THE ESTATE PLANNER

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Life insurance
A FLEXIBLE TOOL FOR CHARITABLE GIVING

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Estate Planning Red Flag
A significant portion of your wealth is concentrated in a single stock

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Life insurance

A flexible tool for charitable giving

For most people, life insurance is a key component of their estate plans. When someone dies, life insurance can provide liquidity for the estate or family to pay taxes and other expenses. It can also create a new source of wealth to provide for the deceased's loved ones.

If you're charitably inclined, there are a variety of ways to use life insurance to increase the size of your charitable gifts or to make them more cost effective. Here are several strategies to consider.

Donating a policy to charity

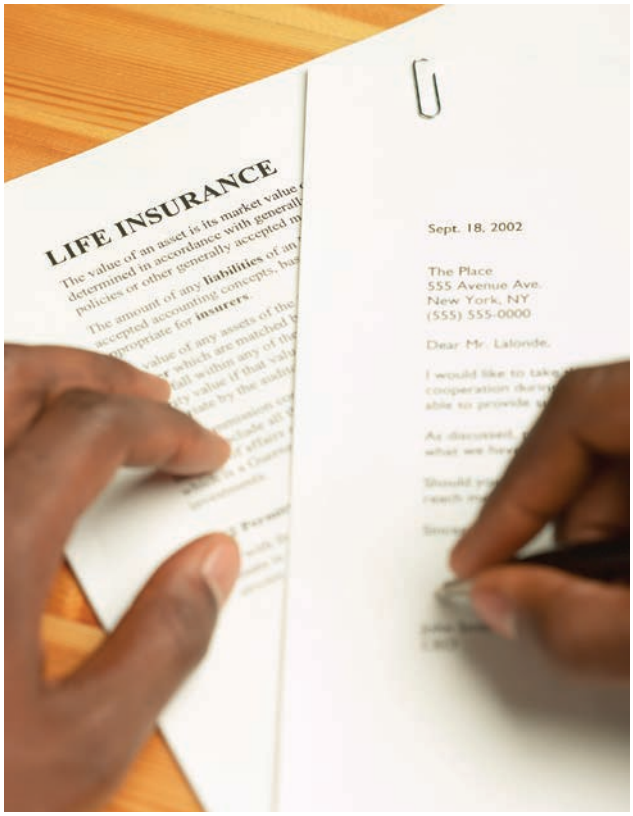
If you have a life insurance policy you no longer need, donating the policy to charity can be an attractive option. Why would you no longer need a policy? Perhaps you purchased it to cover estate taxes back when exemption amounts were significantly lower. Or maybe the insurance proceeds were originally intended to provide financial security for your children, who are now financially independent adults. Either way, the purpose for which you bought the insurance no longer applies.

You could simply cash in the policy, of course, but if it has built up a substantial cash surrender value, you'll end up owing taxes on your gain. A more cost-effective approach, assuming you plan to make charitable donations anyway, is to transfer ownership of the policy to a charity. Doing so generates a current charitable income tax deduction and allows you to avoid any taxable gains on a surrender. In addition, donating a policy removes it from your estate and shields it from estate taxes. However, if you die within three years of making the transfer, the policy will be included in your estate. By virtue of the corresponding charitable deduction, though, the estate tax result should be the same as if you'd survived the requisite period.

Before you donate a policy, be sure you understand how your charitable deduction is calculated. (See "Donating life insurance: What's deductible?" on page 3.) Also, for this strategy to work, the charity must have an insurable interest in your life. The laws in most states have fairly liberal definitions of insurable interest when it comes to charity-owned life insurance, but it's a good idea to check your state's law before you donate a policy.

Naming a charity as beneficiary

A simpler and more flexible approach is to keep your policy but designate a charity as beneficiary. You won't enjoy a charitable deduction, but as owner of the policy you'll have the flexibility to access its cash value (through withdrawals or loans)



or to change beneficiaries in the event you determine that your family needs the money after all. Also, you'll have the power to designate a different charitable beneficiary if your philanthropic goals change. The policy will be included in your taxable estate, but your estate will be able to take a charitable deduction for estate tax purposes.

If you're not prepared to give up the insurance proceeds altogether, it's possible to donate a *portion* of the death benefit to charity.

Using insurance for wealth replacement

Another approach is to donate other types of assets to charity and to use life insurance to replace that wealth for your loved ones. This strategy is particularly effective for assets that would otherwise be inefficient for transferring wealth.

