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WithumSmith+Brown's Tax Services Team Newsletter

# ESTATE & TRUST

**04-07** YEAR-END PLANNING FOR CHARITABLE GIFTS

## CONSIDER THE IMPACT ON YOUR FAMILY WHEN MAKING SIZABLE GIFTS



Learn how to take advantage of the five million dollar tax-free limit on lifetime gifts per person.

# CONSIDER THE IMPACT ON YOUR FAMILY WHEN MAKING SIZABLE GIFTS

Rhea Harris, CPA, MBA, Manager

**The increased \$5 million exemption per person on estate and gift taxes and the lowered tax rate of 35% on the excess estate created by the Tax Relief Act only lasts until December 31, 2012. So, you may wonder why the richest Americans are hesitating to take advantage of this tax break.**

Rushing to give away everything to your kids to save future estate tax is not necessarily the best plan. Family strategies and philosophies regarding wealth need to be considered before choosing among the various leveraging vehicles out there to remove those assets from the family balance sheet and pass on to future generations.

**YOU MAY WANT TO ASK YOURSELF A NUMBER OF QUESTIONS, THE ANSWERS TO WHICH MAY GIVE YOU A DIRECTION AS TO HOW TO TAKE ADVANTAGE OF THE \$5 MILLION DOLLAR TAX-FREE LIMIT ON LIFETIME GIFTS PER PERSON.**

- How can I be generous to my children yet still instill a work ethic? How do I avoid creating “trust fund brats”?
- How much do I really want my children to know about my finances?
- How can I fulfill my philanthropic wishes, remove assets from my estate and still retain a source of income?
- How can I be sure that the economy will not weaken to the extent that I will need money that I gifted away?



As CPAs, we can provide the alternatives, create the spreadsheets and analyze the cost benefits, but families should decide what fits their particular objective before any gifting occurs. Estate and gift planning should be part of your family’s wealth management and be connected to your values.

## **FAMILY LIMITED PARTNERSHIP (FLP)**

The Family Limited Partnership (FLP) still remains a viable technique for asset protection and estate tax savings. The Tax Act did not limit this estate planning technique. Safe assets that can be maintained in a FLP are bank and brokerage accounts, and interests in business entities. Gifting discounted interests to children or trusts established for their benefit to the FLP is an excellent way to minimize future appreciation and remove assets from your Estate. Utilizing a program of regular gifting, you can shift the value of your assets out of your estate without losing control.

Under a typical family partnership scenario, the parents retain a small general partnership interest. The children are gifted small limited partnership interests, thus slowly removing the assets from the owner’s estate. The parent(s) retain complete control and no management authority is given to the limited partners (children). The FLP shares are discounted for lack of marketability and control. Children become involved in the family business, parents still have control, and the business is passed on to the next generation at considerably less than its value.

# CONSIDER THE IMPACT ON YOUR FAMILY WHEN MAKING SIZABLE GIFTS

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## QUALIFIED STATE TUITION PROGRAMS (SECTION 529 Plans)

Section 529 Accounts are a powerful, flexible and appealing way to save for a child/grandchild's college education. Such accounts enjoy tax deferred growth, tax free distributions for "qualified education expenses," exemption from the GST tax, and front end loading of gift tax annual exclusions. Currently, \$60,000 or \$120,000 for a married couple can be given at one time per beneficiary. The contributions are removed from the owner's estate and at the same time the owner can still direct how the funds are used. This aspect is pretty remarkable for those who can't stand the thought of giving away their assets and losing control. In most cases, the beneficiary has no rights over how the funds are used. The owner decides when the withdrawals are taken and for what purpose.

If you are a parent or grandparent who, like many people, have worked hard to build up their net worth and who are uncertain about what the future may hold (the "rainy day" concern), you may be reluctant to follow through with annual gifting because you do not wish to irrevocably part with your assets. The 529 plan of gifting allows you to ask for the money back if you really need it or if you change your mind. Any earnings from funds taken back and not used for qualified purposes will be subject to income tax and a 10% penalty. This estate planning vehicle provides both financial and emotional benefits (you can have your cake and eat it too): be generous to your beneficiaries and maintain control over the funds at the same time.

