# Scripps Heritage Planner

An Income, Estate and Gift Tax Newsletter for Professionals
from the Office of Gift Planning at Scripps Health Foundation

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## Case Studies On Tax and Gift Planning

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# Case Studies On Tax and Gift Planning

For more than a decade, *StoryCorps* has recorded ordinary people sharing compelling stories about their lives.[1] Over 100,000 of these recordings are archived in the American Folklife Center of the Library of Congress. All are available to anyone who wants to listen to them—and many people do. We like hearing other people's stories, even when they're tinged with sadness, because it reminds us of our shared humanity.

*StoryCorps'* mission might also resonate with professionals dedicated to furthering the charitable interests of clients, since client stories provide a context for the technical solutions we propose. Life stories connect us to clients and to the charities that can fulfill our clients' most heartfelt wishes to leave a legacy and make a difference.

In this issue of ***Scripps Heritage Planner***, we present three case studies—fictional examples of donors inspired to give, each employing a different giving technique appropriate to their individual circumstances:

- **The Case of Dr. Keller: Charitable Remainder Trust and Wealth Replacement Insurance**
- **The Starks' Strategy: Gifts of Retirement Benefits**
- **Krenshaw's Dilemma: Charitable Gift Annuities**

## The Case of Dr. Keller: Charitable Remainder Trust and Wealth Replacement Insurance

Often, donors want to make a substantial gift to charity but feel constrained by concerns about their family's financial security. A technique called wealth replacement (also known as capital replacement) provides a solution. In a nutshell, here's how it works.

A donor:

- Funds a charitable remainder unitrust (CRUT) with appreciated property
- Establishes an irrevocable life insurance trust (ILIT) with a life insurance policy
- Uses annual CRUT income to make gifts to the ILIT for premium payments
- Names the charity that will receive the CRUT remainder at the donor's death
- Designates heirs to receive the life insurance proceeds from the ILIT

Let's see how Dr. Fritz Keller uses this technique.

### Competing Goals

Dr. Fritz Keller, 67, is a prosperous heart surgeon and decorated Vietnam veteran. His wife, Jen, is a retired accountant. Their sons, Ronald and Phillip, followed in their father's footsteps by joining the military, where Phil continues a successful career. Unfortunately, Ron was not so lucky—he was severely injured during his last tour of duty in Afghanistan and has since retired. Both are married with children. They will undoubtedly earn far less in their lifetimes than their father did in his. The Kellers want to leave their sons with as much of their $14 million estate as possible to help them support their growing families.

Still, Dr. Keller continues to have a compelling interest in the lives and concerns of his military comrades, and the Kellers have a strong desire to give back by contributing substantially to their community hospital. A completed gift during the current year would not only be personally satisfying, it would reduce the amount of income tax the Kellers owe. However, they remain concerned about gifting assets, as their sons may need the money for support, emergencies, or their children's college tuition. The Kellers are particularly concerned about the ongoing medical expenses Ron faces as a result of his military injuries.

### Putting Together a Plan

The Kellers meet with their financial advisor, Thomas Sloane, who introduces them to the concept of wealth replacement. They are thrilled to find a way to reduce income and/or estate taxes, make significant charitable contributions, and still provide their sons with an equivalent inheritance amount. With Thomas' help, the Kellers take the following steps to implement this plan.

**Establish a CRUT.** They transfer $1 million in long-term appreciated securities (with a cost basis of $300,000) into a charitable remainder unitrust (CRUT). They briefly considered a charitable remainder annuity trust (CRAT), but the CRAT didn't allow additional contributions. They select to receive 5% of the trust assets annually for both of their lives, and choose three charities to share equally in the remaining assets at the end of the trust term.

The Kellers appreciate the benefits of this arrangement:

- **They receive a charitable deduction of $387,320—** the present value of the charity's remainder interest, based on the 2% applicable federal rate (AFR) at the time of the transfer. This deduction is subject to the

30% limitation.[2] If they can't use it all in one year, they have five years to use the rest. In their 39.6% marginal tax bracket, this deduction will save them $153,378 in federal income taxes.

