ESTATE PLANNING

Ideas to Help You Plan for Your Future

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Everyone is Talking About *"Having Your Cake And Eating It Too"*

What This Expression Really Means, It Has Nothing to Do With Cake or Eating!

Are you confused when you read this expression in relationship to financial or estate planning? It can be very confusing unless you understand what is the "cake" and who does the "eating". Metaphors aside, the important point is that you can give money away and still have the use of the money for you and your spouse. In estate planning there are three basic strategies:

(1) *make use of the marital deduction and split assets between spouses;*

(2) *make gifts of $10,000 per year to get assets out of your estate; and*

(3) *make effective use of the unified estate and gift tax credit in order to maximize the amount which is exempt from estate tax; this year that exempt amount is $675,000, and it will gradually increase to $1 million over the next 7+ years.*

For people with substantial wealth, use of the $10,000 per year gift tax exclusion is a "no brainer". The gift is not subject to estate tax, and does not use any portion of the $675, 000 which is exempt from estate tax. For people in the top estate tax bracket, every $10,000 gift saves $5,500 in estate taxes. Further, once the $10,000 is out of the individual's estate, the future income on the money does not accumulate in the donor's estate.

Sometimes people are reluctant to totally give up the use of $10,000. I have developed a strategy for a married couple to make gifts and still have use of the money. An example of this technique is a couple who each have $2 million, two children and a total of four grandchildren. The first step is to divide the assets between the spouses, and of course make sure they have Wills which maximize the use of the amount exempt from estate tax by use of a by-pass trust.

Then one of them should create a living trust. For this example it will be the husband creating the trust. The wife, the children and the grandchildren are the discretionary beneficiaries and the trustees have discretion to distribute the income and principal of the trust to any of the wife, the children and the grandchildren. The husband then makes gifts to the trust of up to $20,000 per child and $20,000 per grandchild. Under our assumed facts, that's $40,000 on account of the two children and $80,000 on account of the four grandchildren, total $120,000.

On the gift tax return, the wife consents to have the gifts treated as if they came one-half from her, and the couple are seen as having each made $10,000 gifts to the trust on account of each child and grandchild. The gifts to the trust are subject to the so-called "Crummey" withdrawal power (Crummey was the name of the person who first used this withdrawal technique, so it's now called a "Crummey" power). The trustees send the children and grandchildren letters saying that each of the children and grandchildren have a

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draw the $20,000 given to the trust on account of them. The right of withdrawal exempts the gifts to the trust from gift tax. Presumably, the children and grandchildren will not exercise their right of withdrawal. However, there should be no prearranged deal that people won't exercise their right of withdrawal. Once the assets are in the trust (the gifts don't have to be money, they can be stock, bonds, etc.), the trustees can pay the income to the wife. Presumably, she will use the income she receives for the couple's joint needs. The couple's cash flow will be the same as before the gifts and the trustees can have discretion to distribute principal to the wife, although they probably would never need to do it since the wife has a substantial estate.

The wife did not make the gifts to the trust, and the right to receive income will not cause the trust to be included in her estate. Since the husband is not a beneficiary of the trust, the trust will not be taxable in his estate when he dies. If the wife passes away first, the income flow to the parents stops, but presumably the balance of the combined estate will be sufficient to provide for the husband for the rest of his life. He will have what's left of his original $2 million, as well as the wife's $2 million. The assets in the trust can be distributed to the children, or continued in trust for them, with ultimate distribution to the grandchildren.

While the wife is still alive, and the couple's estate continues to grow, the trustees of the trust can exercise their discretion to give the income to the children and grandchildren. Since the trust is a Grantor Trust for income tax purposes, the income can be accumulated tax-free in the trust and the parents will pay the income tax on the trust income.

In our scenario of two children and four grandchildren, the parents can move $120,000 per year out of their estate, thereby saving $66,000 per year in future estate taxes. If any of the children and grandchildren are married, we could include their spouses in the group who would receive the Crummey notices, thereby increasing the gifting. If the gifts are made this year, and again on January 1st of next year, in a few months we have moved out $240,000, and saved $132,000 in estate taxes. All of this is accomplished without losing cash flow to the couple.

CRUTs, CRATs, NO ONE SAID THE NAMES WOULD BE EASY…………
BUT THE TAX SAVINGS ARE

Gains in the stock market have left a lot of investors holding highly appreciated securities which they would like to sell in order to diversify their investments. They are reluctant to sell because they will lose up to 25% in value due to the capital gains taxes that have to be paid on the gain realized upon the sale.

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In 1969, the Internal Revenue Code was amended to limit the types of charitable remainder trusts that would qualify for tax deductions. A charitable remainder annuity trust (CRAT) is one in which an individual receives an annuity from the trust for a period of years or for life, and after the individual's interest ends the assets remaining in the trust go to charity. On the other hand, a CRUT (Charitable Remainder Unitrust) is a trust that pays the life beneficiary a percentage of the value of the trust assets each year for a specific period of time. For instance, the trust might say that the beneficiary is entitled to a "unitrust amount" equal to 7% of the value of the trust assets on January 1 of each year for the lifetime of the beneficiary.

