Scripps Heritage Planner

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

SUMMER 2009

Life Income Gift Plans and Saving for Retirement:

Charitable Options for Working Professionals

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www.scrippsheritage.org

Scripps Health Foundation

Our Services

Scripps Office of Gift Planning is available as a resource to estate planning professionals. Our office will provide these services at no cost or obligation:

- **Immediate Telephone Consultations**
- **Summary of Benefits**
- **Private Client Meetings**
- **Seminars for Clients**
- **Charitable Deduction Calculations**
- **Flow Charts and Graphs**
- **Presentations at Your Office**

Our Website: Resources for Estate Professionals

Please visit us online at www.scrippsheritage.org to find many helpful tools, calculators and links to tax laws and articles. You may also sign up easily for our weekly eNewsletter on our web site.

Upcoming Gift Planning Lunch Presentations

Inadvertent Triggers of Real Estate Property Reassessment: How to Avoid a Ticking Time Bomb	**October 7, 2009**
2009 Year-End Tax Planning	**November 4, 2009**
Optimizing Charitable Gifts of Real Estate in Your Clients' Estate Plans	**December 2, 2009**

All presentations will take place from noon to 1:30 p.m.
at the Founders Room, Schaetzel Center for Health Education

Scripps Memorial Hospital La Jolla
9888 Genesee Avenue
La Jolla, CA 92037

See back cover for further information about these educational opportunities.

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Introduction

High income earners (professionals, consultants, executives, business owners, etc.) can encounter difficulty saving for retirement if they rely solely on annual contributions to qualified retirement accounts. For instance, an individual can contribute $16,500 to a 401(k) account in 2009 [IRC Sec. 402(g)(1)]. This amount may be acceptable for an employee age 35 earning $100,000 a year, but does not meet the savings requirements for an executive age 49 earning $400,000 a year. Though it is true that these statutory limits on contributions to qualified retirement accounts are indexed to inflation, the increase may be only $500 or $1,000 from year to year. And, even though the law may provide individuals age fifty and older the opportunity to contribute additional amounts above the stated limits (called a “catch-up provision”), these amounts are modest in size, i.e., $5,500 above the usual $16,500 contribution to a 401(k) [IRC Sec. 414(v)].

High income earners often want to save more for retirement than the qualified plan contribution limits allow, so they must seek out additional options. In advising clients of those options, consider how a planned gift to a charity might serve a dual purpose. There are ways to structure a charitable remainder trust or a charitable gift annuity so that it fits both the need for increased retirement income and the personal goal to make a difference through philanthropy.

Saving for Retirement

To start, there are many ways to save for retirement.

- Defined benefit pension plan
- Investments and savings
- Defined contribution plan
- Social Security
- Life insurance
- Annuities
- Charitable life income gift plans (charitable gift annuities, charitable remainder trusts, pooled income funds)

A defined benefit pension plan is a qualified plan installed by an employer that guarantees a specified benefit level at a normal retirement age. The paid benefit depends on the particular formula employed by the plan. The maximum annual benefit permitted under defined benefit plans is $195,000 or 100% of the average compensation in the employee’s three highest earning years (whichever is less) [IRC Sec. 415(b)(1)]. Defined benefit pension plans require that the employer maintain assets to cover pension benefits to its employees that have vested in the plan. Defined benefit pension plans can be somewhat complicated and expensive to administer. For these reasons (and others), many employers decided to convert these plans into defined contribution plans over the past twenty years.

Today, the employers who are interested in a defined benefit pension plan are smaller firms with older, higher paid employees who are owners or shareholders. The reason defined benefit plans appeal to these firms is because the benefit formula can be based on recent compensation levels, largely ignoring time of service requirements for accumulating a sizeable pension benefit, subject to IRS limits.

Investments and savings are a prime source of income in retirement years. Individuals (often working with a financial planner or advisor) strive to create a portfolio of assets balanced between growth and income objectives and investment risk. The income the investments produce – whether as a dividend or interest, or as capital gain upon the sale of the asset – is taxed to the individual at the time it is received (not on a tax-deferred basis).

