



Advanced Planning Strategies

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Dear Reader,

President Bush signed the “Pension Funding Equity Act of 2004 (H.R. 3108) into law last month. The bill allows some employers to adopt a different interest for projecting contributions to defined-benefit plans. The bill replaces the 30-year Treasury bond interest rate with a composite corporate rate for calculating funding qualified defined-benefit retirement plans. It also provides relief for deficit-reduction contributions to certain employers. The higher rate will result in reduced funding requirements. The IRS responded immediately with IRS Notices 2004-34 and 38 to help affected employers comply with the changes. The rate for January 2004 will be 6.55 percent, as opposed to 5.51 percent under the prior rules. The interest rate changes apply for pension plan years beginning in 2004 and 2005. The deficit-reduction relief applies to commercial passenger airlines and steel manufacturers and would apply to plan years beginning after December 27, 2003, and before December 28, 2005.

It appears that the real impact of taxes has, in fact, been reduced by the tax relief provisions enacted in the last 3 years. The Tax Foundation reported recently that “Tax Freedom Day[®]” occurred on April 11, 2004, the earliest such day since 1967. This day is the time the average American will have paid off all federal, state, and local taxes for the year. To put this in perspective, the day was not reached until May 2 in 2000. There are, of course, variations from state to state. For example, Tax Freedom Day[®] arrived on March 26 in Alaska but not until April 28 in Connecticut.

The November elections promise to have taxes as a major campaign issue. President Bush has consistently fought for making all recent tax relief provisions permanent. (As we’ve reported, the lion’s share of recent tax cuts expires after a term varying between the end of 2004 and 2010. For example, the child-care tax credit expires at the end of this year.) The President points to a strengthening economy as a justification for continuing tax relief. Senator Kerry has begun to provide the details of his tax agenda and would provide more relief to middle-income Americans through relief for tuition and health care. We’ll keep you up-to-date as more proposals are clarified.

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

CHARITABLE REMAINDER TRUSTS "GIVE YOUR CAKE AND EAT IT TOO"

WHAT IS A CHARITABLE REMAINDER TRUST?

A charitable remainder trust (hereinafter referred to as a CRT) is an irrevocable trust created and funded by a donor. The CRT provides current benefits to a noncharitable beneficiary, generally the donor or a member of the donor's family. The noncharitable beneficiary's interest will continue for a specified term of years (limited to a maximum of 20 years) or for the life of the beneficiary. If the donor selects more than one noncharitable beneficiary, the noncharitable term can last two or more lifetimes (subject to the limitations discussed below). At the termination of the trust, the remainder of the trust principal is paid to the charity.

TAX REQUIREMENTS OF CRTs

The donor receives current income and gift tax deductions for donations to a CRT even though the charity will not receive its interest until later, perhaps many years later. For the donor to qualify for the deduction, the CRT must meet strict rules in the income tax laws. Primarily, these rules limit the type of noncharitable interest the CRT may provide. Nonqualifying trusts will lose the current income and gift tax deductions. Specifically, a CRT may provide either an "annuity trust" or a "unitrust interest" as follows:

- A *charitable remainder annuity trust* (CRAT) provides the noncharitable beneficiary with an annual annuity payment that is fixed in amount (a sum-certain annuity) but not less than 5 percent or greater than 50 percent of the initial fair market value of the trust principal. No additional donations are permitted after the CRAT is funded.
- A *charitable remainder unitrust* (CRUT) provides the noncharitable beneficiary with a fixed percentage (again, not less than 5 percent or greater than 50 percent) of the annual value of the trust principal (a variable annuity). Because the payout from the CRUT varies with the size of the principal, additional donations are permitted in later years.

In addition, in either type of CRT, the value of the charity's interest (determined by actuarial calculation) must be at least 10 percent of the value of the property contributed to the CRT.

Because the CRUT permits additions and varying payout rates, it is generally more flexible than the CRAT. The CRUT's flexibility should not be overlooked. One stumbling block with CRTs is that the annual payout must be made. This means that the CRT principal might have to be sold if trust income is insufficient to make the required annual payments to the beneficiary. If the unitrust approach is adopted rather than fixed-amount annuity payments, it is permissible to limit the payout to actual income if that income is less than the required unitrust payment for the year. These deficiencies can be "made up" in future years when income exceeds the required payment.