If you've got significant wealth retirement plans, which generally are subject to *both* income and estate taxes, naming a charity as beneficiary and using insurance to replace their value can be a far more efficient method of passing wealth to your family. If you've got highly appreciated assets, for example, there may be risk management and tax advantages to contributing the assets, getting a current tax deduction, and using life insurance as a way to allow your heirs to inherit the equivalent value.

Rather than donating the highly appreciated assets outright, an effective approach can be to transfer the asset to a charitable remainder trust. That way, you'll receive current tax benefits and retain an income stream you can use to pay insurance premiums or for other purposes.

Exchanging a policy for a charitable gift annuity

If your unneeded life insurance policy has accumulated significant cash value, one attractive option is to use it to fund a charitable gift annuity. This strategy allows you to benefit a charity while enjoying a current charitable tax deduction and an income stream for life. Keep in mind that, if the policy's value exceeds your cost basis, your charitable deduction will be reduced by a portion of the gain.

Explore your options

These are just a few of the ways life insurance can be used in charitable giving. Your estate planning advisor can help you identify the best strategies for your personal financial circumstances. ▮

Donating life insurance: What's deductible?

Contrary to popular belief, when you donate a life insurance policy to charity, your income tax deduction isn't the policy's face value or cash surrender value. Rather, it's the *lesser* of:

- The policy's fair market value (based on a combination of factors), or
- Your tax basis — generally, premiums paid less any withdrawals or dividends received.

Bear in mind that these deductions, like other charitable deductions, are limited to 50% of your adjusted gross income (AGI) — 30% for gifts to certain private foundations, with the excess carried forward up to five years.

You're also entitled to deduct any premium payments you make after you donate a policy. Generally, it's best to make these payments to the charity rather than directly to the insurance company. If you pay the insurer, the amount you can deduct may be reduced from 50% to 30% of AGI.

Beware of donating a policy that's subject to an outstanding loan. Doing so can wipe out your charitable deduction or even trigger an income tax *liability*.

Harnessing the power

Powers of appointment beneficial in an uncertain estate planning environment

There are a variety of tools you can use to build flexibility into your estate plan. One of the most versatile is the power of appointment.

How does it work?

A power of appointment is simply a provision in your estate plan that permits another person — a beneficiary, family member or trusted advisor, for example — to determine how, when and to whom certain assets in your estate or trust will be distributed. The person who receives a power of appointment is called the "holder."

These powers come in several forms. A testamentary power of appointment allows the holder to direct the distribution of assets at death through his or her will or trust. An *inter vivos* power of appointment allows the holder to determine the disposition of assets during his or her lifetime.

Powers may be general or limited. A general power of appointment allows the holder to distribute assets to anyone, including him- or herself. A limited power has one or more restrictions. In most cases, limited powers don't allow holders to distribute assets for their own benefit (unless distributions are strictly based on "ascertainable standards" related to the holder's health, education or support). Typically, limited powers authorize the holder to distribute assets among a specific class of people. For example, you might give your daughter a limited power of appointment to distribute assets among her children.

The distinction between general and limited powers has significant tax implications. Assets subject to a general power are included in the *holder's* taxable estate, even if the holder doesn't execute the power. Limited powers generally don't expose the holder to gift or estate tax liability.

What are the benefits?

Powers of appointment provide flexibility, and enhance the chances that you'll achieve your estate planning goals, by allowing you to postpone the determination of how your wealth will be distributed until the holder has all the relevant facts.

For example, suppose your plan establishes a dynasty trust designed to benefit multiple generations decades or even centuries into the future. Currently, the most you can contribute to such a trust without triggering the generation-skipping transfer (GST) tax is $5.49 million. But if Congress repeals the GST tax in the future, the holder of a power of appointment could funnel far more wealth into your dynasty trust.

The distinction between general and limited powers of appointment has significant tax implications.

Here's another example: Suppose you and your spouse have three young children. Your plan calls for your wealth to be placed in a trust that benefits your spouse for life and then divides your assets equally among your children. But it's impossible to predict your children's financial future, so you give your spouse a limited, testamentary power of appointment that allows him or her to distribute the trust assets according to the children's needs. This way, if one child is financially independent, your spouse can reduce that child's inheritance. Or if one child has developed an alcohol or substance abuse problem, your spouse might direct that child's inheritance into a trust that restricts his or her access to the funds.

Dealing with uncertainty

In estate planning, there's only one thing we can be certain about: uncertainty. Will lawmakers repeal the federal estate tax? If so, will it be restored a few years later? How will your loved ones' financial needs change over time? Powers of appointment can give your plan the flexibility to deal with whatever the future may bring. ▮

Unmarried couples must consider alternative planning strategies

Unmarried couples face many of the same estate planning concerns as married couples. However, married couples can use more advantageous estate planning strategies than unmarried couples. What this means is that unmarried couples must engage in special planning to ensure that their decisions regarding asset distribution and health care are carried out per their wishes.