- **They avoid paying $140,000 in capital gains tax** by transferring their $1 million appreciated stock to the CRUT instead of selling it ($700,000 appreciation taxed at a 20% rate). The savings are even greater when they factor in the 3.8% Medicare surtax.
- **They pay tax on gains inside the trust only as funds are distributed.** Because the trust is income tax exempt,[3] the trust does not owe capital gains tax when the trustee sells the stock and reinvests the proceeds. The Kellers pay tax on capital gains inside the trust only as those gains are paid out. (Gains are taxed under the four-tier system, which mandates that the trust pays out the highest taxed income or gain first.)[4]

### CRATs and CRUTs—A Refresher

A gift of a partial interest does not typically qualify for the income tax, gift tax or estate tax charitable deduction. CRTs offer an exception to this "partial-interest rule." A CRT is an irrevocable trust wherein the donor receives trust income for life (or for a period of up to 20 years) and after this term, the trust corpus is distributed to charity. The payout period may last for more than one life, but the present value of the charitable remainder must be 10% or more of the initial value of the property placed in trust.

Charitable remainder trusts come in two forms—charitable remainder annuity trusts (CRATs) and charitable remainder unitrusts (CRUTs). The major difference is in the payments to the donor. CRATs pay a specified percentage of the initial value of the trust assets, meaning each payment is the same amount. CRUTs pay a specified percentage of the annually revalued trust assets, allowing the payment to vary each year with any increase or decrease in the trust principal. In either case, the percentage must be at least 5% and not more than 50%, and the payments must be made at least annually.

**Create an ILIT and purchase a life insurance policy.** The central idea of wealth replacement is to "replace" the assets transferred to the CRUT with life insurance proceeds, so the Kellers, who are in good health, purchase a second-to-die life insurance policy. But since their estate will likely be subject to federal estate tax, they wisely choose not to purchase the policy personally. Instead, they establish an irrevocable life insurance trust (ILIT) which will purchase and own the $1 million policy. Ron and Phil are the beneficiaries of the ILIT and will receive the proceeds under the trust terms. The ILIT keeps the life insurance policy out of the Kellers' gross estates for federal estate tax purposes,[5] and also provides protection from creditors, in case that becomes an issue in the future.[6] The income tax deduction from the CRUT helps the Kellers balance out the life insurance purchase, and they can use the CRUT distributions each year to pay the premiums (the initial year's $50,000 distribution will not remain constant since future distributions will vary from year to year as trust assets are revalued to account for gains and losses).

**Grant Crummey powers.** When the Kellers make annual gifts to the ILIT to enable the trustee to pay the insurance premiums, those gifts are subject to the federal gift tax—unless they qualify as gifts of a present interest. To make sure they qualify, Dr. Keller grants "Crummey powers" to Ron and Phil,[7] giving each son the right to take a distribution of these annual gifts for a limited time after each addition to the trust (say, 30 days). Provided Ron and Phil choose not to exercise these powers, the trustee will use the funds to pay the life insurance premiums. Thanks to the Crummey powers, the annual gifts qualify for the gift tax exclusion ($14,000/child in 2016, or $28,000/child with gift splitting).

## Analyzing Results

After the Kellers pass away, the life insurance proceeds will flow into the ILIT for distribution to Ron and Phil, and the CRUT will pay out its remaining balance to the charities. Ron and Phil may even inherit more wealth than if they had inherited the appreciated stock under their parents' wills, where it would have been subject to estate tax when the second parent died.

The Kellers were able to:

- Fulfill their dream of making major gifts to meaningful charities without reducing their children's inheritance
- Turn the untaxed appreciation in their stock into a current economic benefit in the form of a charitable deduction of $387,320
- Use the income tax savings and the CRUT payouts to fund premiums on a life insurance policy, with enough left over to supplement their retirement income

- Avoid federal gift tax on the annual transfers to the ILIT through the strategic use of Crummey powers
- Remove both the assets transferred to the charity and the life insurance proceeds from their gross estates for federal estate tax purposes
- Provide protection from creditors by using an ILIT

## The Starks' Strategy: Gifts of Retirement Benefits

Many people would like to give money to charities that are important to them, and doing so as a bequest in a will is a simple option. A bequest ensures donor access to the entire estate during life and leaves open the possibility of altering or even eliminating the bequest if circumstances change. However, a bequest of cash or securities, or a more general percentage of the estate value, is not necessarily the best choice. Making a gift of retirement plan assets can prove highly beneficial to heirs, who avoid the possibility of double taxation on these assets.

