

Bever Dye, LC

Attorneys at Law

Epic Center

301 N. Main St., Suite 600

Wichita, KS 67202-4806

Telephone: 316-263-8294

Fax: 316-263-3142

www.beverdye.com

Summer 2009

Tax Memo

LOW INTEREST RATES PROVIDE ESTATE PLANNING OPPORTUNITIES

The remarkably low interest rates we are now experiencing may furnish a strong incentive for certain individuals to employ estate planning strategies to shift wealth in a tax advantaged fashion to younger family members. The techniques include such things as a charitable lead annuity trust (CLAT) or a grantor retained annuity trust (GRAT). CLATs and GRATs are similar in that both are irrevocable trusts created for a limited term to make annuity payments to a designated beneficiary and at the end of the term to transfer the remaining trust assets to younger family members.

With a CLAT, the annual annuity payment is distributed to one or more charitable organizations, and the remainder interest usually passes at the end of the term to the donor's children. At the time the trust is funded, the donor is deemed to have made two gifts: a tax deductible charitable gift of the lead interest and a taxable gift to the remainder beneficiaries. A CLAT may be created during the grantor's life or at death.

For purposes of calculating the tax effect of a CLAT, the donor first calculates the value of the charitable annuity, and then subtracts that value from the value of the transferred property to determine the extent of the taxable gift to the children. The IRS provides interest rate calculations using the Internal Revenue Code Section 7520 rate. This rate has ranged from 3 % to 6 % over the last two years. The May 2009 rate is 2.4 %, which is nearly an all time low.

A low interest rate in the month a CLAT is created provides two significant benefits: (1) it increases the present value of the charity's lead interest, which provides a larger charitable income tax deduction to the grantor; and (2) it decreases the amount of gift that occurs due to the remainder interest passing to family members. Any appreciation in the value of the CLAT's assets above the IRS's assumed rate of return (the 2.4 % assumed rate) effectively passes to family members free of gift and estate tax.

To see the effect of a CLAT, assume that a parent creates a \$1 million, nine-year CLAT in May 2009, naming his child as the remainder beneficiary. At the outset,

the CLAT provides that approximately \$122,000 per year will be distributed to charity. The individual receives a charitable deduction of approximately \$1 million and is treated as making only a very small gift to his children. However, if the CLAT assets actually earn an 8 % per year return, when the trust terminates in nine years there will be approximately \$460,000 in the CLAT that can then be distributed to the child at no gift tax cost to the parent.

Compare this result to the results of a CLAT created two years ago. In March 2007, the 7520 rate was 5.8 %. To avoid a significant gift, the annuity payment to the charity would have been increased to approximately \$145,000 per year. Again assuming the CLAT actually earned an 8 % return, the net amount remaining in the trust at its termination would only have been approximately \$180,000. It is still advantageous and passes tax free to the child, but it obviously is not nearly as advantageous as the benefits afforded in the current interest rate climate.

The operation of a GRAT is similar to that of a CLAT, except that a GRAT does not involve a charitable

gift. With a GRAT, the grantor retains an annuity interest for himself while passing the remainder interest to a non-charitable beneficiary. Obviously, there is no charitable deduction at the outset. However, the mathematical advantages provided by the current low interest rate environment make the GRAT, like the CLAT, an excellent vehicle to shift wealth to younger family members. With a GRAT, the entire value of the trust is included in the donor's estate if he or she dies before the end of the GRAT term. For this reason, we often advise the use of short term "cascading" GRATs. What this entails is usually the creation of a GRAT with a very short term (e.g., two or three years); a very high annuity payment (e.g., 40 to 50% of the GRAT corpus) with the thought that the donor will create a series of GRATs essentially rolling over the corpus each time a GRAT terminates or makes an annuity payment.

A GRAT can be funded with interests in a family business held in a corporate, limited partnership or limited liability form. And, the asset contributed to the GRAT could be one with limited voting rights and other restrictions, so that the value of the contributed asset can be discounted, somewhat, for tax purposes.

