

# Silver Bridge Insights



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## Top Tax Saving Techniques for Year-End Planning

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Why wait for tomorrow when we have today? As Ben Franklin said, “Never leave that till tomorrow which you can do today.” Time is one of the most important tax and financial planning tools in today’s uncertain environment. At the close of 2010, President Obama signed into law legislation that offers significant wealth planning opportunities, which are set to expire at the end of 2012 (and which could end earlier should Congress so choose). Taking a “today” approach to year-end planning with the techniques described below will allow individuals to take advantage of the current tax and regulatory policies.

### 1. This year and next year offer a window for generous outright gifting.

#### A. Annual Gift Tax Exclusion

The annual gift tax exclusion is an easy way to reduce the size of your taxable estate, while transferring significant wealth to beneficiaries without gift tax consequences. Under federal law, each individual may gift up to \$13,000 (for 2011 and 2012) in cash or property per donee and per year. For married couples, the combined annual exclusion is \$26,000 per donee. This annual exclusion is administratively the easiest tax benefit to utilize. The beneficiary will not only receive the value of the gift, but also the appreciation of the gifted asset. Gifts must be of a vested, or present interest, in order to qualify for the exclusion.

#### B. Lifetime Gift Tax and Generation-Skipping Transfer Tax (GST) Exclusion

In 2011 and 2012, individuals may give away \$5 million during their lifetime (\$10 million per married couple) without incurring federal gift tax or GST tax. The increase for 2011 and 2012 from the previous lifetime gift and GST tax exemption of \$1 million was more generous than estate planners anticipated. Individuals who have already used their \$1 million lifetime exemption can now gift an additional \$4 million. The increased exemption opens the door to numerous estate tax planning strategies which can allow individuals to transfer sizeable wealth gift tax free. Please note that some states have their own gift tax laws with varying exclusion amounts, so you might have to pay a state gift tax.

**2. The current federal gift tax rate for gifts above the exclusion amount is at an all time low of 35% for 2011 and 2012.**

From 2007 to 2009, the rate was 45% and in 2013, without change to the current law, the rate is scheduled to increase to 55%. If an individual has already used their \$5 million lifetime gift tax exemption and would like to transfer additional wealth, then making taxable gifts now may be the best option. The future of gift tax rates is unpredictable, but given the historically low rate, it might make sense to pay the tax now to avoid paying higher rates later. Also, making a gift now will remove the assets from your estate and will allow the appreciation of those assets to grow outside the estate. The ways in which gift taxes and estate taxes are calculated favor lifetime gifting. Gift tax (assuming you live for 3 years after making the gift) is calculated on a tax exclusive basis (i.e. only the value of the asset received by the beneficiary is taxed) while estate tax is calculated on a tax inclusive basis (i.e. the value of the entire taxable estate, including the portion used to pay taxes, is taxed).

**3. Interest rates are at a historic low since the inception of the AFR (Applicable Federal Rate) system in 1985.**

The short-term AFR for December 2011 (used for obligations with terms of 3 years or less) is 0.20% versus the historical average of 4.84%. While these low rates may be a bit disheartening for investors, they can be extremely effective for various transfer planning techniques ranging from simple strategies, such as loaning money to family members and refinancing current family debt obligations, to more complex strategies, such as split-interest trusts.

One type of split-interest trust, a zeroed out grantor retained annuity trust (GRAT), gives the grantor an annuity payment equal to the amount contributed plus interest and allows the remainder to pass on to the heirs without being subject to the gift tax. GRATs are a great vehicle for clients who have assets with the potential for significant appreciation. The rate upon which GRAT structuring is predicated (IRS Section 7520 rate), which is different but comparable to AFR, is at an all time low. With such low rates and depressed asset values caused by volatility in the markets, for both securities and real estate, a substantial portion of asset appreciation can be gifted tax free.

**4. In light of the current market downturn and lower income tax rates, converting your Traditional IRA to a Roth IRA may save significant taxes over the long term, especially if you are under 45.**

2010 brought major changes to retirement planning for individuals. In 2010, the income limits that once restricted one's ability to convert from a Traditional IRA to a Roth IRA were repealed. Adjusted gross income (AGI) limitations still exist for individuals that wish to contribute directly to a Roth IRA, however the new rule allows people to make contributions to a Traditional IRA and then convert the Traditional IRA to a Roth IRA. This conversion rule treats the taxpayer as receiving a distribution from the IRA, causing the individual to realize taxable ordinary income. Distributions from a Roth IRA are not taxable, so by paying the tax up front at the conversion, you allow for future growth in the account to compound tax free.

**5. Re-characterization gives you the option to take back a Roth conversion.**

Due to recent volatility in the markets, an individual who made a Roth conversion earlier in 2011 might find that their account value is markedly lower today than it was at conversion date. You can undo the conversion through a process called "re-characterization."

Then, to take advantage of the current lower market value of their account, the individual can reconvert the account back to a Roth IRA after a specified waiting period. As the tax liability on a Roth conversion is based on the account value at the time of conversion, the re-characterization strategy can result in material tax savings. For 2011 re-characterizations, an individual must wait the later of 30 days or until January 1, 2012 to reconvert the account back to a Roth.

**6. Federal capital gains tax rates are at an all time low of 15%.**

This rate is set to expire at the end of 2012, and increase to 20%. While the stock market has seen a recent decline, many individuals and entities hold long-term assets with significant unrealized appreciation. Realizing gains and

taking advantage of the low rate now in order to diversify a portfolio may save a significant amount of tax in the future.

#### 7. Realizing capital losses can also be valuable in reducing the burden of capital gains taxes.

As year-end approaches, we encourage our clients to work with their advisors to review their investment portfolios to address whether loss harvesting is appropriate. Up to \$3,000 of excess capital losses can be used to offset ordinary income in the current tax year with any remaining excess losses being carried forward to future years.

When selling and buying back securities there are many rules to understand. The “wash sale” rule, for example, defers the use of a tax loss realized upon a sale of stock if the client repurchases the same asset within 30 days. If you repurchase 31 days after the sale, assuming the value has stayed depressed, the taxpayer will have effectively refreshed his or her basis in the position and received a current tax benefit.

#### 8. Evaluating whether charitable contributions can be meaningful deductions is an important planning tool for families.

With the current low tax rates and a high likelihood that taxes will increase, many families are choosing to delay their charitable contributions and receive their deductions in a higher tax rate environment when the tax savings would be greater.

#### 9. Taxpayers should monitor their alternative minimum tax (AMT) status.

AMT is a parallel tax system that calculates tax at a lower rate but adds back certain deductions (state taxes, itemized deductions, etc.). The taxpayer pays the tax on the higher calculation (AMT or regular tax). If the taxpayer is not projected to be in the AMT bracket, then the taxpayer should consider accelerating deductions (prepaying fourth quarter state taxes, real estate taxes) into the current year to lower the AGI.

As 2011 comes to a close, we encourage taxpayers to meet with their investment, tax and legal advisors to discuss which tax strategies make the most sense for their particular situation. Given the budgetary crisis, erratic capital markets and current political landscape, taxes are expected to increase in the near future. Adding to the current economic and political pressure in favor of an increase in tax rates, the additional 3.8% Medicare contribution tax on unearned investment income is set to take effect in 2013. Taking advantage of the current low interest rates, low federal gift tax rate, the exceptionally high lifetime gift and GST tax exemption, and low long-term capital gains tax rate, can add significant value for families. We encourage you to take the time to plan today.