### Selecting Assets to Donate

Joseph Stark and his wife Penny both enjoyed prosperous and extremely successful corporate careers, but struggled with the stress and disappointment of discovering that they were unable to start a family of their own. They soon redirected their energies into caring for foster children. Eventually, Penny quit her job and dedicated herself full time to caring for these children. Shortly thereafter, they decided to stop fostering and adopt. Joseph's concern for the plight of these children ran especially deep as he was orphaned at the age of six. He had a hard time saying no, and they finally adopted seven children over the course of seven years.

Joseph and Penny have made a huge difference in the lives of many individual children, but they both long to have a more far-reaching impact. They believe their estate is large enough (at over $14 million) to provide inheritances for their adopted children and also give generously to a charity they have worked with for many years—an organization that works with foster children and orphans.

### Beyond Cash Contributions

At their annual meeting with Diana Dixon, their financial advisor, the Starks talk about their intent to make bequests to two special organizations. They plan to leave their real estate and retirement assets to the children and donate most of their investment portfolio to charity. Diana suggests rethinking this plan. First, the children may need liquidity to pay taxes and other final costs when the Starks die. Second, the retirement assets could actually be more beneficial to donate.

Their estate value breaks down as follows:

- 401(k) plans - $3.5 million
- Defined benefit plans - $2 million (present value of future monthly benefit)
- Deferred compensation arrangements - $1.2 million
- Investment portfolio (including both stock and bond mutual funds) - $4 million
- Real estate - $3.5 million

After considering the benefits, they decide to fund their legacies by making the charity the beneficiary of their retirement accounts because, as Diana explained, these assets are double taxed as an asset in the estate as "income in respect of a decedent" (IRD) by the estate tax, and at the beneficiary's income tax rates upon withdrawal. The estate receives an estate tax charitable deduction for the charitable gifts and the qualified charities will owe no taxes because they are tax exempt.

#### IRD Refresher

Income in respect of a decedent (IRD) is, of course, any income an individual earns or has a right to prior to death, but which was not includible in the estate before death.[8] It includes common items from unpaid salary and bonuses to accrued interest or rent, to, of course, retirement assets and commercial annuities.[9] Although the following list is not exhaustive, IRD results when any of these retirement assets become part of a decedent's estate:

- Qualified plans—Defined contribution plans (profit sharing, 401(k), money purchase, ESOP) or defined benefit/cash balance plans
- 403(b) tax deferred annuities
- 457(b) deferred compensation
- IRAs (traditional and Roth), SEPs and SIMPLEs
- Nonqualified deferred compensation arrangements

The problem with IRD is that it is taxed twice—once in the decedent's estate for federal estate tax purposes, and again when the recipient receives the funds. (For federal income tax purposes, IRD keeps the same tax character when it reaches the final recipient, so retirement plan distributions are also taxed to beneficiaries as ordinary income.)[10]

### Analyzing Results

Let's examine what the Starks accomplish by donating their retirement assets.

- **Estate tax deduction.** Their combined wealth of over $14 million exceeds the current combined estate tax exemption of $10.9 million. The $6.7 million bequest (current value, which may increase or decrease by the time of their deaths depending on changes in their retirement accounts) will generate a very helpful and sizable estate tax charitable deduction.
- **Liquidity plus a step-up in basis.** They will leave all non-retirement related assets—cash, securities and real estate—to the children. This will provide the children enough liquidity to handle all final taxes and expenses. The children will not owe income tax on these assets and will benefit from a step-up in basis.[11]
- **No double taxation on IRD.** Retirement assets, as IRD, are doubly taxed—both in the estate and again to the beneficiaries—and would not receive a step-up in basis.[12] However, the charity, being a tax-exempt organization, avoids these taxes.

For philanthropically minded estate owners, making a charitable gift of IRD assets is an ideal strategy for avoiding the potential one-two punch of high estate and income tax liability.[13]

## Krenshaw's Dilemma: Charitable Gift Annuities

Some donors want to make a meaningful gift but hesitate when confronted with complex strategies or issues related to finances or timing. Charitable gift annuities offer an attractive option and are well suited to these individuals—especially to older donors, since tax benefits improve as a donor's life expectancy decreases.

Let's see how a charitable gift annuity helps one couple accomplish their goals in the face of uncertain circumstances.

