Tax Savings Trust Plan Provides Multiple Benefits

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The concept of charitable estate and financial planning is basic. You can increase your current spendable cash flow, get a current Federal and State income tax deduction, avoid capital gains taxes on the sale of appreciated assets, and avoid or reduce Federal and State estate and inheritance taxes by transferring assets to a **Charitable Remainder Trust**.

Current laws impose a significant tax on assets that are earned, accumulated and sold or transferred. Additionally, recent tax law changes have severely limited opportunities for tax advantaged investing. Today, one of the few remaining investment options with substantial tax benefits is the **Charitable Remainder Trust**. Bear in mind, this is not a tax shelter, but rather a tax alternative. It amounts to re-designating dollars earmarked for Federal and State taxes into dollars which will provide for your selected churches, hospitals, schools and community organizations that are vital to our way of life.

This planing is based on conventional, time-tested financial instruments, such as mutual funds, listed securities and life insurance, in combination with sanctioned charitable tax strategies and concepts, to provide maximum lifetime tax, income and investment benefits now for your client and a way to replace the assets eventually given away to selected charities for your client's children and grandchildren, free of estate and inheritance taxes. In fact, compared to your current financial and estate plan, charitable financial planning may provide a larger estate for your client.

Although **Charitable Remainder Trusts** have existed since the 1969 Tax Reform Act, the recent increased interest in the tool can be attributed to several factors. *First*, demographic information shows that the American population is aging, and a large percentage of these individuals have significant amounts of accumulated wealth. *Second*, tax law changes have reduced the number of estate planning tools to a handful of options. *Finally*, the amount of information available to tax and legal professionals regarding the technical aspects of these trusts has increased, and complex software explaining potential client benefits has been designed.

In this area of planning, a person's desire to do good is balanced by his/her desire for financial security. As a result, it is important to examine your objectives in relation to the financial and charitable benefit that may result from the use of a **Charitable Remainder Trust** to determine if it is an appropriate tool for your client's estate plan.

The Basics

A **Charitable Remainder Trust** is an irrevocable, tax-exempt trust that creates a split interest gift. The gift is split between the income interest and the remainder interest. The first step associated with this type of planning is to create the Trust and transfer cash or other assets to the Trust. Second, the donor receives a charitable income tax deduction for making the contribution. The Trust is set up to distribute income, at least annually, usually to the donor and his/her spouse. Because the trust is tax-exempt, no capital gains tax would be paid on the sale of appreciated assets that have been gifted to, and sold within, the Trust. Third, when the trust terminates, usually at the death of the donor and his/her spouse, the remaining assets are paid to the charity or charities selected by the donor. The trust corpus value is included in the estate of the last spouse to die. However, if the trust is established to pay income only to the husband and wife, the estate tax deduction effectively will eliminate these assets from taxation within the estate.
In essence, the use of a **Charitable Remainder Trust** will achieve the following basic objectives for the client:

- Federal and State deductions for income tax purposes.
- Capital gains tax savings upon the sale of an appreciated asset.
- Reduction in Federal and State estate taxes.
- The opportunity to substantially increase lifetime income for client, for another or for a survivor.
- A substantial endowment for the good works of charities of choice.
- Protection of assets from creditors.
- Avoidance of probate.

<u>The Advantages</u>

1. A Charitable Remainder Trust results in a current income tax deduction for Federal and State tax purposes.

The tax deduction is equal to the actuarially determined present value of your gift to charity after the death of the last income beneficiary. The deductible amount is determined by application of IRS tables and assuming the charity is a public charity. Gifts of cash produce a write-off of up to 50% of your adjusted gross income (AGI). Gifts of appreciated property generate a deduction of up to 30% of your AGI. To the extent that you cannot use the entire deduction in the year of the gift, you may carry the excess deduction forward and write it off over the next five years. Generally speaking, the greater your age and the smaller your retained income, the greater the deduction (and vice versa).

