



# Advanced Planning Strategies

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Dear Reader,

The debate over tax amendments has begun with the release of the Bush administration's budget for fiscal year 2007. The proposed tax changes begin with the permanent extension of the tax cuts passed in the 2001 and 2003 acts. These provisions contained expiration dates for the tax cuts, the furthest expiration date being December 31, 2010. This extension would result in an estimated \$1.41 trillion revenue loss to the Treasury. New proposals in the budget include

- creating Retirement Savings Accounts (RSAs) to replace the three types of IRAs. Contributions of \$5,000 annually would be permitted without income limitations.
- creating Lifetime Savings Accounts (LSAs) to permit \$5,000 annual contributions, regardless of earned income, to save for any purpose
- creating Employer Retirement Savings Accounts (ERSAs) to supplant 401(k), 403(b), 457(b), SIMPLE, SARSEP and other employee deferral plans. Contributions of up to \$15,000 annually would be permitted with an additional \$5,000 permitted for employees aged 50 or older. For 2006, the maximum contribution, including the employer's share, would be the lesser of 100 percent of compensation or \$44,000.
- increasing the Section 179 current expensing limits to \$200,000 annually for many businesses
- permitting tax-free withdrawals after age 65 from IRAs for direct contributions to qualified charities

Of course, Congress has the ultimate responsibility for composing legislation and this work has begun. The House has come up with a tax reconciliation bill (H.R. 4297). The Senate has named conferees and the bill progresses to the Joint Committee for inevitable compromises. We'll let you know as soon as tax legislation passes.

The Deficit Reduction Act of 2005 was signed by the President, and the changes to the Medicaid qualification rules we discussed in a prior letter were enacted. These changes will make it much more difficult to qualify for public funds to pay for the costs of long-term care.

*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 laws 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 from 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, the surviving spouses of such children or their other heirs.

**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 \$12,000 (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 \$12,000). 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

### ANNUITY TABLES NOT NECESSARILY CONTROLLING FOR ESTATE TAX VALUE OF LOTTERY ANNUITY

Decedent passed away after receiving 10 out of 20 annual payments of \$209,000 from a state lottery. The executor argued that the payments could be valued with a discount for lack of marketability and reached a value of \$800,000. The IRS took the position that the Sec. 7520 annuity tables were controlling (table value \$1,607,164) and denied the estate's refund request for over \$506,000.

The court noted that the Sec. 7520 methodology takes into consideration only the factors of time and interest rate and ignores marketability issues. The opinion added, "A hypothetical buyer would naturally be willing to pay less for a nonmarketable annuity than he or she would be willing to pay for a marketable one . . . [The IRS's method] seems, mistakenly, to equate the 'present value' of a nonmarketable asset with its 'fair market value,' something that, at least at this juncture, this court is unwilling to do." The court denied both parties' motions and sent the case back to a full jury trial to determine the valuation issue. *Davis v. United States*, 97 AFTR 2d 2006-332, 12/19/2005.

Note that there have been several lottery cases decided with different holdings and the marketability issue will depend on the rules of the state's lottery and the ability to transfer the annuity. No decision has yet considered the evidentiary implications of the price available from various companies who purchase lottery annuities.

### IRS DEFERS IMPLEMENTATION OF SPOUSAL WAIVER FOR CHARITABLE REMAINDER TRUSTS

The IRS issued a Revenue Procedure in 2005 (2005-24, 2005-16 IRB. 909) that caused some concern for taxpayers and their advisors with respect to charitable remainder trusts (CRTs). The 2005 Procedure indicates that the nondonor-spouse's right of election against the will of the donor-spouse who creates a CRT could disqualify the CRT for tax purposes. The right of election and its impact on a CRT depends on state probate law. The IRS indicated that all CRTs formed before June 28, 2005, would not be disqualified if the right of election was not exercised. However, new CRTs would require a formal waiver of such rights when the CRT is formed or, if later, when the donor marries or becomes subject to a state law that would make the CRT subject to a right of election. Practitioners sent comments to the IRS indicating that the waiver requirement would be a difficult burden because subsequent marriages and migratory clients would make compliance highly impractical. In a new IRS Notice (2006-15, IRB, 2/3/2006), the imposition of the waiver requirement was delayed until further guidance is issued.

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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