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Making the right financial moves—resolutions that last

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Did you make a financial resolution at the start of 2009? If you did, you weren't alone. According to USA.gov, the top five New Year's resolutions all involved getting into better shape—whether physically or financially. But statistics show that keeping those resolutions is easier said than done. By Valentine's Day, approximately 80% of all New Year's resolutions ultimately fall by the wayside. So how can you avoid becoming another statistical casualty? Below we've outlined some key financial moves that can help you stay on the right track and achieve your financial goals.

Personal financial statements

Everyone should keep his or her own set of personal financial statements, including a net worth statement, cash flow statement, and budget. These documents are essential to managing your personal goals and tracking where you're headed financially in the new year.

Net worth statement

Creating a net worth statement is relatively easy and can help you take stock of where you stand financially. First, list all of your assets, such as checking and savings accounts, your home, and investment accounts.

Don't forget to include company-provided benefits, such as a 401(k) or 403(b) plans, vested stock options, and deferred compensation. Next list your liabilities, such as a home mortgage, credit cards, 401(k) loans, and any other lines of credit. The difference between the two numbers—between your total assets and total liabilities—is your current net worth.

Cash flow statement

Another statement you should keep on hand is a monthly cash flow statement, which lists and categorizes all income and expenses for a given month. Although creating this statement can be time-consuming, it's one of the most useful tools for tracking where and how you spend your money on a monthly basis.

Always start with your gross income from employment earnings—that is, your income before any deductions are taken out. Then list any additional sources of income, including, for example, interest and dividends, alimony, or social security. A good cash flow statement also includes payroll or employment-related expenses (e.g., taxes, medical expenses, or contributions to a

retirement plan), fixed expenses, and discretionary and irregular expenses that vary from month to month.

The next step is the most important and often the hardest to complete: Once you've drafted a cash flow statement, you'll need to track all of your expenses down to the penny for at least a month—or better yet, for three months. Make sure you're also keeping track of money withdrawn from ATMs or requested back from debit card purchases.

Finding out where your money is actually going can be an eye-opening experience—one that is bound to surprise and maybe even shock you. In most cases, you should be able to free up a meaningful amount of money to redirect toward accomplishing one of your financial goals.

Budget

After you've tracked your expenses for one to three months, you can leverage that information to establish a budget—what you'd like to limit your expenses to each month. Having preset spending guidelines will help you stick to and accomplish your financial goals.

Make sure your budget includes both long-term and short-term goals, such as savings for retirement, a down payment for a home, or a family vacation for the summer.

A good budget incorporates not only monthly expenses, but also irregular expenses, such as real estate taxes, gifts, auto insurance, or maintenance on your home or car. Creating a good budget is not about eliminating every unnecessary expense. It's about gaining the freedom to plan for your future goals, while knowing what's available to satisfy your current wants—for example, going out to dinner or purchasing one of the items on your wish list.

As with dieting, it's important to reward your efforts and build a plan that fits your lifestyle. Be sure that the categories you use to organize your budget are meaningful, without being overly burdensome to track and manage. A budget isn't useful unless you compare it regularly to your monthly cash flow statement. By keeping the process simple and easy, you are more likely to stick to your budget throughout the year and realize the fruits of your labor through increased savings and reduced stress.

Utilize free resources to help you save

Employers often provide a wide range of benefits designed to help employees accomplish their financial goals. One of the most common benefits is a 401(k) plan—a great way to save money on a pre-tax basis and defer tax payments until retirement. In 2009, the pre-tax contribution limits were raised to \$16,500, with an additional \$5,500 for individuals aged 50 years or older.

If your 401(k) balance has been hit hard by the current economic environment, try not to lose heart. Although the losses in this bear market have been difficult, 401(k) plans still represent one of the most effective methods for dollar cost averaging. What exactly does that mean? If you continue putting your money into the market on a regular basis during both market highs and lows, you can effectively reduce the volatility of the investment and your purchase price in the investment over time.

401(k) plans are even more beneficial if you work for a company that offers a matching program. Even if you don't plan to contribute the maximum amount, try to rearrange

your budget so that you can take advantage of at least some portion of a potential company match and maximize your contributions on both a pre-tax and post-tax basis.

Flexible spending accounts are another great way to save. Sponsored by many employers, these accounts allow you to set aside pre-tax money to pay for a long list of qualified medical expenses, including dental and eye care. If you missed your company's enrollment period, consider looking into the benefits your employer provides for auto, home, life, disability, and/or long-term care insurance. These are all essential forms of insurance that are often cheaper when purchased through your employer. Contact your local HR representative to learn more about the benefits your company has to offer.

Emergency funds

In light of the current economic environment, emergency funds have grown increasingly popular during the past year. An emergency fund is typically a savings or money market account that is both liquid and very low risk. Historically, the standard "rule of thumb" has been to put at

least 3–6 months worth of expenses into a fund that can be used in the event of an emergency, such as a large medical expense, unexpected repairs, or a layoff. These days, however, having 1–2 years worth of expenses in liquid funds may help you feel more comfortable.

