S O U T H W E S T E R N   M E D I C A L

PLANNING MATTERS

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Tax Planning: Turning Hindsight Into Foresight

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Q. As you work with your clients, especially towards year-end, what are some of the typical income- and estate-tax planning goals you are trying to achieve?

R. The planning process involves knowing your clients and their goals, needs, and concerns. These elements can be vastly different for families who own private businesses, families who have retired and own investment assets, and executives who have a variety of corporate plans and assets. However, there are many similarities, and for year-end income-tax planning we generally look at opportunities to defer income and accelerate deductions. With regard to deferral of income, most tax planning is accomplished at the time the transaction takes place. For example, if a sale of property occurred during the year, the opportunity may have been available to take the payments on the installment method and defer the payment of income tax on the sale until next year or beyond. However, at year-end there may still be opportunities to defer bonuses or defer sales of property. It is important to emphasize that the economics of a transaction are most important and should dictate the tax-planning opportunities.

With regard to accelerating deductions, we look at the client's itemized deductions. Most itemized deductions such as real estate taxes and mortgage interest will be paid during the year and offer little flexibility. However, the one deduction that a client has control over is donations to charitable organizations. Clients can determine how much and what type of property they want to give. We explore opportunities to give appreciated property, such as securities rather than cash, to avoid the future long-term capital-gains tax on the appreciation.

Also, year-end planning sessions are a great time to review other issues such as gift and estate planning. Specifically, we explore changes in value of assets and changes in family needs.

Q. As income- and estate-tax rates decrease, have the decisions your clients are making changed?

R. I haven't seen this to any great degree. Even though tax rates are very low for capital gain and qualified dividends, clients have not shifted their investment portfolios or their asset allocations for that reason alone. On a short-term basis,

I have seen clients benefit from already having a significant portion of their investment assets in dividend-paying stocks. However, I have not observed investment advisors making recommendations to take advantage of this short-term benefit versus long-term investment objectives.

At this point in time, the estate-tax rates and property exemption are very uncertain, but for the most part I've seen planning proceed in the normal manner. Under current law we have seen an increase in the property-transfer exemption; therefore some smaller estates are no longer subject to the estate tax. However, the crux of estate planning is disposition and management of wealth. Taxes are certainly an important factor, but are not usually the driving factor. Clients want to explore techniques to protect their assets and their families from an untimely death, creditors' claims, or a child's divorce.

Q. Are there two or three common ways, other than outright gifts, in which an individual transfers estate assets to children and other family members?

R. One of the planning techniques we frequently see today is the grantor retained annuity trust (GRAT) or unitrust (GRUT). For example, executives with a concentration in employer stock that could increase in value significantly can benefit by putting those assets in a short-term GRUT. The client transfers the stock to a trust for remainder beneficiaries but retains a significant distribution right for a short period of time. At the end of the term, the client will have received, through distributions, the value of his/her original transfer. If the assets increase in value, the appreciation goes to the remainder beneficiaries. These trusts can be established with little or no gift-tax consequences.

Then, we are seeing activity in the creation of family limited partnerships. Typically, parents transfer significant assets to a limited partnership and ultimately sell or gift units of the partnership to second- or third-generation beneficiaries. The value for sale or gift purposes of units representing a minority interest in the partnership can generally be discounted. You are banking on future appreciation in the units of the partnership being transferred to family members without additional gift or estate tax. This type of planning is not appropriate for every family because the parents should give up or share control over the operations of the partnership, and the family needs to have a cohesive relationship.

For clients who are charitably motivated, we are seeing a combination of charitable remainder trusts (CRTs) and charitable lead trusts (CLTs). Typically, in a CRT, parents transfer appreciated assets to a trust and reserve an income interest—either in the form of an annuity or a fixed percentage of the value of the assets. The income beneficiary can be mom and dad, children, or any other noncharitable person and it can be set up for multiple beneficiaries. The remainder beneficiary must be a qualified charitable institution, which receives the balance in the trust after a term of years or the life of the income beneficiary. The parents receive a charitable deduction upon the transfer and will have a taxable gift if the income beneficiary is someone other than themselves. I've seen CRTs used as vehicles to supplement payments that you're already making to another person without any tax benefits. Say you are helping support an elderly aunt with a thousand dollars a month. You could establish one of these trusts to make that payment to your aunt.

