2011 YEAR-END TAX PLANNING

The Moment of Truth

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PART 1: THE INCOME TAX LANDSCAPE

Last December, the National Commission on Fiscal Responsibility and Reform released a bold report entitled "The Moment of Truth." In that report, the Commission's co-chairs called for immediate action to address the nation's dire fiscal predicament. Their prescription? A combination of spending cuts and broad tax reform.

Almost a year later, political leaders on both sides of the aisle are somewhat reluctantly taking up the tax reform banner, differing only in whether reform should also generate increased tax revenues. As a result, all of us now face our own personal "moment of truth" as we attempt to gauge the direction of future tax policy and its implications for our own finances.

Absent Congressional action, current income and transfer tax rates are scheduled to revert to 2001 levels in 2013, with a 39.6% top rate for ordinary income and a 55% top rate (with an exemption of $1 million) for gift and estate taxes. Under this regime, long-term capital gains would be taxed at 20% in 2013, while qualified dividends, now taxed at 15%, would be subject to ordinary income tax rates as high as 39.6%.

Neither President Obama nor Congress, however, appears to favor an across-the-board return to high rates. Instead, there are dozens of alternate proposals and mini-proposals, many over-lapping. For example, the recently proposed "Jobs Through Growth Act," sponsored by Senator John McCain, contemplates a maximum income tax rate of 25% for both individuals and corporations. A maximum 25% tax rate is also featured in Paul Ryan's "Path to Prosperity," approved by the House of Representatives last April 15 as H. Con. Res. 34. Similarly, all of President Obama's 2012 budget plans would maintain low income tax rates for lower-income taxpayers, with increases topping out (as in 2000) at 39.6% only for the affluent.

Although the "Moment of Truth" proposes eliminating the current preferential rate for both long-term capital gains and qualified dividends, that suggestion does not have a broad following to date. President Obama's budget plan, for example, would leave the 15% rate in place for taxpayers in the 28% and 25% brackets, increasing the rate to 20% for upper-income taxpayers in the 36% and 39.6% brackets. Other proposals would keep the 15% rate in place for all taxpayers.

Importantly, despite their differences, each of these proposals does posit significant reductions in so-called "tax expenditures" – i.e., the tax deductions, credits and exclusions that currently reduce the nation's aggregate tax liability, by about $1 trillion annually. The Obama proposals, for example, would consistently limit the benefit of all itemized deductions (as well as certain exclusions and exemptions) to 28%, including the charitable and home mortgage interest deductions. And President Obama has company on this point. Under Senator McCain's "Jobs Through Growth," the Senate Finance Committee would be directed to find sufficient limitations on credits, deductions and "subsidies" to offset the cost of a lower 25% maximum rate.

That said, what we cannot do is assume that the current income tax system will remain in place indefinitely. Come 2013 – or sooner – things are likely to change. If politicians are generally reluctant to give us detailed specifics, perhaps they have good reason: U.S. taxpayers, although happy to see someone else pay more tax, are reluctant to relinquish tax benefits on their own Forms 1040.

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PART 2: THE TRANSFER TAX LANDSCAPE

Estate, gift and generation-skipping taxes are estimated to contribute less than 5% to total federal revenue. As a result, they are not in the current deficit spotlight.

Optimists may imagine a scenario where legislators would make a trade-off: maintenance of today's generous transfer tax exemptions for cutbacks in the itemized income tax deductions that principally benefit the affluent. On the other hand, that is not the only possible scenario. Although exemptions might not decline, as scheduled, to $1 million, a return to 2009 levels ($3.5 million for the estate and generation-skipping transfer tax, $1 million for the gift tax) is within the realm of possibility – and, in fact, is a consistent element in the Obama 2012 budget plans.

