



Financial Advisory Services

Profitable Gifting Strategies – Updated 2005

Profitable Gifting Strategies!

How gifts increase family wealth

Have you ever thought about making a gift to your child or grandchild, and then changed your mind because you were afraid they weren't financially responsible and the money would be gone in an instant? Have you avoided giving to your favorite charitable organizations because you'd rather keep it yourself or give it to your family?

Profitable gifting is not about giving money or assets away...it is about *preserving wealth* in the family. It's about paying less in taxes – income, estate and capital gains taxes – and using those benefits for family, self or your favorite charitable projects.

The benefits of charitable gifts as well as gifts to family members or other non-charitable beneficiaries are explained below. Because of the unique benefits afforded to charitable gifts, we will cover each separately.

TOPICS:

Profitable Gifting Strategies1

Charitable Giving Techniques1-4

Non-Charitable Gifts4-5

Other Gifting Techniques5

Charitable Giving Techniques

You are probably familiar with the standard reasons that people make charitable gifts:

- Charitable income tax deduction
- Estate Tax deduction
- Interest in the charitable organization's projects

But, how familiar are you with some of the more exotic benefits for charitable giving?

- Avoiding capital gains tax on appreciated assets
- Creating or increasing an income stream
- Involving family in charitable endeavors

Let's explore *several ways* in which one can make charitable gifts, what they are, how they are created and their respective benefits, beginning with the simplest gift -- **cash**.

Suppose you are in the 28% tax bracket. You would like to make a \$4,000 contribution to the local art museum this year and are considering alternatives to fund the contribution.

Tax Benefits of Charitable Gifts

If you donate cash, you would be entitled to a charitable income tax deduction (if you itemize). Tax savings

assuming a 28% tax bracket is \$1,120 (\$4,000 deduction x 28% = \$1,120). That's \$4,000 in cash that you may have needed for other spending needs, however. Let's look instead at using appreciated stock that's sitting in your investment account.

\$4,000 CASH gift:	
Gift amount	\$4,000
Tax savings	<u>1,120</u>
Cost of gift to you:	\$2,880

\$4,000 STOCK gift:	
Gift amount	\$4,000
Tax savings	<u>1,420</u>
Cost of gift to you:	\$2,580

Gifts of Appreciated Securities

Suppose you own a number of shares of ABC stock for which you paid \$10 per share several years ago and now it is worth \$20 per share. If you donate your stock directly to the museum to make your \$4,000 gift, your charitable income tax deduction (if you itemize) is still \$4,000. You will also avoid the 15% capital gains tax on the amount of your gain in the stock. Savings on capital gains tax is \$300 (\$2,000 gain x 15% = \$300).

Perhaps you're thinking "I need the dividends from my stock, I can't afford to forego the income."

A Charitable Remainder Trust is a possible solution.

Continued on next page



Charitable Giving Techniques (continued)

Charitable Remainder Trust

A Charitable Remainder Trust (CRT) is an irrevocable trust set up to provide an income interest to the donor and/or beneficiaries and the remainder of the principal to charities of the donor's choice.

Why: A CRT is treated as a charitable entity and therefore, the contribution of an appreciated asset avoids the immediate capital gains tax on those assets. Appreciated stock can be transferred, sold and reinvested in a more diverse portfolio without paying capital gains tax. Because the trust is considered a charitable entity, there is also a current income tax deduction to which the donor is entitled. The amount of the deduction represents the present value of what the charity will receive when the trust terminates, usually at the death of the donor or the donor and spouse. Many individuals find they can increase the income from assets they would otherwise have been resistant to selling because of the capital gains tax.

