Legal Brief

Take Advantage of Market Conditions

While the economy appears ready to rebound, many assets remain valued at depressed levels and interest rates remain low. It may be worth considering certain strategies that eliminate or minimize the tax consequences associated with the future appreciation that is bound (we all hope) to occur.

Roth IRA Conversions

One way to take advantage of depressed asset values involves converting retirement accounts into Roth IRAs. For tax years 2010 and beyond, the income limits on Roth IRA conversions will no longer exist. At the time of conversion, the retirement account owner will pay tax on the current low value of the account. This tax can be spread over two years if the conversion occurs in 2010. Any amount converted to a Roth IRA will then continue to grow tax-free.

Gifting

Now also might be a great time to gift property that has the potential to increase in value. The annual gift tax exclusion allows you to gift $13,000 ($26,000 if your spouse joins in the gift) to as many people as you desire without any tax consequences. Gifts in excess of the annual exclusion are applied against your lifetime gift tax exemption of $1 million. Once this exemption is exhausted, additional gifts are subject to gift tax.

Gifting allows you to transfer all future appreciation in the gifted property outside of your estate. While gifting is relatively straightforward, the transferee currently receives a carryover basis in the gifted property. Thus, you may be gifting assets that carry with them a hefty tax burden. Accordingly, it is necessary to analyze any potential income tax consequences and your family's ultimate plans for the asset prior to making any gift.

Grantor Retained Annuity Trust

Grantor Retained Annuity Trusts ("GRATs") allow taxpayers to transfer the future appreciation of certain assets out of their taxable estate. As with outright gifts, the taxpayer makes an irrevocable transfer into the GRAT. However, the taxpayer retains the right to receive an income stream for a term of years or for his or her lifetime. The remainder interest typically passes to the taxpayer's family upon the termination of the GRAT, and is considered a completed gift at the time of the transfer.

GRATs are currently attractive because the remainder is valued based on the reduced asset values and the low discount (interest) rate prescribed by the Internal Revenue Service (IRS). Upon termination, any appreciation in the value of the remainder interest in excess of the rate prescribed by the IRS is passed free of estate and gift tax to the taxpayer's family.

Charitable Lead Annuity Trust

For those with charitable intentions, a Charitable Lead Annuity Trust ("CLAT") may be the perfect choice for you. It works in much the same way as a GRAT. The main difference between a CLAT and a GRAT is that instead of the income stream being retained by you, it is directed to a charity of your choosing. At the termination of the trust, your family members can still be the beneficiaries and receive all of the CLAT assets tax-free. The CLAT can be structured so that either: 1) you get a large upfront charitable deduction, but remain responsible for income tax on any income earned by the Trust, or 2) so that the CLAT receives the charitable deduction each year.

Intra-Family Loans

Low interest rates make now a great time to consider a loan to one of your children or other family members. Intra-family loans allow your assets to appreciate outside of your estate, while allowing a family member to invest, buy a home or start a business. The IRS requires a certain minimum interest rate be charged in order to avoid tax consequences. As of November 2009, this rate ranges from less than 1 percent to just over 4 percent, depending on the term of the loan. If the loan proceeds receive a return on investment that is greater than the IRS interest rate, the difference passes to your children tax-free. This strategy can then be leveraged by using annual exclusion gifts to forgive the monthly or annual payments on the loan up to $13,000 a year gift tax-free. However, as with any loan, you may be responsible for reporting interest income or expense depending on the purpose of the loan.

As always, the effectiveness and desirability of any of these strategies depends on your individual circumstances. ☆

For more information about these strategies, contact S. Craig Shamburg at MacDonald, Illig, Jones & Britton LLP at 814/870-7716 or cshamburg@mijb.com.

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