



Advanced Planning Strategies

Albert E. Gibbons, CLU, ChFC, AEP
President, AEG Financial Services

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Dear Reader,

The President recently unveiled an economic stimulus plan that incorporated several tax-reduction items. Although the Republicans currently hold a majority in Congress, we don't anticipate immediate action and expect the tax proposals to face significant debate and, perhaps, revision before the President receives a final bill for signature. Of course, a worsening economic picture could provide greater stimulus for more expedient legislative action.

The President's proposal includes the following items:

- Accelerate the tax-bracket reductions enacted in 2001. This would lower the current 27, 30, 35, and 38.6 percent brackets to 25, 28, 33, and 35 percent for 2003 and provide for immediate adjustments to withholding.
- Accelerate the marriage penalty provisions to provide current relief to 46 million married couples.
- Increase alternative minimum tax (AMT) exemptions to prevent the lower income tax rates from causing more taxpayers to be affected by the AMT.
- Increase current expensing limits for business asset acquisitions to \$75,000.
- Provide an exemption from income taxes for dividends received from corporations.

The total tax reduction from the President's proposal is estimated at \$674 billion over 10 years. Of course, the plan has met criticism. The primary attacks are the total costs of the package and the dividend exemption and its benefit to high-income taxpayers.

Other proposals or amendments will be offered. An interesting tax simplification plan has been introduced by House Ways and Means Committee Chairman Houghton (HR 22) that contains provisions to ease compliance for individuals and businesses. We'll let you know how this progresses and provide you with a feature article if significant provisions are enacted.

Knowledge is not power. Only knowledge in use is power.

A POWER OF APPOINTMENT ADDS FLEXIBILITY TO THE ESTATE PLAN

For many reasons, an estate owner generally wants maximum flexibility when giving or bequeathing property to the next generation. For example, the uncertainty of future estate tax law may change the merit of a specific intended disposition. Or family circumstances may change and force the modification of the estate owner's current thinking. Fortunately, he or she has the "power of appointment," which has been called "the most efficient device that the ingenuity of estate attorneys has ever worked out," as a planning tool.

The holder (also called the donee) of a power of appointment may have no other interest in the property. His or her sole power may be to direct when, to whom, and in what manner the property (usually trust assets) should be distributed among the class of beneficiaries (also referred to as the appointees) designated by the creator of the power.

In making this dispositive decision for the grantor (donor), the holder of the power will presumably take into account the financial needs of the respective beneficiaries, their spending habits, their education, their marital status, and their major interests in life, such as business, politics, teaching, art, and charitable work.

There are five different kinds of powers of appointment that we will discuss. In making selections among these powers, bear in mind that the federal gift and estate tax laws are of paramount importance.

1. The general power of appointment, in effect, gives the holder of the power the right to direct the distribution of the property to anyone. At a minimum, a general power must give the holder the power to appoint the property to himself or herself, his or her creditors, his or her estate, or the creditors of his or her estate. The exercise of this power is, of course, subject to federal estate or gift taxes, depending on when the power is or may be exercised. For many years, the principal use of the general power was to preserve the federal estate tax marital deduction for transfers to a surviving spouse that are placed in a trust. Current law, however, permits the surviving spouse to be limited to an income interest, provided the so-called qualified terminable interest property (QTIP) trust election is made for the trust when the estate owner dies (or creates the trust for a lifetime QTIP).

Estate planners are often so concerned about qualifying the marital trust under the QTIP rules that they overlook letting the surviving spouse hold a *limited* power of appointment over the trust property. After all, the surviving spouse may live for many years and be in a much better position at a later date to determine the needs of the couple's children and grandchildren.

2. The limited power of appointment typically gives the holder of the power the right to direct the distribution of trust assets among a specific class, such as the children and grandchildren, of the creator of the power. The exercise of a limited power of appointment is expressly excluded from federal gift and estate taxes. In many cases, a decedent leaves a trust providing shares of income to his or her children and then gives each child the power by will to direct how the remainder of that child's trust estate will be distributed among his or her children and their lawful issue. Often, the guidelines for distribution are the "health, education, support, maintenance and best interests" of the current and prospective beneficiaries.

3. The "ascertainable standard" power of appointment gives the power holder the right to make distributions to himself or herself as long as the distributions are "limited by an ascertainable standard relating to the health, education, support and maintenance" of the holder. This limitation insulates the power from being a general power. On the other hand, the provision is very strictly construed, and using incorrect language as a measuring standard (for example, "for the happiness of the power holder") makes the trust assets subject to gift or estate taxes.

