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

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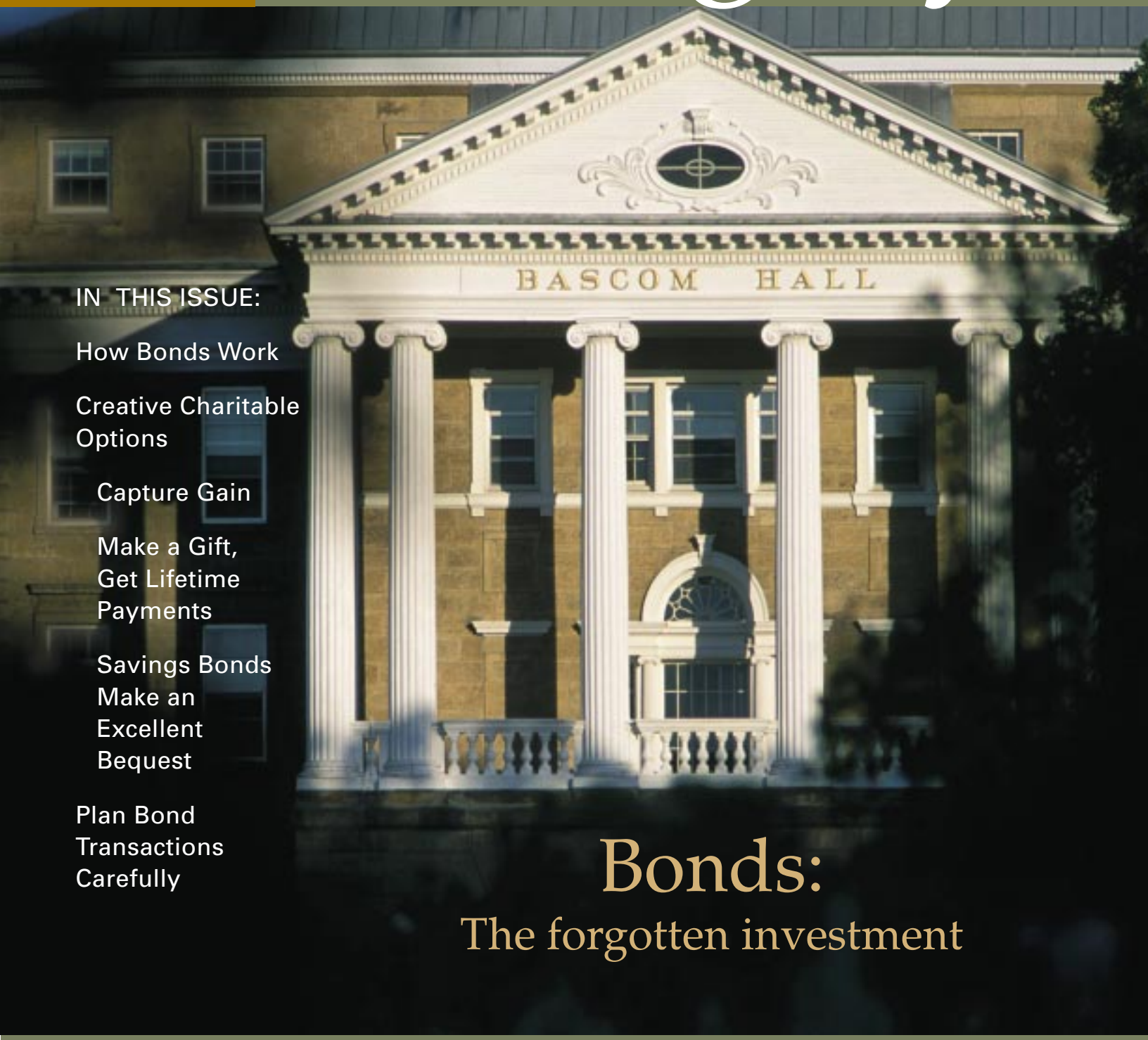
Wisconsin Legacy



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Bonds:

The forgotten investment

When was the last time you heard someone refer to his or her ***bond*** broker? When most of us think about securities investments, we tend to think primarily about stocks. But, bonds should form an important component of any well-balanced investment portfolio. While they come in many varieties, they all share one common goal: to produce income for the investor.

