

*What Every Physician's Spouse Needs  
to Know About Estate Planning*

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## The Tools of Estate Planning Transfers

- I. **WILL:**  
Assets owned outright by decedent at death
  
- II. **LAW:**  
Jointly owned property with a right of survivorship and tenancy by the entirety  
  
Intestate succession
  
- III. **CONTRACT:**  
Life insurance proceeds, retirement-plan benefits, living trusts
  
- IV. **GIFTS:**  
Any assets transferred during life

## Understanding the Probate Process

- I. When a person dies all of the property that person owned will be transferred to others, but the way it is transferred depends on how it was owned.

Property owned in joint tenancy with right of survivorship will pass automatically to the surviving joint tenant. For instance, if a husband and wife hold their principal residence or a bank account in joint tenancy, the survivor becomes the full owner at the death of the first spouse.

The death proceeds from an insurance policy, the balance in an IRA or other retirement account, and the remaining benefits payable under a commercial annuity are all paid to the named beneficiaries. These assets are not governed by a will unless the estate is named as beneficiary.

Property held in trust likewise will not be governed by the will when that person dies. Depending on its terms, the trust may terminate and distribute the remaining principal to named beneficiaries or it may continue, paying income to designated beneficiaries and eventually, at termination, distribute the remainder to the same or different beneficiaries.

Shares held subject to a shareholders' agreement are still another instance of property not controlled by the will. They are transferred according to the terms of the agreement.

The will, then, controls property not passed through one of the above methods. It controls:

1. Property in the individual's name alone
2. Property owned by the individual and others as tenants in common ( a form of ownership, unlike joint tenancy where each tenant has the right to see or give his or her proportionate share to anyone else)
3. Proceeds from IRAs and other retirement plans payable to the estate
4. Proceeds from life insurance policies payable to the estate
5. Property payable to the estate because of death
6. Income and other payments to which the individual was entitled but had not received at the time of death

II. The court-supervised process of validating the will, administering, and distributing the above property per the instructions in the will is called “probate,” and property subject to such administration is called “probate property.” Property transferred in other ways outside the will is “non-probate property.” While the total estate consists of everything the person owned or has an interest in, the probate estate includes only property governed by the will.

A. Responsibilities of the personal administrator (one who administers an estate)

Other terms for the personal representative: “executor” (male administrator), “executrix” (female administrator).

B. Steps to settle an estate

1. Filing will with probate court and appointment of personal administrator
2. Notification of legatees
3. Inventory of estate and appraisals of estate assets
4. Payments of debts and allowable claims
5. Payment of bequests (some may be paid sooner than others)  
Also, a bequest may be paid through a series of partial distributions
6. Filing estate-tax return
7. Audit of estate-tax return and tax clearance letter from IRS
8. Final accounting and payment of fees
9. Closure of estate

## Major 2001 Tax Act Provisions Change the Face of Estate Tax

- I. The most celebrated feature of the new law is the repeal of the federal estate tax. This repeal doesn't happen until 2010, though—and then only after a series of reductions in the top estate-tax rate—and it increases the amount that can be transferred free of tax, the so-called applicable exclusion amount. And absent future Congressional action, the estate tax will be back in 2011.
- II. Since 2002, every individual has been able to transfer \$1million free of tax; that went up to \$3.5 million in 2009 and will disappear in 2010. These changes will occur pursuant to the following schedule:

Calendar Year	Estate and GST tax death time applicable <b>exclusion</b> amount	Applicable <b>credit</b> amount	Highest estate- and gift-tax rates
2002	\$1.0 Million	\$345,000	50%
2003	\$1.0 Million	\$345,000	49%
2004	\$1.5 Million*	\$555,800	48%
2005	\$1.5 Million	\$555,800	47%
2006	\$2.0 Million	\$780,800	46% (flat)
2007	\$2.0 Million	\$780,800	45% (flat)
2008	\$2.0 Million	\$780,800	45% (flat)
2009	\$3.5 Million	\$1,455,800	45% (flat)
2010	N/A (taxes repealed)	N/A	top individual rate under the bill (gift tax only)
2011	\$1 Million	\$345,800	55%

\*Gift-tax applicable exclusion amount \$1 million

## The Applicable Credit Amount

In 2009\* each individual is entitled to a credit of \$1,455,800 against his or her transfer-tax liability:

*Meaning:* Assume D's estate is valued at exactly \$3,500,000. To compute D's tax liability:

	2009
Tentative tax is	\$1,455,800
<i>Less:</i> Applicable credit amount	<u>&lt;\$1,455,800&gt;</u>
Estate tax	0

Any amount in excess of this \$3,500,000 exemption is taxed at a flat rate of 45%.

\*In 2008, the applicable credit was \$780,000 and the exemption was \$2,000,000.

In 1976, the exemption was \$60,000.

Consensus opinion is that this \$3,500,000 exemption and 45% tax rate will be retained.

A growing consensus is that the exemption will be \$2,000,000 per person.

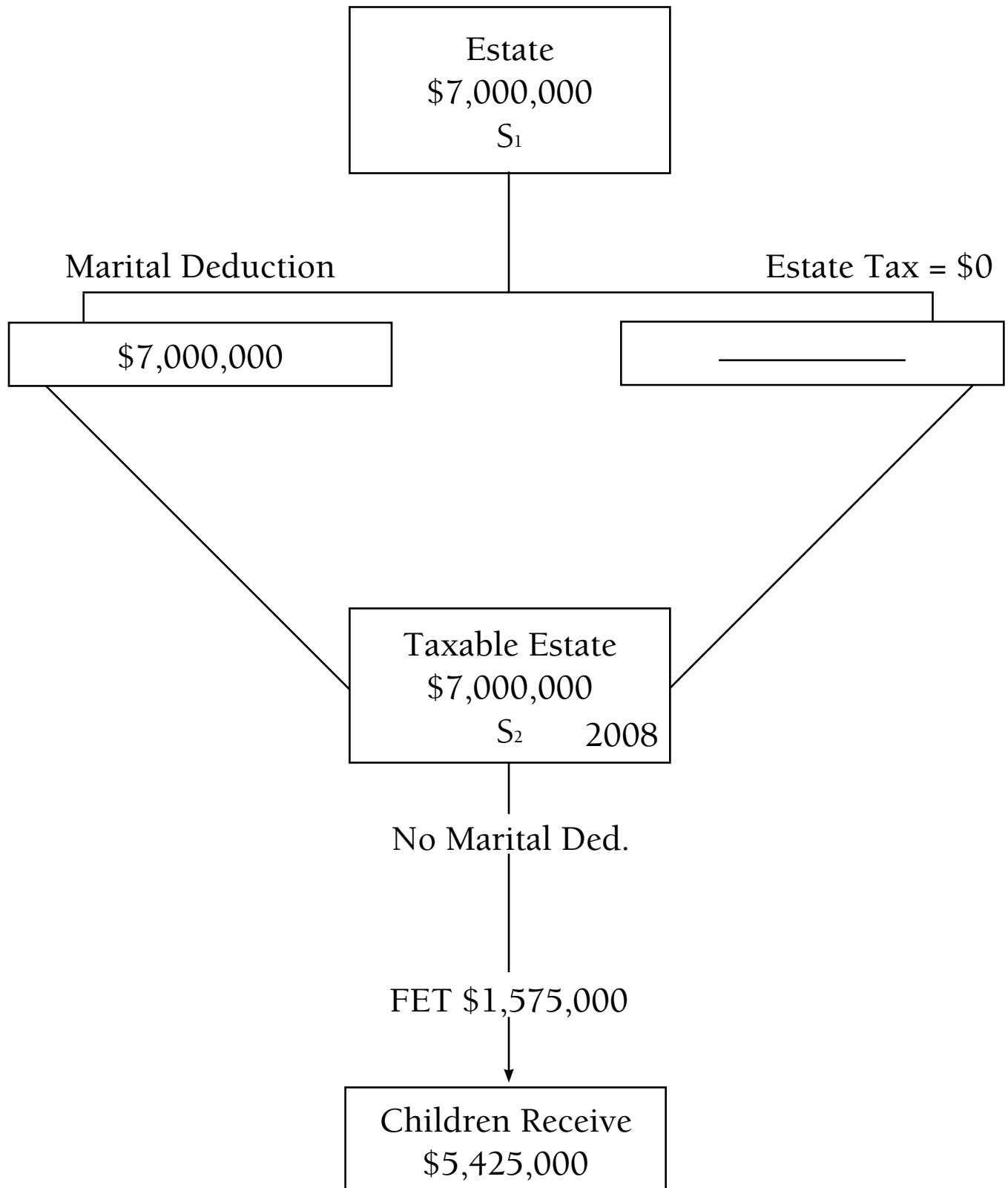
## Federal Estate-Tax Returns Filed 2001-2007