Again, the key is whether the trust assets appreciate faster than the 7520 rate. If they do (and when discounts are available they almost always will) the excess passes to the remainder beneficiaries tax free. The tax professionals at Bever Dye are available to discuss such techniques and provide further examples should you have any questions.

KANSAS ADOPTS NEW "UNI-TRUST" STATUTE

Kansas has a new alternative to the normal determination and distribution of income from a trust. Senate Bill 70 ("SB 70") was recently enacted into law. It is designed to modify the normal rules governing the allocation of income and principal in a trust situation and allow a trust to be administered as a "uni-trust."

Kansas has for a long time had a law which gives trustees direction in how to allocate receipts and expenditures in a trust situation between the income beneficiary and the remainder beneficiaries. Normally, items such as interest and rental income are allocated to the income beneficiary, and items such as capital gains or IRA distributions (with some exceptions) are allocated to corpus and remain in the trust for the eventual benefit of the remainder beneficiaries. The current law is complicated; and there is room for discretionary adjustments by the fiduciary and potential disputes between the income beneficiaries and the remainder beneficiaries. The fiduciary has a duty to keep the best interests of both sets of beneficiaries in mind when investing.

SB 70 opens the door for a whole new method of administering such trusts. Unless the trust provides differently, a trustee can now administer the trust as a "uni-trust." This means the trustee determines an appropriate payout %age (normally between 3 % and 5 %) and then makes distributions on a regular basis to the income beneficiary based upon the payout %age. Such an approach eliminates the often vexing questions which arise regarding the allocation of certain

receipts and expenditures. This permits the trustee to then focus on the best long-term investment strategy for the trust estate, regardless of the needs of the income beneficiary for current income distributions. It also will seemingly permit the income beneficiary to plan better, because he or she will know in advance approximately how much the annual distribution will be.

In order to convert to the uni-trust approach, the trustee must follow a "total return investment policy." The trustee must also notify the beneficiaries, in advance, of the intent to make the conversion to a uni-trust approach. The "income adjustment" provisions of K.S.A. 58-9-104 will need to be released by the trustee. (58-9-104 allows a trustee to adjust the normal income calculations in certain situations.)

From a tax standpoint, the normal income tax rules continue to apply. In other words, the taxable income of the trust is calculated in exactly the same fashion as before, and then the "ordering rules" of the Internal Revenue Code take over, treating the income as first distributed to the income beneficiary (upto the amount actually distributed), with any remaining (undistributed) income being taxed at the trust level.

The tax professionals at Bever Dye are available to consult on this new Kansas legislation at your convenience.

2009 FEDERAL TAX LAW CHANGES

By now virtually everyone knows 2009 has brought us a new President and some fairly significant new tax laws. The 2009 American Recovery and Reinvestment Act

("Act") was aimed at stimulating economic recovery through a combination of tax cuts and stimulus spending measures. Some of the key provisions are as follows:

Making Work Pay Credit. This is a refundable income tax credit that applies for two years (2009 and 2010). It provides \$400 for single individuals and \$800 for married couples in tax relief. The credit is actually 6.2% of "earned income" up to the maximum amounts noted. However, the credit begins phasing out if adjusted gross income ("AGI") exceeds \$75,000 for a single individual or \$150,000 for a married couple.

First Time Homebuyer Credit There is now a credit available of up to \$8,000 for the purchase of a home by a "first time homebuyer." A person is considered to be a first time homebuyer if they have not owned an interest in a principal residence in the U.S. during the three-year period prior to the purchase. The credit applies to homes purchased before December 1, 2009. The credit is, again, phased out for higher income individuals. (The phase out starts at an AGI of \$75,000 for a single filer and \$150,000 for joint filers.) This replaces the first time homebuyer credit that was enacted in 2008 and is much more lucrative. The 2008 version was really an interest free, 15-year loan. The 2009 credit is truly a "dollar for dollar" tax credit and not a loan that has to be repaid, unless the home is resold or otherwise ceases to be the taxpayer's personal residence within three years of purchase.

AMT "Patch" Reenacted. Once again, Congress has acted to keep in place the higher exemptions for alternative minimum tax purposes

that were scheduled to revert back to lower limits. This approach (raising the limits for AMT one year at a time) has occurred for several years in a row, thus the "patch" reference.

