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 2009

As the year comes to a close, we would like to take this opportunity to provide you with an overview of some of the more interesting changes to the tax law. Now is also a good time to review your estate plan to ensure that its provisions remain appropriate, in this ever changing tax landscape.

The recent federal income tax changes are derived from the Emergency Economic Stabilization Act of 2008 and the American Recovery and Reinvestment Act of 2009. The federal estate, gift and generation-skipping transfer tax changes date back to the Economic Growth and Tax Relief Reconciliation Act of 2001, and are likely to be modified by year end or early in 2010.

Under the current federal estate tax law, the tax is scheduled to be repealed for 2010 and then return in 2011 with a $1 million exemption amount and a maximum marginal tax rate of 55%. Although many had expected a new comprehensive federal estate tax bill to be passed by the end of 2009, the attention of Congress and the Administration has been focused on other matters, such as the recession, the ongoing wars and health care reform. For 2010, we anticipate that Congress will simply extend the estate tax as it currently exists, with a $3.5 million exemption amount and a 45% maximum tax rate and will probably pass more comprehensive estate tax legislation some time next year.

I. Federal Legislative Update

- **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 2009, the AMT exemptions will be as follows: $70,950 for married couples filing jointly; $46,700 for single taxpayers and heads of households; and $35,475 for married individuals filing separately.

- **Retirement Savings:**

  - **2010 Roth IRA Conversions.** Beginning on January 1, 2010, all taxpayers will be able to convert their traditional IRAs to Roth IRAs. Prior to that date, only taxpayers with a modified adjusted gross income of $100,000 or less were eligible for such a conversion.

Please note that an income tax will result from the conversion of a traditional IRA to a Roth IRA. With respect to conversions performed in 2010, a taxpayer will have the option to have 50% of the income taxed in 2011 and the remainder in 2012.

There are several key differences between a traditional IRA and a Roth IRA, most notably the income tax treatment of the contributions and distributions, and the requirement to take withdrawals during your lifetime. With respect to a traditional IRA, contributions are deductible for income tax purposes, subject to numerous limitations, and the earnings and appreciation on such contributions are not subject to income taxes until a distribution is received. In contrast, a contribution to a Roth IRA is not deductible on your income tax return. In addition, you are not required to receive distributions from a Roth IRA during your lifetime. As a result, the assets of a Roth IRA can continue to grow tax-free during your lifetime. If you receive a distribution from a Roth IRA during your lifetime, it will not be subject to income taxes provided that the assets have been held in the Roth IRA for at least five years and you are at least 59½ years of age at the time of distribution.

While you may be eligible to convert, you may not benefit from such a conversion. The decision to convert a traditional IRA to a Roth IRA is based on a number of factors, most notably: whether you have sufficient funds outside the IRA to pay the taxes at the time of the conversion; whether you believe that you will be in a higher income tax bracket when you retire; and whether you have a significant time frame before you need the IRA assets.

- **Retirement Savings Limits Remain the Same.** In 2010, the annual limit on contributions to traditional IRAs and Roth IRAs will continue to be $5,000 and the annual 401(k) employee salary deferral limit will continue to be $16,500. Catch-up contributions to an applicable employer plan for individuals age 50 or over remain at $5,500.

- **State and Local Sales Taxes.** For our clients who do not pay state or local income taxes, you may continue to report state and local sales taxes as itemized deductions through 2009. The deduction can be calculated by way of a table provided by the IRS or based on saved receipts.

- **New Car Buyers.** In addition, the state and local sales or excise taxes paid on the purchase of new cars, light trucks, motorcycles and motor homes from February 17, 2009 to December 31, 2009 can be claimed as a deduction on your income tax return. Please note, however, that the deduction is phased out for joint filers with a modified adjusted gross income of $250,000 (and other taxpayers with modified adjusted gross income of $125,000), and you may only deduct the sales and excise taxes paid on the first $49,500 of the purchase price of the new vehicle.

- **Income Tax Consequences of Losses due to Investment Theft.** In response to the various fraudulent investment schemes that were uncovered this past year, the IRS recently clarified that *investment theft loss* is to be treated like ordinary loss and that most of the loss can be recognized immediately. Specifically, the IRS provided that:
  - Defrauded investors are entitled to a theft loss which can offset an unlimited amount of ordinary income (in contrast to a capital loss which can only offset $3,000 of ordinary income per year).
  - *Investment* theft losses are allowable in full, without limitation (in contrast to most *personal* theft losses, which are deductible only to the extent that they exceed 10% of adjusted gross income).
  - Losses may be taken in the year that the fraud is detected.
  - Both the unrecovered original investment and the income from the investment that was reported on prior years may be claimed as losses.