Size of Gross Estate	2001				2003			
	Exempt Amt: \$675,000				Exempt Amt: \$1,000,000			
	Gross estate for tax purposes		Charitable deduction		Gross estate for tax purposes		Charitable deduction	
	Number	Amount	Number	Amount	Number	Amount	Number	Amount
<b>All returns, total...</b>	<b>108,071</b>	<b>\$215,592,994</b>	<b>18,718</b>	<b>\$16,150,000</b>	<b>73,128</b>	<b>\$200,267,169</b>	<b>13,399</b>	<b>\$14,769,000</b>
			17.3%	7.5%			18.3%	7.4%
Under \$1.0 million	45,419	\$36,897,394	6,463	\$873	7,086	\$5,741	908	\$168
\$1.0 million < \$1.5 million	28,317	33,871,690	4,462	1,277	29,703	36,118	4,723	1,151
\$1.5 million < \$2.0 million	12,201	21,160,119	1,884	802	13,327	22,965	2,428	871
\$2.0 million < \$3.5 million	12,695	32,653,156	2,987	1,871	13,136	33,814	2,596	2,008
\$3.5 million < \$5.0 million	3,980	16,603,128	995	1,022	4,130	17,060	921	1,016
\$5.0 million < \$10.0 million	3,550	24,229,334	1,151	1,835	3,732	25,285	1,009	1,687
\$10.0 million < \$20.0 million	1,282	17,218,534	468	1,668	1,273	17,645	486	1,575
\$20.0 million or more	628	32,959,638	301	6,802	720	41,637	329	6,294

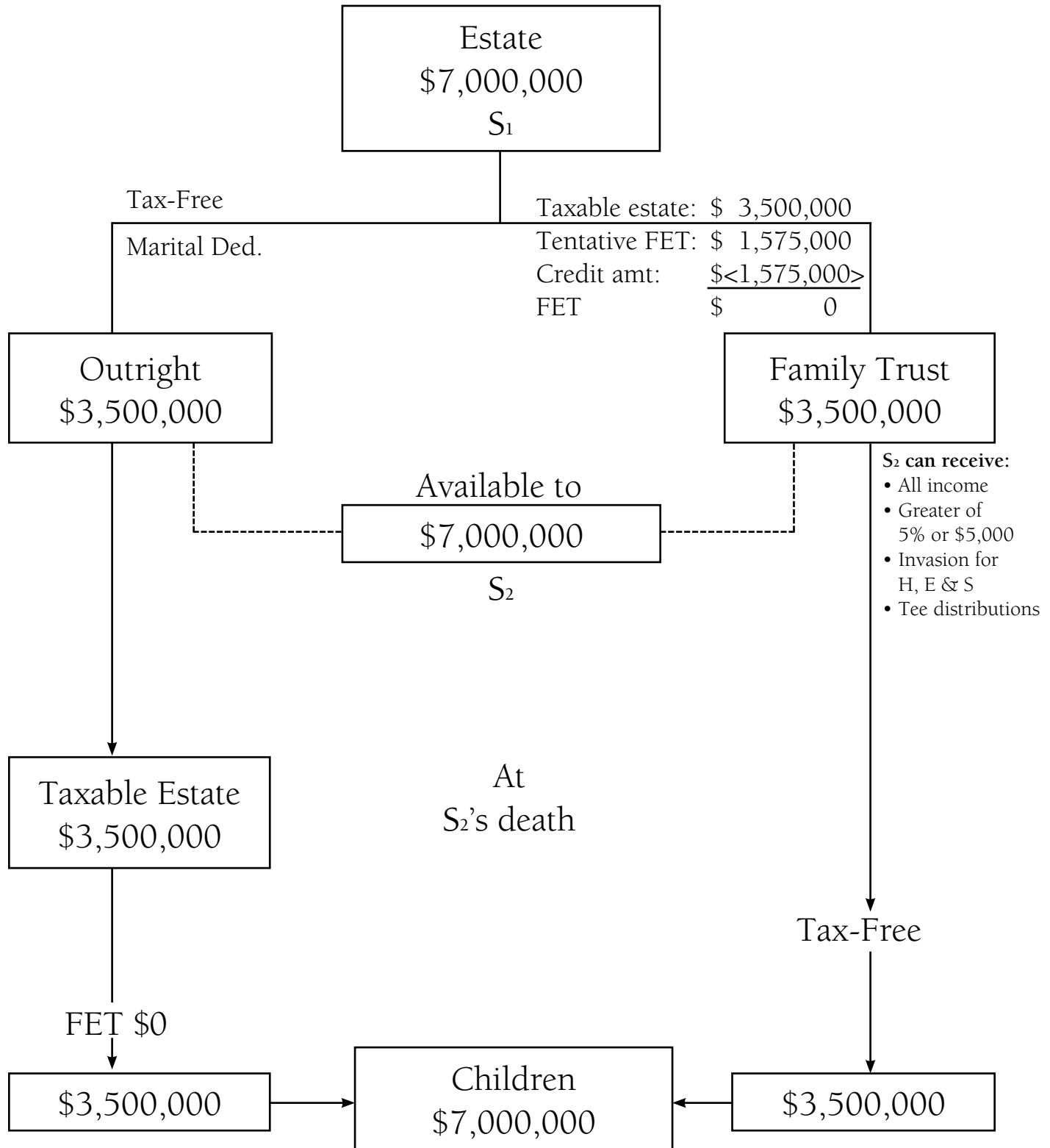
Size of Gross Estate	2005				2007			
	Exempt Amt: \$1,500,000				Exempt Amt: \$2,000,000			
	Gross estate for tax purposes		Charitable deduction		Gross estate for tax purposes		Charitable deduction	
	Number	Amount	Number	Amount	Number	Amount	Number	Amount
<b>All returns, total...</b>	<b>45,070</b>	<b>\$184,696,403</b>	<b>8,785</b>	<b>\$19,782,413</b>	<b>38,031</b>	<b>\$203,095,593</b>	<b>7,672</b>	<b>\$19,701,929</b>
			19.5%	10.7%			20.2%	9.7%
Under \$1.5 million	5,590	\$6,616,339	710	\$218,462	3,945	6,307,809	579	246,314
\$1.5 million < \$2.0 million	13,955	24,047,230	2,334	822,742	19,806	51,481,033	3,521	1,982,948
\$2.0 million < \$3.5 million	14,842	38,162,443	2,814	1,687,401	5,943	24,484,232	1,295	1,187,054
\$3.5 million < \$5.0 million	4,445	18,386,313	1,037	1,084,509	5,429	36,744,179	1,294	2,214,199
\$5.0 million < \$10.0 million	4,122	28,001,268	1,107	1,969,189	1,892	25,673,363	550	1,675,366
\$10.0 million < \$20.0 million	1,358	18,629,863	455	1,587,237	1,017	58,374,979	433	12,396,049
\$20.0 million or more	760	50,832,948	328	12,352,875				