4. The "5 and 5" power of appointment permits the trust beneficiary to withdraw from the trust *each year* "the greater of \$5,000 or 5% of the aggregate value of the trust estate" on a noncumulative basis. The 5 and 5 power is often given to a surviving spouse in either a marital or unified credit bypass trust. It also can be given to a child who is otherwise limited to an income interest in a trust. The 5 and 5 power gives an important invasion right to a trust beneficiary by permitting the beneficiary to invade the principal from his or her trust estate without creating significant estate or gift tax problems. The exercise or lapse of this power incurs no gift or estate taxes except for the amount actually available to the holder in the year of his or her death.

5. The "Crummey" withdrawal power of appointment is an extremely important gift tax planning device. Named after the taxpayer in the landmark *Crummey v. Commissioner* case (397 F.2d 82, 9th Cir. 1968), the Crummey power permits a transfer in trust to qualify for the \$11,000 (the current figure as adjusted for inflation) gift tax annual exclusion even if trust benefits are otherwise delayed into the future. The annual exclusion is usually available only for gifts when the donee receives immediate benefits.

The Crummey power normally gives the beneficiary the power to withdraw the lesser of (1) his or her share of the gift to the trust or (2) the maximum amount eligible for the annual gift tax exclusion (currently \$11,000). The power will generally lapse after a short period (for example, 30 days). The grantor of the trust (and the Crummey power) usually expects the beneficiary to let the Crummey power lapse and permit the trust funds to accumulate for the specified future trust purpose.

Most irrevocable life insurance trusts contain Crummey powers to qualify the gift of policy premiums made to the trust for the annual gift tax exclusion. Because irrevocable life insurance trusts also avoid estate taxes, the Crummey power makes these trusts the most powerful estate planning device currently available.

The appropriate power of appointment gives the estate owner and his or her spouse the flexibility to look ahead to their children's future needs and opportunities. An improperly designed or exercised power of appointment, however, can be extremely costly from a federal gift or estate tax standpoint. Needless to say, the estate owner must retain the services of an attorney who is an expert in the estate planning field to select, design, and implement a power of appointment.

RECENT CASES AND RULINGS

TRANSFER TO CHARITY AS A RESULT OF SETTLEMENT AGREEMENT QUALIFIES FOR ESTATE TAX DEDUCTION

A decedent left most of his assets under the terms of a revocable trust. Prior to his death, the decedent amended the terms of the trust agreement to include a transfer of a share of his estate to his church, a qualified charity. Specifically, the trust created one account that would remain in further trust for 21 years after the death of the last beneficiary. The trust had a provision to distribute annually to 14 separate beneficiaries, including the church. The church was also named the remainder beneficiary of the remaining amounts of accumulated income and growth for any share of an individual beneficiary who predeceased the grantor. Prior to the amendment, the original terms of the revocable trust had provided for the trust estate to be divided primarily between two individual beneficiaries.

The family entered into a dispute in probate court challenging the amendment to the revocable trust, alleging that the revision was caused by undue influence. The parties to the case entered into a settlement agreement, and the court approved an order terminating the trust and distributing shares outright to the beneficiaries, including the qualified charity. Ordinarily, a trust that provides for a remainder interest to charity will qualify for the federal estate tax deduction under IRC Section 2055 only if it qualifies as a charitable remainder trust (CRT) meeting the requirements of IRC Section 664. The CRT must provide the individual beneficiaries with an annuity or unitrust interest of at least 5 percent each year followed by a transfer of the remainder interest to the charity. However, authority exists for the allowance of a federal estate tax charitable deduction, provided a transfer at death to the charity results from a bona fide conflict resulting in a settlement agreement. In this instance (Ltr. 200252077), the IRS ruled that the charitable deduction would be allowable.

This letter prepared, with the help of a nationally recognized tax authority, intends to promote interest in more comprehensive tax and estate planning. References are intentionally brief. If a topic interests you, you should investigate it more thoroughly with your qualified tax advisor. Effective tax and estate planning should involve competent advisors in relevant law, accounting, trusts, life insurance and investments. The knowledge and experience of each in their specialties can make the difference between a wealth transfer that works as intended and one that does not. Please seek competent counsel to determine and satisfy your individual needs.

*Positioning our clients
for the future*



Albert E. Gibbons, CLU, ChFC, AEP
AEG FINANCIAL SERVICES
1288 Valley Forge Road, #53
Phoenixville, PA 19460
Tel. (610) 917-8940
Fax. (610) 917-8962
Email. algibbons@algibbons.com
Web: www.algibbons.com