- **Energy Incentives:**

  - **Alternative Motor Vehicle Credit.** For 2009, a credit is available for the purchase of motor vehicles powered by certain alternative fuels. The dollar amount of the credit depends on the fuel savings and weight of the vehicle. The most popular vehicles subject to the credit are the so-called "hybrids." Please note that a complex system of phase-outs applies based on the specific vehicle manufacturer. As a result, many popular hybrids will not qualify for the credit. Credits are also available for certain lean-burn technology vehicles (also subject to complex phase-outs), fuel cell motor vehicles, alternative fuel motor vehicles and plug-in electric-drive motor vehicles.

  - **Residential Energy Efficient Property Credit.** Tax incentives are available to taxpayers who install certain energy efficient property, such as photovoltaic systems (solar panels), solar water heating, fuel cell property, small wind energy property and geothermal heat pumps. In 2009, a credit is available for the expenditures incurred for such property (with a few exceptions) up to a specific dollar limitation.

  - **Non-business Energy Property Credit.** After expiring in 2007, the non-business energy property credit was reenacted for 2009 and 2010. Property qualifying for the credit includes windows, skylights, exterior doors, insulation, metal roofs, advanced main air circulating fans, natural gas, propane, or oil furnace or hot water boilers, and other energy efficient building property that meets certain energy standards. The credit is 30% of the cost of the improvements up to a maximum credit of $1,500 per year.

II. Federal Transfer Tax Update

The federal estate and generation-skipping transfer taxes will likely continue into 2010 at their 2009 levels. This means that there would be a $3.5 million exemption for each tax and an effective marginal rate of 45%. Also, the lifetime gift tax exemption will likely continue to be $1 million.

Meanwhile, the annual gift tax exclusion in 2010 will continue to be $13,000 per recipient, or $26,000 per recipient for married couples electing to split gifts. The annual exclusion amount for gifts to a non-citizen spouse will be increased to $134,000 in 2010 (up from $133,000 in 2009). As a reminder, your annual exclusion gifts are in addition to your federal gift and estate tax exemptions.

With regard to the future of the federal estate tax in 2011, some proposed modifications that Congress is currently considering include the following:

- Decreasing the exemption to $2 million and indexing that amount for inflation;
- Continuing with the $3.5 million exemption amount with or without indexing it for inflation;
- Increasing the exemption amount incrementally each year, culminating with a $5 million exemption in 2015, which will then be indexed for inflation in future years;
- Varying the maximum tax rate from as low as 35% to as high at 55%;
- Imposing stricter rules on certain estate planning strategies; and
- Permitting a surviving spouse to utilize the unused exemption of a predeceased spouse (the so-called "portability option").

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. Therefore, many states no longer impose a state estate tax. Other states have revised their estate tax laws to "decouple" their estate taxes from the federal estate tax. Currently state estate taxes continue to be imposed in Connecticut, Delaware, District of Columbia, Illinois, Kansas, Maine, Maryland, Massachusetts, Minnesota, New Jersey, New York, North Carolina, Ohio, Oklahoma, Oregon, Rhode Island, Tennessee, Vermont and Washington.

This decoupling could have a significant impact on many married couples with otherwise tax-efficient estate plans that create an Estate Tax Sheltered Trust at the first spouse's death. 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 have the provisions of your estate plan reviewed in order to determine whether or not you need to amend your documents to be eligible for this deferral opportunity.

In addition, currently only Connecticut and Tennessee impose a state 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 therefore never be subject to state transfer tax. However, please remember that gifts made in excess of the annual federal gift tax exclusion amount will reduce your federal exemption amount.

IV. Connecticut Tax Updates

- **Estate and Gift Taxes.** The Connecticut transfer tax threshold will increase from $2 million to $3.5 million for deaths occurring, and gifts made, on or after January 1, 2010. In addition, the marginal transfer tax rates for amounts in excess of the exemption amount will be significantly reduced. The time for filing a Connecticut estate tax return has been reduced, however, from nine months to six months, effective for deaths occurring on or after July 1, 2009.