PART 3: YEAR-END INCOME TAX PLANNING

Long-Term Capital Gains

For investors, year-end is typically a time to tally-up recognized long-term capital gains – and make sure they are offset by recognized capital losses. This year, with considerable uncertainty surrounding the future maximum long-term capital gains rate, consider recognizing built-in gains on positions that have not yet been sold, particularly concentrations. Remember, too, that there is no "wash sale" rule for gains. This allows you, if appropriate from an investment standpoint, to recognize built-in gains on a position and then immediately buy it back.

Retirement Plans

As always, maximizing retirement plan contributions makes sense for both financial and tax reasons: having retirement savings grow tax-free is a good idea in any tax environment. However, if you are considering converting a traditional IRA to a Roth IRA this year, be sure to look closely at your assumptions about the future income tax environment. For example, if you think rates are going to decline, it may make sense to wait and have your conversion income taxed at those lower rates. In addition, talk to your investment advisors about current and anticipated market conditions – and be sure to have your tax advisors do the math.

Front-Loaded Charitable Giving

Year-end charitable giving is a tradition in the United States – and particularly so for our clients. This year, consider maximizing your current income tax charitable deduction by creating a long-term vehicle – a private foundation, for example, or a donor advised fund. Once funded, these vehicles can make transfers to qualified charities for years to come. Meanwhile, you receive an income tax charitable deduction in 2011 – the year of funding – based on *the entire value of your gift.* This is good news, particularly if, as discussed in Part 1, future income tax laws reduce the tax benefits formerly available through deductions, credits, exemptions and/or exclusions.

CASE STUDY #1:

DORA AND THE DONOR ADVISED FUND

Dora, whose adjusted gross income is $500,000 in 2011, transfers $250,000 to a donor advised fund in November 2011. (Local community foundations typically sponsor these funds, which can also be found at financial institutions such as Northern Trust, with its Northern Trust Charitable Giving Program.)

The after-tax cost of Dora's gift in 2011 is roughly $167,000. Why? The $250,000 gift has offset ordinary income otherwise taxed to Dora at rates as high as 35%.

In following years, Dora recommends transfers from the donor advised fund to qualified charities, in varying amounts, consistent with her well-considered personal charitable objectives. Although these transfers from the donor advised fund are made after 2011, Dora enjoys the full tax benefit of her philanthropy this year.

Distributions from a Traditional IRA

Another charitable giving opportunity, the ability to make direct transfers from a traditional IRA to charity is also available in 2011 – but set to expire this December 31. If you are over 70½, you can direct your traditional IRA custodian or trustee to distribute up to $100,000 to one or more qualified charities before year-end. The distributions will count toward your required minimum distribution – and will not be taxable to you. Best advice: Don't wait until the last minute to take advantage of this tax break.

PART 4: **YEAR-END WEALTH TRANSFER TAX PLANNING**

The three transfer taxes – the gift tax, the generation-skipping tax and the estate tax – generally apply to wealth transfers made during life or at death. The effect of these taxes, which are generally imposed on the donor, is mitigated by available exemptions, deductions and exclusions. Potential tax is based on the fair market value of what is transferred, generally valued as of the transfer date.

As 2011 draws to a close, the opportunities for our clients to make lifetime gifts at minimal or no transfer tax cost are unparalleled. Both the gift and generation-skipping tax exemptions are at historic highs ($5 million); the federal discount rate used to value annuities and remainder interests for transfer tax purposes is at an historic – and very favorable – low (1.4% in October 2011); and market conditions have left many assets with depressed values. Some will choose to take advantage of this environment by making transfers that benefit partners, spouses, children and other family members. Others will decide to use vehicles that benefit both loved ones and favorite charities.

CASE STUDY #2: **GRAT TO THE RESCUE!**

Henry, 55, owns a majority share of a commercial landscaping business that is feeling the effects of current economic turbulence. Although the business was valued at $20 million in 2007, its current value is closer to half that amount at only $10 million.

Henrietta, one of Henry's five daughters, works with him in the business and is his chosen successor. Currently, she holds 40% of the company's stock, transferred to her over the past 30 years.