\* Dollar amounts in thousands

# Outright to Spouse (The Way It Was)



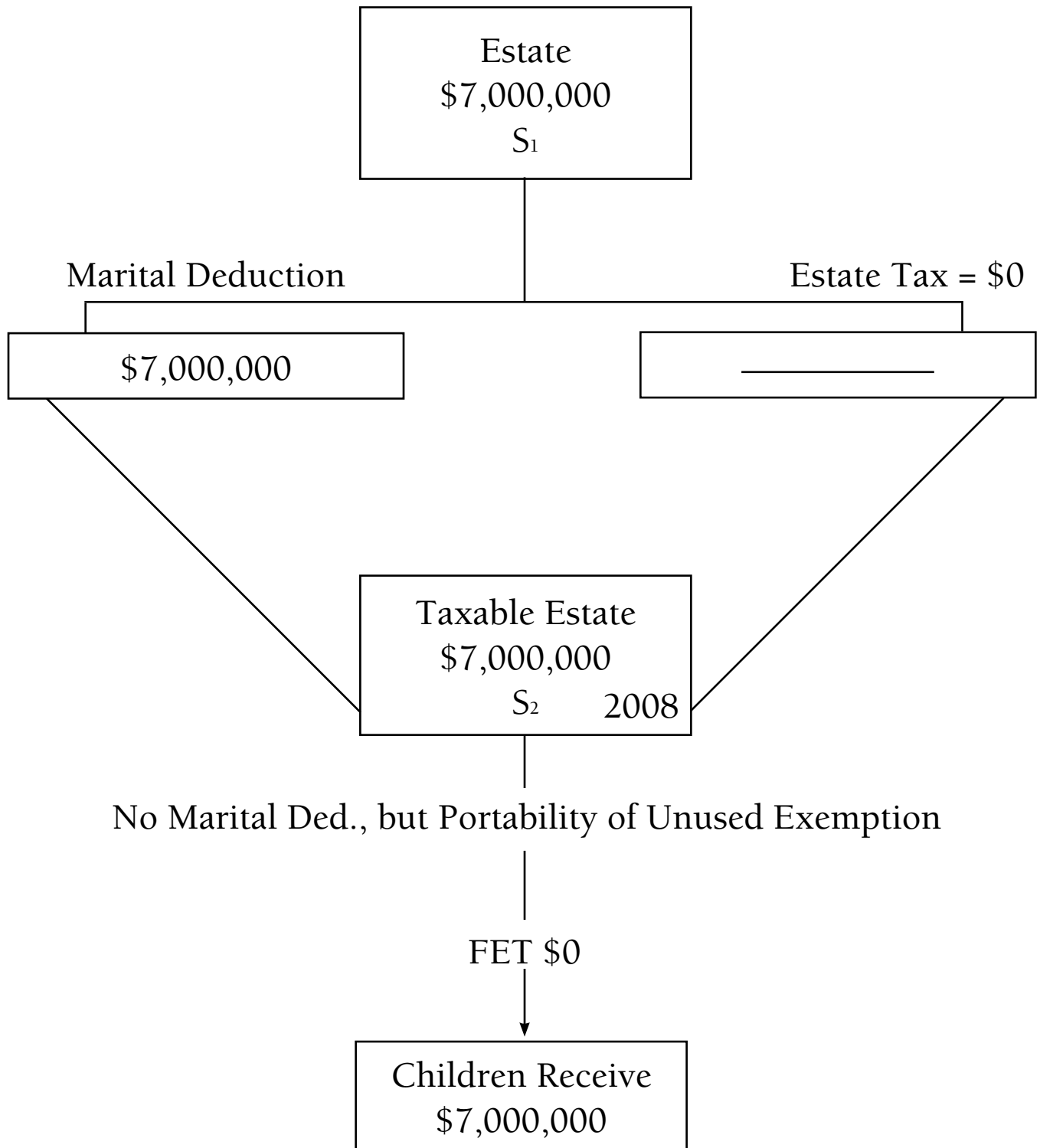
## Half Outright, Half in Family Trust



- S<sub>2</sub> can receive:**
- All income
  - Greater of 5% or \$5,000
  - Invasion for H, E & S
  - Tee distributions

**Savings: \$7,000,000 - 5,524,000 = \$1,575,000**

**Proposed Exemption Portability  
Outright to Spouse (The Way It May Be)**



Savings  $\$7,000,000 - \$5,425,000 = 1,575,000$

## Planning with Lifetime Gifts to Family and Friends

- I. Benefits of a lifetime-gift program  
(Remember: Gift-tax exemption is only \$1,000,000):
  - A. \$13,000 annual exclusion—per donee (indexed for inflation)
  - B. Spousal gift splitting—\$26,000 per donee
  - C. Avoid transfer tax on subsequent appreciation
  - D. Remove gift tax paid from gross estate
  - E. Shift income to lower-bracket taxpayer if under 18 years old or 24 and a full-time student

## Roth IRA Conversions 2010 and Gift Opportunities

### I. Starting in 2010 anyone regardless of AGI will be able to convert an existing traditional IRA to a Roth IRA.

#### A. The \$100,000 limitation disappears next year.

But it's not a free ride. The transfer is a taxable event. Taxpayers can elect to pay the tax with 2010 tax return or elect to pay over two subsequent years in 2011 and 2012.

1. So, you convert your regular IRA into a Roth IRA in January 2010 when the account is worth \$200,000, generating a potential tax liability of about \$80,000.

The market then proceeds to crash 30% and the account is worth only \$140,000. Your tax liability, however, does not go down, it stays at \$80,000, which represents a tax rate of 57% on the remaining \$140,000.

2. *What to do?* You are permitted to reconvert to a regular IRA and forget all about the tax, but you have to do this no later than October 15 of the following tax year. So, if you convert to a Roth in January 2010 you have till October 15 of 2011 to reconvert to a regular IRA. But you have to wait till 2012 to convert to a Roth again.
3. **Query:** What if at the time of reconversion some of the assets in the Roth are way down but others are way up? Can you reconvert only the losers and keep the winners in the Roth?

Any solutions?

- B. The tax impact can be ameliorated with charitable gifts both outright and deferred. Because of the significant tax liability, one option to consider is to accelerate and compress future charitable gifts that you would ordinarily make into the year of the conversion.

For example, if you usually make annual charitable gifts of say \$10,000 a year you could transfer \$50,000 (5 years' worth) or \$100,000 (10 years' worth) into a donor-advised fund this year. You will be entitled to a charitable deduction of an equal amount. so if it is \$100,000 this will result in an income-tax savings of \$40,000 (40% of \$100,000) to offset some or all of the tax liability resulting from the conversion.

You can also stagger the conversions over several years and pay the tax over several years.

