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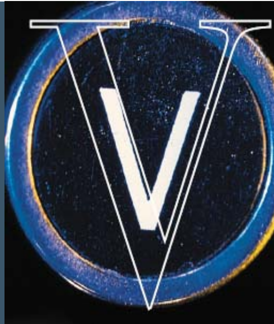

estate planning alert

A PUBLICATION OF VENABLE'S TAX & WEALTH PLANNING GROUP
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Plan Now for Year End Gifts

Many of our clients take advantage of the annual exclusion from gift tax. This is the amount that every person may give to each of as many beneficiaries as he or she wishes in a given year without incurring any gift tax and without using any of the $1,000,000 per donor lifetime gift tax exclusion amount.

The annual exclusion amount currently is $12,000. If a married couple files a gift tax return electing to "gift-split", one spouse may give up to $24,000 per beneficiary per year. If a couple would like to give $24,000 to a beneficiary but does not want to file a gift tax return, each spouse should give a separate $12,000 gift from his or her individual account. Contributions to a Section 529 college savings plan, or a similar state plan (such as the Virginia plan), also qualify for the gift tax annual exclusion. A Section 529 Plan is a tax-favored arrangement that allows individuals to set aside funds for future college or other post-high school tuition, as well as for other expenses of higher education. Section 529 Plan investments grow tax free, and may be withdrawn tax free if used for qualified educational expenses.

Individuals wishing to take advantage of the Section 529 benefits may transfer up to five years' worth of annual exclusion gifts to the Section 529 Plan in the first year. This means that a single donor now may transfer up to $60,000, and a married couple may transfer up to $120,000, to each Section 529 Plan. Because each Section 529 Plan is created for a separate beneficiary, persons with more than one child or grandchild may create multiple Section 529 Plans, funding each Section 529 Plan with up to $60,000 (or $120,000 for a married couple) without making a taxable gift.

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Please note that a donor's other gifts, such as contributions to irrevocable trusts to cover insurance premiums, may reduce the amount such donor may contribute to a Section 529 Plan without triggering a taxable gift. It is also important to understand that, if the donor passes away before the five-year period has expired, a portion of the gifts will be brought back into the donor's estate for estate tax computation purposes.

Payments for medical expenses and tuition for others (related or unrelated) are not considered taxable gifts and are not subject to the annual exclusion limits. For example, a taxpayer may give a grandchild $12,000 in 2008 and may also pay any amount (e.g., $20,000) for that grandchild's tuition at any level from pre-kindergarten to graduate school without incurring any gift tax. However, in order to be exempt from gift tax, payments for medical expenses or tuition must be paid directly to the health care provider or educational institution. (Thus, reimbursement to another for such payment is not exempt from gift tax.) "Medical expenses" include the cost of medical insurance, including long term care insurance, if paid directly to the insurance provider.

Charitable Giving with IRAs

In 2006, Congress passed the Pension Protection Act of 2006. Pursuant to Section 1201 of the Act, individuals may utilize funds in their Individual Retirement Accounts (IRAs) to make charitable contributions. Although this provision had expired for years after 2007, Congress recently extended Section 1201 to apply to charitable contributions made in 2008 and 2009.

Typically, most withdrawals from an IRA are subject to Federal income tax. Under the Act, individuals over age 70½ may withdraw up to an aggregate of $100,000 per year from their IRAs tax free, so long as such amount is contributed to certain qualified tax-exempt organizations before the end of the year of withdrawal. The withdrawal amount may be used to satisfy the individual's minimum required distribution. Although the charitable contribution is not tax deductible, the amount withdrawn is not included in the IRA participant's income.

This provision offers a significant planning opportunity for individuals over 70½ who wish to make charitable contributions in 2008 and 2009. The provision does not apply to withdrawals from qualified retirement plans, such as 401(k) accounts. However, an individual may convert a 401(k) account to an IRA to take advantage of this provision. *Please note that this provision now expires on December 31, 2009.*

Planning to Take Advantage of Lower Interest Rates

When interest rates are historically low, as they are now, the potential for success of certain estate planning techniques increases. One such technique is a grantor retained annuity trust (GRAT).

