BLAIR & POTTS
A PROFESSIONAL CORPORATION
ATTORNEYS AT LAW
TWO STAMFORD PLAZA
281 TRESSER BOULEVARD
P. O. BOX 1214
STAMFORD, CONNECTICUT 06904-1214

TELEPHONE (203) 327-2333
FACSIMILE (203) 327-1731

CLIENT UPDATE - DECEMBER 2008

With 2008 coming to a close, we wanted to take this opportunity to apprise you of recent changes to our tax laws. As we have mentioned in past updates, the numerous changes to our estate, gift and income tax laws enacted in 2001 by the "Economic Growth and Relief Reconciliation Act" are scheduled to lapse in 2011. As a result, it is very likely that the new President and Congress will address these issues early next year.

I. Federal Legislative Update

The Emergency Economic Stabilization Act of 2008 and the Housing Assistance Act of 2008 (collectively referred to as the "Act") were signed into law this year. The Act contained many changes to the federal tax laws and also extended many provisions which had previously expired.

- **Charitable Contributions from Individual Retirement Accounts.** In 2008 and 2009, you may exclude from gross income up to $100,000 of distributions from an Individual Retirement Account ("IRA") made directly to a qualified charity. The distribution is not included in your adjusted gross income, nor is it taken into account in determining charitable deduction limitations. In order to qualify for this opportunity, the IRA owner must be at least 70½ at the time the distribution is made. Private foundations, supporting organizations and donor advised funds are not qualified charities for this purpose.

Any distributions to a qualified charity will reduce the amount that you would otherwise be required to receive from your IRA in the year of the distribution. In addition, to the extent that a distribution to a charity reduces the required distribution amount, it will also reduce your state income tax liability if you live in a state (such as Connecticut) which bases its income tax on your federal adjusted gross income.

- **Alternative Minimum Tax Relief.** The Alternative Minimum Tax ("AMT") is a separate tax structure designed to ensure that certain taxpayers pay a minimum amount of income tax each year. For 2008, the Act provides that the AMT exemptions will be as follows: $69,950 for married individuals filing jointly and surviving spouses; $46,200 for single taxpayers and heads of households; and $34,975 for married couples filing separately. Absent legislation, the AMT exemptions for 2009 will revert to their 2001 levels triggering an AMT liability for a number of taxpayers.

- **State and Local Sales Taxes.** For our clients who do not pay state or local income taxes, the Act extends through 2009 your ability to report state and local sales taxes paid as an itemized deduction. The deduction can be calculated via a table provided by the Internal Revenue Service or through receipts saved by the taxpayer.

- **Limitations on Use of Principal Residences.** The Internal Revenue Code provides that a married taxpayer may exclude $500,000 ($250,000 for single filers) of capital gain from the sale of a principal residence. For sales or exchanges occurring after December 31, 2008, the exclusion will not apply to gain allocable to a period of time in which the residence was not used by the taxpayer or his or her spouse as a principal residence.

- **Retirement Savings Limits Increased.**

  - The annual limit on contributions to traditional IRAs and Roth IRAs will be $5,000 in 2009 and will be adjusted for inflation in future years.

  - The annual 401(k) employee salary deferral limit will increase to $16,500 in 2009, and will be indexed for inflation thereafter.

  - Employees age 50 and over may continue to make annual catch-up contributions of $1,000 to IRAs and $5,000 to 401(k) plans.

II. Federal Estate, Gift and Generation-Skipping Transfer Tax Update

- **Increase in Tax Exemptions.** The federal estate and generation-skipping transfer tax ("GST-tax") exemptions will increase to $3,500,000 on January 1, 2009. Please note that the federal gift tax exemption remains at $1,000,000. The estate and GST-tax are currently scheduled to be repealed for one year beginning January 1, 2010. Absent expected legislation, the federal estate and GST-tax exemptions will both return to $1,000,000 in 2011.

Many commentators believe that legislation will be passed during 2009 to prevent the scheduled repeal of the estate tax for 2010. It is likely that the estate tax exemption will remain at its 2009 level of $3,500,000.

- **Reduction of Transfer Tax Rates.** The highest federal estate, gift and GST-tax rate will remain at 45% for 2009.

- **Annual Federal Gift Tax Exclusion.** On January 1, 2009, the federal annual gift tax exclusion will increase from $12,000 to $13,000 ($26,000 for married couples electing to split gifts). A taxpayer's annual exclusion gifts will not reduce his or her federal gift or estate tax exemptions.