A defined contribution plan provides that the employer can make an annual contribution to the plan. The amount of each employee's retirement benefit ultimately depends on the amount of contributions and the investment performance of that particular employee’s account, rather than the employer’s promise as for a defined benefit plan. The employer’s annual contribution is frequently based on a percentage of compensation. The employer's only obligation is to make these contributions if required; the employee generally bears the risk of investment performance. (With a defined benefit plan, the employer bears this risk.) In fact, defined contribution plans often permit participants to direct the investment of their plan accounts. Defined contribution plans are popular today for several reasons, including little investment risk for the employer, simple administration, and more easily determined employer costs. These plans also are often easier for participants to understand.

The types of defined contribution plans include: the Money Purchase Pension Plan, the Profit Sharing Plan, the Thrift Plan, the Employee Stock Ownership Plan (ESOP), the Target Benefit Plan, the 401(k) Plan, the 403(b) Plan, and the 457 Plan.

Of course, the individual retirement account (IRA) – both the traditional and Roth IRA – is a qualified retirement plan. And, to add to this "inventory" of plans, there are two types of plans that are technically not qualified retirement plans, but alternatives to qualified retirement plans: Simplified Employee Pension (SEP) Plan and the SIMPLE Retirement Plan.

The major differences between the plans lie in plan administration, plan eligibility, contribution limits, and benefit formulas. As noted at the outset, the annual contribution limits to qualified retirement plans can create a difficult situation for high earners who want to maximize the amount they save for retirement.

Qualified Plan Limits for 2009*

IRA	$5,000	($1,000)
SIMPLE IRA	$11,500	($2,500)
401(k)	$16,500	($5,500)
403(b)	$16,500	($5,500)
457	$16,500	($5,500)
SAR-SEP	$16,500	($5,500)

*Provisional amount of additional "catch-up" contribution for taxpayers age 50 and over in parenthesis.

Social Security is an extensive entitlement plan, or "safety net," administered by the federal government. Social Security provides benefits as well as medical insurance to retirees, surviving spouses and children, disabled persons and their families. The eligibility for Social Security extends to most American workers based on successive quarters of coverage worked to become fully insured. An insured worker can claim retirement benefits as early as age 62, or wait until full retirement age to receive a full benefit. The amount of the full benefit depends on the worker's primary insurance amount which is based on the worker's average indexed monthly earnings. Depending on a retiree's income, 0%, 50% or 85% of Social Security income could be taxed.

Life insurance is a component of many retirement plans (both qualified and non-qualified). For example, a policyholder can build up cash values within the life insurance policy without the growth in value being taxed. During retirement, the policyholder can borrow against the policy tax-free to a certain extent as a source of income. There are a variety of life insurance products that will fit an individual's retirement plans such as whole life, universal life and variable life policies.

Annuities are life insurance products that pay an individual a regular income for a specified period of time or for a lifetime in return for a premium paid by the individual. Annuities are taxed by excluding from taxation a pro-rata percentage of the "investment in the contract" from each of the payments received during the life expectancy of the annuitant. There are a variety of annuities to meet an individual's income needs such as fixed, variable or indexed annuities. Annuities can also be immediate or deferred.

Charitable life income gifts such as charitable remainder trusts, pooled income funds or charitable gift annuities are another possible source of retirement income. The following discussion takes a closer look at these options.

Important Issues

Retirement planning is highly complex and ever-changing. This is especially true given the recent market volatility. Even people in retirement have to periodically change their expectations and strategies. But one vital question that often goes overlooked in the retirement planning process is this: Are the people who want to save more for retirement also interested in charitable giving?

One practical approach to retirement is to save as much as possible. But, a more nuanced approach is to integrate philanthropy with retirement planning. For many people, philanthropy is a central part of their retirement lives in the form of civic involvement, volunteerism and commitment to community. Charitable giving provides a capstone for this way of living, so incorporating charitable giving into retirement planning is often a natural thing to do.

Charitable Remainder Unitrust

A charitable remainder trust is a trust which provides for a specified distribution, at least annually, to one or more beneficiaries, at least one of which is not a charity, for life or for a term of years, with an irrevocable remainder interest to be held for the benefit of, or paid over to, charity [Reg. Sec. 1.664-1(a)(1)(i)].

A charitable remainder unitrust (CRUT) is an irrevocable trust that names a charitable institution as remainder beneficiary, and pays one or more income beneficiaries a specified percentage of the value of the trust assets as revalued each year [IRC Sec. 664(d)(2)]. If the trust principal rises in value, the income payout also will increase. The specified percentage of the income payout must be at least 5%, but not more than 50% [IRC Sec. 664(d)(2)(A)]. The value of the charitable remainder must be at least 10% of the net fair market value of all property transferred to the trust as determined at the time of the transfer [IRC Sec. 664(d)(2)(D)].