- C. Compare results over 15 Years with \$100,000 in IRA,

1. Convert to Roth

$$\begin{array}{r}
 \$100,000 - \$40,000 \text{ Tax} = \$60,000 \\
 \xrightarrow[\text{@ 8\%}]{15 \text{ years}} \underline{\underline{\$190,000}}
 \end{array}$$

2. Stay put in regular IRA

$$\begin{array}{l}
 \text{Average minimum} \\
 \text{distributions} \quad (\$5,000 - \$2,000 \text{ tax}) \times 15 \text{ years} = \underline{\underline{\$45,000}} \\
 \text{from } \$100,000
 \end{array}$$

Capital growth \$100,000  
 @ 3% (8% – 5%) over 15 years

$$= \$156,000 - 40\% \text{ tax} \quad \underline{\underline{\$ 93,000}}$$

$$\$45,000 + \$93,000 = \underline{\underline{\$138,000}}$$

D. Who should convert to a Roth IRA?

1. Can you afford to pay the tax?

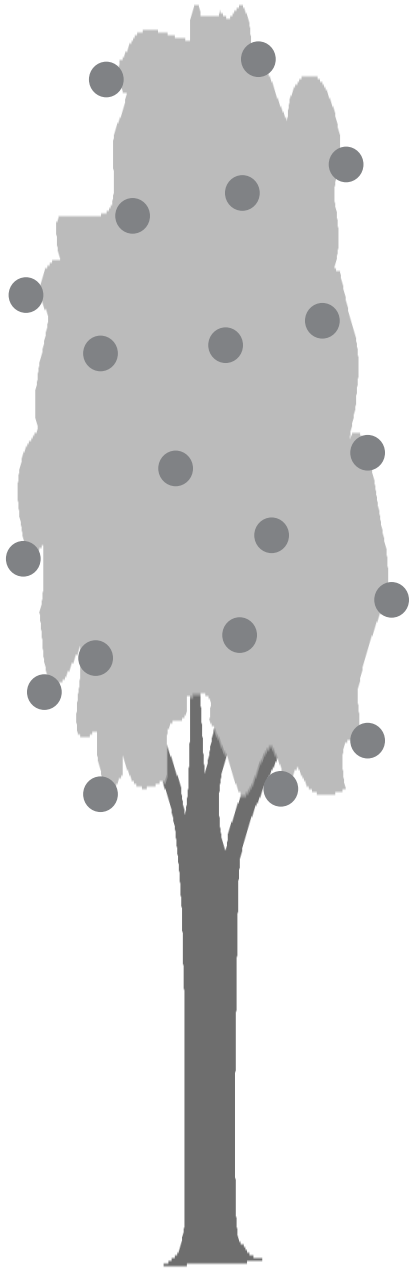
2. From what source should the tax be paid?

3. Are you going to be in a higher or lower tax bracket at retirement?

E. The best gift to a child or grandchild?

F. The five year and 59½ year old rules?

## The Four Methods of Making a Major Planned Gift and the Process of Gift Planning



### A. Outright

### B. Life-income plans— split interest plans

1. Charitable gift annuity
2. Charitable remainder trust
3. Remainder interest in personal residence or farm

### C. Lead trusts

1. Grantor charitable lead trust
2. Nongrantor charitable lead trust

### D. Bequests and other testamentary transfers

1. Living revocable trust
2. Life insurance proceeds
3. Retirement-plan benefits

## I. Outright Gift of Cash

Dr. Hart recently received a \$100,000 cash distribution from a retirement plan that has been discontinued.

In her 33% federal income-tax (FIT) bracket she will incur an unwelcome \$33,000 tax liability.

Dr. Hart decides to contribute the \$100,000 to her favorite charities. Assuming her other adjusted gross income (AGI) is \$200,000 or more, then

Assume other AGI is	\$200,000
Plus, distribution of	<u>\$100,000</u>
New AGI	\$300,000
Less: charitable distribution of	\$100,000
Taxable income—same as before	\$200,000

By making the gift, Dr. Hart was able to direct the \$33,000 tax liability from the government to her favorite causes. The out-of-pocket cost of the charitable contributions to her is \$67,000 (\$100,000 - \$33,000).

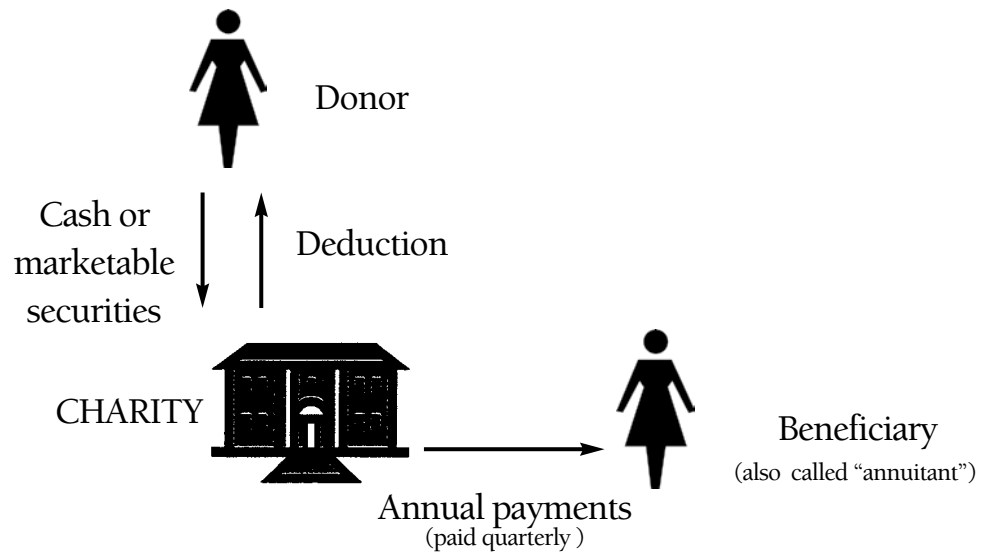
## II. Outright Gift of Appreciated Stock Provides Better Result

Dr. Hart also owns stock valued at \$100,000, which she purchased years ago for \$40,000.

If she were to sell securities		\$100,000
Capital gain	\$ 60,000	
Capital-gain tax at 15%		< <u>\$ 9,000</u> >
Real value to Donor		\$ 91,000
Charitable gift deduction	\$100,000	
Tax savings at 33%		< <u>\$ 33,000</u> >
“Cost” of gift (\$100,000 less \$33,000 less \$9,000)		<u>\$ 58,000</u>

In addition, there could be a potential transfer-tax savings at death because the asset is removed from her estate

## CHARITABLE GIFT ANNUITY



- Donor transfers cash and/or marketable securities to charity.
- Donor receives an income-tax charitable deduction and may save capital-gain tax.
- Charity pays a fixed amount each year to Donor or to anyone Donor names for life (maximum of two beneficiaries). Typically, a portion of these payments is tax-free over Donor's life expectancy.
- The principal passes to Charity.

### III. Give Bonds to Capture Gain, Eliminate Risk, Receive Guaranteed Return from a Gift Annuity

- A. As interest rates have dropped, the value of corporate and government bonds that pay higher than current market rates has increased. Investors who purchased bonds a few years back typically have seen the value of those bonds go up significantly. Now, though, bondholders may feel as if they are sitting on a time bomb with three fuses.

First, some of these bonds may be subject to provisions that allow the bond issuers to call in such bonds at par (face value).

Second, even if the bonds are not called, they will only be worth their face value if held until maturity.

Third, if interest rates start to rise, investors will see their appreciation begin to melt away.

Thus, to capture the benefit of the appreciation, the owner has to sell the bond, which in turn will trigger capital-gain tax.

For these reasons, appreciated bonds can be an excellent choice to fund charitable gifts.

**B. Calculating Value of Bonds**

In 1989 an investor bought a newly issued \$100,000 par value 30-year U.S. Treasury Bond with a coupon yield of 9.17% paid out in semi-annual installments of \$4,585 ( $\$9,170 / 2$ ). The bond will mature in February 2019. In 2009 the yield to maturity (YTM) on a comparable 10-year bond is 3.8%.