2. Immediate capital gains taxes are avoided.

When you sell appreciated property, federal taxes of as much as 28% plus any state or local taxes are due on the realized capital gain. On the sale of appreciated assets after transfer to the tax-exempt Charitable Remainder Trust, no taxes are due upon the realized gain. This allows the trustee to reinvest the sales proceeds, undiminished by taxes, and to provide an opportunity for a larger income stream to the lifetime beneficiaries of the Trust.

3. More tax-favored spendable income is possible.

When low yielding but appreciated assets are transferred and then sold, the selected lifetime income percentage chosen plus the avoided capital gain can result in substantially more spendable income than was generated before. During your client's lifetime (or the lifetimes of your and his/her spouse or other person), the trust will pay, annually, either a fixed dollar (**annuity**) amount equal to a percentage of the initial value of the asset placed in trust or a variable amount (**unitrust**) equal to a fixed percentage, selected by the client, of the value of the trust assets re-valued annually. In both types of trusts, you select the percentage. *For example*, lets assume Mary chooses the **annuity** trust payout and transfers $100,000 to the trust. She decides to receive 8% of its initial value or $8,000 annually, paid in monthly installments for her life and later for her husband's life. However, if Mary chooses the **unitrust** payout and transfers $100,000 to the trust she would then receive 8% of the fair market value of the trust assets at the beginning of each year. In the first year, she receives $8,000 in monthly payments. If the trust assets are worth $110,000 at the beginning of the next year, she would receive $8,800.

4. Income accumulates tax-free.

Since the Charitable Remainder Trust is tax-exempt, the investment income and gains realized in the Trust which are not used for payments to your client or to your client's lifetime beneficiaries are not subject to income tax. Over time, this can substantially increase the growth of the investment Trust portfolio, especially when compared with similar performance on an after-tax basis. For example, if the trust investment return is 10% and the trust is required to pay you 8%, the difference of 2% will be added to the tax exempt trust principal.

5. Lack of investment diversification is avoided.

In many cases, people are locked into a highly appreciated asset which may be the major investment in their portfolio simply because they are unwilling to absorb the tax impact associated with selling all or part of that position. Since the sale of such an asset by the tax-exempt Charitable Remainder Trust avoids immediate capital gains taxes, sale of appreciated property through the Trust can unlock the investment and allow reinvestment into a well-diversified investment portfolio.

6. Federal estate taxes and State death taxes are reduced.

Federal estate taxes begin at a rate of 37% for estate of more than $2,000,000 and climb quickly. North Carolina also collects monies on certain inheritances. By agreeing to retain the use of assets in the Trust to provide payments only during your clients' lifetime and, if appropriate, the lifetime of his/her spouse, leaving the remainder assets to a charitable institution, your client is entitled to additional tax benefits. The entire Trust principal qualifies for the marital deduction if a spouse is a survivor lifetime beneficiary and upon the surviving spouse's death, the surviving spouse's estate receives an estate tax charitable deduction equal to the value of the Trust. The net effect is that the value of the asset transferred and any subsequent appreciation is removed from the estate and, thus, avoid Federal and State death taxes.

7. Probate is avoided.

Since the assets are held in trust, they avoid the expense, delays and publicity of probate upon death when the Trust continues for the spouse or another person, and upon the eventual transfer to the charitable institution. Payments to successive lifetime beneficiaries or eventual distribution of the remainder to charity will not be prolonged by the usual red tape, expense or publicity involved in probate. There is no interruption in the flow of payments from the Trust to the beneficiaries or the chosen favorite charity, and the terms of the Trust, its beneficiaries and its assets are totally private.

8. Spendthrift protection of assets from creditors can be assured.

Full-time professional investment and asset management is also assured. The Trust's assets are exempt from attachment by creditors, thus assuring income for the individual beneficiaries. Efficient and skillful management within the framework of the Trust reduces the risk of mismanagement.