Although bonds are generally not as volatile as stocks, prudent investors regularly monitor their bond investments. Changes in the bond market can signal the need to make moves to protect your financial security. Bonds also can present creative charitable planning opportunities to help you reach personal, family and philanthropic goals.

How Bonds Work

When you buy a bond you are, in essence, loaning money to the issuer of the bond. In turn, the issuer agrees to repay you according to the bond's terms. The borrower may be a corporation, local or state governmental units, or even the federal government itself.

A bequest of savings bonds to charity reduces taxes.

Many bonds are issued at an amount equal to their *face (par) value.* These kinds of bonds pay a *periodic interest rate* equal to a percentage of that value. For instance, XYZ, Inc. may issue a $100,000 bond that pays 6 percent of the face amount annually in quarterly installments. That means the holder of the bond receives $6,000 each year in quarterly installments of $1,500. These bonds pay the stated interest amount until the maturity date stated in the bond, at which time the holder receives payment of the face amount.

Other bonds have a *predetermined maturity value* but are issued at a significant discount. Rather than making actual periodic payments of interest, they increase in value each year—by a percentage rate set out in the bond—until they achieve full maturity value, at which time the holder is paid the bond's face value. This is the way **series E** and **EE U.S. savings bonds** work. Typically you purchase them for one-half of the face value and they are guaranteed to be worth their full-face value at some designated point in the future.

Other entities issue similar kinds of bonds referred to as **zero-coupon bonds,** so-called because they increase in value each year instead of making periodic payments. Such bonds are a wonderful way to invest when you know how much money you will require at some fixed point in the future:

The zero-coupon bond offers a significant planning benefit. Not only is the interest rate guaranteed on the principal investment, it also is effectively guaranteed on the reinvestment of the annual increases—or *accretions*—in value of the bond.

Tax-exempt bonds

Bonds issued by state or local governments or related agencies have an important advantage over other types of bonds: the interest paid is exempt from federal income taxes. Depending on the residence of the investor, the bond also may be exempt from state and local taxes.

These tax-exempt provisions allow such entities to borrow the money they need at substantially lower cost. ***Reason:*** A tax-exempt return provides as much after-tax cash flow to an investor as a higher, fully taxable return. *(See Example 1)*

Example 1

Sharon R is in a combined 35 percent local, state and federal income-tax bracket. She has $100,000 to invest in bonds and wants to find the bond that will give her the best after-tax results.

She narrows her choices to a fully taxable bond that pays 7 percent and a tax-exempt bond that pays 4.75 percent. The first bond would pay her $7,000 (7 percent x $100,000) each year, but she would pay $2,450 ($7,000 x 35 percent) in taxes—leaving her a net amount of $4,550. Sharon chooses the tax-exempt bond that will pay only $4,750 (4.75 percent x $100,000), but she will owe no taxes. ***Result:*** Sharon is ahead by $200 with the tax-exempt bond.

Creative Charitable Options

Capture Gain

Those who have charitable goals have more options than typical investors when it comes to making decisions about bonds. One excellent strategy to capture gain in an appreciated bond is to use the bond—instead of cash—to fund a charitable gift. *(See Example 2)*

Fully Taxable Bond *Payout Equivalent*

Tax-Exempt Bond Rate	Federal Income-Tax Bracket 15%	25%	28%	33%	35%
3.0%	3.53%	4.00%	4.17%	4.48%	4.62%
3.5%	4.12%	4.67%	4.86%	5.22%	5.38%
4.0%	4.70%	5.33%	5.56%	5.97%	6.15%
4.5%	5.29%	6.00%	6.25%	6.72%	6.92%
5.0%	5.88%	6.67%	6.94%	7.46%	7.69%

This chart shows, in various tax brackets, the rate required for a fully taxable bond to net as much as a tax-exempt bond's return.

Example 2

John W is a generous friend of UW-Madison and each year makes a substantial gift to support its work. He has some 9 percent bonds he bought at par for $100,000 several years ago when interest rates were much higher.

Now that rates are at near-historic lows, the bonds are worth $110,000. John would like to capture the gain—especially since the bonds are callable in three years—but is reluctant to sell and generate a $10,000 long-term capital gain.