## IRREVOCABLE LIFE INSURANCE TRUST (ILIT)

An Irrevocable Life Insurance Trust (ILIT) is a tried and true method when the estate tax exemption is less than the grantor's estate. If you are like most people, you want to be sure that your assets do not get squandered after your death. An ILIT is an estate planning vehicle for effectively reducing estate taxes. The most common scenario in which an ILIT is used is where the insured wants to prevent the life insurance policy proceeds from being taxed as either part of the estate, but wants to ensure that the surviving spouse and/or descendants enjoy the benefits of the proceeds as trust beneficiaries. Life insurance proceeds are removed from the estate providing benefits to heirs, marital protection, a source of estate tax funds, and liquidity to the grantor's estate. Additionally, a trust provides a flexible tool for managing and distributing assets and can help accomplish the grantor purpose for which the insurance was purchased.

## QUALIFIED PERSONAL RESIDENCE TRUST (QPRT)

A Qualified Personal Residence Trust (QPRT) removes the property from the grantor's estate and permits the grantor to continue using the property for a fixed term. This can result in a substantial gift at little or no gift tax cost. The value of the property is also frozen when transferred. A QPRT works best for a residence or a second home that the grantor expects to hold for a long time or replace if sold. Psychologically, it is easier to part with a few million dollars of real estate than with investments that may be needed to maintain one's lifestyle. The family can continue to enjoy the property and one can only hope that there is no interfamily bickering after the grantor is deceased.

# CONSIDER THE IMPACT ON YOUR FAMILY WHEN MAKING SIZABLE GIFTS

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## CHARITABLE LEAD TRUST

If you are charitably inclined, a CLT (Charitable Lead Trust) may be your choice. Donors can make a gift that provides immediate income benefits to the charitable beneficiaries at relatively little cost.

Creation of a CLT having the children, or trusts for their benefit, as the remainder beneficiaries results in a gift for gift tax purposes. The amount of the charitable deduction depends on the length of the term of the charity's interest, the amount of the annual payout to the charity and the interest rates. In the case of a CLT as with other transfers involving a charitable gift, the donor can value interests using the IRS discount rate for the month of the transfer or for either of the two months preceding the month of transfer.

The best funding asset for a charitable lead trust is one that is expected to appreciate in value over the years. A common asset used to fund a lead trust is closely held stock in a family business that has the potential to grow over the years. The donor may not want the asset to be sold. However, whatever the asset source, it should generate a dividend or be liquid enough for a portion to be sold to provide cash flow to the charitable organization.

## SUMMARY

These various estate and gift planning alternatives can be married with your own personal value system. The increased \$5 million exemption (or up to \$10 million for both husband and wife) can be the catalyst that your family requires to open up the discussion of financial issues. The psychological impact that wealth transfer can create can be life altering for one's children and beneficiaries. The hard earned wealth that you have accumulated over your lifetime should be preserved and distributed in line with your values and wishes.

## OVERVIEW OF TRANSFER TAX RATES & EXEMPTIONS FROM 2011-2013

(Based on current legislation)

	2011	2012	2013
GIFT EXEMPTION	\$5,000,000	\$5,120,000	\$1,000,000
ESTATE EXEMPTION	\$5,000,000	\$5,120,000	\$1,000,000
GENERATION SKIPPING & TAX EXEMPTION	\$5,000,000	\$5,120,000	\$1,360,000
ANNUAL EXCLUSION	\$13,000	\$13,000	\$13,000
HIGHEST GIFT & ESTATE TAX RATE	35%	35%	55%

# YEAR-END PLANNING FOR CHARITABLE GIFTS

Karen Alviggi, Senior Manager

**As the end of 2011 approaches, each of us receive numerous requests for donations every day from tax exempt organizations. The number of organizations requesting donations seems to increase every year. Important questions need to be answered about donating to charity. How much are you willing to give to charity by December 31, 2011? What organizations will you support with your donations? To answer these questions, you need to look at why you are giving money to charity in the first place.**

Most people decide which charity to donate to based on the cause of the organization, and how that cause pulls on their heartstrings. Examples include organizations that support: battered or abused women, children and animals, religious affiliations, the arts, and research to cure illnesses. Once an organization has been chosen, you need to decide the amount of support to provide and what form the donation will be in. The final and most important concern is the impact the charitable donation will have on 2011 income taxes.