A GRAT is an estate planning tool that allows an individual to transfer interests in appreciating assets to an irrevocable trust at a lower transfer tax cost and retain an annuity interest for a specified number of years. At the end of the term, the property remaining passes to the remainder beneficiaries. Because of the retained annuity interest, the value of the gift is "discounted".

To illustrate, assume that a 60-year old individual transfers $1,000,000 to a GRAT and retains a 10% annuity for 10 years. The value of the gift of the remainder interest is approximately $230,270. Generally, a GRAT succeeds (that is, property remains for the remainder beneficiaries) when the investment return on the property exceeds the IRS established discount rate for valuing the annuity. The IRS established interest rate for November of 2008 is 3.6%. Therefore, if the investments perform at a rate greater than 3.6%, the GRAT is likely to succeed as a wealth transfer tool. Thus, in the example above, if the principal in the GRAT grows at 5% per year, there will be $371,000 for the remainder beneficiaries at the end of 10 years. As a result, in this example the remainder beneficiary will receive $371,000 even though the gift tax was based on a gift of only $230,270.

A similar technique that is beneficial in a low interest rate environment for individuals with current charitable giving goals and significant liquidity is a charitable lead annuity trust (CLAT). In a CLAT, the annual annuity amount is distributed to charity rather than the donor. Because of the annuity amount passing to charity, the remainder interest passing to the donor's children at the end of the CLAT term is reduced for gift tax purposes.

Another technique often used to take advantage of the lower interest rates is a sale of assets to family members (or an entity comprised of family members) for a promissory note. Capital gains rates are likely to increase in 2009. Thus, now is a good time to sell assets and recognize capital gain. Such assets can be sold to family members at fair market value, subject to any appropriate discounts, for an adequate down payment and a promissory note. The IRS-established interest rate for November 2008 is 2.97% for loans that remain in place for more than 3 years but not more than 9 years. For loans in excess of 9 years, the November 2008 interest rate is 4.24%. If the assets' investment return is higher than the IRS-established interest rate, the leveraged purchase will result in greater economic value to the trust beneficiaries.

Please let us know if you would like to learn more about how to take advantage of low interest rates to accomplish gifting and other strategies.

Increase in Gift and Estate Tax Exemption Amounts in 2009

In addition to planning for 2008, individuals also should be looking forward to 2009 and beyond. The gift tax annual exclusion amount will increase from $12,000 to $13,000 on January 1, 2009. This means that an individual may give $13,000 (and a married couple electing to gift-split may give $26,000) to any person in 2009 without any gift tax consequences. This also means that a single donor may then transfer up to $65,000, and a married couple may then transfer up to $130,000, to each Section 529 Plan.

In addition to the increase in the gift tax annual exclusion, the Federal estate tax applicable exclusion amount also will increase in 2009. This is the amount that an individual can pass at his or her death free of Federal estate tax. As of January 1, 2009, the Federal estate tax exclusion amount will be $3,500,000. (Please note that the donor's lifetime gift tax exclusion amount will remain at $1,000,000.)

While there has been much discussion in the past about the scheduled repeal of the Federal estate tax in 2010, it seems more likely that legislation will be enacted making the $3,500,000 Federal estate tax exclusion amount permanent. We discuss the legislative outlook later in this alert.

Increase in Federal Exemption Could Be Costly to Maryland and DC Taxpayers

Under current law, the Federal estate tax exemption is $2,000,000 and will increase to $3,500,000 in 2009. The estate tax exemption in Maryland and DC, however, will remain at its current amount of $1,000,000. Please note that the estate tax in Maryland and DC is imposed on estates that exceed $1,000,000 not only for decedents domiciled in Maryland or DC at the time of death but also for nonresidents who owned real or tangible personal property located in Maryland and/or DC at the time of death.

The differential between the Federal estate tax exemption and the Maryland or DC estate tax exemption forces married clients to make a decision as to whether or not they will pay the Maryland or DC tax on this differential at the death of the first spouse or defer it until the death of the surviving spouse. With the increase in the Federal exemption in 2009, the Maryland or DC estate tax on this differential will increase from $99,600 to $229,200.

