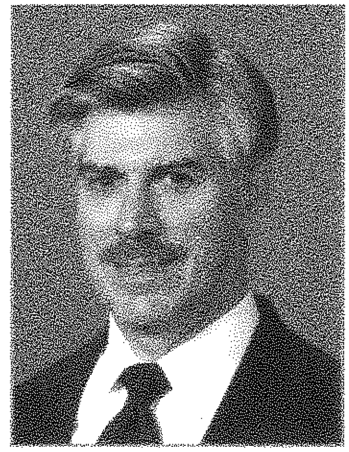
A STEP AHEAD

FOCUS ON GIFTING - 2006

At year's end, we believe that the focus of **A Step Ahead** should be on gifting and gifting strategies. Apart from the fact that giving gifts benefits our loved ones and enhances their mental and physical well-being, it provides a mechanism for reducing the size of our estate. Not only is the value of the gift itself removed from the estate but the growth in the value of the asset, its appreciation, together with its earnings, are also removed from the estate.

It is always important to coordinate gifting with other asset protection strategies. If you are already engaged in Medicaid planning, for instance, it is important to inquire, before making gifts that were not considered in the strategy, what effect those gifts will have on your plan.



CAPITAL GAINS TAX

One important aspect of estate planning is the income tax consequence of employing a particular strategy. Many of our clients have expressed confusion concerning the capital gains tax. The purpose of this column is to explain the capital gains tax in general terms.

Capital gains tax, in its simplest terms, is a tax on the profit realized upon the sale of a capital asset. A **capital asset** is almost everything you own or use for investment purposes, such as stocks or mutual funds, or even your home. The difference between the sales price of the asset and your **basis**, which is your investment in the asset (what you paid for it with certain adjustments), is a **capital gain** or **capital loss**. A capital gain occurs when you sell the asset for more than your basis. A capital loss occurs if you sell the asset for less than your basis. For example, if you bought 100 shares of stock ten years ago for $10 (your cost basis) and sold it today for $100, you would have a capital gain of $90.

In some instances, your basis in an asset can not be determined by its cost. The most common examples are assets received by gift or inheritance. Since you did not pay for the asset, you have no cost basis by which to measure your profit if you were to sell it. Currently, the basis of an asset received as a gift will be the donor's basis at the time of the gift with certain adjustments if the donor's basis is less than the fair market value of the asset. For example, if your aunt gave you 100 shares of stock for your birthday, your basis in the stock will be the same as your aunt's basis before she gave it to you. This is known as **carryover basis**. If your aunt purchased the stock 10 years ago for $10, then your basis in the shares would be $10. If you then sold the stock for $100, you would have a capital gain of $90, which is the difference between the sales price of $100 and your carryover basis of $10.

If you inherit an asset, its basis is its fair market value as of the date of death of the person you inherited it from, the **decedent**. [This may change

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in the future depending on the action, or inaction, of Congress by 2010.] Let's assume that the stock which your aunt purchased for $10 was left to you in her will. If, at her death it was worth $100, you would receive the stock with a **step up** in basis to $100, rather than her $10 cost basis. If you thereafter sold it for $100, there would be no capital gain.

Capital gains and losses are further divided into two categories each having different income tax consequences. If you hold an asset for one year or less, on its sale you have a **short-term capital gain or loss**. If you hold an asset for more than one year, on its sale you have a **long-term capital gain or loss**. A short-term capital gain will be taxed according to your income tax bracket. Because the government encourages long term investing, long-term capital gain gets favorable tax treatment. The amount by which all your long-term capital gains exceed all your short-term capital losses in a given year is referred to as **net long-term capital gain**. Since 2003, the highest long-term capital gains tax rate for most taxpayers is 15%. However, for those taxpayers in the 10% and 15% tax brackets, long-term capital gains are taxed at 5%. [These rates are scheduled to return to the higher pre-2003 rates in 2011.] Thus, capital gains are taxed at a more advantageous rate than ordinary income.

If your capital losses exceed your capital gains, you can deduct up to $3,000 ($1,500 if you are married and file a separate return) against other income in a particular year. If your net capital loss is more than this limit, you can **carry forward** the excess amount to future years, until it is used up. The unused loss can be applied to future capital gains as well as up to $3,000 of ordinary income in any given year.

It is important to have a general understanding of when and how the capital gains tax applies to various estate, gift, Medicaid and other planning strategies which you may consider. It is always advisable to consult with your legal and tax advisors to help you navigate complex tax matters. We look forward to answering your questions about this subject and would welcome the opportunity to meet with you to discuss its applicability to your own unique situation.

CHARITABLE GIVING

Charitable gifting can play an important role in estate and tax planning. Apart from the obvious benefit that the gift will assist the charitable organization in accomplishing goals that may be close to your heart, a well-planned gift to charity may reduce or eliminate estate tax and/or income tax liability. Various strategies are available and can be tailored to suit your wishes.

Charitable Trusts are vehicles for enhancing tax-saving strategies. A charitable remainder trust (CRT), which can be funded with an appreciating asset such as a vacation home or an interest in a family owned business, allows the creator to (1) retain control over the property for a period of time, (2) continue the enjoyment of the asset or the income stream, (3) receive an income tax deduction based on the future value when the asset is transferred to the charity, and (4) remove the remainder value of the asset from the estate and thereby reduce potential estate tax. A charitable lead trust (CLT), the "flip-side" of the CRT, gives the charity the immediate use of the asset and the right to the income for a period of years, after which the asset reverts back to the creator of the trust or to whomever the creator designates in the trust. A CLT can be funded with income-producing stocks or bonds. The creator of a CLT receives a current income tax deduction for the value given to the charity and, if the CLT is implemented at the death of the creator, it reduces potential estate tax.