How does it work? Let's say that you have $400,000 worth of highly appreciated stock, which is only paying a 1% dividend -- annual dividend payment of $4,000. You decide that you would like to keep an income stream but also benefit your favorite charity (or charities) and your family. You create and fund a CRUT with your highly appreciated stock.

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CRUTS, CRATS: Cont'd

The CRUT is a tax-exempt trust and the stock put in the trust can be sold without paying capital gains taxes which allows the proceeds of the sale to be invested in a diverse portfolio that produces a larger income stream. Let's further assume that you and your spouse are ages 64 and 65, and this year you create and fund a CRUT with the highly appreciated stock and you retain the right to receive a 7% unitrust amount each year for the rest of your lives. Based on trust with a $400,000 corpus, your annual unitrust distribution from the trust would be $28,000 per year. If the value of the portfolio goes up, the amount of your unitrust payment would also go up; if the value of the trust's portfolio goes down, so does the amount of your annual payment. The payment amount is calculated each year on the value of CRUT's investments.

You are entitled to an income tax deduction equal to the actuarial value of what will eventually go to charity when the trust ends. Based upon the assumptions outlined above, the income tax deduction would be $88,800. There are limits on how much you can deduct in one year, but you can carry any unused deduction over for 5 years.

At the death of the survivor of you and your spouse, the remaining assets in the trust would go to one or more charities you select, and these gifts to charity would qualify for an estate tax charitable deduction, thereby lowering your estate taxes.

All of this sounds pretty good – no capital gains, diversification of investments, increased cash flow, income tax deduction, estate tax deduction, and benefiting charity.

But what about your family? The amount that goes to charity reduces the amount that your family would otherwise receive. One solution to this is to create a life insurance trust and purchase a policy of insurance on the joint lives of you and your spouse. With the increased cash flow from the CRUT, you can purchase life insurance and still have additional cash left over. At the death of you and your spouse the insurance policy will pay to the trust without any estate taxes. The proceeds can be distributed, free of all taxes, from the trust to your family to replace the wealth that is going to charity from the CRUT.

PAY ATTENTION TO YOUR IRA ! *If You Don't No One Else Will*

(Second article in IRA series)

By the time you reach your Required Beginning Date, (roughly, age 70-1/2) you must make a decision that can have a significant impact upon your beneficiaries after your death. You must decide whether you wish to make withdrawals from the IRA based upon the actuarial life expectancies of you and your beneficiary as determined when you reach age 70-1/2, or, whether you wish to recalculate the life expectancies of you and your designated beneficiary each year.

> *" The problem is worse if you fail to designate a beneficiary or the beneficiary dies before you."*

Recalculation will reduce the amount which you must withdraw each year -- your Minimum Required Distribution, but that election could have negative consequences for your beneficiary. If you elect not to recalculate life expectancies then your beneficiary can continue to withdraw amounts from the IRA over the remaining combined life expectancy of you and your beneficiary. However, if you recalculate life expectancies, your beneficiary is limited to taking withdrawals over his or her life expectancy, perhaps a shorter period. The problem is worse if you fail to designate a beneficiary or the beneficiary dies before you do. In that case, if you elected recalculation of life expectancies, the balance of the IRA must be distributed by the end of the year following the year in which you die, so that huge income taxes will have to be paid.

The designation of beneficiary and the election with respect to life expectancy do not restrict your right to withdraw more than the minimum. What happens if you didn't make a designation of beneficiary as of your

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PAY ATTENTION TO YOUR IRA: Cont'd

Required Beginning Date? In this case your Minimum Required Distribution is calculated solely on your life expectancy, which results in larger Minimum Required Distributions. Remember that the goal is to leave as much as possible in the IRA to grow free of income tax.

What happens if you don't make an election whether to base withdrawals upon the initial life expectancies of you and your beneficiary, versus annual re-calculation? Many IRAs provide that in the absence of an election, life expectancy is recalculated annually. This may mean that at your death your family may be required to withdraw all of the plan proceeds, and pay tax thereon, within a much shorter period than if you had elected not to recalculate life expectancies.

What if you are in a second marriage, and you want your spouse to enjoy the benefits of the IRA, but upon the spouse's death you want what's left in the IRA to go to your children? There are ways to designate an IRA either directly or through a trust so that your spouse enjoys distributions during her or his lifetime, with the remainder of the IRA going to your children at the spouse's death.

The rules on Minimum Required Distributions are very complicated. In addition to the almost incomprehensible provisions of the Internal Revenue Code and IRS regulations in this area, it is necessary to review the terms of your specific IRA or retirement plan to determine what options are available to you and how you exercise those options.

I recommend that you contact a knowledgeable attorney or CPA for advice when you reach age 70 -- well ahead of when you reach your Required Beginning Date. A knowledgeable attorney or CPA can provide you with the necessary information and guidance so that you can make the right choices for you and your family.

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Next Issue: Family Limited Partnerships, what is new on the topic and how it has impacted Estate Planning.

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