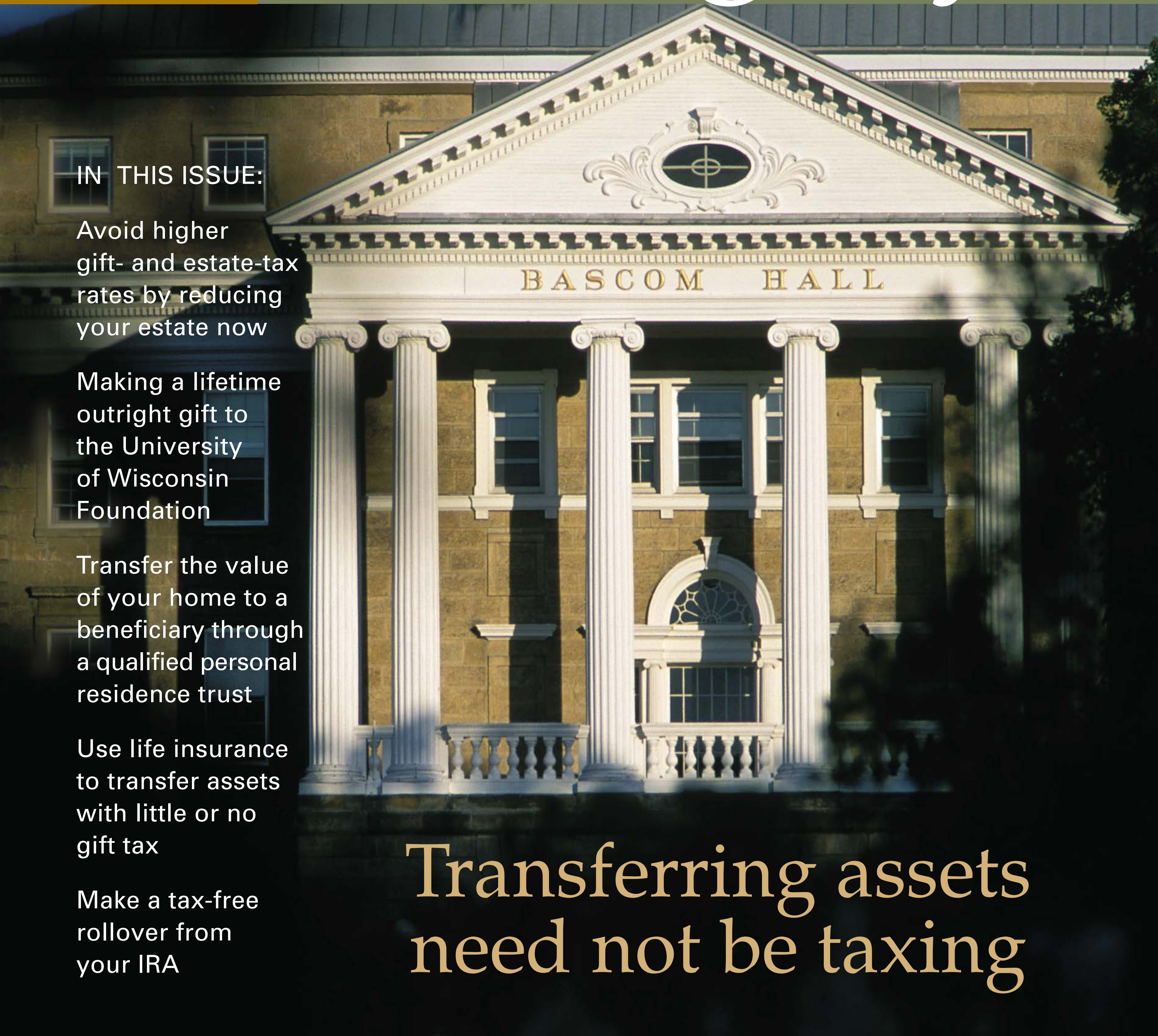
Tax and gift strategies for estate planning from the University of Wisconsin Foundation

Fall 2006

Wisconsin Legacy



In this issue:

- Avoid higher gift- and estate-tax rates by reducing your estate now
- Making a lifetime outright gift to the University of Wisconsin Foundation
- Transfer the value of your home to a beneficiary through a qualified personal residence trust
- Use life insurance to transfer assets with little or no gift tax
- Make a tax-free rollover from your IRA

Transferring assets need not be taxing

How will you transfer your assets so they are not unnecessarily consumed by taxes but instead preserved to benefit the individuals and institutions you care about?

