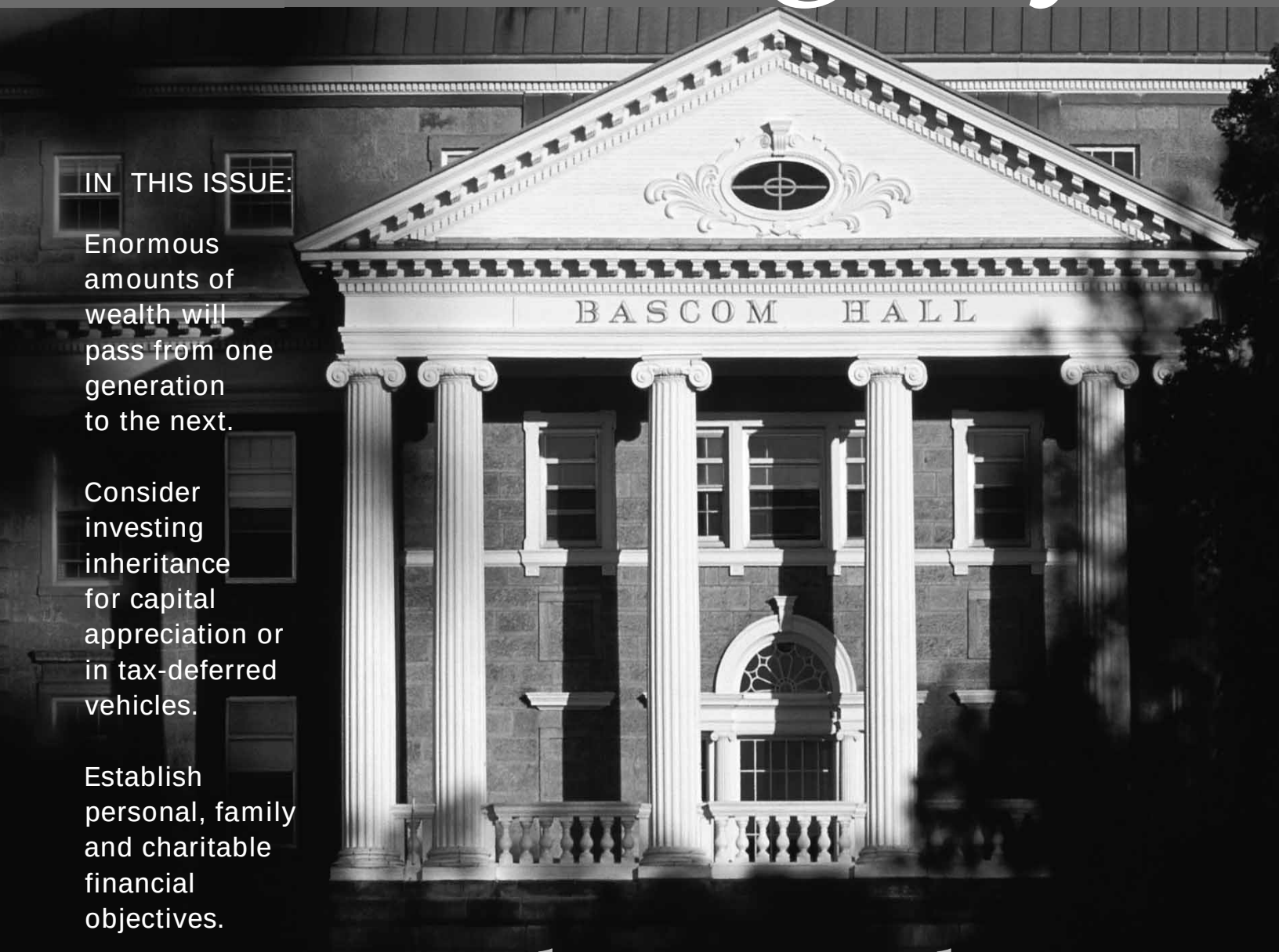
Tax and gift strategies for estate planning from the University of Wisconsin Foundation

Fall 2004

Wisconsin Legacy



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When you inherit:

New challenges, new opportunities

Jim and Susan are very happy with their lives. They have two great children, are doing well in their careers and live in a nice house in a good neighborhood. Their savings account is modest but growing, and they have excellent retirement plans through their employers. Someday they expect to be very comfortable financially.

