

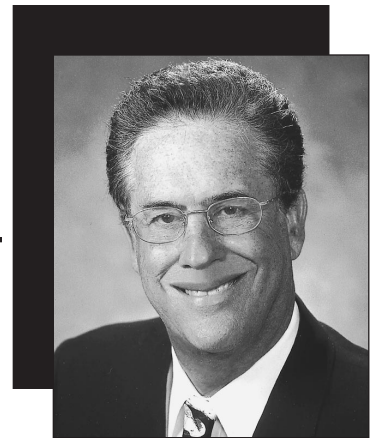
# THE BERNSTEIN TAX LETTER

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SEPTEMBER 2007

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Dear Reader,

The fall legislative season should have a full agenda of tax items up for discussion. However, the narrow majority of Democrats in the Senate and the possibility of Presidential veto make the passage of any new significant law tenuous. The President promised to veto certain tax increases and has, in fact, suggested cutting corporate tax rates. It seems unlikely, however, that Congress will have any serious discussions of reducing corporate rates.

There are several items of importance that have a strong possibility of passage. Certainly, Congress will at least temporarily extend the increased exemption from the alternative minimum tax (AMT). Chairperson Rangel has indicated an interest in taking up an overhaul of the AMT system, but this would probably be viewed as too costly for tax revenue, regardless of bipartisan support. There are other tax provisions that are scheduled to lapse that will be considered such as the deduction for state and local sales taxes and the popular charitable IRA rollover provision that we discussed last month. These are often taken up in a so-called extenders bill. Unfortunately, the extenders bill has passed, in some instances, after the end of the year in which the tax breaks expired. This makes planning impossible and prevents the IRS from delivering tax forms with the appropriate provisions for the affected items.

The Congressional Budget Office (CBO) forecasts the budget deficit at \$158 billion for the year, a substantial decrease from 2006. Despite this improvement, the CBO did note that the federal budget is in long-term difficulty due to the expected dramatic increases in Medicare and Medicaid spending over the next 10 years.

The IRS recently issued sample charitable lead trust forms that tax practitioners and donors who are planning donations to charitable lead trusts (CLTs) can use. (Rev. Proc. 2007-45, 2007-26 I.R.B. 89 and Rev. Proc. 2007-46, 2007-26 I.R.B. 102). These are the first sample CLTs the IRS has issued. The inside report contains a discussion of charitable remainder trusts (CRTs). The IRS sample CRT forms, which have been updated, have been available to taxpayers for several years.

Cordially,

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## CHARITABLE REMAINDER TRUSTS: FAMILY FRIENDLY DONATIONS

### WHAT IS A CHARITABLE REMAINDER TRUST?

A charitable remainder trust (hereinafter referred to as a CRT) is an irrevocable trust created and funded by a donor. The CRT provides current benefits to a noncharitable beneficiary, generally the donor or a member of the donor's family. The noncharitable beneficiary's interest will continue for a specified term of years (limited to a maximum of 20 years) or for the life of the beneficiary. If the donor selects more than one noncharitable beneficiary, the noncharitable term can last two or more lifetimes (subject to the limitations discussed below). At the termination of the trust, the remainder of the trust principal is paid to the charity.

### TAX REQUIREMENTS OF CRTs

The donor receives current income and gift tax deductions for donations to a CRT even though the charity will not receive its interest until later, perhaps many years later. For the donor to qualify for the deduction, the CRT must meet strict rules in the income tax laws. Primarily, these rules limit the type of noncharitable interest the CRT may provide. Nonqualifying trusts will lose the current income and gift tax deductions. Specifically, a CRT may provide either an "annuity trust" or a "unitrust interest" as follows:

- *A charitable remainder annuity trust (CRAT)* provides the noncharitable beneficiary with an annual annuity payment that is fixed in amount (a sum-certain annuity) but not less than 5 percent or greater than 50 percent of the initial fair market value of the trust principal. No additional donations are permitted after the CRAT is funded.
- *A charitable remainder unitrust (CRUT)* provides the noncharitable beneficiary with a fixed percentage (again, not less than 5 percent or greater than 50 percent) of the annual value of the trust principal (a variable annuity). Because the payout from the CRUT varies with the size of the principal, additional donations are permitted in later years.

In either type of CRT, the value of the charity's interest (determined by actuarial calculation) must be at least 10 percent of the value of the property contributed to the CRT.

Because the CRUT permits additions and varying payout rates, it is generally more flexible than the CRAT. This flexibility should not be overlooked. One stumbling block with CRTs is that there must be an annual payout. This means that the CRT principal might have to be sold if trust income is insufficient to make the required annual payments to the beneficiary. If the unitrust approach is adopted rather than fixed-amount annuity payments, it is permissible to limit the payout to actual income if that income is less than the required unitrust payment for the year. These deficiencies can be "made up" in future years when income exceeds the required payment.

