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ABOUT YOUR FOUNDATION

Since 1973, the **Toledo Community Foundation** has provided individuals, families and businesses interested in the well-being of our community with an *efficient, effective, low-cost, professionally managed* mechanism to achieve their charitable goals.

For philanthropists wishing to maximize the impact and life of their charitable gifts, the Foundation provides *resources for thoughtful giving*. Using its expertise and personalized services, **Toledo Community Foundation** helps donors

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Estate Tax Planning Update

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Business & Economic Review
October 2008–December 2008

By Starlene W. Watson

“Recent law changes have created a lot of uncertainty about the federal estate tax.”

While most of us do what we can to minimize our income tax liabilities each year, it is easy to overlook one of the most significant taxes of all: the estate tax. With rates going up to 45 percent, this tax can take a large bite out of what we intend to leave for our heirs.

Recent law changes have created a lot of uncertainty about the federal estate tax. There is much discussion about whether the estate tax repeal currently scheduled for 2010 will actually occur—and if it does, can things simply revert to the way they were prior to the effective date of the 2002 tax act?

To further complicate matters, the 2008 presidential election will also have an impact. Republican Senator John McCain supports a \$5 million estate tax exemption per person with a top tax rate of 15 percent, while Democratic Senator Barack Obama favors a \$3.5 million exemption with a top estate tax rate of 45 percent.

Planning, therefore, is still as important as ever, just a little more challenging.

While there are a variety of strategies that can be used to minimize taxes, this article will focus on four popular and powerful estate-planning strategies.

transform their philanthropic impulse to measurable community impact. Beyond the gifting of assets, the Foundation helps donors identify issues of importance to them and *inspires engagement* with community organizations addressing these issues, thereby maximizing the impact of charitable gifts and creating a greater sense of fulfillment.

Premium Financing

Even with careful estate planning, some people need substantial amounts of life insurance to provide support for their heirs and to pay estate taxes. Yet, paying ongoing premiums on a large life insurance policy can require lots of cash. So some planners have found that banks are willing to lend the full amount of funds necessary to pay a policy's premiums over the insured's remaining lifetime. Interest accrues on those loans and the banks are eventually repaid for all of the premiums and interest from the policy's death benefit. If set up properly, the fixed-index insurance policy's death benefit increases as the loan balance grows. With careful planning, the policy's death benefit will be enough to fully repay the bank and still leave a substantial balance (in a life insurance trust) for the heirs and the estate tax.

The Charitable Remainder Trust

The charitable remainder trust (CRT) can be set up easily and provides immediate tax benefits. You can transfer an asset into the trust and get a charitable contribution deduction on your income tax return for that year.

The amount of the deduction is the fair market value of the asset (if you have owned it for more than a year) discounted over the expected length of the trust. The length of the trust may be either a term certain or your lifetime. The longer the trust is expected to last, the lower your charitable contribution deduction will be. Married couples may choose to establish trusts that will last as long as either spouse is alive.

The deduction for transfers of appreciated assets may offset only 30 percent of your adjusted gross income in any year. But if the deduction is so large that you cannot use it all in one year, the unused portion can be carried forward for as many as five years.

The CRT is tax exempt and can therefore sell appreciated assets you put into it, such as stock and real estate, without paying tax on the gains. This means that the full sale proceeds (not just the after-tax portion) can be invested, generating income for you for the rest of your life.

The proceeds received from selling the assets should be put into income-generating investments inside the CRT. Income should be distributed to you at least annually. You have to pay income tax on the distributions as you receive them. However, your cash flow could be significantly more than it would be if you sold the appreciated assets yourself, paid tax on the gains, and then had only the after-tax sale proceeds to invest.

The amount distributed by the trust is based on a percentage rate, stipulated in the trust document, which cannot be less than five percent annually. The rate can be applied to the initial value of your contributions, or can be applied to the current value of the trust principal each year. The latter approach would result in distribution amounts fluctuating from

year to year.

The CRT can distribute some of the principal to you, as well. The less you leave for charity, however, the lower your charitable contribution deduction will be when the property goes into the trust.

After your death, the remaining principal goes to the charity(ies) of your choice. If you are concerned about your heirs not getting the trust principal, you could use some of the income tax savings generated by your transfers to the CRT to purchase life insurance. At your death, your heirs would get the life insurance proceeds rather than the trust principal.

Some people use CRTs to avoid ever having to pay capital gains taxes. Rather than selling their appreciated stocks, for example, they transfer those stocks to the trust, which then sells them. They must be sure the property has been transferred to the CRT before a sale has been negotiated. Each transfer creates a current income tax deduction and increases the subsequent income distributions to the contributor.

This is also one of the few ways you can enjoy the income stream from investments for your lifetime without exposing those assets to the estate tax.

There are many variations available in setting up these trusts, but all CRTs should be exempt from taxes (unless they have unrelated business income).

Before signing any documents, be sure you understand all of the restrictions. For example, CRTs are irrevocable. This means you cannot get the property back after putting it into the trust. You can, however, reserve the right to change charitable beneficiaries later if you want to.

Transferring passive activity property into a CRT does not free up suspended losses. Losses previously generated by that property remain suspended.

Also, debt on the property, such as a mortgage, should not be transferred to the CRT. If property has debt on it, consider creative approaches, such as putting the property and debt into a Limited Liability Corporation (LLC) and then transferring your interest in the LLC to the trust.

Conservation Easements

Although the Bush administration has been criticized for not being "green" enough, federal tax laws were recently expanded to make conservation easements much more advantageous. And conservation easements are becoming more popular across South Carolina.

Land owners can retain ownership of their property while permanently donating development rights to a tax-exempt conservation group or land

trust. The development groups don't develop the property, but those rights have value that is deductible by the donor.

As always, there are limits on the amount that can be deducted. Donations of non-cash property can be used to offset only 30 percent of the donor's adjusted gross income. Any deduction in excess of that limit can be carried over and deducted during the next five years. However, under a temporary law change, conservation easement donors can offset up to 50 percent of their adjusted gross income each year, instead of just 30 percent. And, the carry forward period was increased from five to 15 years. South Carolina also offers generous tax credits to these donors.

These tax changes have encouraged preservation of our natural resources.

In addition to the income tax benefits, these conservationists will receive estate tax savings because easements reduce the value of the land. They can also retain the rights to use their land for hunting, fishing, cutting timber, and even constructing a vacation home.

Although the conservation easements are permanent, the underlying property can remain in the owners' families for many generations.

Life Insurance Trusts

Life insurance trusts are not new, but they are still one of the most powerful and commonly overlooked estate planning tools. This type of trust can be created easily and inexpensively, and the life insurance policies can be owned by the trust.

If set up properly, the trust can keep life insurance proceeds from being included in the insured's taxable estate. On the other hand, if the policy is owned by the insured, the death benefit is includable in his or her taxable estate, and up to 45 percent of that benefit could go to taxes.

The drawback to the trust is that it is irrevocable. Some who think they may have a falling out with a beneficiary have started using family limited partnerships, instead of irrevocable trusts, to own insurance policies. Partnerships offer some flexibility.

Conclusion

As the estate tax evolves, so do the planning techniques used to minimize that tax. Yet one thing remains the same—strict guidelines must be followed to protect any tax benefits. So, work closely with an attorney and other advisors when making decisions and drafting documents related to these complex matters.

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