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The Five Levels of Charitable Planning

By Salvatore J. LaMendola, J.D

For estates above $2 million, there is only one option available to reduce the Federal estate tax - lifetime gifts. The type of gifts that can be made come in three varieties: 1) gifts of life insurance; 2) gifts that shift or reduce value; and 3) gifts to charity. It is the intent of this article to expound upon the last option – gifts to charity. The hallmark of charitable giving is what has become commonly called the "zero estate tax" plan. The most common form of zero estate tax planning calls for any remaining estate tax exemption to be left to the decedent's heirs, estate tax free. The balance of the estate then passes to the charity of the decedent's choice, thereby eliminating all Federal estate tax because of the unlimited estate tax charitable deduction. The assets left to the charity would then be "made up" to the heirs through lifetime gifts to an irrevocable life insurance trust ("wealth replacement trust"). If the concept of the "zero estate tax" plan is appealing to your clients, then the strategies of the five levels of charitable planning should be explored.

Level I – The Basics

Level I planning is where a simple charitable giving program is desired, and the objectives are to reduce income, capital gains, and Federal estate taxes, or a combination of the three. The tools and techniques used at this level are outright gifts, bargain sales, or testamentary bequests. It is important for the donor to recognize the limitations placed on making outright gifts, in particular the differences between making gifts to public charities as compared to private family foundations. The donor must be aware of some costly limitations that apply to gifts made to private family foundations - the most salient of which is the limitation of the income tax deduction to cost basis for long-term capital gain property (other than publicly-traded securities).

Level II – Life Insurance

Level II planning calls for leveraging current gifts through the purchase of life insurance or through the donation of a life insurance policy to a charity (whether public or private). Here the situation is a desire to give more to the charity at death than possible with the donor's existing assets. The objectives of Level II planning are to reduce income taxes, provide income and estate tax free funds to selected charities, leverage existing funds, and reduce estate taxes. The primary tools and techniques used to accomplish these goals are naming the charity as the beneficiary of a life insurance policy (with no income tax deduction, but with an estate tax deduction), transferring ownership of an existing insurance policy to a charity (and receiving an income tax deduction), or having a charity acquire new insurance on the life of the donor.

Level III– Charitable Remainder Trusts

In Level III, charitable remainder trusts (CRTs) are used to: 1) avoid capital gains taxes on the sale of appreciated assets; 2) reduce income taxes; 3) increase cash flow and/or diversify assets; 4) defer income for retirement; and 5) reduce estate taxes. The various CRTs available are the charitable remainder annuity trust (CRAT), the standard charitable remainder unitrust (S-CRUT), the income deferral unitrust (NIM-CRUT), and the newest addition to the "CRT" family, the FLIP Unitrust.

Level IV– The Charitable Lead Trust

In Level IV, the sister to the CRT, the charitable lead trust (CLT), is used where the objective is to benefit charity, while still passing assets to heirs at reduced or no gift or estate tax costs. The CLT is used in making deferred gifts to heirs or to phase in their inheritances; to make an ongoing gift to charity; to reduce estate and gift taxes on transfers to heirs; to transfer appreciated assets without recognizing gain; and to maximize the use of the generation-skipping tax exemption. The advantage of a CLT is that if the rate of return within the CLT is greater than the payout rate to the charity, the heirs get even *more* estate tax free than they would have under the standard "zero estate tax" plan described above. In the event the CLT under performs, the heirs can still be made "whole" through the use of a wealth replacement trust.

Level V– The Charity of Choice: Your Own

Level V planning involves a desire on the part of the donor to manage assets given to charity. The objectives are many, including: 1) obtaining an immediate income tax deduction, 2) controlling the investment and distribution of donated assets, 3) avoiding paying capital gains tax, 4) carrying on the donor's name in perpetuity, 5) teaching heirs to be altruistic and philanthropic, 6) providing heirs with the self-esteem and public notoriety that comes from benefiting charity, and 7) compensating heirs for their charitable services. Although the donor advised fund

(continued on page 2)

INSIDE

The Florida Intangibles Tax– Do Your Clients Really Have to Pay It?

By Ronald S. Kochman, Esq. and Keith B. Braun, Esq. of West Palm Bech, Florida

(Excerpts from article appearing in *Michigan Tax Lawyer* - 3rd Quarter 1999)

Currently, Florida imposes a tax on certain intangible assets owned by a Florida resident on January 1 of each year. The tax is $2 per $1,000 of fair market value (on December 31 of the prior year) of stocks, bonds and interests in limited liability companies and is payable on June 30 of each year (e.g., the tax on intangibles held on January 1, 1999 is due on June 30, 1999). Beginning January 1, 2000, Florida has reduced the tax to $1.50 per $1,000 of intangibles.

In recent years, many Florida residents have created out-of-state limited partnerships or out-of-state irrevocable trusts in order to reduce their Intangibles Tax obligations. These techniques, while effective, added a great deal of complication and were easier to administer in theory than in actual practice.

In early December 1997, the Florida Department of Revenue issued proposed guidelines on how limited partnerships, corporations and trusts could avoid the Intangibles Tax. In essence, the Department created safe harbors under which assets held in limited partnerships, corporations and trusts would not be subjected to Intangibles Tax by Florida.

