor or pro bono effort, could prove to be personal liability.

Hopefully, the dramatic economic events will begin to calm in the days ahead. But until that time, all fiduciaries must remain vigilant and carefully document the reasons for any decisions. In good times no one complains, but in bad times prudent fiduciaries need evidence to show that they did their jobs reasonably under the circumstances.

Low Interest Rates, Asset Values Aid Transfer Tax Planning

It seems increasingly likely that Congress will not allow the estate tax to expire as scheduled in 2010, even for a single year. The same economic conditions that may preserve the estate tax, however, also present immediate transfer tax planning opportunities. Falling asset values and historically low interest rates make several planning techniques particularly attractive.

Intra-Family Loan. Loans to family members must bear interest at the applicable federal rate (AFR) to avoid immediate gift tax consequences. The December AFR is only 1.36 percent for term loans of three years or less, 2.85 percent for loans of three to nine years and 4.45 percent for loans of more than nine years. The borrower can use such a loan to repay other higher-interest debt or to invest for a higher return. Interest generally is

deductible by the borrower, and any net after-tax return on investments inures to the borrower's benefit without gift tax.

Grantor Retained Annuity Trust (GRAT). The creator of a GRAT places assets in an irrevocable trust for a specified term of years. During that term the creator retains the right to receive a specified yearly payment from the trust; and at the end of the term, the entire remaining trust value goes to the creator's children or other designated beneficiaries. Only the actuarially discounted value of the remainder interest is subject to gift tax. The current low AFRs produce relatively higher values for a GRAT annuity interest and thus attribute less value to the currently taxable remainder interest. If the trust creator lives for the GRAT's full term and the trust assets appreciate faster than the AFR, the extra amount passing to the remainder beneficiaries will escape gift tax.

Charitable Lead Annuity Trust (CLAT). A CLAT is the charitable

equivalent of a GRAT. That is, the creator places property in an irrevocable trust that makes a specified yearly payment to one or more charities for a period of years and then distributes the remaining trust assets to the creator's children or other designated individuals. A charitable contribution deduction shelters the annual payments from gift tax, so only the actuarial value of the remainder interest is taxable as a gift. As with a GRAT, current low AFRs yield a higher value for the charitable payments and a correspondingly lower value for the taxable remainder. Likewise, any appreciation in excess of the AFR passes to the children or other individual beneficiaries free of gift tax.

Those who believe that interest rates will rise and the stock and real estate markets will recover significantly in the next few years should consider using one or more of these techniques to pass additional value on to children or other beneficiaries at reduced transfer tax cost.

When Income Is Not Enough

The recent turmoil in the financial industry has hurt not only individual investors' portfolios, but also trust investment returns. As publicly owned companies slash dividends and federal, state and local governments and banks lower their interest rates on fixed-income products, trust beneficiaries who rely on trust income distributions are facing hard times. And whenever there are hard times, fear and conflict often follow.

When Wall Street is in retreat, trustees must often choose between "staying the course" until the market rebounds (which benefits the remainder beneficiaries) or re-allocating investments, perhaps at a loss, to generate more income (which

benefits the income beneficiaries). Either way, the trustees are almost invariably charged with favoring one set of beneficiaries over the other.

Fortunately, many states permit trustees to go beyond the trust terms and make a one-time adjustment between principal and income, so as to treat all beneficiaries fairly, without having to resort to ill-advised changes in investment strategy. However, trustees must carefully consider many specific factors before making such an equitable adjustment.

Depending on the circumstances, some states also allow the trustee of a trust in which all income is distrib-

uted to one or more beneficiaries to convert the trust to a "total return unitrust." A total return unitrust pays a fixed percentage (usually 3 percent to 5 percent) of the trust's assets each year to the income beneficiaries, regardless of the actual investment income earned. With a total return unitrust, the trustees are free to invest with an eye toward maximizing the trust's total investment return over the long term, which pleases the remainder beneficiaries, while providing the income beneficiaries with more predictable distributions.

