

## Year-End Review and Timely Tax Tips

At the end of each year we like to review what is new and not so new in tax planning and to remind you to reassess your estate planning goals. If there have been significant changes in your family life or in your financial circumstances, it is important to review your planning. Some examples of these triggering events are retirement, divorce, remarriage, the death of a family member, the marriage or divorce of a child, and the birth of a grandchild. If you are anticipating an event that will significantly change your net worth, it is important to plan the strategic use of your lifetime gift tax exemption or to take steps to freeze the value of your estate, passing future appreciation on to the next generation at a reduced tax cost. If you have been fortunate enough to have accumulated more assets than you and your loved ones can enjoy, now is also an excellent time to consider philanthropic planning.

### Planning in a Low-Interest-Rate Environment

Depending on your circumstances, you might consider the current low-interest rates either a positive or a negative. It is certain, though, that some estate planning techniques produce superior results in this low-interest-rate environment. Three techniques in particular — grantor retained annuity trusts, charitable lead trusts, and intrafamily loans — are all worth considering as low-tax methods to transfer wealth to the next generation.

#### GRANTOR RETAINED ANNUITY TRUST

A GRAT is an irrevocable trust that pays you, as the grantor (the person establishing the trust), an annuity for a set term of years. You establish the trust and then transfer one or more high-yield assets into it. Over the course of the term, the trust pays you back an annual amount that is a percentage of

the initial market value of the property transferred to the trust. When the term ends, assets remaining in the trust (including all appreciation) go to the

named “remainder” beneficiaries. If the GRAT is properly structured (and assuming that you did not die in the interim), the remainder beneficiaries receive, with minimal or no gift tax costs, what is left in the trust at the end of the term.

GRATs are most effective in a low-interest-rate environment because they are more likely to earn a rate of return that exceeds the interest rate prescribed by the IRS, called the 7520 rate. This rate is used to measure the present value of annuities for gift tax purposes and is adjusted every month. In December 2008, the 7520 rate fell to 3.43%, a near-historic low. If a GRAT earns a rate of return that is, in fact, greater than the 7520 rate, the effect is that significant wealth will pass free from gift tax to the remainder beneficiaries at the end of the GRAT term.

To give a simple example, if you are 60 years old, fund a 10-year GRAT with an income producing asset valued at \$700,000 in December 2008, and the asset in the trust appreciates or earns income at 7%, the result will be an annual annuity payout to you of \$91,000 and a tax-free gift to the remainder beneficiaries of \$133,000 at the end of the GRAT term. There are a number of strategies for determining the optimal term of years

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#### DID YOU KNOW?

- The 2008 maximum contribution amount for 401(k) plans is \$15,500, plus a \$5,000 catch-up contribution for those 50 or older. In 2009, the maximum contribution amounts increase to \$16,500 and \$5,500, respectively.
- The 2008 and 2009 maximum contribution amount for traditional and Roth IRAs is \$5,000, plus a \$1,000 catch-up contribution for those 50 or older.
- You can have your federal tax return refund deposited directly into your IRA.

#### TRUSTS AND ESTATES AT DAVIS MALM

The Trusts and Estates Group at Davis Malm counsels individuals on legacy planning, wealth management, family business succession, and achieving philanthropic goals. Our estate planning and probate practice includes estates of all sizes and complexity, and we are sensitive to personal needs and family relationships. Estate planning is part of a broader practice that includes income tax planning, planning for disabled persons, administration of trusts and estates, and planning associated with executive compensation and benefits.

## Planning in a Low-Interest-Rate Environment (continued)

and types of assets to use in funding the trust.

If the GRAT is properly structured, it should be treated as a “grantor trust” for income tax purposes. This means that you (rather than the remainder beneficiaries) are taxed on income and realized gains on trust assets, regardless of the amount of the trust’s annuity payments. This further enhances the GRAT’s effectiveness as both a family wealth-shifting and a gift and estate tax saving tool. In essence, you are effectively allowed to make tax-free gifts of the income taxes that are really attributable to assets that will pass to the remainder beneficiaries of the trust. This not only enhances the value of the gift to the remainder beneficiaries, but it also further reduces your estate for tax purposes.

### CHARITABLE LEAD TRUST

Another technique favored in this low-interest-rate environment is a

charitable lead trust (CLT). A CLT allows you to combine a charitable gift with a gift to family members or others, all at a reduced tax cost. A CLT is an irrevocable trust that pays a fixed annual annuity to one or more charities for a fixed term. At the end of the trust term, property remaining in the trust passes to the remainder beneficiaries. As with a GRAT, the remainder beneficiaries of a CLT will benefit more from the trust when interest rates are low, essentially because the trust will have earned more than the assumed interest rate.

