



# Advanced Planning Strategies

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Dear Reader,

The Budget process for the federal government has moved along slowly, but expect some major developments in the near future. There is some indication that a large piece of legislation will be introduced to include both Social Security and tax reform. However, the process is not going to move forward seamlessly. Only about \$70 billion of tax cuts can be approved in the Senate without filibuster unless the tax cuts are offset by some combination of tax increases and/or spending decreases.

The process normally involves separate bills in the House and Senate that will each face numerous attempts at amendments or alternatives. There are simply too many agendas for any initial attempts to reach a necessary consensus. The President will receive recommendations from a special tax reform advisory panel and has been operating with only the direction to maintain the charitable deduction and the home mortgage interest deduction.

At this point, it is difficult to anticipate significant new tax relief. There are a number of provisions that would expire during the President's second term. First, the state and local sales tax deduction is set to expire. The special lower long-term capital gain and dividend tax rate will expire after 2008. Charles Rangel has weighed in with a request to maintain the state and local income tax deductions. There will be an attempt to create a new form of tax in addition to the current system (e.g., a value-added tax or consumption tax). But it is difficult to foresee scrapping the traditional income tax system completely for a new alternative system.

With respect to Social Security reform, this will be a tough political battle, even though many would agree that changes need to be made. The private account suggestion has largely proved unpopular in the polls. The other options include (1) increasing the wage base, (2) raising the full retirement age, (3) indexing benefits to reduce the replacement ratio for higher earners, (4) altering the method for determining COLAs, and (5) raising the payroll tax rate. Each of these choices will draw criticism, particularly when the details are explained to participants in the program who will be adversely affected. With such an important issue on the agenda, we promise to provide you with detailed descriptions of any legislation that is introduced.

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

## **TAKING ADVANTAGE OF THE UNIFIED (APPLICABLE) CREDIT AVAILABLE TO YOUR ESTATE**

All individuals who are citizens or residents of the United States at the time of their deaths are subject to the federal estate tax. However, each decedent is permitted to transfer an "exemption amount" free from federal estate taxes due to the applicable credit. This exemption amount shelters \$1.5 million from tax for deaths in 2005, and the amount increases to \$2 million for deaths in 2006 through 2008. Taking maximum advantage of this credit would result in nearly \$700,000 of estate tax savings for a married couple with \$3 million for a death occurring in 2005 and over \$900,000 of savings for a couple with \$4 million for a death occurring in 2006.

### **COORDINATING THE MARITAL DEDUCTION AND UNIFIED CREDIT**

Congress provided a complete estate tax exemption for property transferred during life and at death to the transferor's spouse through an estate or gift tax marital deduction. However, the property is included in the transferee-spouse's estate and subject to applicable estate taxes at that time. At the first death, the deceased spouse will waste the unified credit if all property is transferred to the surviving spouse under the protection of the marital deduction. This enhances the second estate and the tax savings discussed in the previous paragraph will be wasted.

To provide for optimal tax planning, it is essential that the first spouse to die leaves as much as possible up to the exemption amount (\$1.5 million for deaths in 2005) in a manner that fails to qualify for the estate tax marital deduction. Here are some transfer choices that would permit the use of the unified credit:

- Bypass the surviving spouse entirely and leave the exemption amount up to \$1.5 million to other heirs.
- Create a trust that benefits the surviving spouse and other heirs as determined by the trustee.
- Create a trust that provides income only to the surviving spouse while he or she is alive, with the remainder passing to heirs selected by the transferor.
- Create a trust that provides the surviving spouse with all income and as much principal as necessary for the support, education, and maintenance of the surviving spouse while he or she is alive, with the remainder passing to heirs selected by the transferor.

### **FLEXIBILITY IS ESSENTIAL**

The federal estate tax is currently slated for repeal in 2010, followed by a return of the tax in 2011. Most practitioners feel that there will be additional amendments before that time. The repeal could be accelerated, or a compromise tax bill could make a substantial exemption amount (perhaps \$5 million or more) permanent with a reduced maximum estate tax rate. In any event, a plan should be put in place to take advantage of any current or future exemption amount with the ability to adapt to any tax changes as they are enacted.

More important, flexibility is critical to meet the family's needs since trust planning could be implemented to last for the surviving spouse's lifetime and maybe much longer in the case of generation-skipping trusts. We need to ensure that the support needs will be met over the intended time horizon.

### **JOINT-REVOCABLE TRUSTS**

One technique that is well suited for the optimal marital unified credit plan for a married couple is the joint-revocable trust. Unless one spouse's death is imminent, the order of deaths is speculative and the optimal plan ensures that each spouse has the necessary funds at death to transfer an exemption amount (or as close as possible) in a manner that uses

the unified tax credit. The joint-revocable trust is created by the married couple and funded with an amount at least equal to the exemption available under the credit. Each spouse retains the right to revoke his or her transfers to the trust. This prevents a completed gift at the time the trust is funded and preserves the ultimate flexibility to unwind the transaction if the couple's situation or the tax law changes. The couple is able to take the income or principal from the trust as necessary as long as both spouses are alive.