John decides to use the bonds to make his gift to the UW Foundation this year. He is entitled to a charitable deduction for the full $110,000 value but will not have to recognize or pay tax on any of the $10,000 gain. In his 35 percent federal income-tax bracket John realizes the following benefits:

Income-tax savings *(35% x $110,000)*	$38,500
Capital-gains tax savings *(15% x $10,000)*	$1,500
Total savings	$40,000
Net Cost of $110,000 Gift	**$70,000**

Make a Gift, Get Lifetime Payments

Perhaps you would like the University to have the value of your bonds, but you still need the income they produce for living expenses. It is possible for you to continue to receive an annual stream of income based on the value of your bonds and make a gift—*all while receiving valuable tax benefits.*

One of the most popular and flexible ways to achieve these goals is with a special planning device known as a charitable remainder trust (CRT). You can transfer bonds to the trust and reserve lifetime income for yourself or other beneficiaries you designate. At the death of the beneficiaries, all of the remaining assets in such a trust would pass to the UW Foundation. ***Note:*** A CRT also can be set up for a fixed term of not more than 20 years.

You can choose a charitable remainder *annuity* trust, which makes a fixed payment each year, or a charitable remainder *unitrust*, which makes variable payments based on a fixed percentage of the trust assets as they change from year to year. In both cases the payout must be at least 5 percent.

If your bonds have appreciated, you also get the added advantage of avoiding capital-gains tax on your paper gain. And, with careful planning, some or all of the income you get from a charitable remainder trust can be tax-free. *(See Example 3)*

Example 3

Laura B, 74, would like to make a meaningful gift to support the UW-Madison, but she needs all the income her assets currently generate to maintain her standard of living. Among the assets she owns are tax-exempt bonds that have a current market value of $100,000 and pay $5,000 each year in tax-exempt interest.

Laura decides to use the tax-exempt bonds to create a charitable remainder annuity trust that will pay her 5 percent of its initial value each year for the rest of her life. The payout from the trust is equal to the annual interest on the tax-exempt bonds. If the trustee retains the bonds in the trust, the tax-exempt nature of the interest on the bonds will be passed on to Laura when she receives her annual distributions from the trust.

As a result of her gift, Laura is entitled to a charitable income-tax deduction of $57,225. In her 33 percent federal tax bracket, this produces $18,884 in tax savings.

Savings Bonds Make an Excellent Bequest

As previously noted, series E and EE U.S. savings bonds are sold at a discount from their face value and increase in value each year. The owner of the bonds can choose either to report and be taxed on the annual increases each year or to defer recognizing the income until the bonds are redeemed.

This makes savings bonds an excellent choice to fund charitable gifts you plan upon your death. By leaving the bonds to charity and choosing to leave other assets to individual beneficiaries, you remove the value of the bonds from your taxable estate and the individual beneficiaries avoid recognizing income on the bonds.

Dear Friends,

Each year at this time, the University of Wisconsin Foundation publishes an issue of LEGACY. You are receiving this issue because you have created some form of deferred gift that ultimately will benefit the University of Wisconsin-Madison. It may be as simple as putting us into your will for a certain sum, or it may be a much more complex arrangement involving lifetime income with current and future tax benefits.

Regardless of the form your gift takes, this is our way of saying "thanks" to you for caring, for taking the time and having the foresight to carefully plan to make such a gift.

Each gift is important to us and in this publication we offer some information that you may find useful in your current and future planning.

As with all issues of LEGACY, we have no response card with this mailing. This is not intended to interest you in making any specific type of gift to benefit us. It is merely an informational piece that you may find of interest.

Our hats are off to all of you for providing for the future benefit of the University through your gifts.

You have our gratitude.

Sincerely,

Russ Howes
Vice President, Planned Giving and Legal Affairs

Plan Bond Transactions Carefully

In this issue of *Legacy* we have attempted to address some of the most important aspects of bonds and how they can be used creatively to meet your charitable-giving goals. There are many different kinds of bonds, several of which are subject to some unique rules and considerations. Be sure to seek the guidance of competent financial advisors as you make your plans.

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