9. The philanthropy of your choice can be substantially endowed.

Upon the termination of the Trust, the charitable organizations of your choice will receive the balance of the Trust. Sometimes a donor can be more generous since a Trust maximizes the applications of Federal and North Carolina tax laws which are designed to encourage charitable giving.

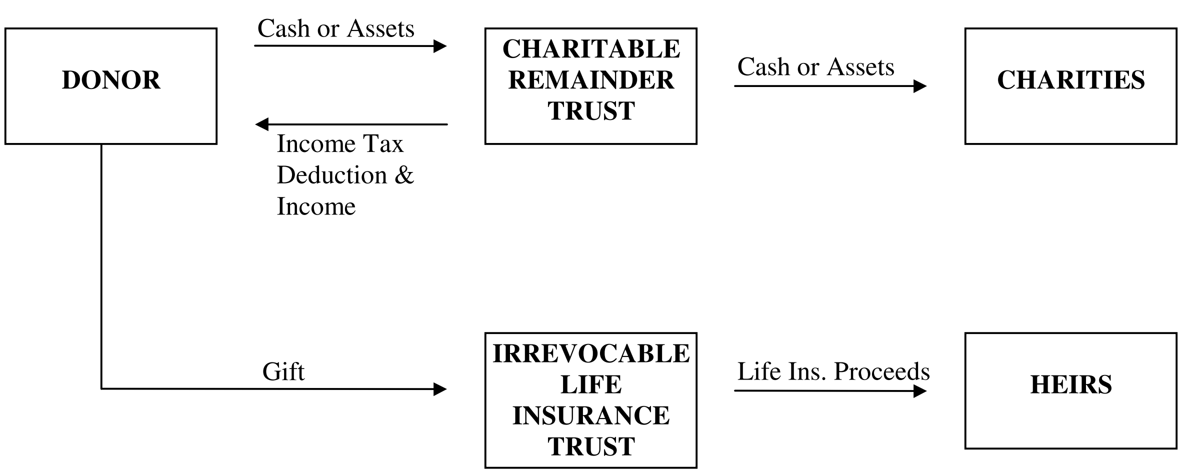
<u>But What About My Heirs?</u>

One of the perceived drawbacks in this area of planning is the fact that when the **Charitable Remainder Trust** ends, the remainder (or corpus) passes to charity. When assets are gifted to a charity, whether outright or in trust, the charity becomes the ultimate owner of these assets.

However, there is a planning technique where one may allocate and distribute some of the tax savings and increased cash flow generated by your **Charitable Remainder Trust**, to the children and grandchildren or perhaps a trust for their benefit. These dollars can be used to buy life insurance which will replace the value of the property eventually given to the selected charities.

Through the use of a special **Irrevocable Life Insurance Trust (or *Wealth Replacement Trust*)**, one can replace the value of the property given to charity for the family through life insurance dollars, free of Federal and North Carolina death taxes. In many cases, this technique can provide significantly more for the family than would have been left for them if the asset had not been transferred to the Charitable Trust, but had been subjected to income taxes, death taxes, and probate. The advantage of this Trust is that one retain no incidents of ownership in the life insurance. Therefore, the proceeds of the policy will not be taxed in the estate or the estate of ones spouse. The life insurance premiums will be provided by annual gifts which the client will make from the increased cash flow and tax savings of your **Charitable Remainder Trust**.

The **Irrevocable Life Insurance Trust** can be designed so that the replacement value of the assets originally transferred to the **Charitable Remainder Trust** will pass, intact, to the children and grandchildren, free of income, capital gains, gift or estate and inheritance taxes which would have been paid on the sale of the appreciated asset and its transfer by gift or at death.



<u>The Results</u>

- Increased tax favored, spendable income for your life;
- Avoidance of capital gains taxes;
- Creation of significant current income tax deductions;
- Reduction of risk through diversification;
- Avoidance of gift, estate and inheritance taxes and probate expenses;
- Increased inheritance for the family;
- Client chooses what to give, when to give it, how much to keep, how long to keep it, who gets it ultimately and what the family receives in exchange; **AND,**
- Client provides a substantial endowment for the philanthropic organizations of his/her choice.