Individuals that take a standard deduction on their tax return, will not see any tax benefit to their charitable nature. These people will make donations simply to feel good. Those that itemize their deductions will consider year-end tax planning to help minimize their tax burden for 2011.

## **“PEASE LIMITATION” - OVERALL LIMIT ON ITEMIZED DEDUCTIONS**

Prior to 2010, the total amount of itemized deductions allowable for certain taxpayers was limited. Charitable contributions were one of the itemized deductions subject to this limitation. In computing the amount of the allowable itemized deductions, all separate floor limitations were applied prior to applying the itemized deduction limitation on upper-income taxpayers. The itemized deductions were reduced by three percent of the taxpayer's Adjusted Gross Income (AGI) if his or her AGI exceeded a threshold amount which was adjusted annually for inflation. The Pease Limitation expired for tax years 2010-2012, and unless legislation is passed, the Pease Limitation will return on January 1, 2013.

## **VALUE OF CHARITABLE CONTRIBUTIONS**

The value of a charitable contribution deduction may be limited to the fair market value of the property given, the donor's tax basis, or some other amount.

Charitable contributions of cash are deductible at the full amount donated subject to the limitations. Long-term capital gain property donated to charity is generally deducted at full fair market value subject to the limitations. Tangible personal property is generally deductible at fair market value if the use of the property by the recipient organization is related to its tax-exempt purpose. Contributions of qualified appreciated stock to private foundations are deductible at fair market value.



# YEAR-END PLANNING FOR CHARITABLE GIFTS

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Charitable contributions consisting of the following appreciated property is limited to the donor's tax basis:

1. Contributions of inventory or other ordinary income or short term capital gain property.
2. Contributions of tangible personal property if the use by the recipient organization is not related to its tax-exempt purpose.
3. Contributions to or for the use of a private foundation other than certain private operating foundations.

In order for a taxpayer to deduct a contribution to a charitable organization of \$250 or more, he or she must obtain a written acknowledgement of the contribution from the charity. The written acknowledgement must state the value of any goods or services provided to the taxpayer. The value of the goods and services must be deducted from the amount of the contribution.

Noncash gifts of more than \$500 will require the filing of form 8283 (Noncash Charitable Contributions) when filing his or her return. If the total value of noncash donated property is more than \$5,000, the taxpayer must obtain a qualified appraisal. An appraisal summary must be attached to the tax return, when filed.

## STATUTORY RULES FOR SPECIFIC TYPES OF PROPERTY

**Vehicles:** Vehicles generally include automobiles, boats and airplanes. If the charitable organization disposes of the vehicle in the condition it was donated, the deduction available to the taxpayer is the lesser of the fair market value of the vehicle and the amount the charitable organization received on the sale. In other circumstances, the deduction may be the fair market value of the vehicle.

**Clothing and household items:** All clothing and household items must be in good condition. Items in this category follow the tangible personal property rules. Since most items in this category will have a fair market value that is less than the original acquisition value, the tax deduction will be limited to fair market value. Any donated property in this category that has appreciated in value will be limited to the original acquisition value when determining the tax deduction.



# YEAR-END PLANNING FOR CHARITABLE GIFTS

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## REQUIRED MINIMUM DISTRIBUTIONS AND THE INDIVIDUAL RETIREMENT ACCOUNT

As 2011 comes to a close, so does the exclusion of up to \$100,000 from gross income for distributions from Individual Retirement Arrangements (IRAs) for charitable purposes. This election is only available to distributions made directly to a qualifying charity from the IRA on or after the IRA owner attains the age of 70 1/2. This temporary exclusion provides the IRA owner to eliminate the need to report the amount distributed to charity directly from an IRA account as part of adjusted gross income and then claiming an itemized charitable deduction for the amount.