#### Charitable Gift Annuities—A Refresher

A charitable gift annuity is relatively simple in concept and execution. It is part gift and part annuity, since the donor contributes property in exchange for annuity payments from the charity. The donor receives an income tax charitable deduction in the year of the gift for the gift portion of the transfer (i.e., the value of the contributed cash or property less the present value of the annuity payments).[14]

### Giving Today without Jeopardizing the Future

Harvey Walton and Patrick Krenshaw, a 65-year-old married couple, met 45 years ago while attending a university in California. Harvey majored in Fine Arts, while Pat pursued a Ph.D. in Landscape Architecture and Environmental Planning. Pat went on to become a professor of environmental history at the university, while Harvey devoted his days to creating lithographs of landscapes based on photographs he took during the couple's visits to many of the state's parks and public spaces. They enjoyed spending their free time visiting art museums and architectural landscape destinations throughout the world.

Their passion for travel reduced somewhat the amount they otherwise would have saved for retirement. Still, Pat was a dedicated saver and earned additional money in consulting fees. Harvey's lithographs eventually drew critical acclaim and he earned significant income through commissions and sales of his artwork. Their estate is currently worth roughly $1.7 million:

- $500,000 in Pat's 403(b) plan and other retirement arrangements offered through the university
- $400,000 in various mutual funds and securities
- $100,000 in cash
- $400,000 appraised value of their jointly owned home
- $300,000 estimated value of Harvey's lithographs if sold at auction

Recently, Harvey was diagnosed with stage III pancreatic cancer. In the planning that followed, Harvey and Pat agreed that it would mean a great deal to them to support an organization that worked for the preservation of nature in their state—nature they had enjoyed together for so many years. While Pat is fully on board with this in theory, he suggests that instead of a cash donation, he should donate his time assisting the park's landscaping engineers.[15] He is privately worried about how Harvey's medical expenses will impact his own financial stability down the line, and therefore nervous about making an overly generous charitable commitment.

### The Best of Both Worlds

When Pat discusses this gift dilemma with a colleague, his friend mentions the charitable gift annuities offered by the university and suggests that the nature preservation charity may offer them as well. Pat and Harvey discover that this type of annuity is a simple contract between a donor and a qualified charity[16] in which the donor makes an irrevocable gift of cash or property and in return, the charity pays a fixed annuity for the lifetime of one or two annuitants. Payments can be monthly, quarterly, semiannual or annual.

Harvey and Pat decide to more aggressively market and sell Harvey's lithographs[17] and use the proceeds to purchase a gift annuity from the nature preservation organization that will pay Pat income for life. They are able to take a current income tax charitable deduction at the time of the annuity purchase. If Pat feels financially able to do so, he can establish additional gift annuities as the lithographs continue to sell.

### Analyzing Results

Let's examine what Pat and Harvey accomplish by establishing a charitable gift annuity.

- They gain the personal satisfaction of supporting the state's natural areas that meant so much to them over the years. In particular, as Harvey's life expectancy is uncertain, the gift annuity fulfills his final wish and provides the legacy he'd hoped for. (A bequest in either his will or Pat's would not have allowed the same satisfaction.)
- As most of their liquid assets are going towards Harvey's medical bills, and Pat is strongly against dipping into their retirement savings, the ability to donate the proceeds from the sale of the lithographs was key to making this plan work.
- The annual annuity payments ease Pat's mind about future income and finances.
- The charitable deduction is welcome.

## Conclusion

The *StoryCorps* archive catalogues recordings on subjects ranging from family and growing up, to Hurricane Katrina and September 11, to legacies, the military—even the loss of memory itself. Each story is unique, just as each donor is unique, with his or her own history, motivation and combination of assets. Listening to and learning from individual stories can be the crucial step in helping clients realize financial security and life-long dreams.

## Endnotes

1 StoryCorps is regularly broadcast on many public radio stations. See Storycorps.org.

2 If the Kellers had used cash to fund the CRUT, the deduction limitation would have been 50% of AGI. The 30% and 50% limits apply to gifts to public charities—different limits apply to gifts to private foundations. See IRC §170(b) and the regulations thereunder.

3 The trust is income tax exempt unless it has unrelated business taxable income (UBTI).

4 As long-term capital gains realized inside the trust are distributed under the four-tier system, the income beneficiaries report capital gains at the rate determined by their tax bracket—20% for the Kellers, but donors with lower income may be eligible for a rate of 15%, or even 0%. See IRC §664(b) and regulations thereunder.

