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Year end tax planning to avoid the tax pinch and Alternative Minimum Tax (AMT)

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As the holidays and New Year approaches, Uncle Sam is continuing his annual April tradition, looking to maximize his haul and collect any morsels that were left on the table. Fortunately, the folks in Personal Financial Services are ready with year-end tax planning ideas to put more money in your pockets for the holiday season and avoid the tax pinch.

Given the millions of taxpayers now subject to the Alternative Minimum Tax (AMT) (see "Grappling with AMT" in the June issue of the PFS Newsletter), year-end planning for individuals subject to AMT is increasingly important. The AMT is a parallel tax system which generally disallows many typical deductions and taxes income at a maximum rate of 28%. Usually, year-end tax planning involves accelerating tax deductions to the current year, deferring income to later years, or doing both in tandem to take advantage of the time value of money. Traditional tax planning techniques such as accelerating deductions and deferring income may actually increase an individual's tax liability when the AMT applies. As we provide you with year-end tax saving treats, we will consider tax planning for both regular tax and AMT purposes.

Prepayment of state and local taxes

Fourth quarter estimated state payments are typically due January 15th of the following year. By prepaying this obligation in December, individuals, particularly for individuals with large estimated state tax payments, can deduct these taxes on their 2007 tax returns rather than waiting a full year to deduct on their 2008 return. Individuals can also consider prepaying real estate taxes to achieve a similar benefit.

However, if a taxpayer will be subject to AMT in 2007, the above strategy should be carefully considered because state and local taxes and real estate taxes are not deductible under the AMT calculation. A taxpayer subject to AMT generally receives no benefit from their state tax deductions. While it may defy commonsense to defer a deduction to the following year, the AMT system often requires such counter-intuitive thinking in order to maximize tax benefits. By delaying estimated and real estate tax payments to 2008, taxpayers subject to AMT in 2007 can preserve those deductions for the following tax year when they may not fall prey to the AMT.

Capital loss harvesting

Taxpayers should consider selling losing stocks before year-end to offset capital gains and ordinary income. Capital losses may be used to offset capital gains in addition to offsetting up to $3,000 of ordinary income such as wages and interest. However, taxpayers should be aware of the "wash sale" rules that disallow losses on securities sold and then repurchased within 30 days of the sale.

While the preferential 15% rate on long-term capital gains applies under the AMT, large capital gains often lead to a phase-out of the AMT exemption. For example, the AMT exemption for married couples filing jointly begins to phase-out at an Alternative Minimum Taxable Income (AMTI) of $150,000. For those facing a phase-out of the AMT exemption, every dollar earned in the phase-out range adds $1.25 of AMTI resulting in a potential AMT capital gains tax rate of 22%. Deferring capital gains to a non-AMT year and capital loss harvesting can help reduce your AMT liability.

Charitable contributions

Charitable contributions provide an easy means for tax planning as the donor controls when and how much is donated. If an individual is expecting a larger than usual tax balance, they can shift charitable contributions into the current year to reduce their taxable income.

Although charitable contributions are allowed for both AMT and regular tax purposes, they may have more value in years when the taxpayer is not subject to AMT. Because the top marginal AMT rate is only 28% versus the top regular tax marginal rate of 35%, taxpayers with charitable contributions may be able to maximize their tax benefit by delaying their contributions to a year when they are not subject to AMT.

Exercise of Incentive Stock Options

When an Incentive Stock Option (ISO) is exercised at a price greater than the option price, taxpayers must add the difference between the stock's fair market value and the option price to their AMTI for that year. Depending on the stock's performance since the grant date, the AMT adjustment could be sizable and require taxpayers to pay AMT in the year of exercise. Below are some planning steps designed to mitigate the AMT impact of an ISO exercise:

1) Planned exercise—Taxpayers can plan to exercise ISOs in years when they expect to receive a large bonus or performance payout. Taxpayers pay the greater of their regular tax or AMT liability, so by exercising an ISO in a year with high regular taxable income, they reduce the chance of paying AMT.

2) Planned sale—If taxpayers own shares from a previous ISO exercise, a sale planned to occur in a year of an ISO exercise could help them avoid paying AMT. This strategy works because the taxpayer's AMT basis in the ISO shares will be higher than their regular tax basis. Thus, the taxpayer's AMT capital gain will be less than their regular tax capital gain leading to a reduction in AMTI. Taxpayers should be careful to wait at least one year after exercise before selling their shares otherwise they will not qualify for statutory treatment.