- **Income Tax.** The following changes will be in effect for taxable years beginning on or after January 1, 2009:

  - **Personal Income Tax.** The marginal tax rate will rise from 5% to 6.5% for joint filers with taxable incomes over $1 million; heads of households with taxable incomes over $800,000; and single filers and married individuals filing separately with taxable incomes over $500,000. To avoid underpayment penalties, affected taxpayers will need to adjust their January 15, 2010, estimated tax payments to reflect the new tax rates.

  - **Fiduciary Income Tax.** The flat income tax rate for trusts and estates will rise from 5% to 6.5%.

- **Sales and Use Tax.** Effective January 1, 2010, the sales and use tax rate is expected to be lowered from 6% to 5.5%. However, this rate decrease is contingent on the State meeting certain revenue projections.

- **Same Sex Marriage and Civil Union in Connecticut.** In 2008, the Connecticut Supreme Court held that a statutory prohibition against same-sex marriage violated Connecticut's state constitution. As a result, Connecticut now recognizes same-sex marriages, in addition to civil unions. Therefore, under Connecticut tax laws, members of same-sex marriages and civil unions are treated the same as members of heterosexual marriages. However, under federal tax regulations, members of a same-sex marriage or civil union are treated as unmarried. There are a number of planning strategies that can be used to efficiently transfer wealth between same-sex spouses despite the non-recognition of same-sex marriage by the IRS.

V. Note to our New York Clients

The State of New York has a new Statutory Durable Power of Attorney that became effective on September 1, 2009. Perhaps most notably, the new law has created specific requirements in order to give your attorney-in-fact the right to make gifts on your behalf. The new statute will not invalidate any Powers of Attorney that were effective prior to September 1. However, all Powers of Attorney executed in New York on or after September 1, 2009, must comply with the new statute.

VI. Estate Planning Opportunities

Assuming your estate planning documents are already designed to enable you to take advantage of the federal estate and generation-skipping transfer tax exemptions, you may wish to

consider certain advanced techniques to reduce your ultimate transfer tax liability. While reducing your net worth in favor of the next generation may seem counterintuitive given the current state of the economy, lower asset values combined with historically low interest rates present excellent opportunities for various gifting techniques. Some of these techniques are summarized below:

- **Lifetime Gifting.** 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 wealth to your family at a reduced 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.

As discussed earlier, you may make annual exclusion gifts without incurring any federal or state gift tax. 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 a 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, you may do so without incurring a federal gift tax so long as your additional gifts, in the aggregate, do not exceed your federal gift tax exemption amount of $1,000,000. A simple set of gift tax returns would need to be filed for informational purposes.

- **Low-Interest Loans to Family Members.** You can transfer significant value to family members during your lifetime without incurring any transfer tax liability by making loans based on the historically low Applicable Federal Rates ("AFR"). The AFRs, which are published each month and are generally lower than commercial rates, are the lowest interest rates that may be charged without having a transaction characterized as a gift. Now might be the right time to consider helping a younger family member take advantage of today's decreased real estate prices by acting as the family bank.

- **Grantor Retained Annuity Trusts.** If you are interested in gifting much larger amounts to your children with little or no gift tax consequences, you may choose to create a Grantor Retained Annuity Trust ("GRAT"). This technique involves transferring property (i.e., stock, bonds, closely-held business interests, etc.) to a trust while retaining the right to receive an annuity for a specified term of years. 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 entire 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 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 beneficiaries transfer tax-free. Because there has been some talk in Congress of limiting some of

the benefits of GRAT planning, and because interest rates are at all time lows, this may be a good time to consider establishing a GRAT as part of your estate plan.

- **<u>Charitable Giving</u>.** If you are considering giving a gift to charity, you may wish to consider creating a Charitable Lead Trust, a Charitable Remainder Trust or a Private Foundation. A Charitable Lead Trust provides for payments to charity for a term of years with the remainder to be paid to the non-charitable beneficiaries at the end of the term. A Charitable Remainder Trust would allow you to provide an income stream to a non-charitable beneficiary for a period of time with the remainder to be paid to charity. 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 these techniques 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 Trust or Private Foundation, and (iv) the removal of property from your estate for federal estate tax purposes.

- **<u>Qualified Personal Residence Trusts</u>.** A Qualified Personal Residence Trust ("QPRT") offers an 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 (i.e. the right to continue using the residence). 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. While this estate planning technique usually works best in a higher interest rate environment, it may potentially benefit many clients now as a result of the decreased real estate values.

To learn more, please visit our website at www.blairandpotts.com.

Happy Holidays!

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