



Advanced Planning Strategies

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October 2006

Dear Reader,

It is likely that some additional tax legislation will be considered and quite possibly pass before the end of the year. Certainly, expired or expiring provisions will be considered, such as the deduction for state and local sales taxes. In addition, there will be further attempts to make the tax cuts from the 2001 and 2003 legislations permanent. These cuts will otherwise “sunset” by the end of 2010 at the latest. It is likely that the extenders bill will be linked with the permanent tax cuts for political reasons. With an upcoming election in November, Congressional time will be limited, and predicting tax legislation in the midst of such political attention is difficult.

The IRS has granted additional flexibility to armed forces personnel serving in combat zones. The Heroes Earned Retirement Opportunities (HERO) Act passed earlier this year permits IRA contributions with tax-free combat pay. The IRS published a news release explaining the deadlines for contributions for years 2004 and 2005. Eligible participants will have until May 28, 2009, to make contributions.

Because taxes are never a pleasant experience, it may interesting to review the average deductions taken by taxpayers who itemize such deductions on their returns. The table below gives a short summary of 2004 results provided by the IRS. Of course, your return may not avoid an audit merely because the deductions fall within the normal range.

<u>Adjusted Gross Income</u>	<u>Interest Deduction</u>	<u>Charitable Deduction</u>	<u>State and Local Tax Deduction</u>	<u>Medical Expense Deduction</u>
\$30,000 to 50,000	\$ 6,933	\$ 2,132	\$ 1,746	\$ 5,324
\$50,000 to 100,000	\$ 8,310	\$ 2,663	\$ 3,160	\$ 6,125
\$100,000 to 200,000	\$10,949	\$ 4,130	\$ 6,403	\$ 9,811
Over \$200,000	\$19,711	\$19,014	\$29,892	\$31,331

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

RETIREMENT PLAN DISTRIBUTIONS: NEW DEVELOPMENTS

PENSION PROTECTION ACT (PPA 2006) ENCOURAGES CHARITABLE DONATIONS FROM IRA ACCOUNTS FOR DONORS ABOVE AGE 70 ½

Many donors would like to make charitable contributions from their IRA accounts since distributions taken from IRAs are subject to income taxes in most instances. (Only in circumstances where the distribution consisted of previously taxed money are such distributions tax free.) In addition, monies remaining in the IRAs at the account owner's death are subject to federal estate taxes and, in some states, state inheritance taxes. Under prior law, distributions taken from the IRA and contributed to charity would cause the donor to incur taxable income to the extent of the distribution and then be subject to the income tax deduction for charitable contributions, which is curtailed in some circumstances by percentage limitations and phase-out rules for itemized deductions.

The new law provides (for taxable years 2006 and 2007) an exclusion from income, not to exceed \$100,000 per taxpayer per taxable year, for qualified charitable distributions (QCDs) from a traditional or Roth IRA to a charity eligible to receive normal deductible contributions. A QCD is not further eligible for deduction, so there is no double tax advantage. The exclusion does not apply to IRAs held under SEPs, SIMPLE IRAs, or distributions from qualified retirement plans. A QCD can be made by the donor only after he or she attains age 70 ½. There has been some discussion about the treatment of inherited IRAs. It would seem logical that IRAs that have been rolled over by the beneficiary would be eligible for a QCD after the beneficiary reaches age 70 ½. It is unclear if an inherited IRA (not rolled over) remains eligible for a QCD if the deceased owner had attained age 70 ½ at the time of death. This and many compliance issues need to be clarified with respect to QCDs in the near future because this is an important year-end tax planning technique for many individuals, and charities will understandably recommend it heavily to potential qualifying donors.

A QCD could eliminate most or all of the income tax on the required minimum distribution that applies to IRA account holders who have reached age 70 ½. The QCD is not subject to normal percentage limitations applicable to charitable contributions; nor does it have any impact on the phase-out of the donor's itemized deductions. The QCD must be made directly from the account to the charity and must be otherwise eligible for a 100 percent deduction. That is, split-interest charitable gifts (e.g., charitable remainder trusts), charitable gift annuities, and bargain sale donations cannot be funded with QCDs. The donor should not receive any value (quid pro quo contribution) from the charity in exchange for the donation. Moreover, QCDs cannot be contributed to donor-advised funds and supporting organizations.

Good candidates to consider QCDs are charitably inclined individuals who (1) do not itemize deductions on their income tax returns, (2) are potentially subject to an itemized deduction phase-out, (3) are already considering donating amounts near the threshold created by the percentage limitation rules applicable to other types of donations, (4) have an estate near or beyond the exemption amount for the federal estate tax, and (5) live in a state that does not provide tax advantages for charitable gifts.

FUNDING MARITAL TRUST WITH BENEFITS FROM QUALIFIED RETIREMENT PLAN OR IRA

In some circumstances, retirement benefits might become payable by beneficiary designation to a trust rather than directly to the surviving spouse or other heir. This is generally considered when the individual leaving the benefits would like some spendthrift protection and/or to ensure that the benefits will

be held for the lifetime of the beneficiary. For example, the plan participant or IRA account owner may want to leave annual lifetime benefits to a surviving spouse while ensuring that any remaining balance at the survivor's death pass to beneficiaries named in advance. Or the participant or account owner may want to guarantee that the beneficiary does not take distributions for income tax purposes any faster than required by the distribution rules applicable to inherited tax-deferred retirement plan accounts.