WIN - WIN - WIN !!!

Now, It's Your Turn to Ask

Q: **Is this transfer to the trust irrevocable?**

A: Yes. The asset contributed cannot be returned and the trust cannot be changed, except that charitable beneficiaries can be changed from time to time. However, flexibility can be maintained by retention of certain powers such as the power to change Trustees. The investments made by the Trust can be changed from time to time to suit client and market circumstances.

Q: **What if the law changes after the gift is made?**

A: It has happened before. In these cases, pre-existing irrevocable trusts were either grandfathered, were permitted to operate under the old rules or were allowed to be amended, notwithstanding the irrevocable requirements. Future changes in the capital gains tax law may enhance payments received from the trust since they may be taxed on a tax favored basis.

Q: **I do not want to lose control of my property. May I be Trustee of the Trust?**

A: Independent and professional, but compatible Trustees are highly recommended. They can assure you of enjoying the significant tax advantages, without questioning the capacity of the donor as Trustee. Additionally, improper tax reporting or perceived mismanagement may result in severe tax and fiduciary penalties and liability.

Q: **Is the trust protected from the claims of my creditors?**

A; Yes. The trust assets belong, in part, to charities since they will eventually receive them. Thus, assets in the trust would not be subject to the claims of your creditors in the event of business reversals, divorce, bankruptcy, or catastrophic illness.

Q: **How do I select the right payout percentage rate?**

A: The rate is decided after considering the effect of beneficiary age(s) and selected percentages (the higher the rate chosen and the younger the lifetime beneficiaries, the lower the deduction and vice versa), client cash flow requirements and client investment philosophy. A lower selected percentage will result in a greater income tax deduction and, depending on investment strategy and results may provide a greater income stream for the long term.

Q: **What is the effect if I keep the income for life, and then name my children to receive the income for their lives?**

A: Since the income tax deduction available is based on the payout rate selected and client age and number of income beneficiaries, designating relatively young children will substantially reduce the income tax deduction. If income protection is important for the children, then providing life insurance for them is probably a better solution. Additionally, there may be estate tax consequences with naming a beneficiary other than a donor and a spouse as an income recipient.

Q. **Is there any restriction on the type of property I may transfer to the trust?**

A: Yes, but the restrictions do not create many hurdles. The best properties are listed securities, real estate, and other marketable appreciated assets. Undesirable assets are burned-out tax shelters, illiquid tangible personal property, highly leveraged or encumbered property or other assets which may be difficult to sell or cannot generate cash flow or property which would trigger unrelated business income.

Q: **To enjoy the maximum income tax deductions, is there are particular time during the calendar year when the transfer must be made?**

A: No. As long as the transfer is completed December 31, the deduction is available for the whole year.

Q: **If I cannot use all the deductions in one year, may the excess be carried over to future years?**

A: Yes. Any remaining deduction is available for five additional years after the initial year of the transfer.

Q: **Is the law different in each state regarding the tax benefits and legality of this concept?**

A: For Federal purposes, income, gift, and estate tax laws are the same throughout the country. However, I need to remind you that it is important that you discuss your individual situation with your legal and tax advisor as each situation is fact specific. It is important that you discuss any estate tax, gift tax, or income tax consequences with your local legal and tax advisor. For state law purposes, income and death tax laws do vary from state to state. To be certain that you proceed wisely, check with your advisors.

Q: **I do no like tax shelters. Is this technique likely to cause an audit, and am I exposed to potential liability?**

A: This is not a tax shelter. It is, as we have discussed, a tax alternative. While the size of your charitable income tax deduction could cause the tax return to be examined, you should not be exposed to liability as long as you have complied with the express rules and guidelines set forth by tax laws and the Internal Revenue Service regulations. On the contrary, proper charitable giving is encouraged by firm tax policy of the Federal and North Carolina governments.