A program of strategic giving requires careful thought and planning, just as accumulating and investing your original assets has. This issue of *Legacy* suggests ways to ensure that maximum value is transferred to the people and charitable organizations important to you.

Protecting Your Assets from Gift and Estate Taxes

Just as taxes on earnings may influence your current decisions, both present and future tax consequences must be considered when you make plans to transfer your assets to others.

Under existing law, each person is allowed a lifetime tax credit that offsets the tax on the first portion of taxable transfers. Currently the estate-tax credit is $780,800, which will offset the tax on the first $2,000,000. The gift-tax credit is $345,800, which offsets the tax on the first $1,000,000. Tax then applies at the rate of 45 percent.

The effect of this interrelated system of gift and estate taxation is that each taxable transfer—whether made during your lifetime or through your estate—may be subject to gift- and estate-tax rates. *(See Example 1)*

Example 1

John T makes a gift of $500,000 to his son Tom. Because John has made no previous taxable gifts and the tentative tax is less than the available credit, no tax is due.

John dies in 2007, having made no other taxable gifts. He leaves his remaining $1,800,000 estate to Tom. Added to his lifetime gift, this makes the total taxable transfer $2,300,000.

The transfer tax on $2,300,000 is $915,800. Although John's estate can apply the $780,800 credit against the tax, the estate still owes $135,000 (i.e., $915,800 - $780,800).

Tax-Free Giving: The Annual Exclusion

You can give each child, grandchild or other individual $12,000 each year free of gift tax (so long as the recipient is able to make immediate use of the gift). Together, husbands and wives can give up to $24,000 tax-free to as many persons as they desire.

If your needs to maintain your standard of living are otherwise met, it may make sense to give away certain assets—*even if their value exceeds the annual exclusion amount.*

If you give away an asset with significant potential for appreciation, you remove its current value from your estate—and you also remove any future appreciation. Remember, you will not actually have to pay any out-of-pocket transfer tax until you make more than $1,000,000 in gifts not covered by annual exclusions. And any gift tax that you do pay will be removed from your estate, provided you live at least three years after making the gift.

Charitable Planning Pointer

Lifetime **outright gifts** to the University of Wisconsin Foundation are free from gift tax and reduce the amount of your remaining assets potentially subject to gift and estate taxes. Moreover, they generate *current* income-tax deductions that reduce your income-tax bill *this year.*

If you give away an asset with significant potential for appreciation, you remove its current value from your estate.

A gift of an asset that is producing little or no current income—perhaps growth stock or undeveloped real estate—generally results in a deduction equal to the full fair-market value of the asset. Better yet, you can usually avoid recognizing—and being taxed on—any of your paper gain.

Preserving the Value of Your Residence

Most people's homes represent a sizeable portion of their net worth, and it can be beneficial to hold on to the family home until death. It can then be passed on to a family member, who will get a stepped-up basis in the home—which means that the gain on any subsequent sale would be based on the value at the date of the original owner's death. Of course, the home's full value would be included in the owner's estate and potentially subject to tax.

Giving the property to a child during your lifetime raises several concerns. Not only could it trigger the gift tax, but the child would also take your basis in the property—probably a relatively low amount—as his or her benchmark for measuring capital gain when selling the home.

An excellent way to ultimately transfer the value of a home to an intended beneficiary at significantly reduced transfer-tax cost is a *qualified personal residence trust* (QPRT). *(See Example 2)*

Example 2

Bob Miller owns a waterfront residence valued at $1,000,000. He would like his two adult children to have the home eventually, but in the meantime, he wants to continue enjoying the property. He also is concerned about the estate-tax liability that will be incurred when the residence passes to his children.

Bob establishes a QPRT for a term of years, making sure that the term is somewhat shorter than his life expectancy. He will live in the home for the duration of the trust; then the property will pass to his children. At the time the trust is established, he reports a taxable gift of $300,000, which represents the present value of the remainder interest. He has not previously used his gift-tax credit, so he does not actually pay any gift tax. At the end of the term, the property has appreciated in value to $2,000,000. Thus, the children receive an asset worth $2,000,000, but only $300,000 is subject to gift tax.

To realize this tax benefit, Bob must survive the trust term. If he dies before the termination of the trust, the entire market value will be included in his taxable estate and he will have gained no tax benefit. He will not have lost anything, however, for the result will be the same as if he had never created the trust.