Strategies unavailable to unmarried couples

Because intestacy laws offer no protection to an unmarried person who wishes to provide for his or her partner, it's essential for unmarried couples at a minimum to create a will or living trust. But marriage offers several additional estate planning advantages that unmarried couples must plan around, such as:

Marital deduction. Estate planning for married couples often centers on the marital deduction, which allows one spouse to make unlimited gifts to the other spouse free of gift or estate taxes. Unmarried couples don't enjoy this advantage; thus, lifetime gift planning is critical so they can make the most of the lifetime gift tax exemption and the $14,000 per recipient annual gift tax exclusion.

Unmarried couples also should pay close attention to transactions that may inadvertently trigger

gift taxes, such as payment of a partner's living expenses.

Tenancy by the entirety. Married and unmarried couples alike often hold real estate or other assets as joint tenants with rights of survivorship. When one owner dies, title automatically passes to the survivor. In many states, a special form of joint ownership — tenancy by the entirety — is available only to married couples.

In addition to survivorship rights, tenancy by the entirety offers protection against claims by the spouse's individual creditors. Unmarried couples who seek greater protection against creditor claims should consider placing assets in a trust.

Will contests. Married or not, anyone's will is subject to challenge as improperly executed, or on grounds of lack of testamentary capacity, undue influence or fraud. For some unmarried couples, however, family members may be more likely to challenge a will simply because they disapprove of the relationship.

To reduce the risk of such challenges, unmarried couples should be sure that their wills are carefully worded and properly executed and use separate attorneys, which can help refute charges of undue influence or fraud. In addition, consider including a "no contest" clause, which disinherits anyone who challenges the will and loses. Finally, explain in the will the reasons for favoring one's partner over relatives.

Health care decisions. A married person generally can make health care decisions on behalf of a spouse who has become incapacitated by illness or injury. Unmarried partners cannot do so without a written authorization, such as a medical directive or health care power of attorney. A durable power of attorney for property may also be desirable, allowing a partner to manage the other's assets during a period of incapacity.

Because intestacy laws offer no protection to an unmarried person who wishes to provide for his or her partner, it's essential for unmarried couples at a minimum to create a will or living trust.

Take advantage of a GRIT

Although married couples enjoy several estate planning advantages over their unmarried counterparts, there are a few situations in which unmarried couples have an edge. For example, with a grantor retained income trust (GRIT), one partner transfers assets to an irrevocable trust for the other's benefit. By retaining income and certain other interests in the trust, however, the grantor minimizes its value for gift tax purposes.

So long as the grantor survives the trust term, a GRIT has the potential to transfer substantial amounts of wealth tax-free, which led Congress in the late 1980s to eliminate these tax benefits for intrafamily transfers. But unmarried couples and other "nonfamily" members can still take advantage of this powerful estate planning strategy.

Planning options are available

There are many reasons life partners decide not to marry. Even though this prevents these couples from using powerful estate planning strategies, there are specific strategies available to achieve estate planning objectives. Your estate planning advisor can help you identify and implement those strategies.

ESTATE PLANNING RED FLAG

A significant portion of your wealth is concentrated in a single stock

Estate planning and investment risk management go hand in hand. After all, an estate plan is effective only if you have some wealth to transfer to the next generation. One of the most effective strategies for reducing your investment risk is to diversify your holdings. But it's not unusual for affluent people to end up with a significant portion of their wealth concentrated in one or two stocks.

There are several ways this can happen, including the exercise of stock options, participation in equity-based compensation programs, or receipt of stock in a merger or acquisition.

To reduce your investment risk, the simplest option is to sell some or most of the stock and reinvest in a more diversified portfolio. This may not be an option, however, if you're not willing to pay the resulting capital gains taxes, if there are legal restrictions on the amount you can sell and the timing of a sale, or if you simply wish to hold on to the stock.

To soften the tax hit, consider selling the stock gradually over time to spread out the capital gains. Or, if you're charitably inclined, contribute the stock to a charitable remainder trust (CRT). The trust can sell the stock tax-free, reinvest the proceeds in more diversified investments, and provide you with a current tax deduction and a regular income stream. (Be aware that CRT payouts are taxable — usually a combination of ordinary income, capital gain and tax-free amounts.)