For some clients, it often is beneficial to pay the state estate tax upon the first spouse's death in order for such property to grow for the next generation free of Federal estate tax (which is imposed at much higher rates than the Maryland and DC estate tax) and additional state estate tax. However, with the increase in the amount of state estate tax that will be owed in 2009, many clients may wish to defer the state estate tax until the surviving spouse's death without losing the benefit of the full Federal estate tax exemption.

In Maryland, this result can be accomplished (with properly drafted documents) by making a "Maryland QTIP election" on the deceased spouse's Maryland estate tax return. With this election, the Personal Representative elects to hold the amount equal to the difference between the Federal exemption and the Maryland exemption (which difference currently is $1,000,000, but will increase to $2,500,000 in 2009 in the absence of further Maryland legislation) in a trust for the sole benefit of the surviving spouse.

This election does not prevent the Personal Representative from using the full Federal exemption on the Federal estate tax return. As the requirements of deferral may be counter to a client's non-tax estate planning objectives, the decision of whether to defer the tax should be made after consultation with counsel. **[Note: DC has not enacted legislation that would allow for the deferral of DC estate tax until the death of the surviving spouse while still utilizing the deceased spouse's full Federal exemption amount.]**

Current estate planning documents may need to be revised to take advantage of this deferral technique. If you have not already contacted us to discuss this change in your documents, you may wish to do so.

Maryland Domestic Partner Legislation

Effective July 1, 2008, Maryland enacted two new laws that give additional rights to domestic partners (both same-sex and opposite-sex partners). The first adds domestic partners to the list of individuals who may be added to or removed from a deed without incurring recordation and transfer taxes. The second affords domestic partners several new rights, including the right to make hospital visits and funeral arrangements.

The first new law defines a "domestic partnership" as a relationship between two adults who are not related by blood, are not married, share a common residence and "agree to be in a relationship of mutual interdependence in which each domestic partner contributes to the maintenance and support of the other domestic partner and to the relationship…." This law requires evidence of a domestic partnership, which includes a signed affidavit by both individuals confirming the domestic partnership and two additional indicia of the domestic partnership. The additional evidence can include the following:

- Joint liability for a mortgage, other loan or lease;
- The designation of the partner as the primary beneficiary of a life insurance policy or retirement plan;
- The designation of the partner as the primary beneficiary under the other's Will;
- Durable power of attorney for health care or financial management granted to the partner;
- Joint ownership or lease by the partners of a motor vehicle;
- A joint checking account, joint investments, or joint credit accounts;
- A joint renter's or homeowner's insurance policy;
- Coverage of the partner under the other partner's health insurance policy;
- Joint responsibility for childcare; or
- A relationship or cohabitation contract.

Once a domestic partnership has been established, the instrument of writing that transfers residential property between the domestic partners, or former domestic partners under certain circumstances, is exempt from recordation and transfer taxes.

The second new law defines a domestic partnership in the same manner as the first and has the same requirements regarding proof of the domestic partnership. Once the domestic partnership has been established, domestic partners are afforded new rights regarding health care facility visitation and medical decisions, including the following:

- Domestic partners and their children have the same traditional visitation rights as were previously afforded only to spouses and certain family members.
- In the case of a medical emergency, once a domestic partner has explained, in good faith, to the emergency care personnel that he or she is in a mutually interdependent relationship with the injured party, he or she should be allowed to ride in the emergency vehicle and be admitted to the hospital on an emergency basis.
- Domestic partners are allowed to share a room in a nursing home.
- Domestic partners can make health care decisions regarding a partner who is incapable of making informed decisions.
- Domestic partners may have priority over the decisions regarding organ donation.
- Domestic partners can provide consent for postmortem examinations.
- Domestic partners may have priority over the final disposition of his or her partner's body.

Virginia Estate Tax Repeal

Effective July 1, 2007, the Virginia estate tax was repealed. This means that the estates of Virginia domiciliaries dying after June 30, 2007 will not be subject to Virginia estate tax. However, the decedent's estate may be subject to Federal estate tax, depending upon the size of the estate. In 2008, only estates that exceed $2,000,000 in value are subject to Federal estate tax. In 2009, this taxable "threshold" will increase to $3,500,000.

Because of the way the law repealing the Virginia estate tax was written, the state estate tax will return in 2011 if Congress does not act before then to change the Federal estate tax laws. As a result, the Virginia legislation does not create a permanent repeal of the state estate tax.

