Advanced Planning Strategies

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

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Dear Reader,

The recent tax rush is now behind us (unless you filed Form 4868 to extend your filing deadline to August 15. However, it is remarkable to reflect now on the dramatic changes that the computer and Internet have made to the tax filing process. Returns can still be done by hand, but fill-in forms are available on CD or at www.irs.gov that can be typed on a personal computer. Software is available from several vendors that provide an interview-based process to generate returns. These returns can be filed online to save time. Direct deposit of refund checks is available. Free online filing software is available for some taxpayers through a partnership between the IRS and a group of software companies (Free File Alliance, LLC). The return is started through links on the IRS web site. Approximately 78 million taxpayers are eligible for this free service that is supposed to cut the refund time in half. Despite all the advances, however, the filing process remains complex and painstaking for most taxpayers, and professional assistance will often be both time- and cost-efficient.

The debate over the budget resolution is breaking new procedural ground. Congress will consider a proposal to adopt a budget resolution to provide a $726 billion tax cut in the House, while providing a lower ($350 billion) tax relief level in the Senate. The tax-writing committees of each House would then begin drafting legislation at each level, respectively. The final bill would be worked out in the joint conference committee. We'll be watching this closely.

The $12.3 billion charitable bill (S.476) reported last month will be considered by the Senate. A new provision was added to provide relief to private foundations from the excess business holdings penalty tax. The bill would affect foundations that receive large gifts or bequests of business interests. Up to 10 years will be provided for the foundation to divest itself of such holdings. The charitable bill includes revenue-offset provisions limiting corporate tax shelters. The economic substance doctrine and associated tax penalties will be enhanced and clarified by this provision.

A FORMULA IN YOUR WILL OR LIVING TRUST CAN SAVE YOUR FAMILY OVER $385,000 IN ESTATE TAXES

Federal estate taxes are imposed on an estate when the value of a decedent's estate plus taxable lifetime gifts exceeds $1 million if death occurs in 2003. The $1 million exemption amount will increase on three occasions over the next 6 years (it will be $1.5 million for 2004 and 2005, $2 million between 2006 and 2008, and $3.5 million in 2009). The initial estate tax rate at $1 million is 41 percent, and the maximum marginal rate is 49 percent in 2003 (this rate gradually reduces to 45 percent by 2007). The estate tax is repealed under current law for 2010, but is reinstated with a $1 million exemption in 2011 by a "sunset" provision in the tax law. There is a great deal of debate about the future of the estate tax. Will it be permanently repealed? Will it reamin after 2009? If it remains, what will the exemption amount and the maximum rate be? These questions depend on many budgetary and political factors that are impossible to predict. However, for the immediate future, a significant estate tax faces the estates of high net worth families.

Fortunately, there are tax planning techniques to mitigate this burden. First, as indicated above, everyone is allowed to make $1 million of taxable transfers without tax, due to the unified credit against estate and gift taxes. The credit currently equals $345,800 (the tax burden on a $1 million gift or bequest). Another tax planning opportunity is the federal estate and gift tax marital deduction. Under this provision of the tax law, outright transfers or qualifying trust transfers to a surviving spouse (if the survivor is a citizen of the United States) are fully deductible from a decedent's gross estate for the purposes of determining estate taxes. If everything is left to the surviving spouse in an appropriate form, there will be no federal estate tax liability at the first death.

At the surviving spouse's subsequent death, substantial estate taxes might be due, because no marital deduction is available to the surviving spouse's estate unless he or she remarries and leaves property to the new spouse. Thus, most federal estate tax planning for married couples is concerned with handling the tax due at the surviving spouse's death.

MARITAL DEDUCTION AND UNIFIED CREDIT SHOULD BE COORDINATED

For married couples, each spouse is able to leave $1 million to family heirs without estate taxes. Therefore, the total family estate tax shelter could be as much as $2 million (in 2003 and more thereafter). However, the form of property ownership and the dispositive provisions of a will or living trust may have to be rearranged to receive the maximum estate tax savings. If all property is left to the surviving spouse and the marital deduction is taken, the unified credit of the first spouse to die will be wasted. This will cause unnecessary estate taxes of at least $385,200 (assuming state death taxes are equal to the minimum federal credit amount for state death taxes). In later years with the increasing exemptions, the savings will be greater if the unified credit is used to its maximum. For example, the use of both $2 million exemptions (in 2006) would save $920,000 in taxes. (Note: State death taxes will have some effect on the actual results, and these taxes differ from state to state.)

For optimal marital deduction planning, each spouse should avoid leaving all property to the other spouse in a manner qualifying for the marital deduction. Because the unified credit currently exempts the equivalent of $1 million, each spouse should leave $1 million in a nonmarital deduction transfer. This is normally accomplished through a formula will or living revocable trust. This will require that the couple's estate plan and property ownership arrangements be continually monitored as the amount of the exemption increases throughout this decade.

A-B TRUST SOLUTION

The so-called A-B trust arrangement is a method of dividing marital property at the first death of two spouses. The A-B trusts can be set by formulas included in the couple's wills or can be provided in living trusts with the A-B trust formation occurring at the first death. (In some instances, the couple could place their assets in a joint

living trust.) The purpose of this arrangement is to make optimal use of each spouse's marital deduction and unified credit. The formulas will simply state that the A-B trust shares be created to reduce the estate taxes to zero, if possible, by (1) fully utilizing the unified credit and (2) qualifying the rest of the estate for the marital deduction.

The A trust, the marital share, will be sheltered from tax by the marital deduction. The options for the A trust can provide the surviving spouse with a range of planning possibilities. Some property received by the surviving spouse may not be in trust at all. For example, the surviving spouse may be the designated beneficiary of a qualified retirement plan or IRA. If the spouse will inherit assets in trust, the trust could provide full invasion powers that, in effect, give the surviving spouse nearly outright ownership. Or the marital trust could limit the surviving spouse's interest to life income with a power to appoint the property at his or her death. To further restrict the surviving spouse's access to the marital trust, the A trust could be designed as a "QTIP" trust under special provisions of the tax law. A QTIP trust can limit the surviving spouse to income only from the A trust for life. At the surviving spouse's death, the trust terms (not the surviving spouse) will determine who gets the principal of the QTIP trust. The executor must elect to qualify a QTIP trust for the marital deduction.

The B trust (often called the bypass trust) is the unified credit exemption share. Because the unified credit is a credit against tax, some tax must be created before anything can be sheltered by this credit. The B trust is specifically designed to bypass the marital deduction and create a taxable estate to be sheltered by the credit. The B trust can be used to provide a life income with some limited invasion powers to the surviving spouse. Or the B trust can provide spray powers to take care of the surviving spouse or be directed to other heirs. But the primary benefit of the B trust is that it avoids the surviving spouse's taxable estate and goes to family heirs free of all estate tax.

MARITAL DEDUCTION PLANNING REQUIRES FOLLOW-UP

To set up and effectively implement an A-B trust plan, the couple will have to execute formula wills or living trusts. Each spouse should have $1 million (or as close to this amount as possible) in assets to transfer to the credit share. As the exemption amount increases in several increments between now and 2009, additional corresponding amounts will be needed to fully fund the B trust. It may be necessary to sever jointly titled property and/or make interspousal gifts to ensure that each spouse has the requisite amount of individual property. If the couple chooses to avoid probate through a living trust, the trust will divide into the A-B shares at the first death and provide the tax savings discussed above. To maximize the effectiveness of this device, assets must be retitled to be owned by the trustee of the living trust. However, these steps should be a small price to pay to avoid over $385,000 in death taxes.

SURVIVORSHIP (SECOND-TO-DIE) LIFE INSURANCE PROVIDES UNIQUE BENEFITS

Survivorship life (also known as second-to-die) insurance is a specially designed permanent life insurance policy providing coverage on the lives of two individuals under one policy. The death benefit under such policies is payable upon the second death of the two insured lives. The insureds are generally spouses who desire coverage to preserve (or enhance) their collective wealth for their heirs.

If the couple chooses to design their estate with an A-B trust arrangement, as discussed above, the survivorship policy provides a perfect fit. The death benefit is paid at the second death of the married couple when all of the federal estate tax will be due. What's more, the policy will be a cost-effective way to replace the estate taxes and preserve wealth for the next generation. The overall premiums paid for the policy are far less than the aggregate premiums payable on individual policies of the same death benefit covering two individuals. The premium for a survivorship policy will depend on the age and health of each insured spouse at the time of application and will often continue to be payable after the death of the first insured.

DEALING WITH AN UNCERTAIN TAX FUTURE

The A-B formula will or living trust remains a powerful technique for reducing estate taxes. The tax savings will grow for large family estates as the exemption increases during this decade. But what about the potential repeal of the estate tax? Suppose the repeal doesn't occur as scheduled or is made a permanent fixture of the tax laws. The key is to create a plan that will take maximum advantage of the current tax laws but also has the flexibility to adapt to changing circumstances. Important considerations for this type of planning include the following:

- Wills are always revocable as long as the testator has the legal capacity to revoke a will and draft a replacement. After an individual has lost testamentary capacity, the family cannot change the will.

- Effective durable powers of attorney are critical for flexible planning. Even after an estate owner has lost the capacity to act, the attorney-in-fact can make changes to some estate plan components. For example, gifts can be made to family members from the principal's property or property can be retitled as necessary to adjust it as required to fund the A-B trusts appropriately.

- Living trusts should become even more important. A living trust can be made revocable at all times until the grantor dies. Even if the grantor has lost the capacity to act, a successor trustee or attorney-in-fact can revoke the trust. The attorney-in-fact could also add more property to the trust if that is appropriate.

- Irrevocable trusts should be made more flexible. A trust could contain language to provide escape hatches for the family to terminate or amend the trust. For example, the trust could be revoked upon a subsequent change to the tax law. The trustee could be given the discretionary power to terminate the trust and distribute the property to the family. If the irrevocable trust is created for estate-tax-planning purposes, the grantor should not control the door to the escape hatch. An independent trustee or "trust protector" should be used.

- Continual monitoring of the plan by the family's advisers is essential. The increasing exemption will create a need to have a larger share of individually titled property for the purposes of funding the B trust. The terminology of the A and B trusts will need review. As the B share grows, the A share diminishes. The surviving spouse may become disgruntled unless significant access is provided to the funds in the nonmarital B trust.

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