3) ISO disqualification—If a taxpayer exercises an ISO and realizes near year-end they might fall subject to the AMT, the taxpayer has the option of disqualifying their ISO exercise. This is accomplished by selling the stock within one year of the exercise date or two years of the grant date. The difference between the fair market value and option price on the exercise date is recognized as ordinary income to the extent of their gain on the sale. This strategy works particularly well when the sale of the disqualified shares results in a loss. Taxpayers should plan carefully to ensure the disqualification occurs in the year of exercise otherwise a mismatch of regular tax and AMT income could reduce the benefit of the ISO disqualification.

Following the above planning tips can help keep the tax bite at bay this upcoming spring. For additional assistance, consult your Personal Financial Services advisor to determine whether the AMT will impact you and what steps can be taken to avoid it.

Legislative note—While comprehensive AMT reform is highly unlikely before the end of 2007, Congress will attempt to adjust the AMT exemption for inflation as it has done in prior years in order for taxpayers to receive some AMT relief in 2007. It should be noted that although a new tax bill introduced by Congressman Charles Rangel proposes a repeal of the AMT, the bill will likely undergo substantial revision from its current form and is not expected to impact 2007 tax returns.

Changing trust rules: "unique" costs not subject to 2% limitation

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Internal Revenue Code (IRC) §67(a) indicates that in the case of an individual, miscellaneous itemized deductions for any taxable year shall be allowed only to the extent that the aggregate of such deductions exceeds 2% of Adjusted Gross Income (AGI). Miscellaneous itemized deductions include investment advisory or management fees.

IRC §67(e)(1) states that administrative costs of estates and non-grantor trusts are allowable in determining the AGI of the trust. These costs are not subject to the 2% AGI limitation provided the trust would not incur these costs if the trust vehicle did not exist, or stated differently, if the costs are "unique" to the trust.

Case examples:

In the 1993 case *William J. O'Neill, Jr. Irrevocable Trust v Commissioner*, the U.S. Court of Appeals for the 6th Circuit ruled that investment advisory fees were unique trust costs and thus not subject to the 2% AGI limitation. In the O'Neill case, the trustees were inexperienced in determining the appropriate investments for the trust. The trustees sought the advice of experienced investment advisors in order for the trustees to successfully meet their fiduciary responsibilities as a "prudent investor". The 6th Circuit Court agreed with the taxpayer that the investment advisory fees were unique, stating that such fees were incurred to meet the trustee's fiduciary obligation.

In the 2001 case *Mellon Bank, N.A. v United States*, Mellon Bank amended a previously filed trust return to reflect that investment advisory fees were not subject to the 2% limitation citing the O'Neill ruling. The Court of Federal Claims denied the refund claim, ruling that IRC §67(e)(1) establishes that two requirements be met in order to exclude expenses from the 2% limitation. First, the costs must be attributable to the administration of the estate or trust and, secondly, the costs would not have been incurred if the trust vehicle did not exist. The Court of Federal Claims ruled that since the investment advisory fees would have still been incurred if the assets were held outside the trust vehicle, these fees should be subjected to the 2% limitation just as if an individual had incurred such fees.

The 2002 *J.H. Scott, et al., v United States* also denied a full deduction for investment advisory fees, instead subjecting the fees to the 2% limitation. The Fourth Circuit Court

determined that a trustee in Virginia is not required to seek outside investment advisory help as part of their fiduciary responsibilities; doing so is discretionary. Thus, the Fourth Circuit ruled investment advisory fees were not unique to the trust and only deductible to the extent fees exceeded the 2% AGI limitation.

More recently, the 2nd Circuit U.S. Court of Appeals affirmed the 2% AGI limitation in *Rudkin v Commissioner*. In this case, Mr. Knight, trustee of the Rudkin Testamentary Trust, argued that trusts are different from individuals due to the fact that trusts are subject to fiduciary rules. Thus trusts should be allowed a full deduction for investment advisory expenses. The 2nd Circuit Court provided an even more strict interpretation of IRC §67(e)(1) than the previous two unfavorable Circuit Court decisions. The 2nd Circuit Court ruled that IRC Section 67(e)(1) unambiguously exempts from the two-percent floor of §67(a) only those costs incurred by a trust that could not have been incurred if the property were held by an individual.

The Rudkin case has been appealed and is scheduled to be heard by the Supreme Court Fall 2007. In the meantime, the Internal Revenue Service recently released proposed regulations following the 2nd Circuit Court's decision to only allow an above-the-line deduction for unique trust costs in an effort to establish a consistent treatment of such fees regardless of the taxpayer's jurisdiction.

