

The Advisor

April 2009

ESTATE PLANNER'S TIP

Scenario: Married clients who saved faithfully and retired at age 55, thinking their nest egg was more than ample for the next 40 years. Both began receiving Social Security benefits at age 62. The couple, now both 68, realize that with the market collapse they need to return to work. And they believe they're stuck with the reduced Social Security payments for the rest of their lives.

Possible solution: Social Security recipients are allowed to rescind their decision to take benefits by Filing Form 521 and repaying all benefits received to date. There is no interest charged and they may even be able to get a refund on any income taxes paid on the benefits (see IRS Publication 915). The couple can return to the workforce and add to their Social Security earnings for eventual retirement at age 70. Or they may simply immediately reapply for Social Security benefits at age 68 and receive checks that are larger than they would have been if they had retired at full retirement. Will this work for everyone? Clearly, the clients would need to have funds available to repay what they had received since first applying. Health concerns are also an issue, since it may take several years of larger checks to recoup their repayment.

STIMULUS BILL HAS SOMETHING FOR INDIVIDUALS, BUSINESSES

Congress has passed and President Obama has signed into law the American Recovery and Reinvestment Act of 2009, which in addition to containing stimulus measures, includes nearly \$300 billion in tax relief. Among the major provisions:

■ By this month, individuals with earned income will begin seeing additional money in their paychecks, under the Making Work Pay credit, which is also effective for 2010. The credit is equal to the lesser of 6.2% of earned income or \$400 (\$800 for joint filers). The credit begins phasing out for those with modified adjusted gross income exceeding \$75,000 (\$150,000 for married couples). The credit offsets workers'

share of the FICA payroll taxes on the first \$6,452 in earnings (\$12,904 for married couples).

■ The alternative minimum tax exemption has been increased to avoid hitting more taxpayers. The exemption amounts for 2009 are \$46,700 for single taxpayers and heads of households and \$70,950 for married couples. The 2008 levels were \$46,200 and \$69,950 respectively, but without the one-year patch, the 2009 rates would have dropped to \$33,750 for singles and heads of households and \$45,000 for married couples.

■ For 2009 only, Social Security recipients and others on fixed income will receive a check for \$250, although if the taxpayer is also eligible for

the Making Work Pay credit, it will be offset by the \$250 check.

■ The Housing Assistance Tax Act of 2008 introduced a first-time home buyers' credit for homes purchased after April 8, 2008, and before July 1, 2009. The credit, which was for individuals with AGI of up to \$75,000 for single taxpayers and \$150,000 for married filers, was equal to 10% of the purchase price of the home, subject to a \$7,500 limit. The credit is to be repaid in equal installments over a 15-year period, beginning two years after the year of purchase, but is accelerated if the home is sold or no longer used as a principal residence. The Recovery and Reinvestment Act raises the credit to \$8,000 and extends it to home purchases made after 2008, through December 1, 2009. The biggest change, however, is that the repayment requirement is eliminated if the homeowner remains in the home for 36 months. Purchases made on or after April 9, 2008, and before January 1, 2009, are subject to the earlier rules.

■ Car buyers also receive a tax benefit under the new law, with an above-the-line deduction for state and local sales taxes or excise taxes paid on the purchase of new vehicles. The deduction applies only to the tax on the first \$49,500 of the purchase price and begins phasing out for taxpayers with AGI exceeding \$125,000 for singles or \$250,000 for couples. Only purchases made on or after February 17, the date President Obama signed the bill, qualify.

PHILANTHROPY PUZZLER

Marsha created a software program for mothers and babies after her first daughter was born. The company is still in its infancy, but she has dreams that some day it will be a hit globally. Marsha would like for the company to grant stock options to several of her favorite charities. The charities could purchase shares at a future date for a price that is roughly equal to the value of the shares today. She has asked whether the company will be entitled to a charitable deduction.

■ Small businesses will benefit under the new law, with an extension of the expensing allowance. Under the Economic Stimulus Act of 2008, the amount that can be expensed in the current year, rather than being depreciated over several years, was increased from \$125,000 to \$250,000. The Recovery and Reinvestment Act extends that level through 2009.

■ Estimated tax payments may drop for some small business owners. Safe-harbor provisions allow individual taxpayers to avoid an underwithholding penalty by making quarterly tax payments equal to 100% of the prior year's income tax liability (110% if the prior year's AGI exceeded \$150,000). For those who certify that more than 50% of the gross income shown on the prior year's return was from a small business (a business with 500 or fewer employees), the safe-harbor amount is 90% of the prior year's tax liability. The taxpayer must have AGI of less than \$500,000.

■ Employees who are laid off between September 1, 2008, and January 1, 2010, will receive a break on health insurance coverage under COBRA rules. The taxpayer can elect to pay 35% of the coverage amount, with the former employer paying 65%. The employer is entitled to a credit against income tax withholding and payroll taxes for the amount paid.

CHARITIES' INTERESTS OUTWEIGH TRUSTEES' DISCRETION

Laurence Moore created a charitable trust, naming five organizations to receive income for the longer of Moore's life or ten years. The trustees had the discretion to distribute income to some or all of the charities, or even to name additional beneficiaries. A disbursement schedule sent by Moore to his attorney named 18 charities and the amounts each was to receive, although it was not made part of the trust.

Following Moore's death, his niece claimed an interest in the assets. While litigation was pending, the successor trustees sought construction of the trust in light of the schedule. The trust was eventually funded with \$4.6 million. The trustees

dismissed their construction action and filed a petition to determine beneficiaries. The five charities claimed the disbursement schedule did not amend the trust and the assets should be distributed in equal shares to them. The charities eventually reached a settlement – without the approval of the trustees – to define the beneficial interests of 20 charities.

