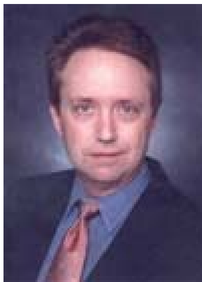
DALLAS CHAPTER

NEWSBRIEF

November 2005



President's Corner

By Gary Wyatt, CPA, CPC, CLU, ChFC
Partner, TravisWolff
(972) 590-5226
gwyatt@traviswolff.com

The time value of procrastination

I have been struck lately by all the "hooplah" surrounding the impending introduction of Roth 401(k) on January 1, 2006. Whether you are excited about the new possibilities or you believe that deductible contributions are generally better, there is a fundamental point that needs to be made.

That point is, people need to save more for retirement beginning at an earlier age.

By comparison to the last generation, few new retirees have a substantial pension generated by decades of work with a large employer. Rather, it is more common to have a number of small rollover balances generated by participation in the defined contribution plans of a number of employers.

Employee choice over both the amount and investment direction of retirement savings has become the norm. Unfortunately, many employees and business owners have chosen perceived current cash needs over the need to save for retirement. Meanwhile, inflation moves on, lifetime lengthens, and everybody gets closer to the end of their employable years.

Suppose a newly retired 65 year old had saved $3,000 per year since age 21, and had earned an average rate of return of 8% (without regard to income taxes). The retiree would have accumulated about $1.16 million. What if the retiree had begun the same savings regimen 20 years later? The accumulation would

be about $220,000. Wait another ten years (age 51) and the age 65 accumulation dwindles to $81,500. In fact, a 51 year old who finally decides to begin saving for retirement would have to put away $36,830 per year to accumulate $1,000,000 by age 65.

My point is that as financial advisors, we need to heartily encourage our clients and contacts (and particularly their children) to begin saving early and regularly for retirement (regardless of whether they deduct or "Roth" the contributions).

Next General Meeting, noon December 7th at the Doubletree Hotel

4099 Valley View Lane, (635 & Midway Rd) Dallas TX 75244
11:30 am - Meet & Greet (Registration)
12:00 pm - Meeting Begins
1 HR CE APPLIED FOR

Topic: Myths & Monsters of Long Term Care
Speaker: Mickey Batsell, CLU, CSA, FLMI

Register online at **www.sfsp.net/dallas or call 972-747-0408** **to register by phone**

Upcoming Chapter Section Meetings

All section meetings held at the offices of TravisWolff unless otherwise noted.

Retirement Plans & Counseling

Next Meeting is Tuesday, November 15
8:30 a.m. – 10:00 a.m.
1 HRS INS and PACE CE CREDIT HAS BEEN APPLIED FOR
Jim Waldorf, CLU will present "Roth 401(k) and Cash Balance Defined Benefit Plans.
Regular meetings scheduled the third Tuesday of odd numbered months.
Forrest Veal is the coordinator (972.250.6516; vealbs@juno.com)

Estate Planning

The next meeting is Tuesday, December 27 (subject to change due to holidays)
8:30 a.m. to 10:00 a.m.
LOCATION CHANGE:
Ackley Financial, 16479 Dallas Parkway, Suite 850, Addison TX 75001
Regular meetings scheduled the fourth Tuesday of even numbered months.
Chad Forsberg, JD, CLU, ChFC, is the coordinator 214.361.5858; chad@forsberglawfirm.com
Next Meeting: February 27

Health & Welfare

Next meeting is Wednesday, December 14
8:30 a.m. – 10:00 a.m.
Regular meetings scheduled the second Wednesday of even numbered months.
Steve Harris is the coordinator (972.680.2777; slhassoc@aol.com)

Tax Snippets

By Hunter Nibert, CPA, CDFA
Partner, TravisWolff
(972) 590-5276
hnibert@traviswolff.com

Watch for problems in estate planning transfers with S corporations

Although the Limited Liability Company (LLC) is rapidly gaining in popularity, the S corporation has been a favorite entity selection for years. There are lots of them out there. The restrictions on qualifying shareholders of an S corporation can cause problems in commonly encountered estate planning transfer situations.

Partnerships cannot be S corporation shareholders, so S corporation stock should not be transferred into a family limited partnership. (Unless you're content to terminate the S-election!) On occasion we've seen such a transfer occur inadvertently when someone failed to consider whether the corporation had made the S election.