At the time of the first death, the decedent is given a "general power of appointment" over the entire trust. This is a technical provision that results in the inclusion of the entire trust fund in the gross estate of the first-to-die. Thus, the entire amount of the contributions made by both spouses can be used to take advantage of the exemption at the first death. The trust then becomes irrevocable and is distributed by its terms to create a unified credit trust funded with the exemption amount and a marital share for any excess in the trust. Of course, the unified credit trust could be drafted to permit the maximum access to the surviving spouse as described in the choices above. The unified credit trust will not be taxable at the second death, thus preserving the maximum tax savings. In addition, it might be prudent to include a trust protector or discretionary distribution powers to alter or terminate the trust if the circumstances indicate. The tax treatment, as described above, of the joint-revocable trust or similar arrangements has been approved by the IRS in private rulings (see, e.g., Ltrs. 200210051 and 200403094).

## **STRATEGIES FOR THE UNIFIED CREDIT TRUST**

The unified credit trust bypasses estate taxes in both estates for a married couple. The normal strategy is to provide a significant growth element to this trust. Discretionary gifts or expenditures by the surviving spouse should be made from the survivor's funds or the marital share left to the survivor by the first-to-die because these assets will be subject to estate taxes at the second death. For this reason, it is generally recommended that qualified retirement plans or IRAs not be used to fund the unified credit trust except as a last resort. These assets are subject to income tax and must be withdrawn under required distribution rules (discussed in our March letter) over the surviving spouse's life expectancy. Thus, these assets would cause shrinkage in the unified credit trust at the marginal tax rate applicable to the distributions.

One option is to use the funds of the unified credit trust in a manner that would minimize distributions and provide for growth. Of course, this strategy is recommended only if the surviving spouse or other beneficiaries won't need the current distributions. If the trust terms don't permit accumulation of income (as defined by the state's principal and income act), the trust could be structured to avoid unnecessary accounting income. Investment advisors should be consulted for strategies to minimize accounting income and provide growth, and the trust terms and state law must permit the investment choices made by the trustee. If the survivor has a substantial estate and associated tax problems, life insurance could be purchased on the surviving spouse's life in the unified credit trust, using some or all of the funds. Life insurance provides no accounting income as the cash surrender value accumulates in the policy, and it provides for growth as a result of the death benefit. Only when the proceeds are received and reinvested after the insured-surviving spouse's death does accounting income begin to accrue. In addition, there are estate and gift tax advantages to this choice. First, the life insurance proceeds avoid inclusion in the surviving spouse's gross estate and pass to the heirs free of any estate tax. Of course, the surviving spouse should not be the trustee (a resignation is always possible) when the insurance is purchased, or the trust should be designed with an independent co-trustee to hold the incidents of ownership on the life insurance policy on the life of the surviving spouse. Second, there are no gift tax consequences.

## RECENT CASES AND RULINGS

### FAMILY LIMITED PARTNERSHIP (FLP) INCLUDED IN GROSS ESTATE

Unfortunately, another family limited partnership case resulted in inclusion in the gross estate of the partnership's primary founder as a result of Code Sec. 2036. In *Estate of Bigelow v. Commissioner* (TC Memo 2005-65), the decedent died at the age of 88 owning an interest in an FLP with her two children. She owned a piece of real estate that she had begun giving two of her children in small parcels under the gift tax annual exclusion, transferring the remainder to her revocable trust. After she entered an assisted-living facility, her children and her trust exchanged the property for a different property and secured some credit using the second property as collateral and providing personal guarantees for the loan. Her revocable trust and her children then formed an FLP and transferred the second property to the FLP as capital. Under power of attorney, her attorney-in-fact made withdrawal of partnership units from the trust and made gifts to her children and grandchildren.

The court held that the FLP and the property are includible in her gross estate under Sec. 2036(a)(1) at date-of-death value, essentially eliminating any gift or estate tax benefits of the FLP. What went wrong? The court carefully analyzed the situation and determined that there was an implied agreement that the decedent would retain the rental income earned by the FLP. The court looked at the decedent's living expenses and income outside of the FLP, which included long-term care policy benefits, and concluded that the decedent had insufficient income to pay her care expenses and repayment of the loans. The transaction impoverished the decedent; without the distributions from the FLP, she would have been unable to pay her required monthly expenses. Distributions were made to her from the FLP to provide the funds for the expenses, but no distributions were made to any other partner while she was alive. In addition, the court found that the FLP formalities were not followed to the extent that capital accounts were not properly maintained. The taxpayer also failed to establish any viable nontax purpose for the FLP. As we have indicated before, the FLP cases won by the IRS have had one or more of these deficiencies in the formation and administration of the FLP.

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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