The trustees objected to the settlement and the court’s acceptance, saying that “all the beneficiaries” of the trust had not consented, since they hadn’t even been identified. They added that a clearly stated, material purpose of the trust was to allow the trustees to select charities and the amount each received.

The Court of Appeals of California determined that ascertaining beneficiaries was not necessary. The exercise of the trustees’ discretion to name additional charities and decide shares is outweighed by Moore’s intent that the trust be dedicated to charitable purposes. In the five years since his death, charity has received nothing from the trust. The time had come to honor Moore’s intent and distribute the estate to charity, the court said (*Boys and Girls Club of Petaluma et al v. Walsh*, A120285).

TRUST TAINTED BY UNDUE INFLUENCE, FRAUD

In 1996, Herbert Posnack executed a trust leaving the bulk of his estate in equal shares to ten charities. In 2000, Posnack purportedly created another trust, leaving modest gifts to the charities and the bulk of his estate to Robert and Joan Downs, neither of whom had been mentioned in his earlier trust.

After Posnack’s death in 2005, the charities filed a petition to determine the validity of the 2000 trust, claiming it was the result of undue influence and fraud by the Downs and was not duly executed. The Downs argued that the charities lacked standing, which the court overruled.

Robert Downs testified as a hostile witness at the trial, but on the last day of his examination by the charities, fell while leaving the witness stand. He died a few weeks later, having never resumed

his testimony or been cross-examined by his attorney. Joan Downs claimed Robert had tripped over computer cables that the charities’ attorneys had stretched across the floor. Joan and her children filed a wrongful death suit against the charities and their attorneys and moved for a mistrial in the trust matter, which the court denied. The trial eventually resumed and the court found the 2000 trust to be null and void.

The Court of Appeals of California determined that the charities had standing as beneficiaries of the 2000 trust, although the court agreed with the Downs that if successful in their challenge to the trust’s validity, the charities would take nothing under its terms. The charities apparently believed they could void the revocation of the 1996 trust in a later proceeding, said the court.

The trial court found numerous discrepancies in the 2000 trust document, including differing numbers of pages, typewriting in two different fonts and handwriting by someone other than Posnack. The court concluded that the Downs were “outright lying” about how the trust came to be. Joan argued that the court erred in focusing on whether the trust was “authentic,” saying that the court instead should have focused on whether the essential elements of a trust had been created. The appeals court disagreed, saying that the trial court could not determine whether the provisions “represented the trust Herbert Posnack intended to create.” The court also found no error in the failure to declare a mistrial due to Downs’ death, noting that the court offered – but Downs’ family declined – to allow the admission of his testimony at the deposition where his counsel had the opportunity to examine him (*Foundation for the Junior Blind of America et al. v. Downs*, B201832).

PUZZLER SOLUTION

The company will be entitled to an income tax charitable deduction, but not until the year the options are exercised. The deduction will be equal to the difference between the option price and the fair market value of the shares on the date of exercise (Rev. Rul. 75-348, 1975-2 C.B. 75).

IT'S THE CHARITABLE LEAD TRUST'S TIME TO SHINE

Investors with faith in an eventual stock market recovery have an opportunity to pass considerable assets to family members at bargain prices – and help charity at the same time. The combination of low interest rates and depressed stock prices makes the charitable lead annuity trust attractive.

The §7520 rate, used to calculate the charitable deduction for split-interest gifts such as lead trusts, charitable remainder trusts, gift annuities and remainder interests in homes and farms, sank to an all-time low of 2% in February. Lower §7520 rates mean higher deductions for charitable lead trusts. The §7520 rate did rebound slightly to 2.4% for March, but because donors can use the rate for the month of the transfer or elect either of the two months prior to the gift [Code §7520(a)], lead trusts created by the end of this month can benefit from the February rate.

With stock prices down substantially from a year ago, deferred gifts to family members from a charitable lead annuity trust will carry a lower gift tax price tag.

Consider a couple with a \$2 million portfolio that they plan to leave eventually to their children. Due to recent market declines, the value of the stock is down 30%, to \$1.4 million. Their tax advisor has recommended that they take this opportunity to fund a charitable lead trust that will satisfy their philanthropic goals while also locking in depressed stock prices for computing their transfer tax. The advisor shows them the tax and financial advantages of acting now, using a charitable lead annuity trust paying charity \$70,000 annually (5%) for ten years, with quarterly payments and the use of a 2% §7520 rate.

Gift tax charitable deduction	\$633,498
Taxable transfer to family	\$766,502

If the same gift had been made two years earlier using a §7520 rate of 5.6%, the results would have been less favorable.

Gift tax charitable deduction	\$528,910
Taxable transfer to family	\$871,090

The advisor explained that the taxable transfer to the children will be fully sheltered by their gift tax credit (\$1 million each), although it will reappear in future estate tax computations. By making the gift now, rather than leaving the assets to the children at their deaths, the couple removes all future growth in the stock from their gross estates, saving estate taxes. In addition, assuming the portfolio earns a 6% return, the couple reduces their current income by \$84,000 annually, saving them income taxes. And finally, over the term of the lead trust, the couple's favorite charities will receive \$700,000 to support important programs.

The couple is optimistic about the ability of their investments to grow over the next ten years. They expect the portfolio to recoup recent losses and increase in value during the trust term. When the trust ends in ten years, the assets pass to the children free of further gift tax, no matter how much the stocks have appreciated. Note: The couple can virtually "zero out" transfer taxes by boosting charity's annuity to 6% and extending the trust term to 20 years, using a 2% §7520 rate.

