THE BERNSTEIN REPORT

Richard S. Bernstein, CEO
Robin S. Bernstein, MBA, President
Arthur L. Bernstein
Wayne G. Monek
Charles Weiser, CPA, CFO
Louis Bamberg, JD, CLU, ChFC

RICHARD S. BERNSTEIN

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RSB
1551 Forum Place, Suite 300A
West Palm Beach, FL. 33401
561-689-1000
1-800-676-6601
rsb@rbernstein.com
website: www.rbernstein.com

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Dear Reader,

The Small Business Jobs Act of 2010 (H.R. 5297) was signed into law by the President last month. The law creates some new tax incentives for businesses and may provide opportunities for both existing and new businesses. The key provisions of the new law include:

- The current expensing limit for capital expenditures was increased from $250,000 to $500,000 for tax years beginning in 2010 and 2011.
- A 100 percent (up from 50) exclusion from gain is provided for the sale of qualified small business stock acquired between September 27, 2010 and January 1, 2011 and held for at least 5 years after acquisition.
- The holding period to avoid corporate-level gains tax for appreciated assets of a corporation converting to Subchapter S tax status is reduced to 5 years (from 10) in some circumstances.
- The deduction limit for business start-up expenditures is increased to $10,000 (from $5,000) in 2010.
- Business owners will be able to deduct 100 percent of the cost of health insurance in 2010 for the purposes of calculating the self-employment tax.

The tax legislation that has drawn the public's attention will apparently be delayed until after the election. Congress failed to reach enough common ground to move forward on addressing the expiring provisions of the tax reductions from the 2001 and 2003 reconciliation acts. The possibility of the expiration of these provisions has been trumpeted as potentially the largest tax increase in history. Estimates of the tax reductions are about $3.7 trillion over the next ten years. Congress will certainly address this after the election

The reform of the federal estate, gift, and generation-skipping transfer (GST) taxes might (or might not) be included in the legislation with the other expiring provisions. Without action by the end of the year, the estate and GST tax exemptions will be reduced to $1 million and the maximum rate will be increased to 55 percent (some large estates would face a 60 percent marginal bracket). However, the estate taxes for decedents are not due for 9 months and the reform of the wealth transfer taxes could be delayed until well into 2011 before any taxes are due for 2011 deaths.

Cordially,

Richard S. Bernstein

A Second Opinion Costs You NOTHING,
But Could Save You MILLIONS!

WHEN IT COMES TO YOUR HEALTH, YOU GET A SECOND OPINION, SHOULD YOUR FINANCIAL WEALTH BE ANY DIFFERENT?

USING A CHARITABLE LEAD TRUST TO REDUCE YOUR TAXES

Charitable Giving in the United States

Americans contributed almost $304 billion to charity in 2009 according to the Giving USA Foundation. The total numbers are slightly lower than prior to the recession, but remain strong. However, there is concern in the charitable community about the effect of the repeal or reform of the federal estate tax on future charitable bequests. A repeal or reduction of the estate tax is expected to be detrimental to charitable giving from estates.

Virtually all donations are (and should be) motivated by philanthropic desires. However, there are other benefits of charitable giving, such as income or estate tax deductions. The donor's charitable intentions are not significant in determining the availability of the tax deductions. The tax code is very specific with respect to the rules for qualifying for tax deductions. One rule is that the donor generally must contribute his or her entire interest in the property donated to qualify for tax deductions. A specific exception is the availability of tax deductions for a contribution to a charitable lead trust (CLT).

What Is a Charitable Lead Trust?

A charitable lead trust provides current payments to charities. The trust continues for a fixed or ascertainable period of time (such as a term of years or a time period measured by an individual's life). After the trust terminates, its assets pass to one or more individuals or to other noncharitable interests, such as a family trust. A charitable lead trust can be a living trust creating a lifetime donation, or it can be a testamentary trust created at the donor's death through his or her will or from the donor's revocable living trust. (Note that the division at death of a living trust into a charitable lead trust makes the transfer nonprobate and thus removes the publicity, if this is desirable.)

What Size Are the Charitable Deductions?

The tax rules limit lead trusts to two types of charitable payments; otherwise no charitable deductions will be available under the income, estate, or gift tax laws. Lead trusts must provide charities with either a "guaranteed annuity interest" or a "unitrust interest." Thus, the two types of qualified charitable lead trusts are called charitable lead annuity trusts (CLATs) and charitable lead unitrusts (CLUTs). The applicable requirements resemble the rules that govern the more well-known charitable remainder trusts (CRTs), but they are not identical. One notable distinction is the CLTs do not have the 5 percent minimum distribution requirement of CRTs and the CLT is permitted to provide an annuity that increases over the term of the trust.