The new rules for corporations are too stringent to be useful in avoiding the Intangibles Tax. Further the new rules for limited partnerships are not much better, but left room for those Florida residents who were using limited partnerships to

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and supporting organization are worthwhile in and of themselves, the hallmark technique continues to be the private family foundation. The reason is that *only* the private family foundation allows for complete and total control to be held by the donor's family. In the context of using a "zero estate tax" plan, there are no limitations with respect to the estate tax charitable deduction on the type of entity chosen (i.e., public vs. private). With respect to lifetime giving (gifts made outright or on a deferred basis through CRTs), careful consideration must be given to the income tax deduction limitations mentioned above with respect to long-term capital gain property.

In summary, there are only three places to leave one's wealth at death – heirs, IRS, and charity – and two must be chosen. When clients realize there is achoice, many decide to "disinherit the IRS." For a more in-depth look at charitable planning, a copy of Mr. LaMendola's 24-page brochure, *The Five Levels of Charitable Planning*, may be obtained by calling his office at 248-528-2200. This brochure can be a valuable marketing tool. The price of the brochure is $9.95, with a discount for quantity purchases of 50 or more.

For more information regarding this article, please e-mail your requests to Salvatore J. LaMendola at sjl@disinherit-irs.com or call Sal at (248) 528-2200.

Charitable Buy-Sell Agreements

By Julius H. Giarmarco, J.D., LL.M.

Transferring a closely held business from one generation to the next can be an expensive proposition because of the imposition of Federal estate taxes on such a transfer. However, by taking advantage of the income tax deduction for gifts to charity, and the gift tax leverage associated with an irrevocable life insurance trust, it is possible to transfer the family business from one generation to the next without adverse estate tax consequences.

Assume we have a family-owned corporation in which the father owns 80 percent of the stock and his son and daughter each own ten percent of the stock. Assume further that the stock has substantially appreciated in value. In such a scenario, a charitable buy-sell would work in the manner described below:

The father would gift to a charity up to 49 percent of the issued and outstanding stock. That would leave the family with 51 percent of the stock. Hence, the family would retain control of the business.

- The father would receive an income tax deduction for the full fair market value of the stock, limited to 30 percent of his adjusted gross income. Any deduction over the 30 percent limit could be carried forward for five years.
- The charity would have the option to *put* the stock to a family trust. A put option requires the family trust to purchase the stock.
- The family trust would be an irrevocable trust established by the father for the benefit of the son and the daughter, and would be funded with a life insurance policy on the father's life. The tax savings generated by the deductible gift of stock would be used to pay the insurance premiums.
- Upon the father's death, the insurance proceeds would be deposited in the family trust free of income and estate taxes. The family trust would then use the insurance proceeds to buy back the stock from the charity.

There are several advantages to using the charitable buy-sell strategy. First, the 49 percent block of stock gifted to charity would escape estate taxes at the father's death because he would not own it. Second, the family would maintain control over the corporation at all times. Third, since the remaining 31 percent of the shares held by the father would represent a minority interest in the corporation, the estate tax value of these shares would be *discounted* both for lack of control and lack of marketability. Fourth, the stock gifted to the charity would return to the son and the daughter through the family trust with a higher cost basis. Fifth, the father would receive an income tax deduction which would help fund the family trust. Sixth, the charity would receive cash for a paper asset. The only loser in this scenario is the IRS.

(continued on page 3)

(continued from page 2)

A word of caution: While the charitable buy-sell works for a regular corporation, special rules apply to stock in a Subchapter S corporation. While a charity can own stock in a Subchapter S corporation, the income earned by the Subchapter S corporation would be treated as *unrelated business taxable income* to the charity, as would any gains or losses arising from the sale of the Subchapter S stock. This would create an income tax liability for an otherwise tax-exempt charity.

For more information regarding this article, please e-mail your requests to Julius H. Giarmarco jhg@disinherit-irs.com or call Julius at (248) 528-2200.

Funding a Family Trust with Retirement Plan Benefits

By Paul G. Wakefield, J.D.

The revocable (Marital-Family) living trust is a popular estate planning tool for married couples to utilize the unified credit of each spouse. In order to preserve both credits, the trust of the first spouse to die typically splits into a separate Marital and Family Trust. Although the creation of a separate Marital and Family Trust is fairly commonplace, many practitioners are un-certain of the tax implications of naming a Marital or Family Trust as the beneficiary of an IRA and/or other retirement plan. This article will address some of the issues presented when the Family Trust (sometimes referred to as the Credit Shelter Trust) is named as the beneficiary of an IRA or other retirement plan (hereinafter referred to as "retirement plan").

It is advantageous to fund the Family Trust with assets that are likely to appreciate because the assets of the Family Trust will pass to the children (or other specified beneficiaries) at the surviving spouse's death estate tax free. The Family Trust should not be funded with retirement plan benefits when there are other assets available. Retirement plans are subject to the minimum distribution rules which require the plan to make taxable distributions. These forced distributions will cause the amount held in the Family Trust to be reduced by income taxes, thereby reducing the amount of assets passing estate tax free at the surviving spouse's death.