The CLT is very beneficial for someone who either wants to accelerate a charitable deduction or transfer property at a discounted value to their heirs. For the person who knows they are going to be making a charitable donation to Southwestern Medical Foundation for the next 10 years, they can set up a trust that will make that payment every year, and at the end of the 10 years the assets revert back to the donor. Their entire charitable deduction will be determined the year the assets are transferred to the trust. The CLT is a useful vehicle to accelerate a charitable deduction in a high-income year. In the other type of charitable lead trust, instead of the assets reverting back to the donor, they go to anyone that the donor picks. It is a way to transfer property to children at a discounted value, but the receipt of the assets by the remainder beneficiary is deferred until the end of the term payments to the charity.

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The Lessons of Year-End

Turning Hindsight Into Foresight

As the year draws to a close, you may realize that a move here or a shift in strategy there can still produce even better financial results. Make your charitable gifts by December 31, for example, and generate valuable tax deductions.

In this issue of *Planning Matters* we take a look at some of the most commonly overlooked planning opportunities, giving special attention to ways you can make your planning even more effective by addressing your personal and charitable goals together.

Capital-Gain Blues

Situation: I'm pleased that my stock investments have held on to much of their gain. But I sold some stock late last year and capital-gains tax consumed 15% of my profit.

Strategy: Capital gain is not taxed unless it is sold. So, you can control the timing of the tax simply by controlling the date on which you sell. For example, at year-end, waiting just a short period of time can push capital gain into next year. What's more, long-term capital gain is taxed much more favorably than ordinary income; the top federal tax rate on long-term gain on stock is 15% compared to 35% on ordinary income.

Example: *Tom T sold some stock for $50,000 that he bought five years ago for $10,000. While preparing his tax return, he realized that the sale caused a tax of $6,000 on his $40,000 gain ($40,000 x 15% long-term capital-gains tax rate).*

If Tom had waited until January to sell, there would have been no tax due this year and the gain would not show up on his tax return until next year.

Charitable alternative: Eliminate concerns about the timing of stock sales by using long-term appreciated stock to fund a gift to charity.

Reason: A charitable gift of long-term appreciated stock produces a charitable deduction equal to the full fair-market value of the stock on the date of the gift, and you do not have to pay tax on unrealized gain.

Example: *Tom has a strong interest in a special project at Southwestern Medical Foundation. If he had contributed the stock instead of selling it, he would have received a $50,000 deduction and avoided the capital-gains tax of $6,000. In his 35% tax bracket, the gift would also have saved Tom an additional $17,500. The net cost of his gift would have been just $26,500 ($50,000 - $6,000 capital-gains tax savings - $17,500 income-tax savings).*

Retirement-Plan Regrets

Situation: I am very concerned about the amount of income tax I had to pay last year. Maybe I should have made more contributions to my employer's qualified retirement plan.

Strategy: Most people have options to set aside funds for retirement in a manner that reduces their taxable income for that year: retirement-planning opportunities, such as a defined benefit or defined contribution plan, a 401(k) salary-reduction plan, or a 403(b) tax-deferred annuity plan.

Research carefully what options are available to you for this year to maximize your retirement contributions.

Charitable alternatives: What if you have already made the maximum permissible contributions to employer-sponsored plans? Is there any other way to increase your retirement security and reduce current income taxes at the same time? If you have significant charitable goals, the answer is a resounding "Yes!"

- A popular way to achieve these objectives is through the use of a ***charitable remainder unitrust***. You can make contributions to a unitrust you establish at Southwestern Medical Foundation with the stipulation that the trust make payments to you (or beneficiaries you designate) each year, based on the value of the assets in the trust.

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Q. What kinds of charitable gifts do retirement assets make compared to other assets within your estate?

R. IRAs are great for the participant in retirement, since tax on all the earnings is deferred until you take distributions and you have the potential build-up of assets over the period you've been contributing. But for beneficiaries, IRAs can be very expensive assets. They get taxed in the estate and also get taxed as income when distributions are taken by the beneficiaries. So, we often advise our clients, if they have a choice, to leave retirement assets to charity and other assets to kids and grandkids.

Q. What advice do you give older clients who are looking to enhance their income, are charitably inclined, and are considering charitable gift annuities?

