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# Uncertain Tax Laws Require Flexible Planning

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The future of the federal estate tax remains uncertain. Changing tax laws require flexible planning in this and many other cases.

The future of the federal estate tax remains uncertain. Under current law, the federal estate tax is scheduled to be reduced incrementally until 2010, when it is completely eliminated, only to be reinstated again in 2011 with a lower exemption and a higher marginal top rate. For 2007 and 2008, the federal exemption is $2 million with a flat rate of 45% on amounts above the exemption. In 2009, the federal exemption will increase to $3.5 million and in 2010, there will be no federal estate tax at all. The absence of federal estate tax is, however, very short-lived. In 2011 and future years, the federal exemption is only $1 million with a marginal top rate of 55%.

There will likely be a change in the law in the next few years, probably prior to the disappearance of the estate tax in 2010, but not until after the elections in 2008. It is hard to predict how the law will evolve, but an exemption in the range of $3.5 million to $5 million with a lower marginal rate seems likely.

The future of the Wisconsin estate tax is also uncertain. Under current law, Wisconsin imposes an estate tax for taxable estates over $675,000. The current law sunsets on January 1, 2008, and will then revert to an earlier form, which eliminates the Wisconsin estate tax. There were no provisions made for an extension of the estate tax in the (2007-2008) Wisconsin state budget that was recently passed. Therefore, it now looks as if the Wisconsin estate tax will expire on January 1, 2008. The issue will most likely be revisited again in 2009.

With the future of the estate tax so uncertain, it is very important to use flexible strategies when creating an estate plan. Some of our clients are opting for "disclaimer" plans, which allow the surviving spouse to look at the tax law and their financial situation at the time of death and then decide what is best for their family situation. Another way of dealing with this uncertainty is to give an independent trustee the power to amend the trust document, in order to take full advantage of future changes of the tax laws. Reinhart attorneys can help you develop a plan that addresses your concerns and creates the necessary flexibility to adapt to the ever-changing tax law.

## IRA Charitable Rollovers

The ability to rollover your IRA to a public charity expires on December 31, 2007. Only persons over the age 70 1/2 are eligible and the maximum amount that can be rolled over is $100,000 per year. Donors who might benefit from an IRA charitable rollover include those who do not itemize deductions on their personal income tax return and those who previously gave more than 50% of their income to charity and would not be able to take the full income tax deduction on additional gifts.

## More Documentation Needed for Charitable Deductions

As of 2007, there are new recordkeeping requirements for contributions of money to charitable organizations. There are also new stricter rules for contributions of clothing and household items after August 17, 2006.

In order to realize any tax savings from charitable contributions, you have to itemize your deductions. Under the new rules, you must also document your donations with much more detail.

As of 2007, you cannot deduct a cash contribution, regardless of the amount, unless you keep a bank record (such as a canceled check or a bank statement containing the name of the charity, the date and the amount) or a written communication from the organization, as a record of the contribution. For a deduction for contributions of $250 or more, you need a written acknowledgement from the organization. Certain payroll deduction records will also qualify.

If you contribute property to a qualified organization, the amount of your charitable contribution is generally the fair market value of the property at the time of the donation. You cannot take a deduction for clothing or household items you donate, unless the items are in "good used condition or better." You must have a receipt from the organization describing the property. As the deduction amount increases, so also do the documentation requirements. For a donation above $5,000, you must generally obtain a qualified written appraisal.

If you wish to donate a vehicle to a qualified organization, your deduction depends on how the vehicle is used by the organization. If the organization sells the vehicle without using it for charitable purposes or making material improvements to it, your deduction is generally limited to the sales price received by the organization.

Donated property with a fair market value of over $5,000 is subject to new recapture rules. If the organization sells the property within three years, and does not provide you with a written statement that certifies the use of the property as related to the charity's purpose or that the intended use became impossible, you have to recapture part of the deduction by
including it in your income. The recapture amount is the difference between the sales price and the amount claimed as a deduction.

## Kiddie Tax

In 2006, the "Kiddie Tax" was extended until the year a child turns age 18. Prior law provided that a child was subject to the Kiddie Tax only until the year a child turned age 14. The Kiddie Tax subjects a child's unearned income (e.g., interest, dividends and capital gain) to the higher tax bracket of the child's parents if the child's unearned income is over a specified limit. The opportunity to lower a family's overall income taxes by transferring income-producing assets to a child under the age of 18 is minimized by the Kiddie Tax.

The Small Business and Work Opportunity Tax Act of 2007 further expanded the Kiddie Tax for the years beginning after May 25, 2007. The Kiddie Tax now applies to both children 18 years old or younger, and to children up to age 24 who are full-time students if the child's earned income does not exceed one-half of the amount of their support.

Under the Kiddie Tax, children owe no income tax on the first $850 of unearned income (in 2007). The next $850 is taxed at the child's rate, which is generally much lower than the parents' rate. All of the child's unearned income over $1,700 (as adjusted for inflation) is taxed at the parents' higher rate.