Henry realizes that the currently depressed value of his company represents a unique business succession opportunity. But, doing the math, he realizes that the gift he wants to make – an additional 20% of the company's shares – would have a value of $2 million. The problem? He has already used $4 million of his gift tax exemption to make gifts to his other children, so that only $1 million of his gift tax exemption remains. What to do?

Henry decides to try an idea suggested by his financial advisors, a seven-year GRAT ("grantor retained annuity trust"), funded with 49% of the company's stock, valued at $4.9 million. He will retain a current interest in the GRAT, receiving fixed payments (made in company shares) each year; his daughter will receive whatever shares remain in the GRAT at the end of the seven-year term.

At the heart of this strategy is the low rate used by the IRS to value the remainder interest in the GRAT for gift tax purposes (1.4% for October 2011). If the stock in fact appreciates more than 1.4% over the seven-year window, Henry will receive fewer and fewer shares each year in payment of his annuity interest – and Henrietta will receive a significant number of shares at the end of the GRAT term. For example, assuming an October transfer, an annuity rate of 12.156% and a steady 10% annual appreciation in the company's value, Henrietta would receive roughly 20% of the company's shares at the end of the GRAT term with a then-value of roughly $3.9 million.

As for Henry, his transfer would be valued, for gift tax purposes, at just under $1 million, which would be covered by his remaining $1 million gift tax exemption.

Note: this simplified example does not take potential minority discounts into account when calculating the value of company shares.

CASE STUDY #3: **CHARITABLE LEAD ANNUITY TRUST MULTI-TASKS FOR FAMILY AND CHARITY**

Mary, who serves on several charity boards, also dotes on her niece Alexandra and Alexandra's twin brother Max. However, as a widow in her 70s, she knows that if she leaves her $12 million estate to the twins outright, roughly 20% will be consumed by state and federal estate tax. She is also concerned that potential changes in the transfer tax rules will increase her potential estate tax liability – and would like to use her $5 million gift tax exemption now "while it is still available."

After talking with her financial advisors, Mary decides to use a lifetime $8 million charitable lead annuity trust ("CLAT") to minimize her estate tax liability – and to make her philanthropic mark.

For a 10-year term, the CLAT pays $64,720 to each of the five charities for which Mary volunteers. At the end of the 10-year term, the CLAT distributes outright to the twins, who by then are in their mid-30s. As with the GRAT, the heart of this strategy is the low rate used by the IRS to value a remainder interest for gift tax purposes.

Assuming a December transfer, a 1.4% discount rate and an annuity rate of 4.045%, the gift tax value of Mary's transfer to the twins would be almost $5 million. What will the twins actually receive in 2021? If the CLAT assets appreciate at a steady annual rate of 4%, the twins will receive almost $8 million.

If, for whatever reason, you decide against significant gifting in 2011, consider, at a minimum, the following ideas.

- **Making intra-family loans**
  In a family setting, there is a thin line between a low-interest loan and a gift. For this reason, the Internal Revenue Code sets minimum interest rates for intra-family loans each month. The rates have never been lower than they are this fall. To avoid costly missteps, have your estate planning attorney draft the note, and, if desired, an accompanying mortgage.
- **Using your annual $13,000 gift-tax exclusion**
  This year the annual gift tax exclusion is $13,000, meaning that you can make $13,000 gifts to an unlimited number of recipients without using any of your gift tax exemption. Consistent use of the $13,000 exclusion, through good times and bad, is a key to effective wealth transfer planning.
- **Making direct payments of medical expense or tuition**
  Your new best friend may be the gift tax exclusion for direct payment of medical expense or tuition. This tax provision allows you to pay unlimited amounts for tuition, medical care or health insurance for others without using any of your gift tax exemption. The catch? Payments must be made directly to the school, healthcare provider or health insurance company. For details, talk with your financial advisor.

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