Paying down debt

Amid negative news about investments and the stock market, getting a guaranteed rate of return of 12% or even 4.5% may seem too good to be true. However, if you have credit card debt or even a mortgage, it is possible to realize those kinds of returns. For example, if you pay down a carryover balance on a credit card with an interest rate of 12%, you are effectively saving 12% on the money you pay toward the card each month. If you have a mortgage of 6% with an effective tax rate of 25%, you can save 4.5% (after factoring in tax savings) by paying down your mortgage.

Recent months have seen a distinct drop in interest rates, and you might consider capitalizing on those declines by refinancing your mortgage. Just be sure to factor

in the costs of refinancing before you make your final decision.

You should also try calling your credit card companies to request a lower interest rate. Doing so is more effective than you might think, since credit card companies would rather lower your rate than risk losing your money through a balance transfer. But before you start paying down your debt, set some money aside in an emergency fund. Committing to pay off your debt is difficult enough without acquiring new debt to cover an unexpected expense.

Key takeaway

At the end of the day, it's important to remember that we're all CEOs of our own personal finances. The key to a winning strategy for 2009 is to set goals, follow a plan, and share your goals with someone else. Putting an accountability structure in place can bridge the gap between simply hoping you can meet your goals and actually achieving them.



Estate planning in a down economy

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The current economic downturn has led to depressed security and real estate values and low interest rates. Although this news is troubling to many, there is a silver lining. Depressed values and low rates provide excellent opportunities to transfer wealth to heirs without incurring much or, in some cases, any gift tax—effectively reducing your potential estate tax in the future.

To take advantage of these low interest rates and the expected future appreciation of currently distressed assets, you might consider the available estate planning techniques described below.

Annual giving

Annual outright gift giving is one way to take advantage of the annual gift tax exclusion while assets are depressed. If used properly, the annual gift tax exclusion allows a taxpayer to exclude a certain amount of gifts from being taxed each year.

Currently, no gift tax is imposed on the first \$13,000 of gifts given to the same donee, provided that those gifts are gifts of present interests. This means that you can give \$13,000

every year to as many different people as you like, without incurring a gift-tax liability. There's an added benefit: Doing so removes the gifted property and any future appreciation from the pool of property that will ultimately be subject to estate tax upon your death.

Here's an example of how the annual gift tax exclusion works: Suppose a taxpayer ("T") wishes to make a gift of stock to his relative ("R"). If the value of the stock is worth \$5 per share, T could make a gift of 2,600 shares to R and remain within the \$13,000 annual gift tax exclusion. If in 2009 the value of the stock drops by half of the share price (i.e., down to \$2.50 per share), T could give R the same number of shares using a lesser amount of his annual exclusion (i.e., \$6,500 of the \$13,000). This would enable T to give an additional \$6,500 (i.e., 2,600 more shares of stock) to R, without exceeding the \$13,000 annual exclusion limit.

As an added bonus, if the stock appreciates in the future and is sold by R, the original (and presumably higher) price paid by the donor could then be used as the basis to

determine gain. By contrast, if the stock is in a loss position, R would not have the benefit of the loss under tax basis rules. For this reason, it may not be advisable to transfer stock as a gift if the stock is expected to decline in the near future.

A "gift-splitting" election is another option to consider if you file a joint tax return with your spouse. Making such an election can increase the amount transferred to a donee gift-tax free. Specifically, if both spouses consent, a gift given by either spouse to a third party will be treated as though both spouses each contributed half of the total gift. In other words, you could make a \$26,000 gift to one person in 2009 and effectively treat that gift as two separate \$13,000 gifts—one made by you and one made by your spouse.

Sale to an intentionally defective irrevocable trust

If your objective is to remove future appreciation of depressed assets from your estate, you may be interested in selling assets to an intentionally defective irrevocable trust ("IDIT"). An IDIT sale takes advantage of the difference between

the estate and income tax rules governing the ownership of property.

While an IDIT is considered a grantor trust for income tax purposes, it's considered a non-grantor trust for estate tax purposes. This means that income from the trust's assets is included in the grantor's income, but that the trust's assets themselves are excluded from the grantor's estate.

How exactly does an IDIT sale work? The technique involves selling property to an IDIT at its fair market value ("FMV") in exchange for a promissory note. If the FMV of the property declines in the year following the sale transaction, the trust will pay less for the asset than it would have paid before the sale transpired. For the term of the loan, the note bears interest at the rate prescribed by the IRS.

If there are no other assets in the trust, it is recommended that the grantor contribute a gifted amount equal to more than 10% of the value of the property purchased by the IDIT. This will give the IDIT economic significance, independent

of the sale of assets. Given today's depressed asset values, the same asset transferred to an IDIT last year may call for a smaller additional contribution this year. That additional contribution, depending on the amount, may be subject to gift tax.