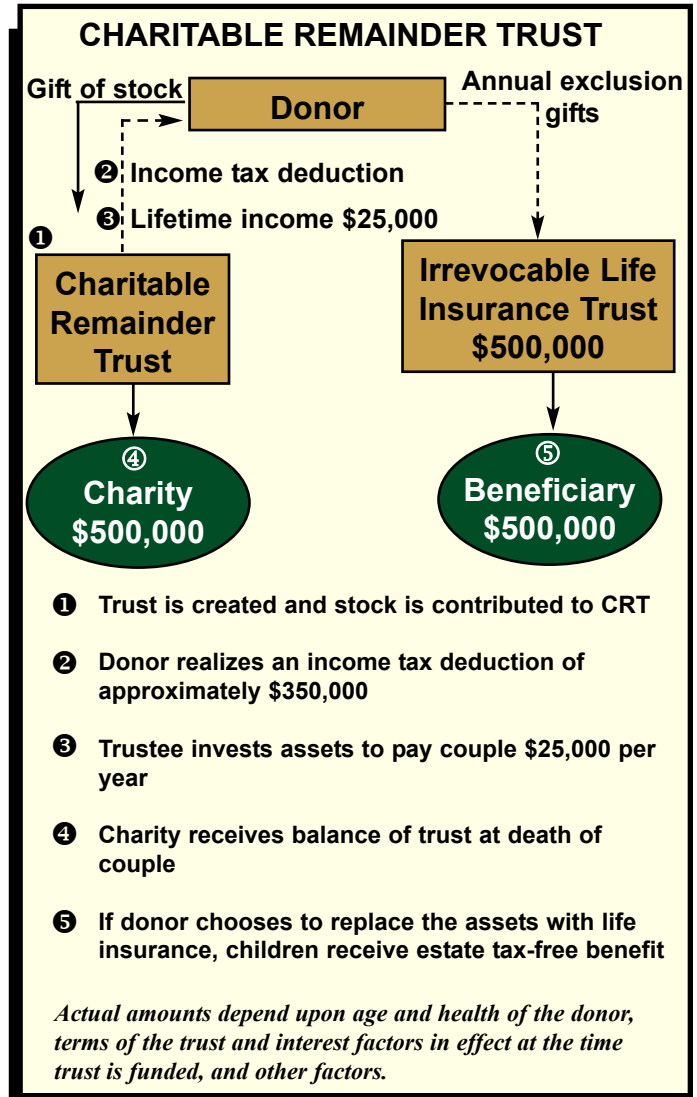
Assets contributed to a CRT will be excluded from the estate of the donor and will reduce estate tax. That's the good news. The bad news is that this is sometimes a problem for donors who want their children to inherit the assets. Often donors use a second vehicle to solve that issue -- a Wealth Replacement Trust (described below).

How: A trust is created by the donor and cash, appreciated securities or real estate are transferred into the trust. The trustee reinvests the assets to make payments to the donor.

A **Wealth Replacement Trust (WRT)** is set up for the purpose of providing assets to beneficiaries who will not receive the principal from the charitable remainder trust.

A WRT is usually an Irrevocable Life Insurance Trust, but may simply be an irrevocable trust investing in other assets for the benefit of the children. Because the trust is funded with annual exclusion gifts, the assets in the trust, investments or insurance, will pass to the children estate-tax free.

In the box at the right, you can see how a CRT funded with \$500,000 of zero-cost-basis stock, paying a dividend of \$5,000 might work for a couple aged 65 at a time when the relevant IRS interest factor is 4%.



Charitable remainder trusts come in two basic varieties. A charitable remainder *annuity* trust pays a fixed amount each year regardless of the value of the assets in the trust. A charitable remainder *unitrust* pays a fluctuating amount based on a percentage of the value of the trust and that value is recalculated every year.

Family Charitable Foundation

A Family Charitable Foundation (also called a private foundation) is an irrevocable trust or corporation set up for charitable purposes. Any distributions must be made for the foundation's charitable purposes. While the donor's family may work in the foundation and be paid for their work, the pay must be reasonable for work actually performed.

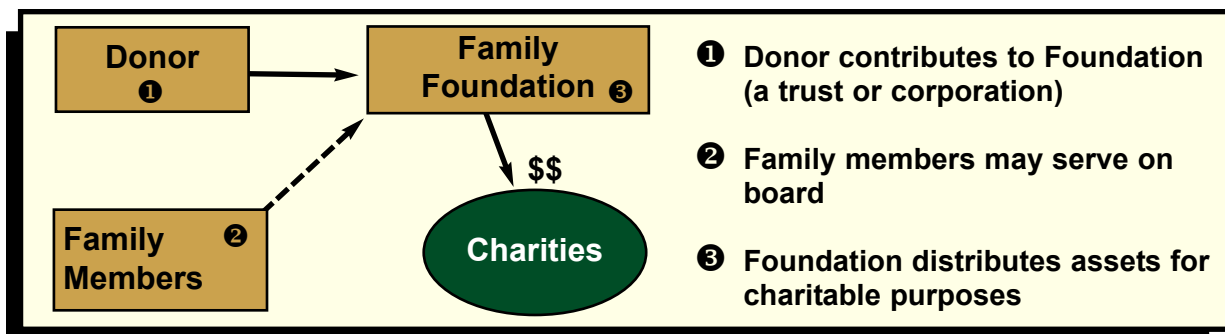
Why: A private foundation provides a means of involving the entire family in charitable endeavors. Contributions of appreciated stock to a private foundation will avoid capital gains tax and provide a charitable income tax deduction for the value of the contribution. Assets transferred to a private foundation are free from estate tax.