Charitable deductions are subject to certain percentage limitations based upon the taxpayer's Adjusted Gross Income (AGI). **The following chart details the limitations.**

	ORDINARY INCOME PROPERTY & CASH	CAPITAL GAIN PROPERTY TO THE RECIPIENT	CAPITAL GAIN PROPERTY FOR THE USE OF THE RECIPIENT
Public Charities	50%	30%	20%
Private Operating Foundations & Private Distributing Foundations	50%	30%	20%
Other Private Foundations (Nonoperating Foundations)	30%	20%	20%

It should be noted that charitable contributions exceeding the limitation can be carried over for up to five years. In each of the five years the excess contribution is carried over. The current year contributions must be used before applying the excess amounts. At the end of the five-year period, any unused charitable contribution carryover is forfeited.

## PARTIAL INTEREST GIFTS TO CHARITY

Generally, a charitable deduction is not allowed for any donation to a charity where an interest in the property has been retained or is transferred to a non-charity. There are some exceptions to this rule. Here are some exceptions that will provide a tax deduction while retaining and interest in the property donated to charity.

## SPLIT INTEREST TRUSTS

The most common split interest trusts are the charitable remainder annuity trust, charitable remainder unitrust, charitable lead annuity trust, charitable lead unitrust and pooled income funds. These trusts must satisfy specific technical requirements to enable the donor to take a charitable tax deduction. A brief explanation of the charitable remainder and charitable lead trusts follows:

- A charitable remainder trust is structured to provide the donor or another individual with income or similar interest from the trust for some period of time. At the expiration of the time period, the remainder interest is paid to a qualified charitable organization. The tax deduction is the present value of a future interest. As such, there is a difference between the value of the contribution and the charitable deduction allowable.

# YEAR-END PLANNING FOR CHARITABLE GIFTS

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- A charitable lead trust is structured to pay the charity specific payments from the trust for a period of time. To qualify for a charitable income tax deduction, the grantor must be treated as the owner of the charitable lead trust. Annually, the donor will report all of the income earned by the trust on his or her income tax return even though the income interest has been paid to one or more charities. At the expiration of the term of the trust, the remainder interest reverts back to the donor or to other named individuals. As with the charitable remainder trust, the tax deduction is generally limited to the present value of a future interest since the tax deduction is available upon funding the trust and covers the charitable interest over a number of years. Remember, this income tax deduction is only allowed for a charitable lead trust where the donor is treated as the owner for income tax purposes and the tax deduction is calculated at the time of the trust creation. All other charitable lead trusts will result in no income tax deduction to the donor.

## SUMMARY

In summary, there are a couple of special incentives for selected groups of taxpayers which will expire in 2011 or 2012. These special provisions are: (1) 2011 is the last year for taxpayers over 70 1/2 to take advantage of the Individual Retirement Account direct distribution to one or more charitable organizations. (2) The elimination of the phase-out of itemized deductions expires at the end of 2012. High income taxpayers should take advantage of the elimination of It should be noted that charitable contributions exceeding the limitation can be carried over for up to five years. In each of the five years the excess contribution is carried over. The current year contributions must be used before applying the excess amounts. At the end of the five-year period, any unused charitable contribution carryover is forfeited.

## MEET THE PLAYERS



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Hal is a tax partner based in our Princeton, NJ, office and has almost 20 years of professional experience providing income tax, financial and advanced estate planning advice to corporate executives, closely-held business owners and affluent individuals. Hal is a certified public accountant, personal financial specialist from the American Institute of Certified Public Accountants (AICPA), certified financial professional and accredited estate planner. He is also a member of WS+B's Estate and Trust Services Group, where he focuses on assessing client financial situations and develops targeted plans to meet individual client goals.

Hal received his bachelor's degree in accountancy from Binghamton University. Prior to joining WS+B, Hal was the regional managing director of Wachovia Bank's Financial Planning Practice serving the Pennsylvania and Delaware regions. In addition, Hal has more than five years of tax experience in the corporate tax department of Price Waterhouse LLP and the personal financial counseling services practice of Deloitte & Touche LLP. He is a member of the AICPA, the New Jersey Society of Certified Public Accountants (NJSCPA) and the New York State Society of Certified Public Accountants (NYSSCPA).

In his community, Hal is V.P. of Membership of the Mercer County Estate Planning Council Board and past Treasurer of Congregation Kol Emet. He resides in Bucks County, PA.

In each issue, we'll feature a different Estate and Trust team member so you get to know our core experts.