



Advanced Planning Strategies

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The bills for an economic stimulus tax package were taking shape at the time this letter was written. President Obama has requested that Congress complete its work on a bill by mid-February. The House and Senate have each introduced versions of the *American Economic Recovery and Reinvestment Act of 2009 (HR 598)* with some differing provisions. Key components of the tax incentives are:

- Expansion of the Hope credit for educational expenses to \$2,500 and it would be made available for four years of college.
- Removal of the requirement to repay the refundable First-time Homebuyer credit for homes purchased in the first half of 2009.
- The extension of the \$250,000 Sec. 179 expensing limit to businesses for 2009.
- The use of a 5-year (as opposed to a 2-year) carryback for net operating losses for businesses for tax years ending in 2008 and 2009.
- A new Making Work Pay credit allowing a refundable amount equal to the lesser of (1) 6.2 percent of an individual's earned income or (2) \$500 (\$1,000 in the case of a joint return). The credit would be phased-out between \$75,000 and \$100,000 of adjusted gross income for single filers (between \$150,000 and \$200,000 for joint returns) and applies to 2009 and 2010.

The National Taxpayer Advocate of the IRS issued its report to Congress. The report identifies the five serious problems encountered by taxpayers as:

- The complexity of the tax code. It is estimated that 7.6 billion hours are spent complying with tax-filing requirements.
- The need for the IRS to consider the hardship placed on taxpayers with economic difficulties when taking enforced collections actions.
- Understanding and reporting the tax consequences of cancellation of debt income.
- Balancing compliance enforcement with outreach and education with respect to employment taxes.
- IRS process improvements to assist victims of identity theft.

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

DISCLAIMERS CAN BE USEFUL TOOL IN ESTATE PLANNING

We often see individuals attempting to accomplish estate planning objectives without adequate knowledge or information about the tax, property, and/or probate laws. Frequently, an individual who receives an inheritance believes that it can simply be transferred to children or grandchildren. Or a child receives informal directions from his or her parent to take care of a sibling with the money and property the parent leaves to the child. Unfortunately, there are gift tax laws that could cause the informal shift of the inherited wealth to become a taxable transfer by the party who refuses or shifts the wealth. The unsuspecting and well-meaning individual might find himself or herself in a position of having to file a gift tax return. In addition, state property and probate rules may have some effect on the attempted transfer. Fortunately, there is a method to refuse a gift or inheritance and accomplish these estate planning objectives without gift tax problems. Such a refusal is known as a qualified disclaimer.

Disclaimers are ordinarily not considered until after the estate owner's death, because more wealth is transferred at death than through lifetime gifts. The sophisticated estate planner, however, often takes into account during lifetime the potential use of a disclaimer after death. Disclaimers can make options or alternatives available to the beneficiaries of an estate that might not otherwise be available.

What is a disclaimer? Code Sec. 2518 defines a "qualified disclaimer" as an "irrevocable and unqualified refusal to accept an interest in property." A very important note: A disclaimer that is not qualified will be treated as a taxable gift by the disclaimant. For a disclaimer to be qualified, it must meet these additional requirements:

- It must be in writing.
- It must be received by the transferor or by his or her legal representative or the holder of legal title of the property interest.
- The refusal must be received within 9 months after the transfer is made, such as the date of the decedent's death, or when a donee or beneficiary attains age 21.
- It must be made prior to the acceptance of the property interest or any of its benefits.
- The disclaimant cannot direct who receives the interest after the disclaimer.

EXAMPLE OF HOW DISCLAIMERS CAN ACCOMPLISH ESTATE PLANNING OBJECTIVES

Suppose a decedent had an estate valued at \$4 million. He dies in 2009 and leaves all of his estate to his wife in a marital trust. Assume that any share disclaimed from the marital trust is poured into the credit shelter trust. If we assume that the surviving spouse has an estate of \$1 million in addition to what she receives from the marital trust, she could save a minimum of \$675,000 (assuming her death occurs in 2009) of federal and state estate taxes on her estate by disclaiming \$3.5 million of her marital trust property. The disclaimed property would pass to her husband's credit shelter trust to make full use the \$3.5 million estate exemption amount available in 2009. The credit shelter trust could be designed to provide for all income and some principal as necessary for support to be paid to her annually.

PLANNING FOR DISCLAIMERS

Although disclaimers are usually a postmortem planning technique, advance planning can often maximize their flexibility and effectiveness. When drafting a will or arranging other types of property

transfers, the estate owner and his or her advisers should always consider the potential for disclaimers. The estate owner could even leave instructions to his or her heirs suggesting the possible alternatives that disclaimers present.