Cost basis in 1989	\$100,000
Current value at 3.8% YTM	\$142,488
In 10 years the bond will be redeemed for	\$100,000

**Calculator Method**

Enter:

FV \$100,000

I  $\frac{1}{2}$  of interest rate  $\frac{3.8}{2} = 1.9$

N number of semi-annual payments remaining 19

PMT amount of semi-annual payment  $\frac{9,170}{2} = 4,585$

Then: punch CPT and PV = 3 years 6% int  
Current FMV of bond \$142,488 13 payments  
\$116,856

**C. Outright-gift option**

FMV of 10-year 3.8% YTM bond \$142,488

Tax savings in 40% bracket \$ 56,995

Capital-gain tax avoided ( $\$42,488 \times 20\%$ ) \$ 8,498

Total tax avoided \$ 65,493

Cost of gift \$ 76,995

**D. Assume that in three years the economy has recovered to the point that interest rates have gone up to 5% and there are 13 payments left on the bond. The FMV of the bond at that time would be \$116,856.**

E. Give Bonds...cont.: Gift Annuity

1. Life-Income Option

An 80-year-old who owns such a bond now valued at \$142,448 would be receiving \$9,170 annually over the next 10 years.

No gift

Annual return	\$ 9,170
Tax at 40%	< <u>\$ 3,668</u> >
After-tax return	\$ 5,502

2. Gift Annuity for \$142,448

a.	Annual annuity	\$10,117
	Tax-free portion	\$5,240 net \$ 5,240
	Capital gain	\$2,226 net \$ 1,781
	Ordinary income	\$2,650 net <u>\$ 1,590</u>
	After-tax return for 9.4 years	<u>\$ 8,611</u>
	Thereafter, after-tax return	<u>\$ 6,070</u>
b.	Charitable deduction	\$72,313
	Tax savings at 40%	\$28,925
	Net return at 3% tax-free municipals	<u>\$ 868</u>
	Total annual return for 9.4 yrs (\$8,611 + \$868)	<u>\$9,479</u> + 72%
	Thereafter (\$6,070 + \$868)	<u>\$ 6,938</u> + 26%

**E. Flexible Gift Annuity—Supplemental Retirement Plan**

**Assumptions:**

Annuitant	60
First payment start date in range	10/1/2019
Last payment start date in range	10/1/2024
Principal donated	\$142,488.00
Cost basis	\$100,000.00
Payment schedule	quarterly

**Benefits:**

Charitable deduction	\$62,455.34
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**Annual Payments and Taxation for Elective Payment Start Dates**

Elective Start Date	Age at Start Date	Annuity Rate	Capital Gain	Tax-free Portion	Ordinary Income	Total Annuity
10/1/2019	70	8.6%	\$1,501.79	\$3,534.60	\$ 7,217.61	\$12,254.00
10/1/2020	71	9.1%	\$1,569.77	\$3,694.60	\$ 7,702.07	\$12,966.44
10/1/2021	72	9.7%	\$1,644.42	\$3,870.30	\$ 8,306.64	\$13,821.36
10/1/2022	73	10.3%	\$1,728.63	\$4,068.50	\$ 8,879.15	\$14,676.28
10/1/2023	74	10.9%	\$1,820.06	\$4,283.70	\$ 9,427.44	\$15,531.20
10/1/2024	75	11.7%	\$1,923.82	\$4,527.90	\$10,219.40	\$16,671.12

IRS discount rate is 3.4%

## G. All That Glitters

Donor has owned 740 South African Krugerrand gold coins for more than one year, and he proposes to transfer them to a CRUT.

In Rev. Rul. 69-63, 1969-1 C.B. 63, the IRS ruled that a collection of rare coins held as collectors items is tangible personal property. The ruling also ruled that cash is not tangible personal property within the meaning of the statute.

The IRS determined South African Krugerrand gold coins are more akin to money than to coins that have value as collectors items. They are one of the best-known types of gold bullion coins, and they have no numismatic value. Also, the trustee is authorized to dispose of the coins. Therefore, pursuant to the rationale of Rev. Rul. 69-63, the IRS concluded that the South African Krugerrand gold coins are not tangible personal property within the meaning of IRC §170(a)(3).

### Gold Prices

2009	\$993.00 (broke \$1,000)	1989	\$401.00	1970	\$ 38.90
2008	\$890.00	1988	\$410.15	1969	\$ 41.00
2007	\$780.00	1987	\$486.50	1968	\$ 43.50
2006	\$620.00	1986	\$390.90	1967	\$ 35.50
2005	\$500.00	1985	\$327.00	1966	\$ 35.40
2004	\$415.00	1984	\$309.00	1965	\$ 35.50
2003	\$350.00	1983	\$380.00	1964	\$ 35.35
2002	\$283.10	1982	\$447.00	1963	\$ 35.25
2001	\$271.04	1981	\$400.00	1962	\$ 35.35
2000	\$279.11	1980	\$594.90	1961	\$ 35.50
1999	\$290.25	1979	\$459.00	1960	\$ 36.50
1998	\$288.70	1978	\$208.10	1959	\$ 35.25
1997	\$287.05	1977	\$161.10	1958	\$ 35.25
1996	\$369.00	1976	\$133.77	1957	\$ 35.25
1995	\$387.00	1975	\$139.29	1956	\$ 35.20
1994	\$383.25	1974	\$183.77	1955	\$ 35.15
1993	\$391.75	1973	\$106.48		
1992	\$333.00	1972	\$ 63.84		
1991	\$353.15	1971	\$ 44.60		
1990	\$386.20				

**A gift annuity to support an aging parent (or a sibling, etc.)**

Dr. Rex has been supplementing his 85-year-old mother's retirement with annual contributions of about \$8,000. (Pre-tax cost to Dr. Rex \$11,940.) Dr. Rex funds a \$100,000 gift annuity with a favorite charity for his mom's benefit. As a result,

Mom's annual annuity			\$ 8,100
Tax-free portion	\$6,350	net	\$ 6,350
Ordinary income	\$1,750 (25% tax)		<u>\$ 438</u>
Over 6.8 years life expectancy			<u>\$ 6,788</u>

Dr. Rex receives a \$56,837 tax deduction that saves him in his 33% tax bracket \$18,756

Assume a 6% return \$ 1,125

Almost enough to make his mom whole (\$6,788 + \$1,125), \$ 7,913

Dr. Rex no longer has to make the \$8,000 annual outlay.

## H. Supplemental Retirement Plans

Dr. Johnson, aged 50, is in the early stages of retirement and estate planning. She learns that some of her retirement goals can be achieved through thoughtful gift-planning arrangements.

After consulting with her advisors, Dr. Johnson establishes a plan whereby she will contribute \$20,000 a year for 15 years to a charitable deferred gift annuity. She will be entitled to a charitable income-tax deduction for a portion of each annual contribution. However, since she has no need for current income, the annuity payments will be deferred for 15 years, when she plans to retire. As a result:

Total contributions for DGA (15 years x \$20,000)	\$300,000
Total charitable deduction	\$157,625
Total tax savings at 35%	<u>\$ 55,169</u>
Annual annuity payments starting after 15 years	\$ 29,340
Tax-free	\$ 7,452
Taxable \$21,888 net after 35% tax	<u>\$ 14,228</u>
After-tax annual income over life expectancy	<u>\$ 21,680</u>

Thereafter, the annuity is all ordinary income.