Because of the repeal of the Virginia estate tax, Virginia may become a desirable place of domicile for many individuals whose estates might otherwise be subject to state estate tax (including, for example, Maryland and the District of Columbia). However, becoming a Virginia domiciliary takes specific planning.

If you wish to become a Virginia domiciliary, you should discuss the necessary planning with us.

New Substantiation Requirements for Charitable Contributions

The IRS issued proposed regulations in August designed to implement Congress' 2004 legislation calling for increased substantiation and reporting requirements for charitable contributions. The proposed regulations apply across the board and do not contain exceptions for even small cash contributions. For example, donations at informal fundraisers or to Salvation Army kettles are required to be substantiated by receipts or cancelled checks. Substantiation of cash donations must be in the form of a written receipt from the charity showing the date and amount of the contribution and the name of the charity.

The proposed regulations also spell out strict rules for the valuation of noncash donations to charity, as follows:

- Deductions claimed for noncash contributions of less than $250 must be supported by a receipt from the charity or reliable records.
- Deductions claimed for noncash contributions of more than $250 but less than $500 must be supported by a contemporaneous written acknowledgment from the charity.
- Deductions claimed for noncash contributions of more than $500 but not more than $5,000 must be supported by a contemporaneous written acknowledgment from the charity <u>and</u> the taxpayer must file Form 8283.
- Finally, deductions for contributions in excess of $5,000 must be supported by a contemporaneous written acknowledgment, Form 8283 and a qualified appraisal (which must be attached to the tax return if the gift exceeds $500,000).

The proposed regulations also specify the requirements for achieving deductions for used clothing and household items (imposing a "good used condition or better" standard) and the limitations on deductibility of vehicle donations. The proposed regulations will be effective only when finalized, but reflect the view of the IRS.

Federal Estate Tax Legislation

Under current law, the amount that an individual can pass to his or her heirs free of Federal estate tax (the "applicable exclusion amount") is $2,000,000, and the highest Federal estate and gift tax rate in 2008 is 45%. Unless Congress acts to provide permanent estate tax relief, the estate tax applicable exclusion amount will increase to $3,500,000 in 2009 and the estate tax will be repealed for one year only in 2010. After that, the estate tax applicable exclusion amount will decrease to $1,000,000 (adjusted for inflation), and the highest Federal estate and gift tax rate will increase to 55%.

Unlike the changes to the estate tax applicable exclusion amount, the lifetime exclusion from gift tax remains constant at $1,000,000. That is, every individual may make gifts (in excess of the annual gift tax exclusion amounts and payments of education and medical expenses directly to the providers) of up to $1,000,000 in the aggregate during his or her lifetime, before having to pay any gift tax. This $1,000,000 threshold does not apply to gifts between spouses, which are not subject to gift tax. As a result, there is no limit on the amount of gifts spouses may make to one another so long as the receiving spouse is a U.S. citizen or resident.

The current Federal estate tax laws have led to uncertainty and made it difficult for people to predict how their estates will be impacted by the tax. There have been several proposals in recent years to revise the Federal estate tax laws, ranging from complete elimination of the Federal estate tax to increases in current exemption amounts coupled with reductions in the tax rate.

In order to avoid a one-year repeal of the Federal estate tax in 2010 followed by the reinstatement of pre-2001 law in 2011, Congress must act in 2009. Last Spring, the Senate Finance Committee held hearings on possible reforms to the Federal transfer tax system. Those hearings provide clues as to the type of action Congress may take. A few of the more likely scenarios follow.

Continuance of the Estate Tax. The tax plans of both Senators McCain and Obama call for a continuation of the Federal estate tax regime in 2010 and beyond. Senator Obama's plan (set forth at his website) would make the 2009 exclusion amount and rate permanent. In other words, we would have a $3,500,000 estate tax exclusion per person ($7,000,000 per married couple), and a maximum estate tax rate of 45%. Senator McCain has not endorsed any particular proposal, but has indicated support for a plan that would increase the estate tax applicable exclusion amount from $3,500,000 to $5,000,000 per person (up to $10,000,000 million per married couple) and would lower the estate tax rate to match the capital gains rate (currently, 15%).