Since these cases, Proposed Regulation §1.67-4 now notes that a "unique" cost is one that an individual could not have incurred in connection with property not held in an estate or trust. The proposed regulation cites that the key to determining whether a cost is unique is to focus on the type of product or service for which the cost is incurred. Examples of unique costs would be costs attributable to fiduciary accountings, fiduciary tax returns, and beneficiary communications regarding trust matters. Under this approach, investment advisory fees would be subject to the 2% AGI limitation. Additionally, the proposed regulations provide that the taxpayer must separate any lump-sum costs between unique costs and non-unique costs when determining which costs are not subject to the limitation rather than "bundling" the fees together.

A public hearing is scheduled later this month for discussion of the proposed regulations. The regulations are proposed to be effective for payments made after the date final regulations are published in the Federal Register.

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The Charitable Remainder Trust (CRT) can be an effective tool that provides individuals an opportunity to donate to charity while retaining income from annuity payments. There are two main types of CRTs: the Charitable Remainder Annuity Trust (CRAT) and the Charitable Remainder Unitrust (CRUT). The trust type depends on how the distributions to the beneficiaries are measured. In a CRAT, the distributions are fixed annual payments of no less than five percent of the fair market value of all assets initially placed in trust. In the case of a CRUT, the distribution amount must be a fixed percentage of no less than five percent of the fair market value of the trust assets, revalued each year.

Case example:

Spouses Tim and Katherine established a Charitable Remainder Annuity Trust (CRAT) and assigned Philanthropy X, a qualified charitable organization, as the remainder beneficiary. Tim and Katherine transferred property with a fair market value of $1,000,000 to the trust. An amount of $50,000 is paid annually to Tim and Katherine, for their joint lives, and to the survivor of Tim and Katherine for his or her life. When the annuity payments terminate, the remainder interest in the trust is to be transferred to Philanthropy X.

Later, when the couple are set financially for life, Tim and Katherine decide they no longer need the annuity payments and inquire about terminating their CRAT. Doing so would accelerate the benefit to the charitable remainder beneficiary and remove the administrative costs and time associated with the CRT. In addition, the termination may provide them with an extra income tax deduction.

Methods of termination:

There are two methods for early termination of a Charitable Remainder Trust (CRT):

(1) Assignment of the donor's entire annuity interest to the charitable remainder beneficiary

(2) Division of trust assets between the donor/beneficiary based on respective actuarial values

Generally, to complete a termination of a CRT an attorney would need to file a petition in the appropriate court stating the reason for the early termination. Attached to the petition would be consent statements from Tim and Katherine, as current beneficiaries and Philanthropy X, as remainder beneficiary, verifying that the information in the petition is complete and that each party consents to the petition.

If Philanthropy X remains the beneficiary of the CRAT and consents to the early termination, the court generally should not require approval of the Attorney General. In addition, Tim and Katherine should have medical examinations and obtain statements from their physicians regarding their life-expectancies. These statements will confirm that there is no reason to believe their life expectancy is less than the IRS mortality tables. Otherwise they would not be able to rely on the IRS published life expectancy tables.

If method one, as described above, is utilized then the charity would receive the entire balance of the CRT on the date of termination. If method two is chosen, the CRT is broken into two interests. Tim and Katherine would receive the actuarial present value of their annuity for life and the charity would receive the balance.

State law considerations:

State laws on trust administration and termination vary from state to state. Some states may require the Attorney General's consent or other additional requirements.

Federal tax consequences:

Gift Tax

To ensure that the additional gift to the charity is not a taxable gift the transaction needs to be carefully structured to provide for a charitable gift tax deduction.

Restriction specific to CRT and private foundations

The IRS has ruled absent any abuse the transaction described does not violate self-dealing rules. They have ruled the termination does not disqualify the trust from being treated as a CRT. Finally, the IRS has ruled that the Private Foundation Termination Tax does not apply to the termination of a CRT as described above.

Income to donor

If the trust assets are divided between the donor and beneficiary, the transaction is treated as the sale or exchange of a capital asset. The Internal Revenue Service's position is that the entire amount the donor realizes from the distribution is considered either short or long-term capital gain.

Deduction to donor

In general, if the donor foregoes all of their interest in the CRT, the IRS has indicated it will be treated as a transfer of the donor's life annuity interest to the charitable organization, described in Code Section 170(c), and qualifies for an income tax charitable deduction.

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