Estates of decedents qualify as S corporation shareholders, but only certain trusts qualify as S corporation shareholders. These include:

a) A grantor trust for income tax purposes – Revocable (living) trusts qualify. So also do intentionally defective grantor trusts used in a variety of asset protection and transfer techniques.
b) A testamentary trust, but for only two years without special permission from the IRS
c) A qualified subchapter S trust (QSST) - This is a trust that is narrowly drafted so that it has only 1 income beneficiary. The beneficiary of the trust must elect this treatment. Many of our clients use generation-skipping trusts that provide for great flexibility in making distributions among multiple beneficiaries. These trusts would not qualify as QSSTs.
d) An electing small business trust (ESBT) – A trust that otherwise does not qualify may elect ESBT treatment in order to qualify. Such a trust will pay tax at the highest individual income tax rate (currently 35%) on the income derived from its S corporation holdings. Other income and expenses of the trust are taxed using normal trust rules.

Making this election is an easy thing to overlook. Happily, the IRS has been lenient in accepting tardy elections.

One technique used to avoid this set of issues with trust shareholders after the death of the first spouse to die is a non-pro rata partition of assets between the surviving spouse and the estate of the decedent. Such partitions can be used to transfer assets between the two entities to reduce the number of assets that are owned on a 50-50 basis or to accomplish other purposes. Here, a good thing might be for the estate to transfer its half interest in the S corporation(s) to the surviving spouse, receiving other assets of an equal value in return. This might eliminate the need for a future ESBT election (and a high tax rate) if the stock is later funded into a testamentary trust (other than a QSST) that will hold the stock for many years.

Thank You Mrs. Walton – Planning with Zeroed-Out GRATs

By Chad W. Forsberg, Esq. (JD, LLM, CLU, ChFC)
Forsberg Law Firm, P.C.
(214) 361-5858
chad@forsberglawfirm.com

A Grantor Retained Annuity Trust (GRAT) is a popular estate planning technique because it allows a grantor to "freeze" the value of assets so that appreciation in value above a certain point goes to the grantor's family without paying gift or estate taxes. This can be especially useful for rapidly appreciating assets like a growing family business, growth stocks, and real estate in a popular part of town.

In a typical GRAT transaction, a grantor gives rapidly appreciating assets to an irrevocable trust in exchange for a guarantee of annuity payments for a fixed term of years. At the end of the term, whatever is left stays in trust for the family. If the grantor dies during the term, whatever is left in the trust is part of the grantor's taxable estate.

There is gift tax upon creation of the GRAT on the difference between the value of the property (plus an IRS-assumed growth rate known as the Section 7520 rate) and the present value of the annuity payments. For many years, tax lawyers had theorized that it was possible to make the amount of the annuity payment so high that the present value of the annuity payments would equal the value of the property, meaning there would be no gift tax. Until 2000, the IRS had disagreed that this "zeroing-out" technique would work.

In December 2000, the Tax Court handed down its ruling in a case involving two GRATs created by Audrey Walton, the widow of Sam Walton, the founder of Wal-Mart. Mrs. Walton had funded the GRATs with over $100 million each in Wal-Mart stock. The Tax Court agreed with Mrs. Walton's attorneys that a taxpayer could zero-out the gift tax effect of the GRATs and invalidated IRS regulations to the contrary. The IRS subsequently accepted the court's ruling and changed its regulations.

Thanks to Mrs. Walton, we can now use the GRAT technique to shift the appreciation of assets out of the client's estate without incurring significant gift tax. Of course, we must still be careful to pick assets that will appreciate faster the 7520 rate or the trust may use all of its assets to pay the grantor, leaving nothing for the family. Ironically, the GRATs in the Walton case failed because Wal-Mart stock declined significantly in value during the annuity term of the trusts.

Charitable Giving Techniques – Part Two

By Lawrence P. Katzenstein, Esq.
Thompson Coburn, LLP
(314) 552-6187
lkatzenstein@thompsoncoburn.com

SOME OBSERVATIONS ON PLANNING CHARITABLE GIFTS OF TANGIBLE PERSONAL PROPERTY

Planning charitable gifts of tangible personal property presents difficult and unique problems. Not only is tangible personal property often difficult to value, but collectibles are not income producing, which makes their use in split interest gifts problematical.

The rules on income tax deductions for tangible personal property are themselves complex.

A. Code section 170(e) limits the deduction for tangible personal property gifts to basis unless the use by the donee is related to the charity's exempt purpose. Art to the museum is the usual example (assuming the art is of museum quality and the museum does not intend simply to sell it). The Service has interpreted this provision liberally, allowing a deduction, for example, for a gift of art to a nursing home for use in public areas (PLR 8247062). Obviously if the donor's basis is high (because, for example, of a new basis at death) limitation to basis may not matter. If basis is low, a bequest to the surviving spouse who can then make the gift may be the solution in some cases.

B. Code section 170(e) also reduces the charitable contribution deduction by the amount of gain which, if the property were sold, would not be long-term capital gain. Section 1221 excludes from the definition of capital asset a copyright, literary, musical or artistic composition created by the taxpayer or held by a taxpayer whose basis derives from the creator of the property. So a painter may not deduct the fair market value of a painting given to charity even if the use is related. The same rule would apply to a gift by a donee of the creator.