Charitable Giving Techniques (continued)

Family Charitable Foundation (continued)

Often, a private foundation is used as the charitable entity to receive payments from a charitable lead trust or the remainder interest of a charitable remainder trust, enabling the family to obtain all of the tax benefits of those two techniques, while maintaining family control over the charitable funds.

How: A trust or corporation is created by the donor and cash, securities or real estate may be transferred into the foundation. The income and principal is either distributed to other charitable organization(s) as the donor or the family determine, or the funds are made available for charitable purposes, e.g., scholarships. The distributions cannot be made solely for the benefit of the donor's family or beneficiaries.



Charitable Lead Trust

A Charitable Lead Trust (CLT) is an irrevocable trust set up to provide an income interest to one or more charitable entities for a period of time and the remainder of the principal to the donor's beneficiaries. While this *appears* to be a mirror image of the charitable remainder trust, one must be careful not to confuse the two as the objectives and the tax consequences of the two are quite different.

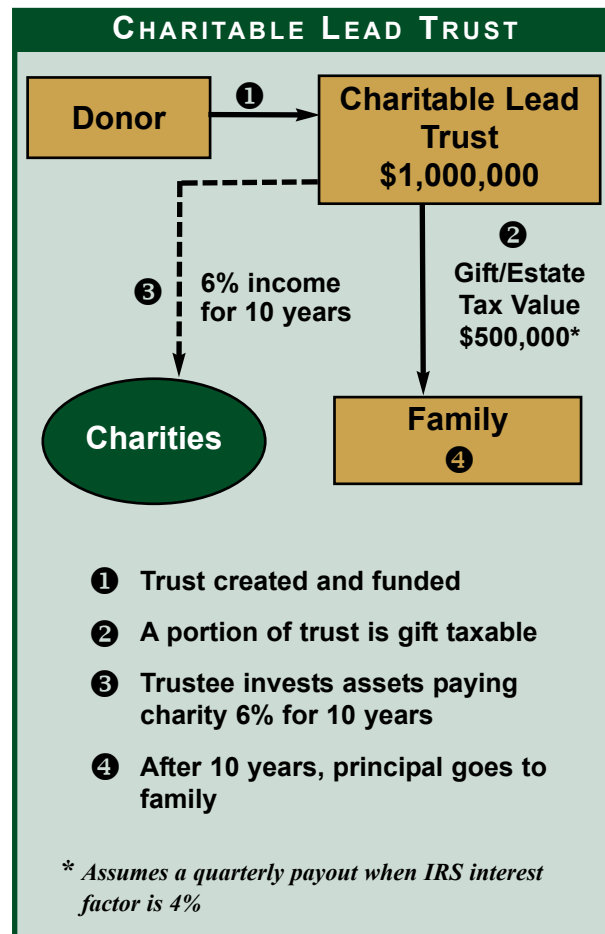
Why: A CLT is a means of transferring property to heirs at a discounted value. A gift of \$1,000,000 to children which must remain in a CLT while it pays out perhaps 6% of its value each year to charities of the donor's choosing, may only be valued at \$500,000 for gift tax purposes depending upon the term of the trust. If the children receive the full \$1,000,000 upon termination of the trust, \$500,000 of that value would have escaped estate or gift taxes.

How: A trust is created by the donor and cash, securities or real

estate are transferred into the trust. The trustee reinvests the assets to make payments to the charity. The trust can be created during the donor's lifetime or at death. If created during life, contributions of appreciated property to the trust may be subject to capital gains tax upon sale within the trust. If created at death, the step up in basis allowed for the decedent's assets will eliminate the gain.

A Wealth Replacement Trust is generally not used in this situation as the donor's family ultimately receives the assets in the CLT.

One type of CLT (a grantor charitable lead trust) allows for a one-time charitable income tax deduction; however all income received in the trust thereafter is taxable to the grantor. A second CLT (a non-grantor charitable lead trust) does not allow for the income tax deduction, and the income earned in the trust is taxable to the trust after a deduction for amounts paid to the charity.



Charitable Giving Techniques (continued)

Gifts of IRAs, Annuities and Qualified Plans to Charities

Annuities, IRAs, Qualified Plans, even savings bonds, are all subject to income tax upon transfer to the beneficiary as well as being included in the estate for estate tax purposes. In some cases, a beneficiary could see up to 75% of the assets lost to a combination of income and estate taxes. On the other hand, when these assets are distributed to a charity at death, no income or estate tax is due on them. If your plans include charities, consider these assets first.

To learn more about simultaneously securing a lifetime income, saving taxes and benefiting a charity, call your Commerce Trust relationship manager for a complimentary copy of "Understanding Charitable Remainder Trusts."

Some strategies may also be available through the charitable organization(s) you select. These include Charitable Gift Annuities, