



Advanced Planning Strategies

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Dear Reader,

The tax filing season will soon be gearing up for the April 15 deadline. For those who are overwhelmed with the deadline, Form 4868 will delay the filing requirement until August 16, but it is still necessary to pay an estimated tax by April 15 for the 2003 tax liability. The extension form can be mailed, phoned in, or e-filed. An additional extension can be requested for valid reasons but is not automatic. Interest must be paid if the actual tax liability is underpaid with Form 4868.

You should have received your 1099s by now. Among the important changes affecting the 2003 taxes is the reduced tax rate for “qualified dividend income” that imposes either a 5 or 15 percent rate. The IRS issued Notice 2003-79 on November 26 last year to provide guidance to financial institutions for reporting dividend income. The IRS refused to provide an extension to February 28 for issuing the 1099-DIVs. We presume that some later corrected 1099s will cause dividend recipients to file amended Form 1040s. Taxpayers with significant dividend income might consider filing for an extension if the 1099-DIVs don't appear correct.

The IRS has provided a checklist with common errors for return filing, including

- ? unclear printing of names and addresses
- ? incorrect Social Security numbers
- ? checking more than one filing status
- ? incorrect number of dependents
- ? failure to enter income, deductions, and credits on correct lines
- ? failure to put parentheses around negative numbers
- ? failure to use correct tax tables for filing status
- ? withholding and estimated taxes filed on wrong lines
- ? math errors
- ? failure to sign return (including spouse's signature on joint returns)
- ? failure to enclose check (or failure to provide Social Security number, tax form number, and tax year on the check enclosed)

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

CREATING A FLEXIBLE IRREVOCABLE TRUST

Irrevocable trusts are extremely useful devices for tax planning purposes. However, the nontax benefits of a trust will dictate the use of a trust in many circumstances, regardless of the tax laws that happen to be in effect at the time. For example, trusts are employed to avoid probate, protect spendthrift or incompetent beneficiaries, take advantage of professional asset management, and protect assets from creditors.

PROBLEMS OF THE IRREVOCABLE TRUST

For estate, gift, and/or income tax reasons, trusts often need to be irrevocable to be effective. What's more, many irrevocable trusts are designed to last for at least one generation, and perhaps longer in some instances. One important concern for the trust's grantor or its beneficiaries is the flexibility of the trust to adapt to changing circumstances. What if the distributions provided to a beneficiary under the terms of the trust become insufficient for the beneficiary's needs? Or, perhaps the trustee may need to be changed. The ever-changing tax laws may also dictate the need for a change. For example, the federal estate and generation-skipping transfer taxes are currently scheduled for repeal in 2010, only to return in 2011.

OPPORTUNITIES FOR REVISING OR REVOKING A TRUST

Even an irrevocable trust can be altered or revoked under certain circumstances. Of course, the advisers of the grantor and beneficiaries should determine the tax and legal consequences before attempting to change an irrevocable trust.

Modification power in trust provisions Quite often, a trustee can be given powers of modify or revoke the trust. For example, the trustee could be given the power to change trust terminology to meet with changes in the tax law. The trustee could be given the power to terminate the trust and distribute principal to specific beneficiaries if the circumstances dictate that the trust is no longer useful. Of course, the trustee and the modification terminology should be carefully selected. A trustee could become liable to beneficiaries or suffer adverse tax consequences as a result of ill-advised exercise of modification powers.

Provisions to replace a trustee or change the legal and tax situs of a trust are often included in the trust provisions. Thus, a trustee who is no longer meeting specific standards or is located too far away from the current beneficiaries of the trust can be replaced.

Trust protector One technique that has recently gained popularity is to appoint a trust protector in the trust provisions. The trust protector could terminate or modify an irrevocable trust under specified circumstances.

Powers of appointment. The many advantages of powers of appointment have been discussed in previous letters. A power of appointment is granted to an individual (known as the donee of the power) by the grantor of the trust. The donee has the ability to appoint the principal of the trust to "appointees" as provided under the terms of the power of appointment. The power of appointment will give the donee the ability to distribute some or all of the trust's principal to family members (even back to the grantor of the trust) if the trust is no longer serving a useful purpose. For estate or gift tax purposes, the donee is generally given a limited power of appointment when this provision is incorporated to add flexibility to an irrevocable trust.

Court action If the requisite flexibility is not provided in the terminology of the trust, the grantor and/or trust beneficiaries might consider requesting a construction or reformation of the trust in court. A construction action could be taken to clarify ambiguous provisions in the trust. A reformation action might be taken to modify or terminate a trust that was clearly drafted but is no longer in the best interests of the beneficiaries. For example, courts regularly permit reformations to trusts that are not correctly drafted to comply with specific tax-driven goals for the trust. Obviously, court action is generally considered

to be a last resort; courts might be very reluctant to permit a reformation simply to change distributions to current beneficiaries.

TOTAL-RETURN TRUSTS

One problem that often exists for a trust is the traditional concepts of income and remainder beneficiaries. Trusts are often designed to provide all income to the current beneficiaries and to have principal accumulate for remainder beneficiaries. For tax reasons, this distinction is often automatically contained in typical irrevocable trusts. For example, marital deduction trusts must, at the very least, provide all income to a surviving spouse for the remainder of his or her lifetime. For some trusts designed to provide for the surviving spouse, such as a unified credit shelter trust or a life insurance trust, the surviving spouse must be limited to income to avoid estate tax problems for a surviving spouse.

The difficulty that has arisen over time results from the definition of income for trusts contained in state law and the federal tax code. Trust income is traditionally defined as income, dividends, rents, and royalties with capital gain (both realized and unrealized) on trust assets being allocated to trust principal. In the current investment climate, income is generally inadequate for support needs of trust beneficiaries due to low dividend and interest rates. If the trustee invests to maximum current income, the investment policy will generally yield poor capital appreciation. Thus, the changing investment climate has created a need for more flexibility for trust investment and distribution provisions.

Many states have adopted some form of the Uniform Prudent Investor Act. The provisions of this act permit a trustee to invest for total return. This would provide for a balance between income and capital appreciation returns. State laws have begun to modify the provisions with respect to distributions to the trust's income beneficiaries. For example, a majority of state laws permit the trustee to use reasonable discretion with respect to allocating some portion of the trust's annual capital gain or unrealized appreciation to income beneficiaries. To make the adjustment to define income in this manner, the trustee should be treating beneficiaries impartially. Another possibility is to create a "total-return unitrust." In this vehicle, the current beneficiary is provided with a percentage (e.g., 4 percent) of the annual value of the trust's principal. A minority of states permit conversion of a traditional income trust to a unitrust. Under either of these new income provisions, a trustee can invest under normal concepts for total return and still provide adequate distributions to the current income beneficiaries.

Please be aware that the provisions of state laws will vary significantly with respect to the ability to provide such flexibility in a trust. However, it is possible to "forum shop" because a trust can certainly be created and administered in a state with favorable laws.

NEW IRS REGULATIONS FOR TRUST INCOME

One problem with the new concepts of income distributions in a total-return trust is the large body of tax laws that define income in the traditional sense. The tax law definition of income was designed, in many instances, to prevent abuses that might occur under different definitions of income. Early this year, the IRS and the Treasury released final regulations that modify rules with respect to the definition of income for trust income tax purposes (Treas. Reg. Secs. 1.643(a)-3 and 1.643(b)(1)). In addition, changes have been made to the charitable remainder trust and the estate and gift marital deduction regulations (Treas. Reg. Secs. 1.664-3, 20.2056(b)-5 & 7, 20.2056A-5, and 25.2523(e)-1). Generally, proposed regulations permit the definition of income for tax law purposes to include the modern definitions, if permitted by the trust and the state law governing the trust. The regulations do not permit unlimited flexibility. The power to adjust must be applied reasonably and consistently to provide a reasonable apportionment between the income and remainder beneficiaries to treat all beneficiaries impartially. The unitrust percentage appears to be limited to a range of 3 to 5 percent. The regulations are effective for tax years ending after January 2, 2004.

RECENT CASES AND RULINGS

IRS PROVIDES EXCEPTIONS TO 60-DAY REQUIREMENT FOR IRA ROLLOVERS

Rollovers from one IRA to another are subject to withholding tax unless they meet a 60-day time requirement. Tax laws give the IRS the authority to waive the 60-day requirement for hardship reasons. Rev. Proc. 2003-16 (2003-4 IRB 359) indicated that the IRS would consider the following in granting such waivers: (1) errors committed by a financial institution, (2) inability to complete a rollover due to death, disability, hospitalization, incarceration, restrictions imposed by a foreign country or postal error, (3) the use of the amount distributed (e.g., if the check was cashed), and (4) time elapsed since the distribution occurred.

The IRS recently issued a series of private rulings providing waivers of the 60-day rollover requirement for the following reasons:

- ? The taxpayer requested funds to purchase a home from his brokerage account, but the financial institution made a distribution from an IRA instead (Ltr. 200401020).
- ? The taxpayer took the distribution from the IRA to a second financial institution, which opened a nonretirement account with the funds contrary to the taxpayer's instructions (Ltr. 200401023).
- ? The taxpayer withdrew funds from an IRA, intending a rollover to a Roth IRA. The taxpayer also provided non-IRA funds to the financial institution, which failed to separate the funds and deposited all funds in a non-IRA account (Ltr. 200403099).
- ? The taxpayer was the surviving spouse and received the decedent's IRA through the provisions of a joint revocable trust. The surviving spouse had back surgery and was hospitalized for 21 days. Mistakenly believing that the IRA distributions had to commence immediately, the surviving spouse withdrew all funds from the IRA. The survivor's attorney realized the mistake and attempted a spousal rollover of the funds 5 months later. The IRS waived the 60-day requirement due to the confusion created by the taxpayer's health problems (Ltr. 200402029).
- ? The taxpayer suffering from Alzheimer's disease requested IRA funds to purchase a residence. The taxpayer's daughter got a medical evaluation demonstrating the taxpayer's lack of capacity to make the decision. The IRS permitted the untimely rollover at the daughter's request (Ltr. 200401025).

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*



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