C. Remember that all of these special rules--related use and limitation to basis for non-capital assets--apply for income tax purposes only. There are no such limitations in section 2055 for estate tax purposes.

Watch this trap in gifts of copyrighted property, especially works of art. Most art work created in the last 70 years is protected by copyright. If the donor owns both the art work and the copyright and conveys the painting to charity without also conveying the copyright, the gift is a split-interest gift and no deduction is allowable. The following points should be considered:

A. If the owner of the art work owns only the art work and does not own the copyright, he may safely contribute the property to charity because the donor will have given all of his interest in the property, just as a person owning only a life estate or remainder may contribute the entire interest without violating the split interest rules.

B. The reason it is so easy to fall into this trap is that under the 1977 Copyright Act, a conveyance of an art work does not carry with it the copyright unless it is specifically conveyed. For works created before the 1977 copyright revision, the
presumption was just the opposite. A purchase of the art work automatically carried with it the copyright unless it was specifically reserved.

C. In cases where the donor owns the copyright--either because it was a pre-1977 work and the conveyance was silent as to copyright or because the donor specifically purchased the copyright with the art work--a lifetime gift of the art work by itself without the copyright will be a split-interest gift and will not qualify for an income tax deduction.

D. Note that for estate tax purposes, the rule is different. Section 2055(e)(4) provides that works of art and their copyrights are treated as separate properties for estate tax purposes.

E. Query as to the effect on the valuation of art work given to charity without the copyright where, for example, the artist has retained copyrights.

I. What many donors of art would really like to do is keep a life estate and donate a remainder interest to charity, as donors are permitted to do with a personal residence. Since 1969, of course, this cannot be done because the split interest is not in the form of an annuity trust or unitrust.

A. This rather simple case can sometimes be handled in part by gifts of undivided interests in art. This is ideal for the donor who spends a portion of the year at another residence.

Example: Donor spends four months each year at a Florida residence and resides for the remainder of the year in a cold northern city. Donor can give to Museum a one-third undivided interest in the painting and retain an undivided two-thirds interest. Museum will have the right to possess the painting for one-third of the year and the donor will have the right to possess the painting two-thirds of the year.

B. Note that in Winokur, 90 T.C. 733 (1988), Acq. 1989-1 C.B.1, the United States Tax Court ruled that the deduction would be permitted even if the museum did not in fact exercise its right so long as it had the legal right to do so. The risk the donor runs, however, if the museum does not exercise its right is that the Service would argue that there was an understanding that the museum would not exercise its right during donor's lifetime.

C. A deduction is permitted for an undivided interest despite the prohibition of Section 170(f)(3), which denies a deduction in the case of a contribution not in trust of an interest in property which consists of less than the taxpayer's entire interest in the property. The deduction is permitted because the taxpayer is contributing an undivided interest in all of the taxpayer's interest. In other words, a vertical division is permitted but a horizontal division is not.

D. In PLR 200202032 the Service ruled that artworks bequeathed subject to restrictions on display would be fully deductible for estate tax purposes. The will did not prohibit sale, but if it had, it could very well be includible in the gross estate at a higher value than the allowed charitable deduction. See *Ahmanson Foundation,* 674 F.2d 761 (CA-9, 1981). The ruling is interesting in part because the Service was willing to rule on what is essentially a valuation question.

II. Use of tangible personal property in charitable remainder trusts.

A. The statement is often made that tangible personal property cannot be used to fund a unitrust as no charitable deduction will be allowed. Is that statement really correct?

B. There are two possible problems with using tangible personal property to fund charitable remainder trusts, section 170(a)(3) and section 170(e).

C. Section 170(a)(3) provides that payment of a charitable contribution which consists of a future interest in tangible personal property shall be treated as made only when all intervening interests in, and rights to actual possession or enjoyment of, the property have expired or are held by persons other than the taxpayer or a related party.

D. Note that this section was added to the Code in 1964, and therefore preceded the present split interest trust rules by five years. (There is some speculation that failure to repeal it in 1969 was inadvertent.) But Section 170(a)(3) is a timing provision. It does not say that no contribution is permitted for a gift of a future interest in tangible personal property. It says that no contribution deduction is permitted until the intervening interests have expired or are held by persons other

than the taxpayer or a related person. It would appear, therefore, that if tangible personal property is contributed to a charitable remainder trust, the deduction will be permitted at such time as the property is sold by the trust.). The Internal Revenue Service has acknowledged that this interpretation of this statute is correct. In PLR 9452026, the taxpayer proposed funding a charitable remainder unitrust with tangible personal property--in this case a musical instrument. The Service ruled that the deduction would be allowable at the time the property is sold and that the trust qualifies as a charitable remainder trust. What is not clear is whether the donor's deduction will be limited to basis because of the related use requirements of section 170(e)(1)(b)(i). Can a technical argument be made that since the deduction is not deemed to have occurred until the property is no longer owned by the trust, and since at that point the trust holds cash, that the gift is considered one of cash rather than tangible personal property and therefore the cut down to basis is not required? It is interesting to note that the Service ruled favorably despite the fact that no deduction was permitted at the time the trust was funded. .