For income tax purposes, an IDIT is disregarded, so no gain or loss will be recognized on the initial sale. While the grantor is alive, he or she will not be taxed on interest payments for the promissory note, and the IDIT will have the same tax basis in the assets purchased as the grantor does. Today's low interest rates mean that the IDIT (and consequently the heirs as beneficiaries of the IDIT) will not need to pay as much interest on the purchase of the assets contributed to the trust.

There's another key benefit: The grantor will be taxed individually on the income generated by the IDIT. By paying the income tax, the grantor effectively makes additional transfers to the IDIT's beneficiaries gift-tax free.

For estate and gift-tax purposes, transfers to an IDIT in the form

of gifts and sales are treated as completed transactions between the grantor and the trust, and property owned by the trust will not be treated as part of the grantor's estate. All future appreciation of the trust's assets passes to the IDIT's beneficiaries (who are typically members of the grantor's family), without incurring estate and gift taxes. Because depressed assets begin appreciating at a lower starting point, the donor could potentially transfer even more appreciation to his or her beneficiaries in this economic environment.

To achieve the maximum benefits of using an IDIT, the yield on the property sold to the trust (i.e., income and appreciation) must exceed the interest rate of the note (i.e., the rate prescribed by the IRS for the month of the sale). For February 2009, the IRS rates for annual compounding interest are 0.6% for short-term loans (i.e., less than or equal to 3 years), 1.65% for mid-term loans (i.e., greater than 3 to 9 years), and 2.96% for long-term loans (i.e., greater than 9 years).

Grantor retained annuity trust

A grantor retained annuity trust (“GRAT”) is a third option for transferring wealth while the economy is down. Once a GRAT’s term expires, the amount of combined income and appreciation of trust assets in excess of the applicable interest rate, which is currently set at 2.0% for February 2009, will pass to the GRAT’s beneficiaries gift-tax free. If those assets are depressed when contributed to the GRAT, the benefits will be substantial.

A GRAT is an irrevocable trust to which the donor contributes appreciating or income-producing assets (e.g., stock) for a specified term and for which the donor retains the right to receive a fixed annual annuity payment for a set number of years. The amount remaining will pass either directly to the grantor’s family or to a trust for which the grantor’s family members are beneficiaries.

At the time of initial transfer to the GRAT, the grantor will need to make a taxable gift up to the value of the GRAT’s remainder interest. This initial

contribution will not be subject to gift tax as long as the annuity payment is set at a rate high enough to make the present value of those payments equal to the present value of the property used to create the GRAT. By doing this, the remainder interest is valued at zero, and no gift is made.

While using a GRAT can offer substantial benefits, it poses a number of risks, as well. One such risk is that a GRAT, unlike an IDIT, uses a different interest rate, which could be higher or lower depending on the term of the IDIT loan. There’s another significant difference between an IDIT and a GRAT: If the grantor of the GRAT dies during the GRAT’s term, the GRAT property will be included in the grantor’s estate. But if a grantor dies during the term of a promissory note, that alone would not cause the IDIT assets to become part of the grantor’s estate. It’s important to weigh such relevant risks and rewards before selecting a wealth transfer vehicle.

Charitable lead annuity trust

A charitable lead annuity trust (“CLAT”) can offer tax benefits similar to those of a GRAT. A CLAT

is a type of split-interest trust (i.e., benefitting both charitable and non-charitable beneficiaries), whereby the grantor transfers cash or other assets to a trust that makes annual annuity payments to a charity. Assets in the trust generally pass to a family member at the end of the trust’s term.

A CLAT can be structured as either a grantor or non-grantor trust. If the CLAT is structured as a grantor trust, the grantor may take a charitable deduction at the time of the transfer in the amount of the charity’s interest in the trust. If the CLAT is a non-grantor trust, the trust may take charitable deductions as the annuity payments are made.

The grantor is subject to gift tax on the value of the remainder interest in the CLAT. However, gift-tax consequences may be minimal if the annuity payments to the charity are set at a rate high enough to make the resulting present value of the remainder interest nominal.

Appreciation in the value of the assets transferred to a CLAT will pass to the beneficiaries, free of

transfer taxes. Since the transferor of a CLAT does not receive annuity payments, it is less risky than a GRAT. There is no adverse estate tax consequence if the transferor dies during the CLAT's term.

Conclusion

Although planning for wealth transfer taxes may not be top of

mind for many in today's economic environment, significant tax savings can be achieved by acting now while interest rates are low and asset values are depressed. The tax benefits of the above estate planning techniques will vary depending on the type and amount of assets involved, as well as your specific goals and risk appetite.

Before making any financial planning decisions, please consult your PwC tax and financial planning advisor to discuss your specific circumstances and determine which technique is most appropriate for you.



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