Appreciated assets, life insurance policies and 401(k) plan assets can also be gifted directly to charities with beneficial tax consequences. An appreciated asset will be subject to capital gains tax upon its sale. [See article on Capital Gains Tax also in this issue]. By gifting it to charity, the donor receives an income tax deduction based on its fair market value. The charity receiving 401(k) plan assets is not taxed on the income and the donor receives an estate tax deduction for the value

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of the assets that passed to the charity. For a short period time clients who have attained the age of 70 2 years may make charitable contributions directly to a charity from their KEOGH plans. In the past, KEOGH assets could only be gifted from the participant after taking a distribution from the KEOGH plan. While the distribution from the KEOGH would be offset by the charitable contribution, the increase to the adjusted gross income could have a negative impact. This change avoids that result.

If it's a question of giving your money to the IRS or to your favorite charity, most of our clients opt for the charity. Please call us to discuss how to effectuate a plan that incorporates these strategies and combines them to help you make the most of your charitable giving opportunities.

MISTAKES AND MISCONCEPTIONS

Estate planning, whether simple or complex, requires careful attention to details which, if overlooked or misunderstood, can undermine the plan's effectiveness. We will devote space in each issue to highlight common estate planning mistakes and misconceptions.

Many people mistakenly believe that they can make gifts of up to $10,000 a year without incurring a gift tax. The good news is that the annual gift tax exclusion permits each of us to gift the sum of $12,000 per person this year. This is because the annual gift tax exclusion has been increased to keep up with inflation. A husband and wife are each permitted to transfer $12,000 to any number of recipients before year's end, and again next year. Together, they can gift up to $24,000 per person per year without tapping into their gift tax exemption amounts and without incurring a gift tax. However, this is not cumulative. We are not permitted to save this year's exclusion and apply it to a larger gift in a subsequent year. It is a "use it or lose it" opportunity. A gift that exceeds the exclusion amount is taxable to the donor and not the recipient of the gift.

TRANSFERRING THE HOME

Occasionally clients inquire about transferring their homes to their child or children. Sometimes this question is inspired by friends who have made such a transfer. Generally, people have two very different reasons for transferring a home: Medicaid planning and estate tax planning.

Medicaid Planning: Some clients wish to ensure that the value of their homes will be protected in the event they require long term care. In virtually every case, the transfer of the house to an irrevocable trust will be a better alternative than an outright gift of the house to the children. First, an outright gift of a house is subject to the uncertainties that can occur in the lives of the recipients. If, for instance, a child who is the recipient of the parent's home has credit problems, or is found liable in an unanticipated lawsuit, or divorces, or dies before the parent, the property may wind up in the hands of someone other than those whom the client would have intended. Another drawback to outright gifting of a house is the capital gains tax consequence and the potential loss of the step-up in basis [See article on Capital Gains Tax also in this issue]. If the house is transferred instead to a properly drafted Medicaid trust, the transfer to the children will not be complete until after the death of the parent. This will eliminate the capital gains tax issue and ensure that the house winds up in the hands of the intended beneficiaries. Note: we have discussed in recent issues of **A Step Ahead** that a transfer of the house, either to a trust or to the children, will result in a period of ineligibility for Medicaid benefits that could be as long as sixty (60) months.

Estate Tax Planning: Estate tax is the highest tax our government

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currently imposes (as high as 45%). A client whose estate is in excess of $2,000,000 faces the prospect of having that excess exposed to both federal and state estate tax. Transferring assets out of the estate during lifetime, by the implementation of gifting strategies, will minimize or eliminate the estate tax. But a direct gift of the house to the child or children does not accomplish that result. One gifting strategy is to implement a Qualified Personal Residence Trust (QPRT) which enables a house to be transferred at a discount of its value. Under the terms of the QPRT, the client retains the right to remain in the house for a specified period of years or for life. At the end of the term, the Trust terminates and the beneficiaries named in the Trust become the owners of the property. Because the child or children do not immediately benefit from the "gift," its value to them is less than the actual value of the property. This is important because the value of the gift for gift tax purposes is based upon its value to the beneficiaries, not the value as of the date of the transfer. Thus, a valuable asset in an otherwise taxable estate can be gifted at a fraction of its value. The longer the term of the Trust, the longer the beneficiaries must wait to benefit from the ownership of the property, the greater the discount for gift tax purposes. However, the anticipated benefit of a lengthy term must be tempered by the fact that the value of the property will still be included in the estate of the client if the client dies before the completion of the term. Also, after the term expires, the step-up in basis will be lost, resulting in a a capital gains tax if the property is sold at a profit. This still results in a net benefit to the family since the estate tax rate is much greater than the capital gains tax rate. In contrast, if the property is transferred to the beneficiaries after the death of the client, the capital gains tax is eliminated provided that the property is sold soon after the client's death.

If either of these strategies is pertinent to your situation, do not try to implement this planning on your own. Consult with a qualified attorney who can assist you.

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