TAX ADVANTAGES OF CRTs

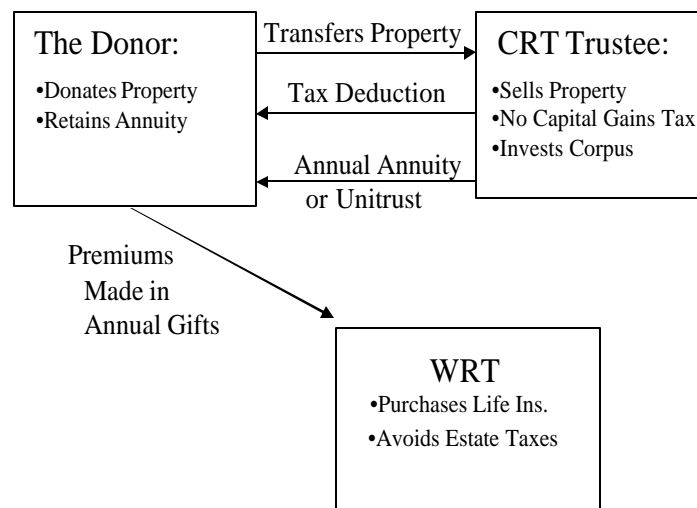
Through a CRT, charitable contributions can significantly reduce a donor's income and estate tax liability without completely divesting the donor, or perhaps the donor's family members, of the current benefit of the donated property. In addition, if appreciated property is donated to the CRT, the donor can avoid the realized capital gain on the contributed property because the CRT is a tax-exempt trust. Thus, a donor can avoid capital gains taxation of highly appreciated real estate or marketable securities donated to a CRT. It is important to note that if the sale of the appreciated asset is prearranged by the donor and the trustee, however, adverse tax consequences will result.

WHO CAN BE THE TRUSTEE?

The donor, a member of the donor's family, or a friendly adviser can be the trustee. However, in certain instances, an independent trustee should be used to avoid adverse tax consequences. An independent trustee should be used if the trustee will have discretion to distribute benefits among several noncharitable beneficiaries, or if the CRT will hold hard-to-value assets, such as closely held stock or real estate.

WEALTH REPLACEMENT TRUST (WRT)

The CRT works particularly advantageously with an irrevocable life insurance trust (a "wealth replacement trust"). Here's how: The CRT gives the donor an opportunity to (1) receive an immediate income tax deduction equal to the present value of the remainder interest, (2) avoid built-in capital gains tax on appreciated property contributed to the CRT, (3) receive annual income (in the form of annuity or unitrust) from the trust, and (4) reduce his or her estate taxes since the appreciated property is deductible from the donor's estate tax base. The irrevocable life insurance trust is funded with life insurance paid for, at least in part, by a combination of the tax benefits provided by the charitable donations.



AN EXAMPLE OF HOW A CRT WORKS

Daniel Donor, aged 62, and his wife Debbie, aged 60, are forecast to be in the highest percent federal estate tax bracket (48 percent in 2004) and, naturally, are concerned about the costs of settling their estates. Of course, they want to retain the maximum family wealth to pass on to their children. They also feel strongly about the charitable needs of a local hospital, but they don't consider themselves wealthy enough to forgo significant wealth currently; nor do they want to divest their children of family wealth. Daniel and Debbie have a large parcel of undeveloped real estate and are worried about the fluctuations in market value. They purchased the property 20 years ago for \$100,000; its current market value is \$1 million. They are also worried about the built-in capital gain should they choose to sell the unproductive land and convert it to an income-producing investment.

Suppose Daniel and Debbie contribute the land to a CRT with the remainder payable to the hospital and retain

a unitrust interest of 7 percent for their joint lives. The trustee sells the real estate and invests the proceeds. Daniel and Debbie also create a wealth replacement trust to purchase a \$1 million survivorship life insurance policy. The benefits of this transaction are as follows:

- Daniel and Debbie save at least \$135,000 (15 percent of the \$900,000 gain) of capital gains tax at the current 15 percent capital gain rate.
- The CRUT creates a current income tax deduction of \$195,310 for the value of the remainder interest given to charity (the size of the deduction is based on the actuarial value of the remainder interest provided to charity). Daniel and Debbie will have an annual limit for this deduction equal to 30 percent of their contribution base (generally the adjusted gross income), but they can carry any unused deductions forward 5 tax years. This tax deduction increases their cash flow by \$68,359 if they are in the 35 percent income tax bracket and can use the entire deduction this year.
- The annual policy premium for the \$1 million survivorship life insurance policy will depend on Daniel and Debbie's health and policy performance, but the total outlay for premiums may be significantly less than the total tax savings. The total cost versus total tax savings cannot be determined until the time of their second death when the amount of premiums paid and the value of the estate tax deduction at that time are known with certainty.
- Daniel and Debbie retain a valuable source of retirement income from the CRT that continues until their second death. For example, the initial unitrust payment to the Donors is \$70,000.
- An estate tax charitable deduction is available when the remainder interest is paid to the museum.
- Their children receive \$1 million from the life insurance trust free of estate taxes. This benefit replaces the wealth donated to charity.
- The hospital receives the remaining principal at the death of the survivor of Daniel and Debbie.

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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