The IRS recently examined three fact patterns concerning the designation of a marital trust (qualified terminable interest property or QTIP trust) as the beneficiary of a deceased spouse's IRA or qualified retirement plan benefit. This ruling (Rev. Rul. 2006-26, 2006-22 IRB 939) was necessitated by new state laws that define principal and income of trusts. The primary issues are how to merge the laws that require (1) the payment of all income annually to the surviving spouse from a QTIP trust and (2) the withdrawal of the minimum required distributions from an IRA or qualified retirement plan account by the trustee of the QTIP. In a QTIP trust, the surviving spouse can compel the trustee to make trust investments productive for income purposes. In addition, the spouse can require the trustee to withdraw and distribute the income from an IRA payable to a QTIP trust.

In the first situation posed by the IRS, the state has a law that permits the trustee to alter the traditional concepts of principal and income, allocating them in a manner to treat the beneficiaries of the trust impartially. The trustee must always withdraw the amount of the required distribution from the IRA. In addition, the surviving spouse can compel the trustee to withdraw the amount allocated to income pursuant to the state's law if it is greater than the minimum required distribution from the IRA. The distribution to the surviving spouse can be limited to the amount properly allocated to income.

In the second situation, the state has a provision to replace the traditional accounting of income by paying 4 percent of the annual fair market value of the trust to the surviving spouse. If the surviving spouse compels the distribution of all income, the trustee withdraws the greater of the minimum required distribution or the 4 percent unitrust amount and distributes, at a minimum, the 4 percent unitrust to the surviving spouse.

In the final situation, the state has only the traditional definition of income, and the surviving spouse will have the right to compel the traditional accounting of income with respect to the IRA and receive this distribution.

The IRS held that the three situations would result in the qualification of the trust for the federal estate tax marital deduction under Sec. 2056(b)(7). The QTIP election must be made for both the trust and the IRA. There are some caveats about this ruling. First, the required minimum distributions must be withdrawn from the IRA by the QTIP's trustee, or there will be a 50 percent tax penalty. Second, the trust did not have other beneficiaries aside from the surviving spouse and children. Thus, only individuals could potentially benefit and the surviving spouse as the oldest beneficiary would have his or her age used to determine the minimum distribution. Third, these situations all create the possibility that some of the required minimum distribution (if greater than income, however determined by the state's law) could be held by the trust for future distribution. This could cause some of the distribution to be taxed at the trust's income tax rate, a potentially unfavorable situation.

Furthermore, the ages of all beneficiaries of the trust must be considered for minimum distribution purposes, which would cause a problem if a potential beneficiary is older than the surviving spouse. This situation could be avoided by a conduit trust that stipulates, at a minimum, that all required distributions be paid annually to the surviving spouse. Under the conduit trust, only the age of the current income beneficiary (the surviving spouse) is used to determine the required distribution. The conduit trust could, however, result in a lesser trust accumulation at the end of the surviving spouse's lifetime if the minimum required distribution from the IRA or qualified retirement plan account is greater than the QTIP income.

DISTRIBUTIONS FROM IRA TO SPECIAL NEEDS TRUST FOR DISABLED BENEFICIARY

Distributions from inherited IRAs to beneficiaries, other than a surviving spouse, must begin for income tax purposes no later than the year following the year of the account owner's death. The balance must be distributed over the fixed term life expectancy of the beneficiary based on his or her attained age. If multiple beneficiaries are named, the age of the oldest beneficiary is used unless separate accounts are created for each beneficiary. The IRS examined a situation (Ltr. 200620025) in which the decedent named four individual beneficiaries from an IRA, including a disabled beneficiary who was receiving Medicaid benefits. Separate accounts were created for each beneficiary, and distributions were made based on each beneficiary's age. A guardian received the disabled beneficiary's distributions.

The guardian petitioned the court to create a special needs trust (SNT) for the disabled beneficiary. The guardian will transfer the beneficiary's interest in the IRA to the SNT. The SNT complies with the provisions of OBRA '93 and will not be considered as an asset of the beneficiary for the purposes of receiving public benefits under Medicaid. The SNT's trustee can distribute assets to or for the benefit of the disabled beneficiary at the trustee's sole discretion. As required by the statute governing SNTs, the state must be reimbursed at the beneficiary's death for benefits provided under Medicaid. Note: Without the SNT, the benefits of the IRA might have disqualified the disabled heir from receiving public benefits until the benefits were expended on his or her medical and/or long-term care and the beneficiary met the state's impoverishment standards.

The IRS ruled that the SNT is a grantor trust of the disabled beneficiary and, as such, is ignored for income tax purposes. Thus, the transfer of the IRA to the trust does not trigger income tax on the remaining balance, and the tax deferral of the IRA is preserved until distributions are actually taken. Regarding the timing of the required distribution from the IRA, the IRS held that the circumstances of the establishment of the SNT and transfer of the IRA satisfied the separate account rule and that it is appropriate to determine required distributions based on the disabled beneficiary's life expectancy.

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.

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for the future***



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