Portability of the Estate Tax Exclusion and the GST Tax Exemption. A "portable" estate tax exclusion means that any unused portion of a deceased person's applicable exclusion amount would be made available to his or her surviving spouse. If the applicable exclusion amount is portable, then couples who either are unable or fail to sever jointly owned assets or transfer assets from the wealthier spouse to the less wealthy spouse before the death of the first spouse may take advantage of each spouse's applicable exclusion amount. In other words, the estate tax applicable exclusion would no longer be a "use it or lose it" provision. (Such portability would be applicable only once, thus eliminating the multiple successive marriage ploy.)

> For example, if a married couple has assets of $4,000,000 held in a joint brokerage account, the standard estate planning recommendation for 2008 under present law would be to create a $2,000,000 account in husband's name, and a $2,000,000 account in wife's name. Upon the death of the first spouse, the $2,000,000 in his or her sole name would be held in a Family or Credit Shelter Trust for the benefit of the surviving spouse and the couple's children for the life of the surviving spouse. On the death of the surviving spouse, all of the assets (including any growth) remaining in the Family or Credit Shelter Trust, together with the $2,000,000 (assuming neither growth nor discrimination) in the surviving spouse's sole name will pass, free of any estate tax, to the couple's children.

Without such planning, on the first spouse's death, the jointly held assets pass to the surviving spouse. As a result, the first spouse's $2,000,000 exemption is not used. Instead, the surviving spouse has $4,000,000 in his or her estate, only $2,000,000 of which is exempt from estate tax on the surviving spouse's death. If a portability provision were in place, then the surviving spouse's estate would be entitled not only to the surviving spouse's $2,000,000 exemption, but also to the deceased spouse's $2,000,000 exemption.

Note: It is important to remember that, even with a portability provision, having assets set aside in the Family or Credit Shelter Trust on the death of the first spouse is beneficial. If a Family or Credit Shelter Trust is created, the appreciation of trust assets will escape estate tax at the death of the surviving spouse. Thus, if the $2,000,000 of assets in the trust grow from $2,000,000 to $5,000,000 by the time of the surviving spouse's death, the entire $5,000,000 is exempt from estate tax. Had the $2,000,000 passed directly to the surviving spouse, the $3,000,000 of appreciation would be subject to estate tax at the surviving spouse's death.

<u>Reunification of Estate and Gift Tax Exemptions</u>. Since 2001, the Federal estate tax exclusion and the generation skipping transfer (GST) tax exemption amounts gradually have increased from $1,000,000 to $3,500,000, while the lifetime exemption from gift tax has remained constant at $1,000,000. The discrepancy between the gift and estate tax exclusions creates a disincentive to engage in business succession planning during life, as business interests passed to the next generation by gift could trigger a gift tax liability, while those same interests potentially could pass free of estate tax if held until the grantor's death. Reunification of the estate and gift tax exclusions would promote simplicity and would not hinder the lifetime transfer of family businesses.

<u>Elimination of Minority Interest Discounts</u>. The Democrat-controlled Congress is concerned with ensuring that any decrease in revenue collection is offset by a comparable revenue-raising measure. Portability of the estate tax exclusion amount, higher exclusion amounts and reduced tax rates all will reduce the revenue of the Federal government. To help "offset" these revenue reductions, one often-mentioned proposal is to eliminate or curtail the use of valuation discounts when transferring minority interests in entities that are not "active" trades or businesses to family members.

> For example, if Client owns 80% of the interests in a limited liability company ("LLC") holding passive investments, and the LLC's value is $100,000, Client's 80% interest has a value of $80,000. Under current rules, if Client gives a 20% interest to each of her two children, those interests should be valued at a discount to take into account the inherent lack of control and lack of marketability associated with a

minority interest in the LLC. Under the Senate Finance Committee proposal, the value of each 20% interest for transfer tax purposes would be one-quarter (20/80) of the value of Client's 80-percent interest, or $20,000. This value is a pro-rata share of the value of Client's controlling interest and does not reflect any minority or lack of marketability discount.

If you have been planning a transfer of a family business entity to the next generation and would like to utilize valuation discounts, you should consider completing the transfer in the 2008 tax year. Any legislation enacted in 2009 could be effective retroactive to the first of the year.

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