III. State Estate Tax Issues

Prior to 2005, many states had what was commonly referred to as a "pick-up" estate tax which was equal to the state death tax credit the estate received on its federal estate tax return. On January 1, 2005, the state death tax credit was replaced by an estate tax deduction for the actual amount of the state death tax paid, effectively repealing state death taxes to the extent such taxes related directly to the federal death tax credit. Many states, most notably Arizona, California, Colorado, Florida, Georgia, Montana, New Hampshire, New Mexico, Pennsylvania and South Carolina, no longer impose a state estate tax. Other states, including Connecticut, Maine, Maryland, Massachusetts, New Jersey, New York, Oregon, Rhode Island, Vermont and Virginia, have revised their estate tax laws to "decouple" their estate taxes from the federal estate tax. Consequently, a state estate tax continues to be imposed in those states.

This decoupling could have a significant impact on many married couples with tax-efficient estate plans that create an Estate Tax Sheltered Trust at the first spouse's death to be funded with the deceased spouse's remaining federal estate tax-free amount. If the deceased spouse is a resident or owns real property or tangible personal property in a "decoupled" state, it is possible that a state death tax would be due at the first spouse's death. The state death tax may be deferred, and in some cases avoided, depending on the terms of the Estate Tax Sheltered Trust. Therefore, it is advisable to review the provisions of your estate plan to determine whether or not you need to amend your documents to be eligible for this deferral opportunity.

In addition, currently only Connecticut, North Carolina and Tennessee impose a gift tax. If you reside in a state which imposes an estate tax, but not a gift tax, you can reduce your state estate tax liability by making taxable gifts during your lifetime. The gifted assets will not be included in your estate and subject to estate taxes at your death. As a result, the gifted assets will never be taxed by the state.

IV. Connecticut Gift and Estate Taxes

Currently, each Connecticut resident may make taxable gifts of up to $2,000,000 without incurring a Connecticut gift tax. However, once the aggregate amount of taxable gifts exceeds $2,000,000, a Connecticut gift tax will be due on the total amount of taxable gifts made after January 1, 2005 (including the first $2,000,000).

Similarly, the Connecticut estate tax allows each resident to leave a taxable estate of up to $2,000,000 before a Connecticut estate tax will be due. However, once the taxable estate exceeds that amount, an estate tax will be due on the total taxable estate. Any taxable gifts made after January 1, 2005 will reduce the amount of your Connecticut estate tax-free amount remaining at your death.

V. Estate Planning Opportunities

Assuming your estate planning documents are already designed to enable you to take advantage of your increasing federal estate and GST-tax exemptions, you may wish to consider other techniques to reduce your ultimate transfer tax liability.

- **Lifetime Gifting.** As mentioned, prior to January 1, 2009, you may make annual exclusion gifts of $12,000 per recipient ($24,000 if you are married) without incurring any federal or state gift tax. Those amounts increase to $13,000 per recipient ($26,000 if you are married) for gifts made in 2009. The gifted property is removed from your estate and will not be taxable at your death. Transfers may be made outright or to specially designed trusts, all with the same gift tax-free result.

In addition to annual exclusion gifts, transfers in excess of the annual exclusion amount which are made to pay tuition or meet the medical needs of the beneficiary are also gift tax-free, provided they are made directly to the educational institution or care provider.

If you are inclined to give away more than your annual exclusion amount to reduce your ultimate transfer tax liability, you may do so without incurring a federal gift tax so long as your additional gifts do not exceed your gift tax exemption amount of $1,000,000.

Lifetime giving generates transfer tax savings since all future income and appreciation connected with the gifted property will inure to the benefit of the recipient of the gift and therefore will not be included in your estate at death. Consequently, a carefully structured gifting program may enhance your ability to transfer more property to your family at a smaller tax cost. Lifetime gifting continues to be a critical part of an effective estate plan, given the likelihood that the estate tax and GST-tax will not be repealed permanently.

- **Grantor Retained Annuity Trusts.** Current interest rates and low equity valuations create an opportunity to transfer assets to your children with little or no gift tax consequences through a Grantor Retained Annuity Trust ("GRAT"). This technique involves transferring property (i.e., stock, bonds, etc.) to a trust while retaining the right to receive an annuity for a specified term of years ("GRAT term"). The transfer to the trust is a taxable gift, but the value of the gift is reduced by your retained right to receive annuity payments. A GRAT may be drafted so that the value of your retained interest equals the value of the property contributed to the trust. This arrangement is commonly referred to as a "zeroed out" GRAT. In determining the value of your retained interest, the Internal Revenue Service requires that you use the Applicable Federal Rate ("AFR") for the month in which the transfer is made. If you survive the GRAT term and the value of the trust's assets appreciate at a greater rate than the AFR, the excess appreciation will pass to your descendants transfer tax-free. Given the recent decline in the stock market, this may be an opportune time to consider the creation of a GRAT as part of your estate plan.