### TAX ADVANTAGES OF CRTs

Through a CRT, charitable contributions can significantly reduce a donor's income and estate tax liability without completely divesting the donor, or perhaps the donor's family members, of the current benefit of the donated property. In addition, if appreciated property is donated to the CRT, the donor can avoid the realized capital gain on the contributed property because the CRT is a

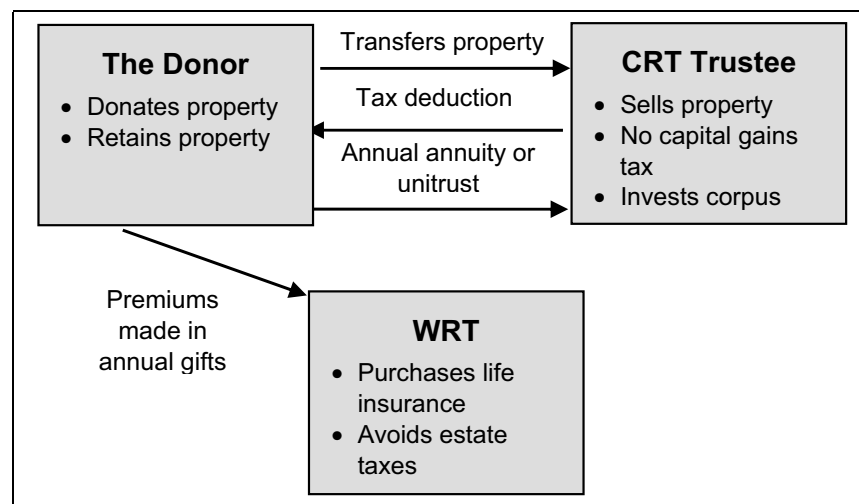
tax-exempt trust. Thus, a donor can avoid capital gains taxation of highly appreciated real estate or marketable securities donated to a CRT. It is important to note that if the sale of the appreciated asset is prearranged by the donor and the trustee, however, adverse tax consequences will result.

## WHO CAN BE THE TRUSTEE?

The donor, a member of the donor's family, or a friendly advisor can be the trustee of a CRT. However, in certain instances, an independent trustee should be used to avoid adverse tax consequences. An independent trustee should be used if the trustee will have discretion to distribute benefits among several noncharitable beneficiaries, or if the CRT will hold hard-to-value assets such as closely held stock or real estate.

## WEALTH REPLACEMENT TRUST (WRT)

The CRT works particularly advantageously with an irrevocable life insurance trust (a "wealth replacement trust"). Here's how: The CRT gives the donor an opportunity to (1) receive an immediate income tax deduction equal to the present value of the remainder interest, (2) avoid built-in capital gains tax on appreciated property contributed to the CRT, (3) receive annual income (in the form of annuity or unitrust) from the trust, and (4) reduce his or her estate taxes because the appreciated property is deductible from the donor's estate tax base. The irrevocable life insurance trust is funded with life insurance paid for, at least in part, by a combination of the tax benefits provided by the charitable donations.



## AN EXAMPLE OF HOW A CRT WORKS

Phil N. Thropic and his wife, Ann, both aged 63, are forecast to be subject to federal estate taxes (45 percent on a taxable estate above \$2 million) and, naturally, are concerned about the costs of settling their estates. Of course, they want to retain the maximum family wealth to pass on to their children. They also feel strongly about the charitable needs of a local hospital, but they don't consider themselves wealthy enough to forgo significant wealth currently; nor do they want to divest their children of family wealth. Phil and Ann have a large parcel of undeveloped real estate and are worried about the fluctuations in market value. They purchased the property 20 years ago for \$100,000; its current market value is \$1 million. They are also worried about the built-in capital gain should they choose to sell the unproductive land and convert it to an income-producing investment.

Suppose Phil and Ann contribute the land to a CRT with the remainder payable to the hospital and retain a unitrust interest of 7 percent for their joint lives. The trustee sells the real estate and invests the proceeds. Phil and Ann also create a wealth replacement trust to purchase a \$1 million survivorship life insurance policy. The benefits of this transaction are as follows:

- Phil and Ann save at least \$135,000 (15 percent of the \$900,000 gain) of capital gains tax at the current 15 percent capital gain rate.
- The CRUT creates a current income tax deduction of \$204,720 for the value of the remainder interest given to charity (the size of the deduction is based on the actuarial value of the remainder interest provided to charity). Phil and Ann will have an annual limit for this deduction equal to 30 percent of their contribution base (generally the adjusted gross income), but they can carry any unused deductions forward 5 tax years. This tax deduction increases their cash flow by \$71,652 if they are in the 35 percent income tax bracket and can use the entire deduction this year.
- The annual policy premium for the \$1 million survivorship life insurance policy will depend on Phil and Ann's health and policy performance, but the total outlay for premiums may be significantly less than the total tax savings. The total cost versus total tax savings cannot be determined until the time of their second death when the amount of premiums paid and the value of the estate tax deduction at that time are known with certainty.
- Phil and Ann retain a valuable source of retirement income from the CRT that continues until their second death. For example, the initial unitrust payment to the Thropics is \$70,000.
- An estate tax charitable deduction is available when the remainder interest is paid to the hospital.
- Their children receive \$1 million from the life insurance trust free of estate taxes. This benefit replaces the wealth donated to charity.
- The hospital receives the remaining principal at the death of the survivor of Phil and Ann.

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This Tax Letter is intended to assist you to conserve your estate and to protect the interests of your family and business associates. Estate planning involves the joint services of a competent Trust Officer, Attorney, Accountant, and Life Underwriter. The experience and advice of each is generally essential.

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