Advanced Planning Strategies

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The Budget details were not complete at the time this letter went to print, but a deal was reported that was linked to reform of the health care system. Apparently, the tax stimulus credit for “Making Work Pay” will be allowed to expire as will many of the investment incentives passed during the Bush Administration. The compromise included an agreement in the Senate to prevent filibuster of upcoming health care reform proposals. Obviously, many components of the Budget agreement will be tax related and we’ll bring you the details in an upcoming letter after legislation is passed.

Major tax reform is expected in 2009. Among the items that will be debated is a higher individual tax rate and the loss of some tax benefits for individuals with income over $250,000. There is a lot of support for a reduction in the maximum corporate tax rate, but this may be coupled with the removal of some corporate tax breaks. The alternative minimum tax (AMT) will be discussed again with an eye towards more permanent relief. There will be some efforts to consolidate and simplify the educational incentives currently provided in multiple forms. Finally, with growing budget deficits, tightening tax enforcement will be a popular topic.

The IRS examination rate for the largest corporations dropped to just over 27 percent in 2008, a significant reduction over prior years. In addition, the examination rate for returns of individuals earning over $1 million also dropped but was still about six times the rate for individuals earning under $200,000.

The Tax Foundation reported that “Tax Freedom Day” occurred 8 days earlier in 2009 than last year. April 13th was the last day that the average taxpayer worked to satisfy federal, state, and local taxes. (www.taxfoundation.org) The largest shares for the average taxpayer are income and payroll taxes. Alaska had the earliest Tax Freedom Day at March 23d and Connecticut had the last at April 30th.

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 law 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.

Terminology of a Power of Appointment

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 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 $13,000 (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 $13,000). 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.

Power of Appointment and Transfer Tax Reform

The use of a power of appointment can be particularly helpful in a period of uncertainty with respect to reform of the federal wealth transfer tax system. Currently, there are a number of proposals to reform the estate, gift, and generation-skipping tax systems. We are uncertain at this time about the exemption levels that will be applicable beyond 2009. The inclusion of a power of appointment in estate planning documents will facilitate the appropriate choices for a trust when exemption levels are determined.

RECENT CASES AND RULINGS

Seventh Circuit Examines Reasonable Compensation For Shareholder-Employee of Closely Held Corporation

A closely held corporation will almost always have shareholders who are officers and employees of the business. A frequent audit item is the tax deduction at the corporate level for the compensation package for shareholder-employees. Large bonuses are particularly subject to scrutiny. The taxpayer owned all voting shares of stock in a large home improvement retail operation. The company had a bonus program to provide the chief executive with 5 percent of the company's net income prior to taxes. The bonus agreement requires the executive to reimburse the company in the event the IRS disallows the deduction for bonus payments. In the tax year in question, the taxpayers salary was $157,500 and the "5 percent" bonus was $17,467,800. The Tax Court found this to be excessive and thought it was a disguised dividend to the shareholder.

The Seventh Circuit Court found this analysis to be "flimsy" and determined that the reasonable compensation test must be based on the "totality of the circumstances." Although the taxpayer was paid significantly more than the CEOs of comparable public companies engaged in the same business, the taxpayer worked long hours and had considerable risk in this bonus structure. The facts also indicated the relative lack of other highly compensated employees and the requisite responsibilities of running a $3.4 billion company falling on the shoulders of one individual. In addition, the entire compensation package (including severance, retirement, etc.) must be considered in determining reasonableness of executive compensation. The circuit court determined that the prior holding of the tax court was clearly in error and reversed its decision. (*Menard v. Commissioner,* 103 AFTR 2d 2009-1280, 3/10/2009)

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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