- **Family Limited Partnerships and Family Limited Liability Companies.** In recent years, family limited partnerships ("FLPs") and limited liability companies ("LLCs") have

been popular vehicles to transfer wealth to younger generations at a discounted value, while allowing the donor to retain control over the gifted asset. Prior to 2003, challenges by the IRS regarding this discounting technique tended to focus on the appropriate discount to be applied in valuing the FLP/LLC interest. However, in 2003 and after, the United States Tax Court has taken an entirely different approach, often finding that the full value of a transferred partnership interest remained taxable in the decedent's estate because the decedent had retained actual or implied control over the assets after they had been gifted. We recommend that all clients with existing FLPs and LLCs contact their tax advisor to discuss the steps, if any, which should be taken to avoid this negative tax result.

- **Qualified Personal Residence Trusts.** A Qualified Personal Residence Trust ("QPRT") offers another opportunity to maximize the use of your federal gift tax exemption by transferring your residence or vacation home to a trust, while retaining the right to live in the residence for a specified term of years. At the end of the term, the beneficiaries (or a trust for their benefit) would become the owners of the property. While the transfer of the property to a QPRT would be a taxable gift, the value of the gift is discounted because of your retained interest in the property. Assuming you survive the QPRT term, the property would not be included in your estate for estate tax purposes, thereby typically resulting in substantial estate tax savings.

- **Irrevocable Life Insurance Trusts.** If you own or are in the process of acquiring single or survivorship life insurance, you should consider arranging for the insurance to be owned by an Irrevocable Life Insurance Trust to avoid paying estate taxes on the policy proceeds. For insurance you are purchasing, the trust should be the initial applicant, owner and beneficiary of the policy. For existing insurance, ownership of the policy must be assigned to the Life Insurance Trust and the trust must be designated as the beneficiary. You must survive for three years from the date of the assignment in order to exclude the proceeds from your estate. You will also be required to provide each beneficiary with a "Crummey" notice when a contribution is made to the trust to ensure qualification of the gift for the gift tax annual exclusion.

- **Charitable Giving.** If you are considering a gift to charity, you may wish to consider creating a Charitable Remainder Trust or a Private Foundation. A Charitable Remainder Trust would allow you to retain lifetime use of assets transferred to charity on a tax-favored basis. A Private Foundation would allow you to retain control over the gift and have a lasting impact on the community or on the charitable area of your choice. Some of the advantages of both vehicles are (i) the fulfillment of your charitable goals, (ii) a current income tax charitable deduction, (iii) no capital gains tax upon the sale of the gifted property by the Charitable Remainder Trust or Private Foundation, and (iv) the removal of the property from your estate for federal estate tax purposes.

- **Retirement Plan Elections.** The Internal Revenue Service has simplified the calculation of your Minimum Required Distributions (MRDs) from qualified plans and rollover IRAs. While MRDs still must begin after age 70½, the new rules provide a much easier method of calculation, and, in many instances, will reduce the amount which must be distributed each year.

- **Revocable Trusts.** Although Revocable Trusts (sometimes referred to as "Living Trusts") do not offer any opportunities for estate tax savings that could not otherwise be achieved through the use of conventional Wills, they do offer a number of unique estate planning benefits, such as reducing or eliminating Probate Court involvement in the settlement of your estate and in the ongoing administration of trusts created at death as a part of your estate plan. Revocable Trusts can also provide for effective asset management in the event of your incapacity and can provide a degree of privacy not available through the use of a conventional Will. In addition, if you own real property in other states, transferring such property to your Revocable Trust can avoid the necessity of out-of-state probate proceedings.

- **Durable Powers of Attorney and Living Wills.** It is important to provide for the management of your assets by a family member or trusted advisor in the event of incapacity or absence. If you have not already executed a Durable Power of Attorney, you should consider doing so. Powers of Attorney may be very broad in nature or limited to specified circumstances. Among the powers that are typically granted are powers to manage assets, file tax returns and pay bills. Powers of Attorney can also permit the making of gifts and the transfer of assets to a Revocable Trust. You should periodically review your Powers and consider re-executing the most current version available through our office.

Many states have enacted a statutory form of a Living Will which allows you to express your wishes with respect to the use or withholding of extraordinary medical procedures if you are terminally ill. In addition, those states generally allow you to appoint a health care representative who is authorized to intervene on your behalf to make ultimate decisions should any uncertainty arise with respect to your wishes as expressed in your Living Will. If you are interested in signing an updated Living Will, please let us know.

- **Estate Planning Review.** Given our ever changing tax environment, it is important to review your estate plan every few years to ensure that its provisions remain appropriate. In addition, your estate plan should be reviewed in light of recent changes many states have made to their estate tax laws.

- **Come Visit Us on the World Wide Web.** We recently updated our web site which will allow us to provide our clients with up-to-date information regarding recent developments in estate, gift and income taxes. Please visit us at www.blairandpotts.com.

clientupdate-Dec.2008.docx