**Flexible Gift Annuity**

**ASSUMPTIONS:**

Annuitant	50
First Payment Start Date in Range	10/14/2024
Last Payment Start Date in Range	10/14/2029
Cash Donated	\$300,000.00
Payment Schedule	quarterly

**Charitable Deduction** **\$102,624.00**

**Annual Payment and Taxation for Elective Payment Start Dates**

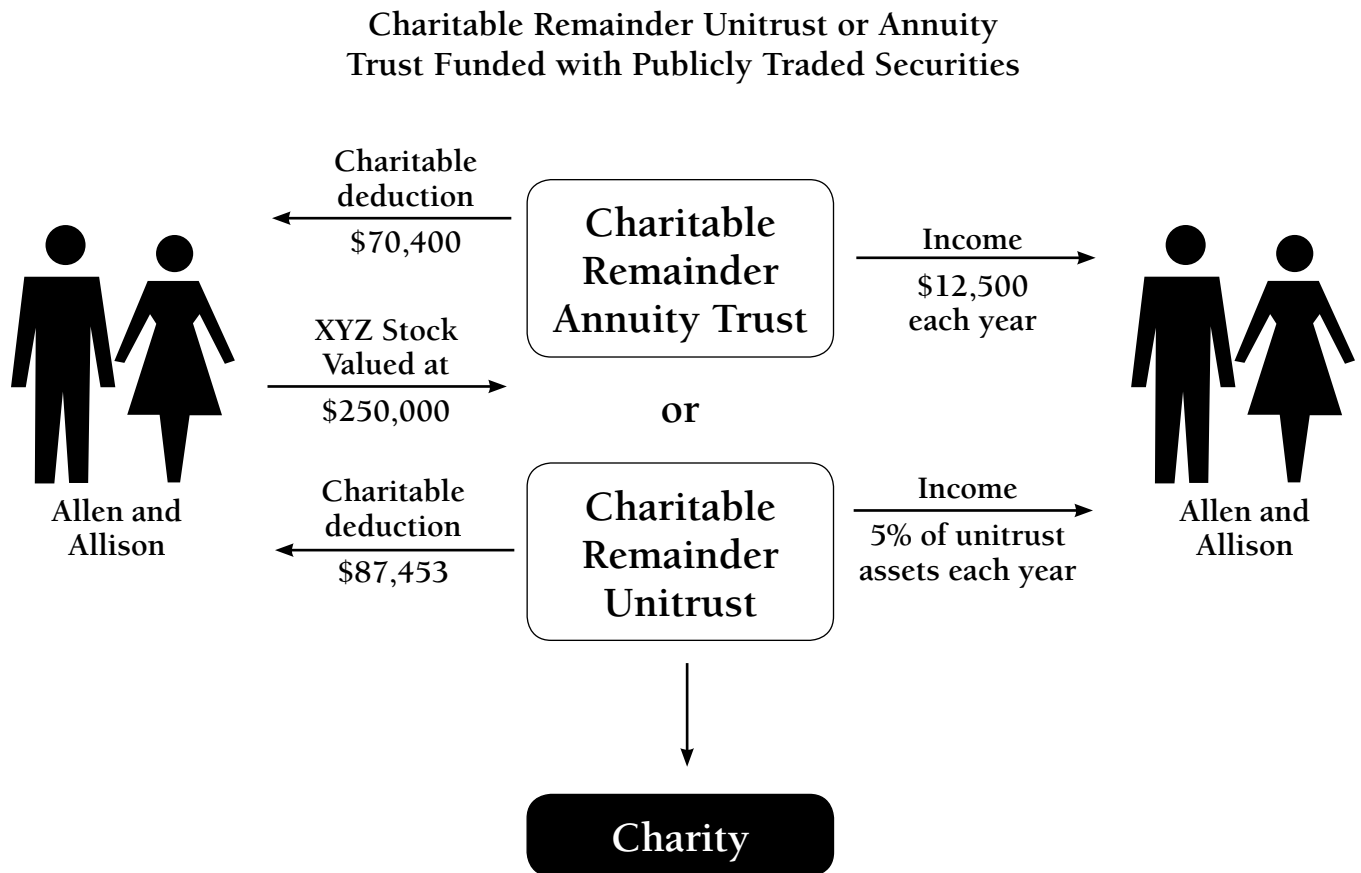
<b>Elective Start Date</b>	<b>Age at Start Date</b>	<b>Annuity Rate</b>	<b>Tax-free Portion</b>	<b>Ordinary Income</b>	<b>Total Annuity</b>
10/14/2024	65	9.8%	\$9,907.80	\$19,492.20	\$29,400.00
10/14/2025	66	10.4%	\$10,327.20	\$20,872.80	\$31,200.00
10/14/2026	67	10.8%	\$10,789.20	\$21,610.80	\$32,400.00
10/14/2027	68	11.5%	\$11,281.50	\$23,218.50	\$34,500.00
10/14/2028	69	12.2%	\$11,821.80	\$24,778.20	\$36,600.00
10/14/2029	70	13.0%	\$12,402.00	\$26,598.00	\$39,000.00

The entire annuity will become ordinary income after the life expectancy of the annuitant.

## Example of Charitable Remainder Unitrust or Annuity Trust Funded with Publicly Traded Securities

### Situation

A number of years ago Allen and Allison purchased stock in XYZ Corporation for \$50,000. The stock has grown in value to \$250,000 and is currently paying a dividend of 2%. The Allens, having both reached the age of 65, are retiring and would like to increase their cash flow. They have considered selling the stock but have hesitated to incur a large capital-gain tax. They are also concerned about the eventual estate tax the surviving spouse will have to pay. Both are philanthropically minded, and they would like to support a charity with which they have been involved.



\*Based on a CMFR of 4% and quarterly payments.

## Cash Flow Projection Annuity vs. Unitrust

5.0% Payout Rate

Assumes average net total trust return of 6.5%.  
Actual return could be higher or lower,  
and it will not be a constant rate.

Year	Trust Balance beginning of year		Trust Earnings		Trust Payout	
	Annuity Trust	Unitrust	Annuity Trust	Unitrust	Annuity Trust	Unitrust
1	250,000	250,000	16,250	16,250	12,500	12,500
2	253,750	253,750	16,494	16,494	12,500	12,688
3	257,744	257,556	16,753	16,741	12,500	12,878
4	261,997	261,419	17,030	16,992	12,500	13,071
5	266,527	265,340	17,324	17,247	12,500	13,267
6	271,351	269,321	17,638	17,506	12,500	13,466
7	276,489	273,361	17,972	17,768	12,500	13,668
8	281,961	277,461	18,327	18,035	12,500	13,873
9	287,788	281,623	18,706	18,306	12,500	14,081
10	293,994	285,847	19,110	18,580	12,500	14,292
11	300,604	290,135	19,539	18,859	12,500	14,507
12	307,643	294,487	19,997	19,142	12,500	14,724
13	315,140	298,904	20,484	19,429	12,500	14,945
14	323,124	303,388	21,003	19,720	12,500	15,169
15	331,627	307,939	21,556	20,016	12,500	15,397
16	340,683	312,558	22,144	20,316	12,500	15,628
17	350,328	317,246	22,771	20,621	12,500	15,862
18	360,599	322,005	23,439	20,930	12,500	16,100
19	371,538	326,835	24,150	21,244	12,500	16,342
20	383,188	331,738	24,907	21,563	12,500	16,587
21	395,595	336,714	25,714	21,886	12,500	16,836
22	408,809	341,764	26,573	22,215	12,500	17,088
23	422,881	346,891	27,487	22,548	12,500	17,345
24	437,868	352,094	28,461	22,886	12,500	17,605
25	453,830	357,376	29,499	23,229	12,500	17,869

*Note:* In actuality, returns on trust assets will not be constant, which means unitrust payments may fluctuate up and down. Constant returns are used here to demonstrate the difference between unitrusts and annuity trusts.

#### IV. Tax Implications

Income tax charitable deduction (annuity trust)	\$70,400*
Income tax charitable deduction (unitrust)	\$87,453*
Tax on capital gain	
To the donor when the stock is transferred to the trust	-0-
To the trust when the trustee sells the stock	-0-
To the beneficiary when they receive trust payments	Possibly portion of payments taxed as capital gain

(The portion of payments to beneficiaries consisting of capital gain realized by the trusts will be taxed to them as capital gain.)

\* These amounts will vary depending on the applicable CMFR, and the CMFR will have a much greater effect on the deduction associated with an annuity trust than on the deduction associated with a unitrust. With respect to both types of trusts, the higher the CMFR, the higher the deduction. The calculations of the charitable deductions in this instance were based on a CMFR of 4.0%.