To illustrate this, assume that you set up a 20-year CLT in December 2008 with \$1,000,000 in seed money and that it will result in a 5% payout to your charities. Assume further that you will earn 7% income or appreciation. The result would be the remainder beneficiaries receiving a gift of \$1,820,000 at the end of the term, while only \$283,000 is treated as a taxable gift. Note that unless you have already given away \$1,000,000 during your life, you would not actually pay a gift tax currently, but it would reduce the amount you can give away tax free at death. In addition to the gift-tax savings, you would be entitled to an income tax charitable deduction of \$717,000 when the trust is established.

### INTRAFAMILY LOAN

Another attractive technique you can employ to take advantage of the current low-interest-rate environment is an intrafamily loan. For example, you might loan money to your child in exchange for a promissory note. If the child can invest the money wisely, earning more than the rate you charge for the loan, the child will benefit from the interest-rate spread with no gift tax implication.

### UPDATE ON CHARITABLE CONTRIBUTIONS FROM IRAS

Last year, we reported that, during 2007, a person 70½ years of age or older could donate up to \$100,000 directly from an IRA to a charity, without taking a distribution first. This opportunity has been extended until January 1, 2010. The withdrawal will not be included in the adjusted gross income of the account owner and will not be subject to income tax. Even though no distribution is made directly to the account owner, the donation will count toward the account owner’s required minimum distribution. Thus, if you are charitably inclined and over 70½, it is advantageous for income tax purposes to make a charitable contribution directly from your IRA in 2008 and 2009.

### DID YOU KNOW?

Under President-elect Barack Obama’s estate tax reform plan, as disclosed during the campaign, (1) the per-person exemption from estate tax would be fixed at \$3,500,000 (the 2009 exemption amount) and indexed for inflation after 2011, (2) any unused exemption after the death of the first spouse would be available to the surviving spouse, and (3) the top estate tax rate would be maintained at the current rate of 45%. That said, even in the midst of the current economic uncertainty, it is important to focus on the estate planning process to ensure that your goals for sharing your legacy with the next generation are met.

For the intrafamily loan to work as an estate planning device, the loan must be a real loan with the expectation of repayment, and it must be documented as such. Importantly, you must charge adequate interest, which the borrower must actually pay. The minimum interest rate on the promissory note is determined by the applicable federal rate (AFR), which is published monthly by the IRS. The AFR represents the minimum interest rate you must charge on the loan in order to avoid having the loan treated as a gift by the IRS. The AFR varies with the type and term of the loan, but the lowest permitted rate currently is only 1.36%. Because the AFR is now very low, it is likely that the borrower can earn an investment return on the borrowed funds that comfortably exceeds this rate. **DMD**

# Double Dipping: Taking Social Security Early AND Again After Full Retirement Age

**THE BASICS:** The earliest you can start receiving Social Security retirement benefits is age 62, which is considered “early” because age 62 is before the “normal” or full retirement age set by the government, ranging from 65 to 67. If you choose to take your Social Security benefits early, your monthly benefits will be smaller than they would be if taken at your full retirement age because the benefits will likely be paid to you over a longer period of time. In contrast, if you choose to take your benefits “late” (i.e., at your full retirement age), your monthly benefits will be larger because payments will be made over a shorter period of time. Whether to take Social Security benefits early or late is a question that weighs heavily on many of our clients’ minds. A little-known technique will allow you to take your Social Security benefits early, pay them back after your full retirement age, and start over at the higher level of monthly payments.

**HOW YOU CAN HAVE YOUR CAKE AND EAT IT TOO:** By submitting Social Security Form 521 “Request for Withdrawal of Application,” you can undo your decision to take your Social Security benefits early at the smaller monthly benefit level (even after having taken all those early payments) and then reapply and start taking your Social Security benefits at the larger monthly benefit level.

**THE CAVEAT:** You must repay all the benefits received, including any monies withheld from your Social Security checks, such as Medicare premiums. However, there is no interest or inflation adjustment applied to the repayment amount. Essentially, you can treat the benefits you received as an

interest-free loan from the government. Upon repayment of the “loan,” you can immediately reapply for your Social Security benefits and start receiving benefits at the higher level.

**THE RISKS AND THE BENEFITS:** One drawback is the risk that the government may shut down this option to withdraw your initial application after you elect to take your benefits early but before you submit your application to withdraw and reapply. Another risk is that you could die after you have reimbursed your early benefits but before you recoup the amount of your repayment through the receipt of the larger monthly payments. In this scenario, you would have missed out on passing on to your beneficiaries the cash you used to make the repayment. The decision as to whether or not to try this option will thus depend on many factors, including your (and your spouse’s) age, health, life expectancy, income level, availability of other assets, and inflation. **DMD**

## LOSSES IN 529 COLLEGE SAVINGS PLANS

Many clients with young children or grandchildren have spent the past several years investing in 529 plans and are now seeing these college savings radically reduced due to the recent losses in the stock market. If you are one of these frustrated parents or grandparents, you have the option of withdrawing the money you had set aside for college (incurring the penalties and taxes associated with such a withdrawal) and deducting the losses from your taxable income. Note that there are consequences to making such a withdrawal, as well as a possible negative impact on any gift tax planning you have undertaken to date.