To reduce your risk without selling the stock:

- Use a hedging technique, such as purchasing put options to sell your shares at a set price.
- Buy other securities to rebalance your portfolio. Consider borrowing the funds you need, using the concentrated stock as collateral.
- Invest in a stock protection fund. These funds allow investors who own concentrated stock positions in different industries to pool their risks, essentially insuring their holdings against catastrophic loss.

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Designating a Beneficiary of your IRA

The IRS does not allow you to keep retirement funds in a tax-deferred retirement account forever. When you reach 70½ years of age, you must start taking required minimum distributions ("RMD") from your individual retirement account or qualified plan. The RMD is the minimum amount you must withdraw from your retirement account each year. You can always take more than the RMD. However, the consequence for failing to take the RMD is a 50% excise tax on the amount not distributed.

If you do not withdraw all of your retirement funds before you pass away, designating the right beneficiary of your retirement account will enable your heirs to continue the income tax deferral. An individual (such as your spouse, children, or grandchildren) or an entity (such as your estate, charity, or trust) may be designated as the beneficiary although the rules set forth under the Internal Revenue Code differ depending on the beneficiary designation.

If you are married and designate your spouse as the sole beneficiary of your retirement account, your spouse has several options with regard to the distribution of the account after your death. Your spouse can assume ownership of your retirement account by rolling it into his or her own account. This allows your spouse to delay the RMD until he or she turns 70½ years as well as make additional contributions and designate his or her own beneficiaries.

Absent a rollover, your spouse can treat your retirement account as an inherited IRA. If, at the time of your passing, you already started taking the RMD, your spouse has the option of basing the RMD on his or her own current age or on your age at the time of your death. On the other hand, if you were not required to take the RMD at the time of your passing, your spouse must withdraw all of your funds within 5 years of your death or may wait to take the RMD until you would have been required to at 70½ years of age.

If you designate your children, grandchildren or other individuals as beneficiaries of your retirement account, their options depend on whether you were required to take RMD during your lifetime. If, at the time of your passing, you already started taking RMD, your beneficiary will take distributions based on the younger of the beneficiary's age or your age at the time of your death. However, if, at the time of your passing, you were not required to take RMD, your beneficiary may take a lump sum distribution of the funds in your account within 5 years of your death or take distributions based on his or her own age. By stretching out the distributions over the beneficiary's life expectancy, your retirement funds (except for RMD) will stay in an inherited IRA account continuing to grow tax-deferred resulting in a substantial growth over the lifetime of the beneficiary.*

You can name an entity (such as your estate, charity, or trust) as the beneficiary of your retirement account; however, because an entity is not a person, in most cases, it will not be considered a "designated beneficiary," and therefore, post-death income tax deferral will be limited or unavailable. If an entity is named as your beneficiary, and at the time of your passing, you already started taking the RMD, your retirement funds must be distributed to the entity over your remaining life expectancy. However, if an entity is named as your beneficiary, and at the time of your passing, you were not required to take RMD, your retirement account must be distributed to the entity within 5 years of your death.

If you name an estate as your beneficiary, your retirement funds will be subject to probate and your heirs will not have the distribution options that would have otherwise been available to them if they were designated as individual beneficiaries.

If you name a charity as your beneficiary, and your estate is subject to federal estate tax, you will receive a charitable estate tax deduction. Plus, there will be no income tax liability associated with your account once in the hands of the charity.

If you name a correctly structured trust as your beneficiary, you maintain maximum control over the management and distribution of your retirement account. If the trust meets certain IRS requirements, it will qualify as a see-through trust and the oldest beneficiary of the trust will be treated as the designated beneficiary and the RMD will be paid to the trust over his or her life expectancy. Your remaining funds will stay in the account continuing to grow income tax-deferred as if you named the trust beneficiary directly as an individual beneficiary.

You can designate both an individual and an entity. If an entity is named as a beneficiary of only a share of your retirement funds with an individual beneficiary receiving your remaining funds, the individual beneficiary may be treated as a designated beneficiary if, within a year of your passing, the entity takes a lump sum distribution of its share, or if your funds are divided into separate accounts for each beneficiary.

You can designate several beneficiaries of your account; however, the distributions will be based on the life expectancy of the oldest beneficiary. In the alternative, you can split your account into separate shares and name a different beneficiary for each share. This would allow the life expectancy of each beneficiary to determine distributions for his or her respective share.

*A proposed law may eliminate the ability of a non-spouse individual beneficiary to stretch an inherited IRA, which may have a drastic impact on such beneficiary's financial security. Stay tuned for any legal changes to this valuable estate-planning tool.