One critical question in planning disclaimers is, what happens to the disclaimed property? This is certainly important to both the estate owner and the disclaimant. One of the rules for a qualified disclaimer is that the disclaimant cannot direct to whom the property interest is transferred. A brief summary of the effect of a disclaimer is as follows:

- A disclaimed lifetime gift causes the property to be returned to the donor.
- The disclaimer of property received by beneficiary designations (for example, from life insurance policies or retirement plans) causes the property to go to the contingent beneficiary of the contract. If no contingent beneficiary is named, the proceeds become payable to the estate.
- A disclaimed specific bequest becomes payable to the residuary estate.
- A disclaimed interest in a testamentary trust causes the trust to pass to (or be held in trust for) the remainder beneficiaries.
- The disclaimant of inherited property is generally treated as if he or she predeceased the decedent. (Note: Some state laws provide a different result. Thus, it is important to check the terms of the will and state law where the decedent was domiciled or the disclaimed property is located to determine the outcome of a particular disclaimer.)

DISCLAIMER TRUSTS

A popular method for handling disclaimers by a surviving spouse is the disclaimer trust. In this instance, the will is drafted to contemplate the surviving spouse's disclaimers, and the disclaimer trust is treated as the alternate beneficiary of property the surviving spouse disclaimed. (In our example above, the credit shelter trust might be called a disclaimer trust.) Thus, if the surviving spouse and his or her advisers determine that a disclaimer is wise, the disclaimed property does not pass to the decedent's children (or other heirs) but is transferred to the disclaimer trust. Ordinarily, the disclaimer trust will provide the surviving spouse with all trust income and give the trustee the ability to invade principal for the surviving spouse's support, health, and maintenance. A disclaimer trust can be sheltered from estate taxes by the deceased spouse's unified credit.

A disclaimer trust is a good planning method to give the surviving spouse the flexibility to reduce estate taxes if the will transfers too much property directly to the survivor. The surviving spouse and his or her advisers have 9 months after the deceased spouse's death to determine whether to make a disclaimer and which assets to disclaim.

DISCLAIMERS AND RETIREMENT BENEFITS

One important use of a disclaimer is to adjust the postdeath distributions from a qualified retirement plan or IRA benefits. First, these plans are payable at death to a designated beneficiary. The participant or account owner should always name a designated beneficiary and at least one successor or contingent beneficiary. The required payout (the applicable distribution period) depends on the individual or entity designated as beneficiary. For example, a surviving spouse as beneficiary provides potentially the most income tax advantages because the account can be rolled over and distribution delayed in some instances. The estate as designated beneficiary generally provides the worst income tax result. Tax regulations provide for the beneficiary to be identified for such plans or accounts by September 30 of the

year following the year of the participant's or account owner's death to determine the applicable distribution period. Thus, the family has time to get advice about these assets, and a timely (as described above) disclaimer (or disclaimers) could cause the shift of the benefit to the most desirable beneficiary. The beneficiary ultimately selected must have been on the list of contingent beneficiaries to receive the benefits. Therefore, appropriate predeath beneficiary choices are essential. Again, this type of disclaimer is complicated and poses traps for the unwary so qualified professional advice is required. With retirement benefits, it is critical that the beneficiary designation include language that the contingent beneficiary will receive the benefits if the primary beneficiary predeceases the participant or disclaims the benefits.

Recent Cases and Rulings

IRS Permits Charity to Purchase Commercial Annuity Policy in Conjunction with a Charitable Gift Annuity Donation

Charitable gift annuity transactions have been discussed in our prior letters. A new wrinkle was added in a transaction that was the subject of a private ruling (Ltr. 200847014). In this donation, it was stipulated that the donor would transfer property to a qualified charity in exchange for the charity's agreement to pay the donor an annual annuity. The agreement between the donor and the charity provides that the annuity payments are a general obligation of the charity, backed by all of the charity's assets.

The contract between the donor and the charity provides that the charity is authorized, but not obligated, to use donor's gift (or a portion thereof) to purchase a commercial annuity with the annuitant's (donor's) life being the measuring life. The timing and amount of payments from the annuity policy are substantially the same as the timing and amount of payments that the charity is obligated to pay to donor under the gift annuity contract. The charity is the sole payee under the commercial annuity policy and the donor's involvement in the policy is limited to having his life used as the measuring period for the annuity payments. All policy proceeds after the donor's death will be paid solely to the charity. The portion of the donor's gift that is not used to purchase the commercial annuity may be used by the charity immediately for its general operating purposes.

The IRS ruled that the donation will qualify for income and gift tax deductions under IRC Secs. 170 and 2522 and the transaction will not run afoul of the penalty provisions applicable to personal benefits contracts for life insurance and annuity policies.

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. Securities and Investment Advisory Services offered through Capital Analysts Incorporated, Member FINRA/SIPC. AEG and CAI are independent non-affiliated entities.

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for the future***



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