If you are a trustee or trust beneficiary and would like to learn more about equitable adjustments and unitrust conversions, please contact us.

What Lies Ahead: Some Thoughts About Possible Legislation Affecting Estate Planning

Predicting changes in tax legislation is risky business, but failing to consider how the transfer tax rules might change in the near term is also not prudent. So, where are we now and where might President-elect Obama and the next Congress take us in areas that affect estate planning decisions?

Current law

Based upon current law, we know that the credit against estate and generation-skipping transfer (GST) taxes will adjust in January 2009 to a level that will fully shelter transfers of up to \$3,500,000. Some have estimated that this change in the shelter level will eliminate estate tax filing requirements and tax exposure for 99.7 percent of all decedents' estates.

To discourage taxpayers from using large lifetime gifts to shift future taxable income to individuals in lower income tax brackets, however, the gift tax rules will remain unchanged in 2009. The lifetime shelter against taxable gifts (that is, gifts in excess of what will be the \$13,000 annual exclusion) will continue to be \$1,000,000. As has been the rule all along, if you use any portion of your lifetime shelter against gift taxes, the amount so used will offset the maximum shelter available at death against estate, and possibly GST, tax.

The new year will also see no change in the maximum estate, gift and GST tax rates, which will remain at 45 percent.

The 2009 shelter amounts and tax rates are currently scheduled to change dramatically in the future. The estate and GST taxes are repealed for individuals dying in 2010. However, they are due to return in 2011 with only

a \$1,000,000 shelter amount for estate tax purposes and at least \$1,300,000 for GST tax purposes (due to automatic inflation adjustments since 1997), with a maximum tax rate of 55 percent.

Future possibilities

Looking beyond what we know will transpire and moving into the area of speculation on future changes in the law, we know that President-elect Obama has supported freezing the estate and GST tax shelter amounts at the 2009 levels of \$3,500,000 and maintaining a maximum tax rate of 45 percent. He has made no proposals to change the gift tax.

Also, many family investment partnerships invest one third or more of the entity's assets in marketable securities. In the past, the IRS has attempted to get Congress to enact legislation that would reverse decades of Tax Court decisions defining and shaping how the fair market value of property, including interests in family partnerships, would be determined for estate, gift and GST tax purposes. Most notably, the IRS has attempted to eliminate the use of discounts for lack of control and lack of marketability when valuing transfers of interests in family-owned businesses, including investment partnerships.

The most recent of these attempts was evidenced by the 2005 Joint Committee on Taxation (JCT) proposals. Had the proposals been adopted, they would have imposed a series of complex rules that would have severely limited the use of valuation discounts for transfers of interests in a family-controlled business among family members, even if the interest transferred represented only

a minority interest. Furthermore, the 2005 proposals contained "look-through rules" for valuing interests in a business entity that held marketable securities amounting to more than one third of the underlying assets of the business. Under these rules, the portion of the transferred interest attributable to the company's marketable securities would have been valued separately, as if those securities were directly owned by the transferor, while any applicable valuation discount applied only to the remaining portion of the transferred interest.

Again, no one knows what Congress will actually do with future tax legislation. But it is clear that the IRS has long wanted to see legislation enacted that would overrule the use of discounts in valuing transfers of interests in family-controlled businesses. It is also apparent that the more conservative members of Congress prevented these measures from becoming law in 2005. Now that the mix in both houses of Congress has changed and budget pressures are increasing, one can assume that the IRS has not forgotten what was on their legislative wish list in 2005. Therefore, the prospect of an additional attempt to secure legislative changes in valuation rules should not be minimized.

For anyone who has been delaying his or her estate planning because of an expectation that the estate tax will be repealed, or who has been considering a future gift of interests in a family-controlled business, it might be a good idea to accelerate your thinking into action soon.

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