Why is a CRUT a good choice for retirement savings? Because the payout is determined by the percentage of the trust assets as revalued every year. The payout increases as the value in the trust increases. This can provide a hedge against inflation. Of course, in difficult economic times, the investment performance of the assets may drop – and the unitrust payout will be lower as well. Compare this characteristic to a charitable remainder annuity trust that must pay the same amount every year – it is possible that a CRAT could fail if the trust assets are depleted by a severe drop in the market.

NICRUT and NIMCRUT

A variation possible only with a CRUT is the net-income unitrust (NICRUT). The trust agreement can direct that each annual payment is to be the lesser of the specified percentage of the trust's value for that year, or the net income actually earned by the trust [IRC Sec. 664(d)(3)(A)].

If this net income option is selected, the trust agreement may provide that if less than the specified percentage is paid out in one or more years, the accumulated "income deficits" will be made up in subsequent years in which income exceeds the specified percentage [IRC Sec. 664(d)(3)(B)]. A net income unitrust with such a make-up provision is called a NIMCRUT.

The NIMCRUT technique can be used to time trust income payouts to coincide with the donor's need for retirement income. The trust could be funded with non-income producing assets, or the trustee might initially invest the trust corpus in assets that produce little or no income. When the donor reaches retirement age, the trustee would then convert the corpus to income-producing investments and begin to pay out trust income (including any make-up amounts, if called for by the trust instrument).

What Is Income?

The trust document for both a NICRUT and a NIMCRUT should contain a provision that defines income for accounting purposes. Trust documents that lack a stated definition for income must use the state law definition of income. And this definition is critical. If the trust has the option to distribute only income and the definition of income is restrictive, the trust will distribute little or nothing. Generally, trust accounting income includes the following: interest, dividends, rents and royalties and subtracts all the expenses required to generate that income [Reg. Sec. 1.664-3(a)(1)(i)(*b*)(3)]. In 2003 the IRS changed the regulations to expand the definition of income to include allocation of capital gains and losses between income and principal. Also, income can be calculated under a unitrust-determined formula and/or the trustee can shift assets between income and principal if, in the trustee's discretion, the adjustment is necessary to treat charitable and non-charitable beneficiaries with impartiality. However, even if state law permits, trust income may not be determined by reference to a fixed percentage of the net fair market value of the trust property.

The "Flip" CRUT

The Flip CRUT is a hybrid CRUT: a NICRUT or NIMCRUT that "flips" into a straight CRUT. A trigger event converts the CRUT from the net-income version into the straight CRUT. For example, a donor funds a CRUT with a parcel of real estate. The trigger event is the completed sale of the real estate. The real estate itself generates no income so the NICRUT (or NIMCRUT) makes no payments from the trust. When the real estate sells, the trustee invests the proceeds in equities that produce returns that will enable the trust to satisfy the required payouts.

Not any event can be a "trigger" event – acceptable triggers for a Flip CRUT include:

- A specific date
- The sale of a specific asset or assets
- The occurrence of some event outside the control of an individual (birth, death, marriage, divorce of a particular person)

[Reg. Sec. 1.664-3(a)(1)(i)(*c*) – 1.664-3(a)(1)(i)(*f*)]

Of course, retirement on a specific date could be set as the trigger for a Flip CRUT.

Note that a Flip CRUT utilizing a net-income make-up provision can be tricky. The advantage of a NIMCRUT is taking a greater amount than the payout percentage allows in future years based on the make-up provision. However, the undistributed make-up amount is forfeited upon the flip into a straight CRUT.

Purpose-Driven Life Income Gifts

Life income gifts such as a charitable remainder unitrust or a deferred charitable gift annuity appeal to donors because they make a gift and receive an income. This generosity becomes part of the planning. Often, donors have a particular program or purpose they would like their gift to benefit. And, in a similar sense, donors might direct the income they receive from a partial interest gift to meet a certain expense or provide discretionary spending in retirement.

For instance, a donor might set up a charitable gift annuity with a charity in order to pay for travel holidays. Or, more practically, a donor might set up a charitable remainder unitrust and use the distributions from the trust to pay the premiums of a life insurance policy contained in an irrevocable life insurance trust as part of a wealth replacement approach.

