



# Advanced Planning Strategies

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The Health Care bill seems to have stalled somewhat with a lack of consensus over many parts of the plan, particularly the public option and the tax increases that would be required to pay for the package. The recent address by President Obama to Congress will probably not solve the dispute. It is likely that this will be completed later this fall, if at all. We obviously will stay on top of this and report the tax implications when anything develops.

The Office of Management and Budget (OMB) and the Congressional Budget Office (CBO) released new estimates of the deficit for the 2009 fiscal year indicating a figure near \$1.6 trillion. The OMB estimated that over \$9 trillion would be added to the national debt for 2010-2019. The CBO estimated that the annual deficit will be approximately \$500 billion during that period. Of course, future results could be dramatically different than the estimates based on the condition of the economy and future tax and spending policies. The current CBO estimates are based on current tax law which includes the expiration of most of the tax cuts from the Bush Administration.

There appears to be a consensus that the deficit is a serious concern and it is often amusing to hear specific anecdotes of wasteful spending. The CBO provides summaries of expenditures and revenue. The discretionary component of the federal expenditures is actually shrinking over time. In 2008, expenditures as a percentage of federal spending were as follows: Medicare and Medicaid 23 percent; Social Security 21 percent; defense 21 percent; other discretionary 17 percent; other mandatory 10 percent; and interest on the national debt eight percent. Individual income taxes, social security and other social insurance taxes, and corporate income taxes accounted for 45, 36, and 12 percent of the federal revenues, respectively.

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

## **The Implications Of The \$3.5 Million Exemption For Your Estate Plan**

All individuals who are citizens or residents of the United States at the time of their deaths are subject to the federal estate tax. However, each decedent is permitted to transfer an “exemption amount” free from federal estate taxes due to the applicable credit. This exemption amount shelters \$3.5 million from tax for deaths in 2009, and maybe thereafter. With appropriate planning, this exemption would result in \$1,575,000 of estate-tax savings for a married couple with \$7 million for deaths occurring when the current exemption is effective. This tax savings could even be greater if the funds exempted at the first death appreciate in value before the death of the surviving spouse. One important note about the exemption is that estate tax reform is expected by the end of this year, but the best guess is that the exemption will remain at \$3.5 million, perhaps with indexing for inflation. We’ll be sure to provide a planning summary as soon as this legislation is enacted.

### **Essential Planning: Coordinating The Marital Deduction And The Estate Tax Exemption**

Congress provided a complete estate-tax exemption for property transferred during life and at death to the transferor’s spouse through an estate or gift tax marital deduction. However, the property is included in the transferee-spouse’s estate and subject to applicable estate taxes at that time. At the first death, the deceased spouse will waste the estate tax exemption if all property is transferred to the surviving spouse under the protection of the marital deduction. This enhances the value of the second estate and the tax savings discussed in the previous paragraph will be unavailable.

To provide for optimal tax planning, it is essential that the first spouse to die leaves as much as possible up to the exemption amount (\$3.5 million) in a manner that fails to qualify for the estate tax marital deduction. Here are some transfer choices that would permit the use of the unified credit:

- Bypass the surviving spouse entirely and leave the exemption amount of \$3.5 million to other heirs
- Create a trust that benefits both the surviving spouse and other heirs under the discretion of the trustee
- Create a trust that provides income only to the surviving spouse while he or she is alive with the remainder passing to heirs selected by the transferor
- Create a trust that provides the surviving spouse with all income and as much principal as necessary for the support, education, and maintenance of the surviving spouse while he or she is alive with the remainder passing to heirs selected by the transferor

### **Flexibility Is Critical**

The tax savings provided by the exemption are too good to pass up for most families. However, most people are resistant to take significant steps that might be irrevocable in implementing an estate plan. The uncertainty of the future for federal estate tax law has provided an additional motive to procrastinate. It is essential that any plan can be altered to adapt to potential tax changes.

More importantly, flexibility is critical to meet the family’s needs since trust planning could be implemented to last for the surviving spouse’s lifetime and maybe much longer in the case of generation-skipping trusts. We need to ensure that the support needs of the beneficiaries will be met over the intended time horizon.

## **Living Trusts/Joint-Revocable Trusts**

One technique that is well suited for the optimal use of the marital deduction and the estate tax exemption for a married couple is the joint-revocable trust. Unless one spouse's death is imminent, the order of deaths is speculative and the optimal plan should ensure that each spouse would have the necessary funds at death to transfer an exemption amount (or as close as possible) in a manner that will not qualify for the marital deduction. The joint-revocable trust is created by the married couple and funded with an amount up to the \$7 million exemption currently available for a married couple to avoid estate taxes. Each spouse retains the right to revoke his or her contribution to the trust. This prevents a completed gift at the time the trust is funded and preserves the ultimate flexibility to unwind the transaction if the couple's situation or the tax law changes. They would be able to take the income or principal from the trust as necessary as long as both spouses are alive.