According to rules as set forth in the tax regulations, a charitable lead annuity trust must provide payments to the selected charities in annual stated annuity amounts. According to IRS Revenue Procedure 2007-45 (2007-29 I.R.B. 89), the annuity payments are not subject to a minimum and can increase during the term of the CLT. A charitable lead unitrust also provides for annual payments, but payments are based on a fixed percentage of the net fair market value of the trust's assets, determined annually. Therefore, a charitable lead unitrust's payments will vary in size each year with the value of the principal.

Who Should Consider a Charitable Lead Trust?

Like most planning techniques, the CLT is not for everyone, but many individuals who have accumulated wealth and charitable goals will find them useful. The following circumstances might indicate a charitable lead trust as an advantageous estate planning strategy:

- The donor has charitable goals.
- The donor wishes to donate a temporary income interest to charity but doesn't want his or her family to give up the property permanently.
- The donor has a large estate and would like to make lifetime gifts of appreciating property to younger generation family members at a minimum transfer tax cost.
- The donor faces a substantial estate tax cost and would like to remove significant value from his or her gross estate for tax purposes.
- The donor (or his or her family) can live comfortably without the trust property during the charitable term of the trust.
- The donor needs a large income tax deduction in the current year and is willing to incur taxable income during the term of a living charitable trust.
- The donor has appropriate property and is optimistic with its appreciation possibilities.
- The donor would like to take advantage of the currently low federal interest rate to maximize the charitable deduction and the CLT's benefits for the family. The appreciation on the property in excess of the Sec. 7520 interest rate (2 percent in October 2010) provides family benefits that are not subject to gift or estate taxes.

An Example of How It Works

David and Dolores Donor have become aware of significant death taxes for their estate. The Donors are contemplating a charitable lead annuity trust to benefit Metropolis Children's Hospital, which recently cared for their daughter. They plan to transfer $5 million of assets to a 20-year lead annuity trust. The annuity trust will provide for a $300,000 annual payment to the hospital to be made at the end of each year. The remainder of the CLAT will be distributed to a trust for their children. Under the current valuation interest rate (2 percent in October 2010), they will receive an income and gift tax charitable deduction of $4,905,520 for the charitable lead interest provided to the hospital for 20 years. Thus, the remainder will provide a taxable gift of only $94,580; an amount easily sheltered by a small part of their $1 million lifetime gift tax exemptions. If the assets of the CLT appreciate at 7 percent, the remainder distributed to the family trust after the 20-year term will be $7,049,775.

Other Considerations

The CLT can either be a grantor or nongrantor trust. To receive the upfront income tax deductions described in the example above, the CLT would have to be a grantor trust. The drawback of this approach is the grantor will remain subject to income taxes on the CLT's income, even if it is distributed to a charity. For this reason, the grantor CLT could be funded with municipal bonds or a universal life insurance policy. The life insurance policy would be best used if an increasing annuity is used. This technique would require a significant amount of planning for the design of the CLT and selection of the investment.

In addition, the rules for applying the GST exemption to a CLAT, if grandchildren are the remainder beneficiaries, are not favorable. The GST exemption cannot be applied to a CLAT until the trust terminates. Hence, a CLUT is more favorable if grandchildren are remainder beneficiaries.

Since a CLT diverts the principal from the donor's family for a potentially long period of time, how can the donor take care of the family's needs? The CLT should not be considered unless the donor is able and willing to part with the assets. In addition, the remainder's value is uncertain since its size is dependent on the performance of the CLT's investments over a long time horizon. There may ultimately be a large or small transfer to the remainder beneficiaries. In the case of a CLAT, poor investment performance might even cause the trust to be exhausted before the family receives the remainder. One way to replace the donated assets is a life insurance trust. If the donor is healthy, life insurance can be placed in a trust to provide for the family's immediate needs at the donor's death and avoid estate taxes on the death benefits.

RECENT CASES AND RULINGS

Estate is Permitted to Discount Closely Held Corporation's Value by Full Amount of Tax on Built-In Capital Gains

The executor of the estate included the decedent's 82 percent interest in a closely held corporation whose main asset was a parcel of real estate. The appraiser used an adjusted book value approach and discounted the value of the stock by 100 percent of the tax attributable to the built-in capital gain on the property. This analysis presumes that the property would be liquidated under the adjusted book value approach. The IRS challenged the valuation and assessed a $333,245 estate tax deficiency. The IRS used a different valuation method and offered possibilities for how appropriate planning would eliminate the taxation of the built-in gain. The Tax Court did not find the suggested methods to avoid capital gain viable in this circumstance and accepted the estate's position permitting the full discount for the tax on the built-in gains on the corporation's property. (*Estate of Marie J. Jensen v. Commissioner*, TC Memo 2010-182)

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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RICHARD S. BERNSTEIN AND ASSOCIATES, INC.

Insurance Consultants

561/689-1000
FAX 561/689-0745
TOLL-FREE 800/676-6601

1551 FORUM PLACE, SUITE 300A
WEST PALM BEACH, FL 33401

www.rbernstein.com