E. Section 170(e) reduces the deduction for gifts of personal property to basis unless the use of the property by the donee is related to the donee's exempt charitable purpose. What does this mean in the context of a charitable remainder trust funded with personal property? If a charity sells donated property, the property will normally be considered to have an unrelated use. If the charitable remainder trust sells the property in order to raise funds in order to pay the annuity or unitrust amount, the gift would appear to be a gift of an unrelated use. But basis can still be deducted and this may in some cases be substantial. Given percentage limitations, a deduction for basis may be sufficient. Sheltering of the capital gain is often more significant in these cases than the deduction. If the deduction is important, why not mix and match: give an undivided interest outright to the museum (deductible at full fair market value with no capital gains realization) and use the rest to fund a charitable remainder trust (deduction limited to basis but no capital gain on sale). The charity can buy the undivided interest from the trust. (After all, it will get the remainder back some day.) If the trust is an annuity trust, the charity can buy the art work for a note calling for payments of interest only in an amount sufficient to cover the annuity obligation. The note would call for a balloon balance due after the donor's life expectancy.

F. Other solutions are fun to think about but cutting edge: using a partnership or corporation to hold art in order to avoid the tangible personal property characterization is one idea. Is this a sham? It may depend on whether the entity has other activities. Another untried method would be contribution to the trust of a deep in the money option to buy the painting, which the charitable remainder trust would sell to the museum remainderman. Has the donor given an option or tangible personal property? This seems to fly in the face of PLR 9501004.

III. An oft-overlooked solution.

A. In analyzing gifts of personal property to charitable remainder trusts, donors and their advisors often overlook another alternative which has none of the disadvantages of the charitable remainder trust: A contribution of tangible personal property to a charity in exchange for a charitable gift annuity.

B. Section 170(a)(3) would not apply because the charity does not have a future interest but a present interest in the property.

C. The unrelated use rule will not apply if the charity's exempt purpose is related to the gift.

> **Example**: Suppose that the Museum wishes to acquire a painting from Donor. Donor has some charitable interest but also wants to have some income from the gift. Donor can contribute the property to Museum in exchange for a charitable gift annuity. The American Council on Gift Annuities sets annuity rates so that approximately one-half of the contribution supports the annuity and the other half qualifies as a charitable contribution. If there is substantial appreciation in the painting, the capital gain will be spread over the donor's life expectancy (if the donor is an annuitant) although in no event will it exceed the amount which would have otherwise been excluded from income under the Section 72 annuity exclusion ratio rules.

D. This may be a better result than could be obtained with the charitable remainder trust, where all of the income would be taxed under the tier system at ordinary income rates, assuming there is sufficient income to cover the payments.

E. The charity, it is true, will have to dip into current revenues to pay the annuity. But museums have acquisition budgets and purchasing art work with a gift annuity is much cheaper than paying full fair market value.

CHAPTER MEETING DATES & DETAILS

Wednesday, December 7th
Luncheon Meeting - Doubletree Hotel
4099 Valley View Lane, (635 & Midway Rd) Dallas TX 75244
Employee Benefits Topic & Speaker TBA

Wednesday, January 4th
Breakfast Meeting - Park City Club
5956 Sherry Lane, 17th Floor, Dallas TX
Regulatory Environment Topic & Speaker TBA

Wednesday, February 1st
Luncheon Meeting - Doubletree Hotel
4099 Valley View Lane, (635 & Midway Rd) Dallas TX 75244
"Positive Publicity" Presented by Jeff Crilley of FOX4 News!

Wednesday, March 1st
Breakfast Meeting - Park City Club
5956 Sherry Lane, 17th Floor, Dallas TX
Business Compensation Topic & Speaker TBA

Wednesday, April 5th
Luncheon Meeting - Doubletree Hotel
4099 Valley View Lane, (635 & Midway Rd) Dallas TX 75244
Annual SFSP Dallas Beverly Brooks Award Presentation
Topic & Speaker TBA

Wednesday, June 7th
Breakfast Meeting - Park City Club
5956 Sherry Lane, 17th Floor, Dallas TX
Annual SFSP Dallas "Town Hall Meeting"
Come and let us hear from you! Your comments and opinions will help shape the 2006-2007 year.

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P. O. Box 797746, Dallas, TX 753798 / 972-747-0408

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