When that day comes, they know they will have new opportunities—opportunities to do things for their family and for the causes important to them, like the University of Wisconsin-Madison. They also know they will need to step up to a new level of planning for their finances, but that time seems far off.

For many families, "someday" comes much sooner than they ever anticipated—and not simply because careers take off or investments skyrocket. Often it comes because of an inheritance.

There has been extensive research and much written in recent years about the enormous amount of wealth poised to pass from one generation to the next. Estimates vary but, whether the actual amount is $5 trillion or $15 trillion, suffice it to say that a lot of wealth will change hands in the next several years.

You may be among the millions of Americans who have—or will shortly—come into an inheritance and have questions about how these new resources will affect your life. Or you may be in an older generation and concerned with helping those who will inherit from you to develop a new financial paradigm. This issue of *Legacy* is designed to address the way new wealth dictates different financial ground rules. Generally this means developing new perspectives on spending, saving, investing and giving.

The first step: Get good advice

One of the first things you will want to do is consult advisors you trust. Good advice from qualified lawyers, accountants, investment advisors and other financial professionals is invaluable as you formulate approaches appropriate for your new level of wealth. Their advice will be critical in several key areas:

Tax and investment planning

The influx of substantial assets may dramatically alter your income-tax outlook, quite likely pushing you into higher brackets. The degree to which major new assets affect your income-tax situation depends to a great extent on how you use and invest those assets.

Planning pointer

If your current level of cash flow is sufficient to meet expenses and support your desired lifestyle, there is little reason to select investments that will produce a lot of ordinary income—much of which will be lost to income tax at rates as high as 35 percent. Consider investing a substantial portion of your assets for capital appreciation or in tax-deferred vehicles.

On the other hand, capital appreciation in investments such as stock is taxed only when the asset is sold at a profit—and then generally at the maximum rate of 15 percent. Note: Inherited appreciated capital-gains assets receive a step-up in basis at death and thus avoid capital-gains tax on the later sale of the asset.

Similarly, tax-deferred investments, such as commercial variable annuities, produce no taxable income until you receive a distribution or make a withdrawal. Caution: Many tax-deferred investments (including retirement plans) carry substantial penalties if you make a withdrawal before the age of 59½. And these assets are not stepped up at death.

Estate planning

The more assets you have, the more you will need to be concerned about federal estate tax. Currently you can transfer up to $1.5 million of assets at your death without incurring tax. This amount is scheduled to increase until it reaches $3.5 million in 2009. Note: The estate tax is repealed for the year 2010, but it will return in 2011 with an exemption of $1 million unless Congress takes further action. The gift-tax exemption will remain at $1 million. *(See Example 1)*

Establishing personal, family and charitable financial objectives

Your advisors can be valuable resources for formulating new ways of thinking about your financial goals. An inheritance may change the focus from "What do I need from my money?" to "What can I do with my money?"

Example 1

Bill Smith has an estate of $900,000 and has made no taxable gifts during his lifetime. Since he has less than $1.5 million, his entire estate is sheltered from the federal estate and gift taxes.

Bill's mother dies and leaves him $2 million, making his total estate $2.9 million. If Bill dies in 2008, his estate will be subject to a marginal tax rate of 45 percent. His federal estate-tax bill could be as much as $405,000.

If you suddenly find yourself with an estate that exceeds the amount currently effectively sheltered from federal estate and gift tax, your plans will be tempered by new tax considerations. Be sure to factor in those tax considerations as you chart a new course.

Your first priority, of course, is to ensure your own financial security, both now and in the future.

The next priority for most people is to determine what they can and should do for their families—and when.

Most parents search for a balance between giving their children enough to give flight to their dreams without giving them so much that it destroys their initiative.

Once you have addressed these objectives, you can be intentional in addressing charitable objectives to perpetuate your values beyond your own lifetime. And, of course, good charitable plans work in harmony with your personal and family goals.

The power of giving

Once you have formulated a solid plan for personal, family and charitable objectives jointly, specific actions can flow from that plan.

Ultimately, your assets can go to only four different places:

- To support your personal expenses during your lifetime;
- To your family and other beneficiaries during life and at death;
- To charity; and
- To the government as taxes.

