



Advanced Planning Strategies

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The President's budget has been released for fiscal year 2008. The tax proposals include making all of the tax relief provisions from the 2001 and 2003 tax acts permanent. In addition, the AMT relief that expired would be extended for 2007 and the charitable IRA rollover contribution provision expiring at the end of the year would be made permanent. Once again, proposals are included to create new retirement savings accounts that would consolidate the multitude of individual and employer retirement savings mechanisms into two basic forms. The retirement account proposals have been included in past budgets in some form and have failed to gain traction.

The new composition of Congress will make it difficult for the President to get significant tax legislation passed without considerable compromise. For example, the minimum wage bill has bogged down due to the inclusion of business tax breaks to offset the additional cost of minimum wage employees for certain employers. The House passed a \$1.3 billion small business tax package (H.R. 976) to be coupled with the minimum wage bill. The bill would extend the Sec. 179 expense provision to 2009 and increase the limit to \$125,000. The revenue-raising offset in this bill would prevent a taxpayer from shifting assets to dependent children who would incur lower capital gains taxes. The Senate minimum wage bill has different business tax breaks and revenue-offset proposals.

The President's budget proposes a 5.58 percent increase in the funding for the IRS, a \$11.4 billion annual expenditure. Substantial emphasis will be placed on improving taxpayer service and enhanced enforcement of the tax laws. The IRS reports a 44 percent increase in delinquent tax collections since 2002. The total receipts have risen by \$600 billion since 2003, with the highest growth in collections from corporations and high-income taxpayers.

The IRS issued a news release (IR-2007-26) indicating its preparedness to deal with the extenders legislation passed after the initial tax forms had been designed. Notably, the extenders bill affected the state and local sales tax and higher education tuition and fees deductions. The IRS encourages e-filing of returns for maximum speed and accuracy.

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 grantor's and beneficiaries' advisors 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 to 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 worded. 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 trust 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 Principal and Income 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.

IRS REGULATIONS FOR TRUST INCOME

A large body of tax laws governing trusts and income interests require validity for an income interest. The tax law definition of income was designed, in many instances, to prevent abuses that might occur under different definitions of income. IRS rules provide an updated definition of income for trust income tax purposes (Treas. Reg. Secs. 1.643(a)-3 and 1.643(b)(1)). These 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. In addition, the IRS provides rules for IRAs payable to a marital deduction trust to be administered under the various definitions of income provided by state law and to qualify for the federal estate tax marital deduction (Rev. Rul. 2006-26, 2006-22 IRB 939).

RECENT CASES AND RULINGS

IRS PERMITS DEDUCTION FOR TUITION FOR SPECIAL NEEDS EDUCATION

The parents of a special needs child enrolled the child in the tenth grade of a school designed specifically for the education of students with the condition affecting the child. The child was diagnosed with several developmental disorders, and the physician performing the tests recommended that the child be placed in a specialized educational environment for therapy beyond what was available in the special education program at the public school. The special school accepts only students with documented conditions that impair the child. Specifically, students enrolled in the school do not have strong visual/spatial abilities, which severely limits their ability to process information in typical classroom settings. The school provides both specialized instruction in typical educational topics and has curriculum with a heavy emphasis on social and life skill development targeting emotional regulation, conflict resolution and independent living.

The IRS ruled privately that the costs of the special school will be permitted as a medical expense deduction under Sec. 213. The regulations provide that the cost of medical care includes attendance at a special school for a mentally or physically handicapped individual if the condition is such that the resources of the institution for alleviating such mental or physical handicap are a principal reason for the student's presence there. If this provision applies, the cost of attending such a special school includes the meals and lodging, and the ordinary education furnished by the school (Treas. Reg. Sec. 1.213-1(e)(1)(v)(a)). To meet the standard for qualifying education, the special school must have as its primary purpose the enabling of the student to compensate for (or overcome) a handicap. The ordinary education provided to the student must be incidental to the specialized educational component for the deduction to be allowed on the parent's income tax return.

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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