Trust income tax rates present another disadvantage of funding the Family Trust with retirement plan assets. For 1999, a trust reaches the 39.6% income tax bracket when it has $8,450 of taxable income. Individuals do not reach that rate until they have $283,150 of taxable income. Furthermore, distributions made from a retirement plan to a trust are generally considered to be "income" for income tax purposes despite being considered "principal" for trust accounting purposes. Therefore, if distributions are made from a retirement plan to a trust, and those distributions are retained in the trust, they will likely be subject to a 39.6% income tax rate.

If the Family Trust permits distributions of income and principal to the spouse, the higher trust income tax rates can be avoided by distributing all "income" (which includes required minimum distributions) to the spouse. These distributions of "income" will be taxed at the spouse's individual income tax rate, which might be lower. However, if all plan distributions are passed through the trust to the spouse, the Family Trust will be depleted and the assets dis-tributed to the surviving spouse will be taxed in his or her estate upon death, thereby wasting the unified credit used for the Family Trust.

For example, assume husband names his Family Trust as beneficiary of his $650,000 IRA in order to preserve his unified credit at death. Upon husband's death, the trustee withdrawals the income from the IRA in five annual installments of $130,000. Pursuant to the terms of husband's Family Trust, the IRA income is distributed to his wife at least annually and, therefore, is taxed at her individual income tax rate. If the principal is distributed to the wife each year to take advantage of her tax bracket, the Family Trust will be depleted after five years. Moreover, any distributions remaining in the wife's estate at her death will be subject to estate taxes a second time.

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avoid the intangibles tax to continue using them if they were very careful in how the limited partnerships were managed. The real safe-harbor, however, was created through the use of trusts.

The proposed trust rules, which became law in 1998, created a workable safe-harbor by which if a trust: (1) was irrevocable for a period of time; (2) had an out-of-state trustee; (3) was totally discretionary - that is the out-of-state trustee had complete discretion over distributing income and principal to the grantor; (4) had all of its assets located outside of Florida; and (5) did not mandate that the same assets which went into the trust were to be returned to the grantor, then there would be no Intangibles Tax liability.

The new law also provides that the mere fact that a Florida bank or trust company acts as an *agent* for a trust (but not a trustee), does not cause the trust assets to be subject to the Intangibles Tax.

To illustrate, a Florida resident can utilize this safe-harbor to avoid the Florida Intangibles Tax by creating and funding an irrevocable trust with a term of 30 days (including January 1) prior to the end of the year, having the resident's child who lives outside of Florida act as trustee, giving the trustee discretion to distribute income and principal to the resident during the trust term and providing that the remaining trust assets will be dis-tributed to the resident at the end of the trust term. The trust assets should be held at either institutions located outside of Florida or with a Florida bank or trust company. Based on this safe-harbor, any assets held by such trust on January 1, 2000 would not be subject to Intangibles Tax.

The new rules and the statute present an extraordinary opportunity for wealthy Florida residents to reduce or even eliminate their Intangibles Tax bill.

For more information regarding this column, please e-mail your requests to Julius H. Giarmarco at jhg@disinherit-irs.com or call Julius at (248) 528-2200.

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The most common reason for funding a Family Trust with retirement plan benefits is to utilize an individual's unified credit when there are insufficient non-retirement assets available. When the Family Trust is funded with retirement benefits and the participant dies before attaining his or her required beginning date (generally age 70 ½), the plan proceeds must be distributed within five years of the date of the participant's death. However, if the surviving spouse is the sole beneficiary of the Family Trust, plan distributions can be delayed until the participant would have attained his or her required beginning date. This works well when the participant and his or her spouse are approximately the same age. However, if the spouse is significantly younger than the participant, than it is usually more favorable from an income tax standpoint to name the spouse as primary beneficiary of the plan so as to utilize a spousal roll-over. Doing so would allow the younger spouse to "stretch out" the income tax deferral by delaying required minimum distributions until he or she attains age 70 ½.

When a revocable living trust is named as a retirement plan beneficiary (rather than the Family Trust itself), the participant should consider using a "fractional" marital deduction formula in the trust rather than a "pecuniary" funding clause. If a pecuniary clause is used, income taxes on plan benefits may be accelerated upon the participant's death when the Marital and Family Trusts are created and funded. Alternatively, one can name the Family Trust as the plan beneficiary rather than the revocable trust. This would allow the plan benefits to bypass the funding clause and be paid directly to the Family Trust.

Because of the downfalls associated with funding a Family Trust with retirement plan benefits, it is usually advantageous for the participant to name his or her spouse as the primary beneficiary and his or her revocable trust as the contingent beneficiary. This allows for the use of a spousal rollover to minimize income taxes and to stretch-out plan distributions. Furthermore, the spouse can "disclaim" plan benefits if he or she desires to fund the Family Trust in order to preserve the deceased spouse's unified credit.

For more information regarding this article, please e-mail your requests to Paul G. Wakefield pgw@disinherit-irs.com or call Paul at (248) 528-2200.

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