## INCREASE IN ANNUAL EXCLUSION AMOUNT AND GUIDELINES FOR MAKING QUALIFYING GIFTS

Currently, you can give away \$12,000 per recipient, free of gift tax, to an unlimited number of persons; these are called annual exclusion gifts. The annual exclusion amount will rise to \$13,000 in 2009. For a gift to qualify for the annual exclusion, you must follow certain guidelines:

- Gifts must be made either outright to the recipients or to trusts that are drafted specifically to qualify for the annual exclusion.
- Any gifts made by check to an individual must be deposited or cashed by December 31, even if the check does not clear until after January 1.
- Change of ownership of certificated securities that are being given as gifts must be made in the corporate records by December 31. Gifts of securities should be made as soon as possible to allow time for the stock transfer processes, which can take several days, due to heavy end-of-year volume.
- If you make a gift of fractional interests in real estate, you must obtain an appraisal of the property. The same appraisal may be used for a gift made in December 2008 and for a second gift made in early January 2009.

# Year-End Income Tax Planning

Year-end tax planning may be especially challenging this year. Future capital gains rates are uncertain, and securities markets are volatile. That said, there are still a few tax certainties against which taxpayers can plan — one is that familiar antagonist, the Alternative Minimum Tax (AMT).

**DEATH, TAXES, AND THE AMT**  
Despite renewed efforts to banish it in the last act, the AMT (like death and taxes) seems to be with us always. Critics vilify the AMT because it thrusts additional taxes on only a very peculiar subclass of upper-middle-income taxpayers. Worse still, it boggles the minds of all taxpayers with a complexity that is extreme, even by income tax standards.

This year, the tax melodrama has an unlikely hero: the bailout bill. Our champion is that same Emergency Economic Stabilization Act of 2008 that authorized the Treasury to purchase troubled assets from certain financial institutions and that made scores of tax changes. Among those is a “patch” to the AMT that increases the exemption allowed, reducing the number of Americans affected by an estimated 20 million people. Nevertheless, the bailout bill did not eliminate the AMT but only reduced its effect for the current year.

The bailout bill specifies that the AMT exemption for 2008 will climb to \$46,200 for single taxpayers and \$69,950 for those filing jointly. This represents an increase of about 5% from last year. This increase means that fewer Americans will be subject to the AMT for 2008 than for 2007, but it also means that the AMT will continue into 2009 and beyond. Any taxpayer earning a six-figure income still needs to think about the AMT. So do modest earners, given that they can be easily propelled into high-tax brackets by onetime events such as a sale of

property, bonus compensation, or even good luck in the lottery.

The AMT targets some comfortable (but rarely wealthy) taxpayers who (1) have large families, (2) live in high-tax states, (3) invest in certain types of municipal bonds (the kind that fund hospitals and housing projects), or (4) exercise stock options received from their employers. The tax benefits otherwise associated with these “preference items” are selectively offset by the AMT.

## WHAT CAN YOU DO?

If you fall within the AMT’s clutches, you may be able to ease the effect by reducing your 2008 income through traditional year-end techniques such as accelerating deductions and deferring income. Taxpayers who consistently are subject to the AMT can try to spread out “preference items” over two or more years; this takes advantage of the exemption amounts and also minimizes the effect of the phase-outs that apply to these exemptions at higher income levels. To shift preferences from year to year, a taxpayer can defer or accelerate the preference item, for example, by paying state and local taxes this year rather than next (or vice versa) or by exercising an incentive stock option later rather than now. All taxpayers should consider the effects of AMT before exercising stock options. Since the AMT is only paid when it exceeds the regular tax, each taxpayer’s anticipated 2008 and 2009 regular taxes must be considered in determining whether (and to what extent) it is advantageous to shift preference items. **DMD**

## LEGISLATIVE UPDATE: New Homestead Election in the Works

The Massachusetts Senate has passed a much-needed amendment to the homestead law, and the bill (S. 2653) is now pending in the House Ways and Means Committee. If passed, all homeowners would have an automatic homestead of up to \$125,000 of home equity. Homeowners who record a homestead declaration would still be able to protect up to \$500,000. This provides protection for your home against some claims that an unsecured creditor may have against you. The proposed legislation would allow homestead declarations to be filed on a home even though the home is held in a trust. This is very good news because holding a home in trust rather than in your own name avoids probate as to that asset on death or disability.

## CONTACT

If you would like to discuss any of these topics or any other tax or planning strategies in more detail, please contact Marjorie Suisman at 617-589-3836 or at [msuisman@davismalm.com](mailto:msuisman@davismalm.com).

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