R. From an advisor's standpoint, I have yet to figure out why more people don't do them because they are a winner and very simple to establish. The client transfers assets to a charity in return for a promise to pay a fixed amount each year for life. The donor receives a charitable deduction for the calculated remainder. The charity has use of the assets from the date the annuity is established. The rates of return that the charities offer are in excess of what you can get through financial institutions. So, if someone wanted to enhance their income, had charitable intent, and felt that their other financial goals had been met, the charitable gift annuity is a great option. For example, if you have $100,000 of excess funds sitting in a CD earning a low return, why not increase your income and get a charitable deduction to offset some of your other ordinary income? Maybe as our population ages they'll become more popular.

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Q. How do you work with other advisors who make up the planning team?

R. I am a big believer in the planning team. If the client and the advisors will work as a team, you get better results and better service for the taxpayer and his family. Lawyers, CPAs, and other professionals provide certain services and have certain strengths and weaknesses. If the team will work together on behalf of the family, you typically come up with more creative solutions to your client's concerns.

Q. Do you counsel families about their philanthropy, and how do you help them identify their goals and strategies?

R. Yes, and that is something we try to emphasize. If you have a family that is very philanthropic, there are various ways to get that second and third generation involved, whether through a private foundation, a supporting organization of a public charity, or a donor-advised fund. Sometimes even the family limited partnership can be a way to get everybody involved. It may not be on the charitable side, but through that involvement of the second and third generation in the family business or investments, that experience of working together can benefit the family's charitable planning. If you have a family who has not been very charitable, the discussion can educate them on different opportunities to meet objectives and solve concerns through the use of these techniques.

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We Are Here to Help

There are countless ways in which your charitable plans can join forces with your personal and family goals to produce enhanced results on all fronts. If you would like to explore other planning ideas, we would like you to have a complimentary copy of our booklet, ***Givers Guide to Federal Taxes '04***. Simply return the enclosed postage-paid card or call Randy Daugherty, Planned Giving Director, Southwestern Medical Foundation.

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Payments can continue for life or for a specified period of time up to twenty years. When the payments stop, the remaining assets pass to Southwestern Medical Foundation for the benefit of UT Southwestern.

You may tailor such a unitrust for your retirement by including special *income-only* and *make-up* provisions that allow annual payment to be made only to the extent the trust has "income" and for any difference to be made up in future years when the trust has excess income.

If the trustee invests for capital appreciation until the beneficiary retires, the trust will grow substantially but will distribute no income until that point. If the trust is then invested for income, significant payments will be available to supplement the beneficiary's retirement income.

■ Another and sometimes preferable strategy is to use a ***flip trust***. A flip trust starts out as an income-only unitrust that may or may not have a make-up provision and then converts, or "flips," to a unitrust that pays a fixed percentage of its annual value, regardless of the trust's income. Often this gives the trustee a considerable amount of flexibility in structuring the trust's investments after the flip occurs.

Example: *Janet B, 50, is a successful professional. She has made maximum contributions to all retirement plans available to her, but she would still like to further reduce her current income taxes and create an additional source of retirement revenue. She would also like to make a major gift to Southwestern Medical Foundation for the benefit of UT Southwestern.*

After consulting with her advisors and a member of our staff, Janet decides to create a $100,000 flip trust. The trust will pay her 5% of its value each year—but only to the extent it has income—until she reaches the age of 65. At that point, the trust will "flip" and pay her a fixed 5% of its annual value.

The trust is invested for capital appreciation and achieves a 9% growth rate. It makes no payments to Janet during the next fifteen years due to the initial "income only" provisions, but the trust grows in value to $364,248. At that point, the trust begins making annual payments to her, with the first payment being $18,212 (5% of $364,248).

Over the course of her life expectancy, Janet will receive payments totaling $467,065. Ultimately, $737,900 will pass to Southwestern Medical Foundation to fulfill Janet's charitable goals.

Results: *This plan produces an income-tax deduction of $28,028 for Janet this year, saving her more than $9,810 in her 35% federal income-tax bracket. Plus, Janet gets larger payments at retirement —when she really needs them.*

The information in *Planning Matters* should not be construed as legal advice, tax advice, or as a substitute for advice based on particular factual situations. You should consult your attorney prior to finalizing any of the planning techniques discussed.

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