#### V. Other Common Applications of Charitable Remainder Trusts

##### A. Asset Diversification

Some individuals hold a large number of shares of a particular stock that has appreciated significantly. They would like to diversify their portfolios to lessen risk, but they hesitate to sell shares in this stock because of the tax on capital gain they would incur. They might consider funding a charitable remainder trust with some of their shares. The trustee could then sell those shares and invest the proceeds in a diversified portfolio. Since the trust is tax-exempt, it would not be taxed on the capital gain.

**Situation:** Lynn, 45, owns 30,000 shares of AA company. The stock is now selling for \$70 per share. She acquired the shares over the past 15 years, some for as low as \$4 per share. Although she has confidence in the company, she recognizes that it operates in a very competitive environment, and she is nervous about having so much of her net worth in a single stock. Lynn is single and plans eventually to leave most of her estate to charities—though she does want to make modest provisions for nieces and nephews and for a few friends. She enjoys studying the market and would be disinclined to surrender

investment control of any of her assets. At this time, her salary is sufficient for her lifestyle apart from any investment income. However, she wants to retire at the age of 60, and at that time she would like additional cash flow.

Lynn contributes 15,000 shares of AA stock (selecting the shares with the lowest cost basis) to a NIMCRUT that will flip to a SCRUT when she attains the age of 60. The payout rate of the trust is 5%, and there are five charitable remainder beneficiaries, each of which will receive an equal share. She is the sole income beneficiary, and payments will be made to her for the duration of her life. She names herself as trustee and takes responsibility for investing, but she outsources trust accounting and tax filing. In her capacity as trustee, she sells the AA stock and invests the proceeds in a diversified growth-oriented portfolio. Net income is minimal, but it is sufficient to cover trust administration and provide small distributions to Lynn.

The gift results in an income-tax deduction of \$241,993. Lynn then sells enough of her remaining shares of AA stock to generate capital gain equal to her usable deduction, and she uses the proceeds to purchase other securities. This helps her balance her portfolio with little or no tax cost. (Some portion of total itemized deductions will be lost when adjusted gross income exceeds a certain level—\$159,950 in 2008 but adjusted for inflation each year and ultimately eliminated by the Economic Growth and Tax Reconciliation Act of 2001 (hereinafter “EGTRRA”).) Beginning with the tax year immediately following the year she turns 60, she will start receiving 5% of the value of trust assets, and those assets could have grown to several million dollars by then.

## B. Supplemental Retirement Plan

Although the EGTRRA increases the contribution limits for IRAs and employer-sponsored retirement plans, many individuals who contribute the maximum allowable would like to accumulate still more for retirement on a tax-favored basis. They might consider creating a NIMCRUT that will flip to a SCRUT at the age they plan to retire. To the extent that their financial situation permits, they can make additions to the trust during their working years.

**Situation:** Robert has been contributing the maximum allowable to his qualified retirement plan, and he would like to accumulate more for retirement. He has some stocks that have performed very well, though they have lost some of their value during the past year. He is not spending all of his after-tax income, and he would be willing to contribute some of that excess income toward his future retirement. Robert and his wife, Barbara, are both aged 50, and they would like to retire no later than the year they attain the age of 65. They have two adult children, aged 25 and 23, but they believe they can make significant transfers to a charitable instrument and still provide adequately for the children.

To provide a substantial supplemental retirement plan, they establish a NIMCRUT with a 6% payout rate and include in the trust agreement a provision that causes the trust to “flip” or convert from a NIMCRUT to a SCRUT, effective the tax year following the year Robert and Barbara turn 64. They initially fund the trust with stock valued at \$200,000 and each year for the next ten years make additional contributions to the trust. These additions average approximately \$10,000 per year.

By the end of the year in which Robert and Barbara reach the age of 64, the trust corpus has grown to approximately \$1,500,000 and the accrued deficiency (total percentage payout amounts in excess of net distributions for all years combined) is nearly \$700,000. These results were achieved by the trustee’s investing trust assets to maximize growth and minimize current interest and dividends.

Beginning the year in which Robert and Barbara will turn 65, they start receiving 6% of trust assets. Initially, this amount is more than \$90,000, and it will increase or decrease based on future investment performance. The charitable income-tax deduction from contributions to the trust will have exceeded \$100,000.

**Increasing flexibility.** The above plan has these disadvantages:

1. Distributions prior to the year the trust starts functioning as a SCRUT are limited to interest and dividends (assuming assets are invested in securities).
2. Once the NIMCRUT flips to a SCRUT, the accrued deficiency is forfeited. To make more substantial distributions prior to the “flip” date possible, the trust agreement could contain a provision allocating post-gift realized capital gain to income. The trustee, taking into consideration the income beneficiaries’ desire for distributions, could sell some trust assets, realize some capital gain, and pay this realized gain to the beneficiaries to the extent of the accrued deficiency. Of course, such distributions are possible only if the trust assets appreciate beyond their value on the date of contribution. The Regulations pertaining to charitable remainder trusts, which became effective December 10, 1998, prohibit pre-contribution gain from being allocated to trust income. (See Reg. Sec. 1.664-3(1)(b)(4).)

If gain is allocated to income, a trustee could liquidate assets and make distributions prior to the “flip” date. This would not only meet the needs of the income beneficiaries but also make use of the accrued deficiency before it is otherwise forfeited.

## Income Security During Retirement Years

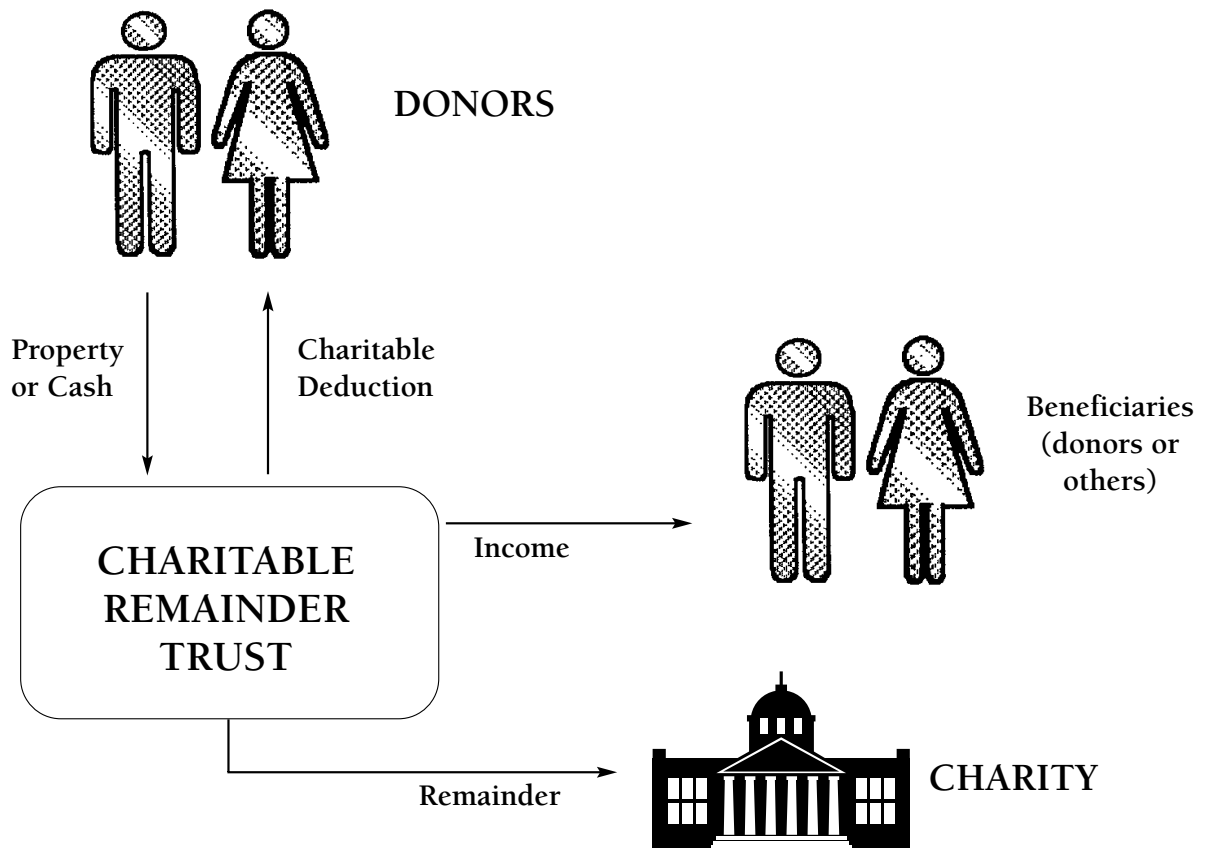
*Example:* Patrick and Maria, both age 84, have various appreciated stocks in their brokerage account with a combined value of \$500,000 and a cost basis of \$100,000. Their annual dividend income is approximately \$10,000. They would like to increase cash flow, not worry about market fluctuations, and arrange a memorial endowment at their alma mater. (Assuming a CMFR of 4%.)