Sales Tax on New Car Purchases. The Act allows taxpayers to claim an income tax deduction for sales tax on the purchase of most new vehicles (cars, light trucks, motorcycles, motor homes). The deduction is limited to the sales tax on the first \$49,500, and the deduction is phased out for taxpayers with AGIs above \$125,000 (single filer) or \$250,000 (joint filers).

Bonus First-Year Depreciation Deduction. The Act continues the 50% bonus first year depreciation for business assets which was first allowed to taxpayers under the 2008 Economic Stimulus Act. The bonus depreciation would otherwise have expired for purchases in 2009.

Section 179 Deduction. Also, the Act continues the 2008 Economic Stimulus Act increase in the Section 179 deduction available to taxpayers. The 2008 Act increased the deduction to \$250,000, and the 2009 Act continues at that level.

Net Operating Loss Carryback. The Act now ensures taxpayers with a 2008 net operating loss can carry the loss back five years and recoup taxes paid in earlier years. However, this is limited to small businesses with average gross receipts of less than \$15 million.

The Act also contains some energy credits and a very significant change to the COBRA insurance coverage provisions. COBRA is the provision which allows individuals who are involuntarily terminated

from their job to purchase health care insurance for a period of time after their termination. Previously, the entire cost of the COBRA insurance was born by the worker who was involuntarily terminated. The Act provides that the federal government will pay up to 65% of that cost.

Finally, the Act contains a number of other measures designed to stimulate the economic recovery of the country. If you would like any more information on the above provisions, contact the professionals at Bever Dye.

WHAT IS A "SPECIAL NEEDS" TRUST?

Many families have children or grandchildren who suffer from disabling health conditions. Americans in general are generous people. To help people with disabilities, there are certain programs to provide for the support of disabled individuals. Those programs include such things as supplemental Social Security, Medicaid and other forms of publicly provided assistance. However, many of the programs which provide public assistance are "means tested." This means the government provides assistance only after the individual has exhausted his or her private funds. Individuals who have family members who may be in need of public assistance should consider making provisions for those family members through a "Special Needs" or "Medicaid" Trust. Such a trust may permit the family to provide for the disabled individual such things as travel and family vacations, the cost of attendant or private care, elective medical procedures, or the cost differential between a private

Tax Memo

room and a shared room, all while preserving entitlement to the public programs.

Typically, a "Special Needs" or "Medicaid" Trust is created by an individual for his or her family members through either an irrevocable trust created before death or a testamentary trust created at death. The terms of the trust provide that the trustee can use the funds of the trust for the benefit of the individual, but not if by doing so it makes the individual otherwise ineligible for the governmental assistance. In some instances, the regulations require that the funds in the trust be "paid back" to the state at the death of the individual. In other instances, the remaining assets in the trust at the death of the

individual can pass to other family members.

Special Needs Trusts need to be carefully drafted. The professionals at Bever Dye are available to assist families in both the consideration and implementation of such unique trust arrangements.

Bever Dye Professionals

Don B. Stahr, J.D., C.P.A.
William M. Cobb, J.D., C.P.A.
Jack D. Flesher, J.D.
R. Chris Robe, J.D., C.P.A.
Eric J. Larson, J.D., C.P.A.★†
Robert M. Hughes, J.D., LL.M.★
Gregory L. Franken, J.D., C.P.A.
Hellen L. Haag, J.D., LL.M.
Scott D. Jensen, J.D.
Brian A. Turney, J.D. *
Gregg C. Goodwin, J.D., C.P.A.
Eric S. Parkhurst, J.D.
Eric V. Calvert, J.D.
Matthew D. Mentzer, J.D.
Charles D. Mangrum, J.D., LL.M.★

Special Counsel

Jeffrey D. Arbuckle, J.D., C.P.A.

★Also licensed to practice in Texas.
†Also licensed to practice in Nebraska.
*Also licensed to practice in Oklahoma.

Bever Dye, LC
Epic Center
301 N. Main Street, Suite 600
Wichita, Kansas 67202-4806