Charitable Planning Pointer

If you don't have heirs to whom you want to give your residence, you can consider a **charitable gift with a retained life estate.** In this arrangement the title passes to the University of Wisconsin Foundation and you live in the home for the rest of your life. You will pay no gift or estate tax and no tax on the capital gain and you will receive a significant income-tax deduction.

Giving Away What You Don't Yet Have: Proceeds From Life Insurance

Many people buy life insurance to provide liquidity to pay taxes and debts at their deaths, but the death benefits themselves generate additional estate taxes.

With proper planning, however, life insurance can provide an excellent way to transfer assets with little or no gift tax.

One option is to give the policy to others (usually children). Only the policy's cash value, which is relatively small compared to its face value, will be subject to gift tax—and even that amount can be reduced through the $12,000 annual exclusion. If premiums are still due on the policy, you can make gifts of up to $12,000 to the children, who can use the gifts to make the premium payments. At your death, your children will receive the proceeds free of estate tax because you had no "incidents of ownership" (e.g., the right to change the beneficiary or to borrow against the cash value).

This plan does have a possible drawback. When you give away a life insurance policy, you must live at least three more years—otherwise, the entire proceeds will be added to your taxable estate.

Another way to avoid that tax is to establish an irrevocable life insurance trust. The trustee purchases a policy on your life—or a policy on the lives of both you and your spouse, with the proceeds paid upon the second death—and uses the gifts you make to the trust each year to pay the premiums. Provided that the beneficiaries of the trust are given an opportunity to withdraw the gifts for current use (even though they are unlikely to do so, because they know the purpose of the trust is to enable them to eventually receive the death proceeds free of estate tax), the gifts will qualify for the $12,000 annual exclusion.

It is possible to make a **charitable gift through life insurance,** by naming the University of Wisconsin Foundation as either beneficiary or owner of a policy. In either case, proceeds paid to us are not subject to estate tax. In addition, when you assign ownership of a policy to the University of Wisconsin Foundation, you receive an income-tax deduction for the cash value of the policy and for any premiums you subsequently pay.

Replacing the Value of Gifts to Charity

Some people believe charitable giving will diminish the assets they wish to go ultimately to family members and other beneficiaries. However, creative use of life insurance can replace assets transferred to charity. Consider, for example, what happens when a person in the 35 percent tax bracket makes a $100,000 charitable gift to the University of Wisconsin Foundation. The gift saves $35,000 that would otherwise have gone to pay income tax.

This tax savings can be used to purchase life insurance and the proceeds from the policy, payable to family beneficiaries, would replace some or all of the value of assets given to us.

Creative giving may have a place in your planning. If you would like to know more, please feel free to contact us.

Opportunity Alert: Charitable Gifts from Your IRA

The Pension Protection Act of 2006 provides charitably minded individuals aged 70½ or older a golden opportunity to make gifts to charitable organizations directly from their IRAs. This opportunity is available for 2006 and 2007 on the following terms:

- Transfers must be directly from the IRA to a charity
- Maximum allowable transfer is $100,000 per year
- Gifts must be outright*
- No charitable deduction is allowed

**Transfers to donor advised funds, supporting organizations and charitable remainder trusts and for charitable gift annuities do not qualify.*

Please call our office to learn more about how this new legislation might benefit you.

Dear Friends,

I am pleased to present the latest issue of *Legacy.*

Our newsletters are designed to provide information about financial and estate planning, as well as thoughtful charitable gift arrangements. Each issue features a different topic. In this issue we feature several methods of transferring assets that will reduce your taxes and allow you to make a significant gift to benefit the University of Wisconsin-Madison.

While everyone's specific circumstances are different, we all want to identify the best ways to support our families as well as charitable organizations that are important to us. I would welcome the opportunity to talk with you about your financial goals and objectives. We would like to work with you to design a gift that can fulfill your philanthropic wishes and provide meaningful support to the University.

Sincerely,

Russ Howes
Vice President, Planned Giving and Legal Affairs

For additional information contact:

University of Wisconsin Foundation
Office of Planned Giving
1848 University Avenue
P.O. Box 8860
Madison, Wisconsin 53708-8860

Telephone: 608-263-4545
Fax: 608-263-0781
E-mail: uwf@uwfoundation.wisc.edu
Web site: www.uwfoundation.wisc.edu

The University of Wisconsin Foundation, an independent, nonprofit, tax-exempt corporation founded in 1945, raises, invests and distributes gifts on behalf of the University of Wisconsin.

You should consult your attorney about the applicability to your own situation of the legal principles contained herein.

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1848 University Avenue
P.O. Box 8860
Madison, WI 53708-8860