### Solution

They transfer the stock to a charitable remainder annuity trust with a 7% payout rate. Although they have otherwise provided for their two children, they would like the children to receive some benefit from the trust in the event they die within the next few years. Thus, they provide that trust payments be paid for the longer of their lives or ten years. The two of them jointly and then the survivor will receive income for life. If neither of them lives for ten years, payments will be made to their two children for the balance of the ten-year period.

Value of stock contributed	\$500,000
Tax on capital gain in year of contribution	-0-
Annual payments	\$ 35,000
Increase over current dividends	\$ 25,000
Income tax charitable deduction	\$180,850

## CHARITABLE REMAINDER TRUST



- Donors fund a charitable remainder trust with cash or property.
- They receive an income-tax deduction for present value of the remainder interest.
- They and/or other named beneficiaries receive income for life or a term of years.
- The amount of income is a stated percentage of trust assets as revalued annually.
- Upon the death of the surviving beneficiary, the remaining trust assets are used as designated by the donors.

## VI. Gift of Income Interest in CRT—Another Look

In December of 1996, H and W contributed \$54,000 to a 5% unitrust.  
In December of 1997, they added \$20,000. Total contributions, \$74,000.  
Trust invested in Intel and Cisco.

In December of 1998, NIMCRUT is worth \$215,000.

H and W terminate the unitrust by assigning their income interest (their right to receive future payments from the unitrust), and entire assets are distributed to charity.

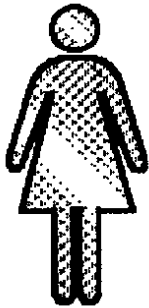
Deduction for initial contributions of \$74,000 to unitrust	\$ 17,000
Value of noncharitable income interest when trust terminated	<u>\$164,000</u>
Total charitable deductions	\$181,000
Tax savings (39.5%)	\$ 71,676
Out-of-pocket cost of gift (\$74,000 less \$71,676)	<u>\$ 2,324</u>

And, not to mention avoiding capital-gain tax of almost \$20,000 at that time.

VII. Retained-Life Estate Gift

**RETAINED  
LIFE ESTATE**

DONOR



Title to personal residence or farm →

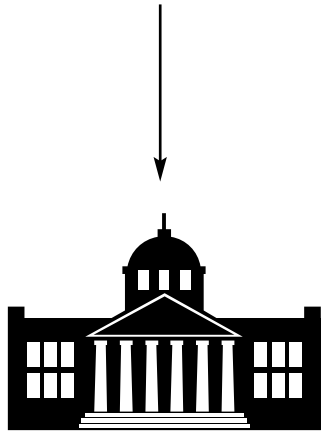
← Charitable income-tax deduction



Donor transfers title but continues to occupy residence or farm for duration of life.

Donor receives an income-tax deduction for present value of charity's remainder interest.

CHARITY



## VIII. Gift of a House with a Retained-Life Estate Gift

Mary, aged 74, purchased her home thirty years ago for \$150,000. It has recently been appraised for \$500,000. Mary would like to both continue living in her home for the duration of her life and ensure that it then goes to a charity. She would also like to reduce her taxes now.

If she gives the home to the charity subject to a retained-life estate, her charitable deduction will be \$262,268.

Assuming her FIT marginal rate is 28%, she will save as much as approximately \$73,435 in taxes in the year of the gift and in carry-over years.

What options are available to Mary if she decides to move out in five years?

- Rent the property and retain the rental income.
- Contribute the life tenancy and receive a deduction.
- Contribute the life tenancy for a gift annuity or to a charitable remainder trust.
- Sell the property and allocate the proceeds.

## IX. Life Insurance

1. Designate charity as a beneficiary of a life insurance policy.
  - a. Proceeds escape FET
  - b. No income-tax deduction for FMV of policy or premium payments
  
2. Designate charity as a beneficiary **and** owner of the life insurance policy.
  - a. Proceeds escape FET
  - b. Income-tax deduction for the lesser of the FMV of policy or net premiums paid
  - c. Annual premium payments deductible for FIT purposes
  
3. Do not get rid of that policy.

A 76-year-old man is considering contributing a \$500,000 life insurance policy to charity. The cash value is about \$100,000, but he finds out that a life settlement company would pay him \$150,000 for the policy.

Viatical settlement:	\$50,000 gain—tax free
Life settlement:	\$50,000 gain—taxable

X. **Good News from Washington:** Extension of Pension Legislation

Pension Protection Act of 2006 (PPA 2006) offers charitably minded individuals a golden opportunity to make gifts from their IRAs and exclude the amount of their gifts from gross income. To qualify:

- The donor must be 70½ years of age or older;
- The transfers must go directly from the IRA to qualified charities;
- Gifts cannot exceed \$100,000 per taxpayer per year; and
- Gifts must be outright.\*

\* Transfers to donor-advised funds, supporting organizations, and charitable remainder trusts and for charitable gift annuities do not qualify.

This opportunity is available to the end of 2009, and no charitable income-tax deduction is allowed.

Until now, individuals withdrawing \$100,000 from their IRAs and contributing it to charity would have had to include the \$100,000 in their income and would have been allowed a federal charitable income-tax deduction of up to \$100,000 (subject to limits of deductibility) to offset the inclusion.

**XI. Testamentary Gifts of Retirement-Plan Assets (IRD) v. Other Assets**

**A. Outright Distribution Example:**

Decedent owns a \$4,000,000 estate that consists of \$3,000,000 in securities and a \$1,000,000 IRA. He wishes to provide \$1,000,000 to his favorite charities and the balance to his children. Which asset produces the more cost-effective gift?

	<b>Charity</b>	<b>Children</b>
<b>Securities</b>	\$1,000,000	\$1,000,000
Less: attributable FET 45%	0	<450,000>
Less: income tax	<u>0</u>	<u>0</u>
Net benefit	\$1,000,000	\$ 550,000
 <b>IRA</b>	 \$1,000,000	 \$1,000,000
Less: attributable FET 45%	0	<450,000>
Less: income tax*	<u>0</u>	<u>&lt;192,500&gt;</u>
Net benefit	\$1,000,000	\$ 357,500**

Children better off by: **\$192,500** (\$550,000 - \$375,500) if they receive securities.

\*Income tax: 35% of (\$1,000,000 - \$450,000).

\*\*Compared to \$212,000 in 2001.