Deferred Payment Gift Annuity

In the conventional gift annuity arrangement, annuity payments begin no later than one year after the gift has been made. However, many high-earning donors do not need or want additional income immediately. Instead, income tax relief afforded by the charitable deduction may be more important at this particular stage in life.

A deferred gift annuity allows donors to defer the starting date of annuity payments and thereby significantly increase both the annuity amount and the income tax charitable deduction which is still available in the year of the contribution.

The American Council on Gift Annuities (www.acga-web.org) publishes a table of factors for adjusting the annuity payout in the case of a deferred gift annuity. These factors are based on the length of the deferral period. Commercial software packages build these factors into their calculation codes so the adjustments are made automatically when deferred gift annuity calculations are run.

The bottom line is that the donor can get more income tax relief during high-income years and a higher income stream later on when, presumably, the donor will have a greater need for supplemental income.

To summarize, the advantages of the deferred gift annuity include:

- A current federal income tax deduction.
- Additional income for retirement, or a grandchild's college tuition, or other purposes.
- A favorably taxed lifetime income once payments begin.

Flexible Start Date for Deferred Gift Annuities

Deferred gift annuities may include a provision in the gift annuity agreement that allows the annuity starting date to be determined in the future. The IRS has approved a deferred gift annuity that did not specify a fixed starting date for the annuity payments [Ltr. Rul. 9743054]. The donor established the annuity at age 50, and could elect to have payments begin at any time after age 55.

The gift annuity agreement between the donor and the charity specified a different payment amount (rising with the deferral of the start date) for each possible age at which payments might begin. The income tax charitable deduction allowed for the gift was based on the lowest possible deduction that would be available at the earliest annuity starting date.

This letter ruling technically applies only to the donor involved therein, but it is generally believed that the IRS will look with favor upon similar cases in which donors seek to preserve some flexibility in setting their annuity starting date – and who are willing to take a lower upfront deduction.

Commutation Clause

Deferred charitable gift annuities may include a clause (known as a commutation clause) that allows the income to be paid in a shortened period of time rather than for an entire lifetime. This option is helpful when the annuitant needs more income during a particular period of time during retirement.

Bridge Income for Early Retirement

Retirement planning involves a sense of timing. An individual may decide to retire earlier than some or all retirement benefits are scheduled to begin or become available. Perhaps the individual leaves his or her workplace to take care of a loved one facing an illness, or to begin retirement at the same time as a spouse. To meet income needs during these “gaps”, an individual can create a life income gift that will meet an income need for a specified number of years. For instance, a charitable remainder trust can be set for a number of years (up to twenty). Or, a charitable gift annuity trust can include a commutation clause.

Other Options

The Grantor Charitable Lead Trust

Although the discussion thus far has concerned charitable gifts that generate an income, the charitable income tax deduction alone can be just as important in a planning context. Consider the grantor charitable lead trust that pays an annual income to a charity for a set number of years then distributes the remaining trust assets back to the grantor. Because of this reversionary right, the grantor is treated as the owner of the trust (assuming the value of the reversion exceeds 5%, as it usually will). The grantor will be taxed on all the income earned by the trust, but the present value of the charity’s income interest is deductible for income tax purposes.

The Super Grantor Charitable Lead Trust

A super grantor charitable lead trust (or intentionally defective non-grantor charitable lead trust) is a grantor trust for income tax purposes, but a non-grantor trust for gift and estate tax purposes. The super grantor CLT is designed so that the grantor retains a right that is enough to trigger grantor trust status, but not enough to pull the trust assets into the grantor’s estate [IRC Sec. 675(4)].

One option is for the grantor to reserve the power for a non-adverse party to reacquire trust assets from the charitable lead trust [IRC Sec. 675(4)(C)].Though the grantor may be such a non-adverse party, this power must be exercised in a non-fiduciary role; it is possible that the grantor would violate the self-dealing rules of IRC Sec. 4941 if he were to use that power (though simply holding the power would be permitted under the incidental exception to the self-dealing rules under Reg. Sec. 53.4941(b)). A better choice might be for the grantor to choose a sibling to hold this power to reacquire the trust assets since a sibling is not considered a disqualified person under the IRC Sec. 4941 rules [PLR 200010036].