Almost certainly the last "destination" is the least desirable to most people. Fortunately, there are numerous strategies to reduce the amount lost to taxes. These strategies can let you exercise control over the ultimate disposition of a much greater percentage of your assets.

It is somewhat ironic to realize that some of the best strategies for controlling the disposition of your assets involve giving some of them away—to family members and other individuals and to charity. Decisions we make about giving can preserve significant assets that otherwise would go to pay taxes. *(See Example 2)*

It is not only charitable gifts that result in savings. Gifts to family members can preserve more assets within the family unit. *(See Example 3)*

Example 2

Mary Thomas is in the 35 percent federal income-tax bracket. She makes a gift of $10,000 to the University of Wisconsin Foundation. As a result, Mary pays $3,500 less federal tax this year. Her gift effectively allows her to control the ultimate use of additional assets equal to those tax savings.

Example 3

Bob and Helen Jones are financially secure. In fact, they have more annual income than they can use, and much of it is lost to federal income tax at the rate of 35 percent. Their children, Carol and Steve, are just starting out in their careers and have young families. Bob and Helen decide to give them some investments that generate $11,000 of income each year—income on which they would otherwise pay $3,850 in federal income tax. Result: Because both Carol and Steve are in the 25 percent tax bracket, they pay just $2,750 in tax. The family is ahead by $1,100.

Reducing gift and estate taxes

As mentioned previously, you can currently give away up to $1 million of taxable lifetime gifts without incurring gift taxes and up to $1.5 million of testamentary gifts without incurring an estate tax. If you exceed that limit, however, the tax hits with a vengeance at rates from 45 percent to 48 percent. With rates this high, you are wise to increase the amount of assets you control with a well-designed giving program.

Planning pointer

Gifts from an estate worth more than $1.5 million to a spouse with a smaller estate let both spouses pass on the maximum amount tax-free and reduce the overall tax. (Note: Gifts between spouses generally are not taxable for gift-tax purposes.)

Lifetime gifts to other family members can also generate estate- and gift-tax savings. Each spouse can give up to $11,000 per recipient each year free of gift tax and remove significant assets from a potentially taxable estate.

Even if your gift exceeds the annual exclusion, it may still make sense.

- First, no actual tax is due until cumulative taxable gifts exceed $1 million.
- In addition, if the assets you give away appreciate in value, all the growth along with any income they generate escapes taxation in your estate.
- Furthermore, if you do have to pay tax on a lifetime gift, the gift tax you pay also will be removed from your estate if you live three years beyond the gift.

Charitable gifts yield major savings

Charitable gifts generate dollar-for-dollar deductions for federal gift- and estate-tax purposes without any limitation on the total amount—and these deductions produce major tax savings. *(See Example 4)*

Choosing the right asset can increase savings

As significant as these savings are, they could be even better, depending on the asset Ken directs to be used to fund his gift. Assume, for example, that Ken's estate includes an IRA worth $1 million.

Distributions from an IRA are typically taxed as ordinary income to the person or entity receiving the distribution. Why? Both the contributions to the account and its earnings have never been taxed. Consequently, if the IRA account passes to Ken's children—even though they get some deduction for estate tax attributable to the IRA account—they could pay income tax of up to $191,730.

If Ken specifically directs the IRA account to the UW Foundation to fulfill his plans to make a $1 million gift, the children will be relieved of the income-tax burden. And, because we are tax-exempt, we will not have to pay income tax on the IRA proceeds. Considering the income- and estate-tax savings, the cost to the children of Ken's $1 million gift could be $328,270.

Example 4

Ken Brown dies in 2004 with an estate worth $5 million. His will includes a provision for a gift of $1 million for the University of Wisconsin Foundation. The gift reduces the tax on Ken's estate by $480,000.

Ken was able to control the ultimate disposition of an additional $480,000 through his charitable planning. This means the real "cost" of this gift to his heirs is not $1 million but rather $520,000 ($1 million- $480,000 tax savings).

Let us be on your team

As you go about the important work of setting and carrying out your goals, we would welcome the opportunity to discuss charitable strategies in more detail with you and your advisors. Please feel free to contact us.

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