At the time of the first death, the decedent is given a "general power of appointment" over the entire trust. This is a technical provision that results in the inclusion of the entire trust fund in the gross estate of the first-to-die. Thus, the entire amount of the contributions made by both spouses can be used to take advantage of the exemption at the first death. The trust then becomes irrevocable and is distributed by its terms to create an exemption (bypass) trust funded with the \$3.5 million exemption amount and a marital share for the excess in the trust. (This funding is accomplished through a formula in the document that factors in all other transfers made by a decedent outside of this trust.) Of course, the exemption (bypass) trust could be drafted to permit the maximum access to the surviving spouse as described in the choices above. The exemption trust will not be taxable at the second death preserving the maximum tax savings. In addition, it might be prudent to include a trust protector or discretionary distribution powers to alter or terminate the trust if the circumstances indicate. The tax treatment, as described above, of the joint-revocable trust or similar arrangements has been approved by the IRS in private rulings (see, e.g., Ltrs. 200210051 and 200403094).

## **Strategies For The Unified Credit Trust**

The exemption trust bypasses estate taxes in both estates for a married couple. The normal strategy is to provide a significant growth element to this trust. Discretionary gifts or expenditures by the surviving spouse should be made from the survivor's funds or the marital share left to the survivor by the first-to-die since these assets will be subject to estate taxes at the second death. For this reason, it is generally recommended that qualified retirement plans or IRAs should not be used to fund the exemption (bypass) trust except as a last resort. These assets are subject to income tax and must be withdrawn under required minimum distribution rules over the surviving spouse's life expectancy. Thus, these assets would cause shrinkage in the exemption (bypass) trust at the marginal income tax rate applicable to the distributions.

One option is to use the funds of the exemption (bypass) trust in a manner that would minimize distributions and provide for growth. Of course, this strategy would be recommended only if the surviving spouse or other beneficiaries won't need the current distributions. If the trust terms don't permit accumulation of income (as defined by the state's principal and income act), the trust could be structured to avoid unnecessary accounting income. Investment advice should be consulted to minimize accounting income and provide growth and the trust terms and state law must permit the investment choices made by the trustee.

If the survivor has a substantial estate and associated tax problems, life insurance could be purchased on the surviving spouse's life inside the exemption (bypass) trust using some or all of the funds.

Life insurance provides no accounting income as the cash surrender value accumulates in the policy, and it provides for growth as a result of the death benefit. Only when the proceeds are received and reinvested after the death of the insured-surviving spouse will accounting income begin to accrue. In addition, there are estate and gift tax advantages to this choice. First, the life insurance proceeds will avoid inclusion in the surviving spouse's gross estate and pass to the heirs free of any estate tax. Of course, the surviving spouse should not be the trustee (a resignation is always possible) when the insurance is purchased or the trust should be designed with an independent co-trustee to hold the incidents ownership on the life insurance policy on the life of the surviving spouse. Second, there are no gift tax consequences to paying the premiums because the transfer taxes were avoided by the use of the estate tax exemption of the first spouse to die when the exemption trust was funded. Again, flexibility is available. If funds are needed by the surviving spouse, the trustee could take money out of the life insurance policy through policy loans. The policy could also be surrendered or settled and the proceeds reinvested in other opportunities if the circumstances indicate making such a change.

## Recent Cases and Rulings

### Terminated Life Insurance Policy Created Ordinary Income

The taxpayer had a life insurance policy with a face amount of \$50,000. The policy owner periodically borrowed against the policy's cash value and made no significant repayment of the loans. Many years later, the loan balance exceeded the value of the policy and the insurer requested payment of the shortfall. The failure to repay resulted in a termination of the policy. The tax court determined in a summary opinion (this type of opinion cannot be cited as precedent by another taxpayer) that the gain on the policy was taxable as ordinary income and that the taxpayer could not deduct the unpaid interest against the gain. (*Giannaris v. Commissioner*, TC Summary Opinion 2009-114). Of course, the taxpayer did have tax-free use of the loans until the loans jeopardized the policy. This case indicates the importance of a periodic "check-up" of your life insurance policies, particularly if there have been any significant policy loans.

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.

***Positioning our clients  
for the future***



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