There are several benefits to creating a super grantor CLT including:

- The grantor can take an income tax charitable deduction for the present value of the charity’s income interest.
- The income tax attributed to the grantor CLT is paid by the grantor and not from trust assets, allowing the trust assets to grow at a greater rate which could result in a relatively larger trust remainder left to go to non-charitable beneficiaries.
- The appreciation on the trust assets between the creation of the CLT and the end of the trust term is not subject to gift and estate taxation.

The Pooled Income Fund

Though the payments from a pooled income fund (PIF) cannot be deferred until some future date, there is a lifetime income and a charitable income tax deduction for the donor.

A PIF is a trust maintained by a charitable organization that holds donor contributions "pooled" for investment purposes [IRC Sec. 642(c)(5)]. Individuals who participate in a PIF irrevocably transfer money to the fund and receive the income earned by the fund over a lifetime.

Each donor receives a portion of the PIF income based on "units of participation". Upon the death of the income beneficiary, the money or property originally donated to the PIF passes to the charity. And, though the charitable organization does not receive the money until some future time, the donor can claim an income tax charitable deduction for the present value of the eventual gift.

It is important to note that the PIF cannot receive or invest in tax-exempt securities, so individuals seeking income tax-free payments should look elsewhere.

In Closing

On one level, this booklet concerns the issue of how working professionals can save more for retirement than the annual limits to defined contribution plans will allow. On another level, the booklet suggests the benefits of informing clients how their charitable giving and retirement planning can be dynamic. Highly successful people are often motivated to give back in some form. A discussion of the ways a life income gift complements retirement planning can be intriguing to philanthropically minded people.

"Through philanthropy, we help to heal, enhance and save lives."

In 2008, Scripps Health provided $264,890,008 in uncompensated and under-compensated care. View our interactive annual report at www.scripps.org/annualreport to learn more about our mission, our work, and the impact of philanthropy at Scripps Health Foundation.

The information and examples provided in this booklet are for information and discussion purposes only. The examples are hypothetical and the facts and tax consequences of individual transactions may vary from person to person. Each estate planning professional must indepedently determine and evaluate the tax and financial consequences of each individual situation.

Upcoming Gift Planning Lunch Presentations

Complimentary lunch and parking are provided — MCLE credit is offered and available for those who qualify.

Reservation details & location are listed below

Inadvertent Triggers of Real Estate Property Reassessment: How to Avoid a Ticking Timebomb

Wednesday, October 7, 2009, noon to 1:30 p.m.

Presented by:

David C. Anderson, Attorney at Law, David C. Anderson, APC

Jeff Olson, Division Chief, San Diego County Assessor's Office

As planning professionals, you focus heavily on income, estate, and gift tax implications of the plans you create for your clients. When dealing with real property, reassessment is an often overlooked consideration that requires careful planning to best serve your clients' needs. Our speakers will share the practical lessons they have learned through their experiences with these issues.

By Reservation Only – Deadline: Friday, October 2, 2009

2009 Year-End Tax Planning

Wednesday, November 4, 2009, noon to 1:30 p.m.

Presented by:

Jim Swartout, CPA, Considine & Considine

Natalie Ganz, Director of Gift Planning, Scripps Health Foundation

From TARP to "Cash for Clunkers", 2009 has seen many developments that may impact your clients' tax planning. This presentation will review the tax rules relevant to tax and estate planning, including charitable giving. Our speakers will also discuss the impact of recent developments in tax law and the resulting considerations for year-end tax planning.

By Reservation Only – Deadline: Friday, October 30, 2009

Optimizing Charitable Gifts of Real Estate in Your Clients' Estate Plans

Wednesday, December 2, 2009, noon to 1:30 p.m.

Presented by:

Ross Caulum, Senior Director of Real Estate, Scripps Health

David E. Williams, Senior Director of Gift Planning, Scripps Health Foundation

What is the current state of the real estate market and what are the implications for your clients' planning? How can a charitable gift of real estate benefit your clients and also help them to meet their goals for tax and estate planning? Our speakers will offer an analysis of the current real estate market, review options for charitable gifts of real estate, and explain how gifts of real estate are handled at Scripps Health.

By Reservation Only - Deadline: Friday, November 30, 2009

PLEASE NOTE:
All presentations will take place at:

Founders 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

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Please visit us online at www.scrippsheritage.org where you will find many helpful tools and links to tax laws and articles. If you are not already receiving our weekly eNewsletter, you may sign up easily on our web site.