## 529 Plans

Section 529 Plans were created under the Small Business Job Protection Act of 1996 to enable parents and grandparents to save for future educational expenses in a tax efficient manner. Earnings in 529 Plan accounts are tax deferred and withdrawals from these accounts for the designated beneficiaries are tax-free if the funds are used for "qualified higher education expenses." The Pension Protection Act of 2006 made the tax benefits of these accounts permanent, and also significantly broadened the definition of "qualified higher education expenses.

When a 529 Plan account is established, the donor designates a beneficiary, but retains control over the account as the "owner." The owner can direct when and how much of the account is distributed to the beneficiary, can change the designated beneficiary, and can even terminate the account and withdraw the funds.

It is important to name a successor owner on all 529 Plan accounts in the event of death or incompetency. State laws vary on the treatment of 529 Plan accounts in the event of an owner's death. Some states provide that the 529 Plan account is transferred according to the owner's estate plan; other states provide that ownership of the account vests in the beneficiary; and still others are silent on this issue.

One way to avoid this uncertainty is to name your Revocable Trust as either the initial or the successor owner of a 529 Plan account. Specific language can be added to your existing Revocable Trust to provide guidance to the Trustee as to how distributions should be made from the account, and when it may become necessary for the Trustee to change the designated beneficiary of the account. Naming the Revocable Trust as the owner of a 529 Plan account clarifies ownership succession of the account and ensures that the account will continue to be administered as you intend. Please contact us if you would like to learn more about naming your Revocable Trust as owner of a 529 Plan account.

## Young Adult Children

An often overlooked lifetime planning idea is Powers of Attorney for Property and Health Care for young adult children when they go to college. When a child reaches the age of 18, he or she is usually treated as completely separate and distinct from his or her parents. Under the Health Insurance Portability and Accountability Act (HIPAA) of 1996, the medical care community owes the eighteen-year-old child full confidentiality unless he or she has executed a Power of Attorney for Health Care with HIPAA waiver provisions. This means that the eighteen-year-old child's parents no longer have the right to know about the child's medical conditions or make treatment decisions on his or her behalf, unless such Power of Attorney for Health Care is in place. While the college student may still be covered under his or her parents' health insurance plan, his or her parents will not have the ability to make health care decisions without the

Power of Attorney for Health Care. Another important topic for your young adult children involves health care coverage. Most family insurance plans only cover dependent children while they are still in school, thus when they graduate they are no longer covered under their parents' insurance plan. While some states are currently exploring the idea of expanding the age definition of a dependent for purposes of health care coverage, nearly 30% of individuals ages 18 to 24 are uninsured and nearly 25% of individuals ages 25-34 lack health care coverage. It is important to make sure your dependent child is covered by a health insurance plan after he or she graduates from college.

## As Interest Rates Vary, So Do Gifting Techniques

There are a variety of gifting techniques available for a client who wishes to transfer assets out of his estate. But as interest rates vary, so does the value of the different techniques.

Techniques that work better when interest rates are low include transfers to Grantor Retained Annuity Trusts (GRATs) and Installment Sales to Intentionally Defective Grantor Trusts (IDGTs).

A GRAT is an irrevocable trust designated to hold assets for a specific period of time. During the designated period, the GRAT makes specified annuity payments to the transferor. When the GRAT terminates, the assets are distributed to the remainder beneficiaries. The interest rate used to value the annuity is 120% of the federal midterm rate or the applicable federal rate (AFR), the so-called "Section 7520 Rate." If the assets that are transferred to the GRAT outperform the "Section 7520 Rate," the property will pass out of the estate without incurring any extra transfer tax.

A sale of an asset to an IDGT in exchange for an installment note is a technique similar to a GRAT in that an asset is exchanged in return for a stream of income. An IDGT is an irrevocable trust which is structured to be excluded from the transferor's estate, but to be treated as a grantor trust for income tax purposes. The interest rate that applies to installment sales to IDGTs is the AFR, based on the length of the note. Since the AFR used in installment sales is generally lower than the rate used in a GRAT, more appreciation passes tax free to the remainder beneficiaries.

On the other hand, a technique that works better when interest rates are high, is the Qualified Personal Residence Trust (QPRT). A QPRT is a trust funded with an interest in the transferor's personal residence or vacation home. The transferor retains the exclusive use of the property for a specific term of years. The retained value of the use of property is determined using the Section 7520 Rate. At the end of the term, the QPRT terminates and the property is distributed to the remainder beneficiaries. The higher the interest rate is, the higher the value of the use of the property is, which in turn makes the value of the gift lower.

For the charitably inclined client, a Charitable Lead Annuity Trust (CLAT) is a good vehicle to use. A CLAT is an equivalent to the GRAT, except the annuity is paid to a charity instead of the grantor. When interest rates are low, more property will likely pass to the remainder beneficiaries without incurring any extra tax.

A Charitable Remainder Annuity Trust (CRAT) works better in transferring property out of the estate when interest rates are high. A CRAT is similar to a GRAT, except that the remainder beneficiary is a charity. When interest rates are high, the value of the gift to the charity is high, which creates a higher tax deduction.