5 If a donor purchases a life insurance policy and transfers it to an ILIT, the death proceeds are still includible in the donor's gross estate if the donor dies within three years of the transfer or retained any incidents of ownership [IRC §2035(a)(2) and IRC §2042(2)]. If the ILIT applies for, owns, and pays the premiums on the policy, the donor should not serve as trustee.

6 An ILIT is unnecessary if the donor does not expect to be subject to the estate tax and/or sees no need for protection from creditors.

7 IRC §2503(b); *Crummey v. Comm'r,* 397 F.2d 82 (9th Cir. 1968); Rev. Rul. 73-405, 1973-2 C.B. 321. Caution—trustees must give beneficiaries written notice of withdrawal rights each year and offer a minimum of 30 days in which to exercise their withdrawal powers.

8 IRC §691(a)

9 IRC §102(b) and §691; see also Rev. Rul. 92-47, 1992-1 CB 198

10 IRC §691(a)(3). Take care to ensure that beneficiaries receive an income tax deduction for taxes paid by the estate under IRC §691(c).

11 IRC §1014(c)

12 Id.

13 Unlike IRD left to other beneficiaries, IRD left to a surviving spouse falls under the unlimited marital deduction and therefore generates no federal estate tax. To the extent the surviving spouse does not spend down the IRD assets during life, these assets will still be subject to estate and income taxes if the estate is over the surviving spouse's exemption amount ($5,450,000 for 2016, not including any unused exemption of the predeceased spouse).

14 If cash is transferred for the annuity, the percentage limitation is 50% of adjusted gross income (AGI). If long-term appreciated property is transferred, the percentage limitation is generally 30% of AGI. Any deduction in excess of the applicable percentage limitation may be taken in up to five following tax years.

15 Donations of time or services, however generous or technical, are not deductible. See IRS Pub. 526.

16 Only qualified charitable organizations may issue gift annuities. A state may require the issuing charity to register with the state insurance departments in the states in which it solicits gift annuities. The solicitation process itself may also be subject to state regulations. State laws often require issuing charities to maintain segregated reserves to cover their potential obligations to annuitants under gift annuity agreements.

17 Harvey is wise to sell the lithographs and donate the proceeds. The tax deduction for an artist who donates his or her own artwork is limited to the item's cost basis.

## Upcoming Gift Planning Seminars

**All presentations will take place at:**

Founder's Room, Schaetzel Center for Health Education
Scripps Memorial Hospital La Jolla • 9888 Genesee Avenue • La Jolla, CA 92037

**To make a reservation:**

email giftplanning@scrippshealth.org or call 858-678-7120

Reservations are required and spaces are limited. We often fill all available spaces and start a waiting list. If you make a reservation and learn that you cannot attend, please promptly notify us so that we can offer your seat to another professional. Complimentary lunch and validated self-parking provided to those who RSVP. MCLE credit is offered and available for those who qualify.

Wednesday, May 4, 2016 Noon-1:30 pm MCLE Credit: 1 hour general

### Advance Healthcare Directives - Will Your Client's Wishes Be Honored

**Presenters:** **Margaret Mangin, Esq.,** Corporate Counsel Scripps Health
**Eloise Hock Feinstein, Esq.,** Law Office of Eloise Hock Feinstein, APC

**Reservation Deadline:** Friday, April 29, 2016

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Wednesday, June 1, 2016 Noon-1:30 pm MCLE Credit: 1 hour general

### Retirement to Skilled Nursing to Dementia Care Facility to Hospice Levels of Care and Who Pays For It

**Presenters:** **Phil Lindsley, Esq.,** San Diego Elder Law Center
**Amy Abrams, MSW/MPH,** Education & Outreach Manager, Alzheimer's San Diego

**Reservation Deadline:** Friday, May 27, 2016

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Wednesday, July 6, 2016 Noon-1:30 pm MCLE Credit: 1 hour general

### Estate and Gift Planning for Real Estate – Planning Outside the Box

**Presenters:** to be announced

**Reservation Deadline:** Friday, July 1, 2016

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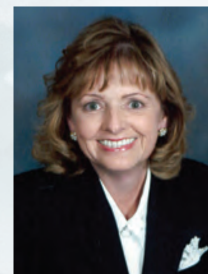

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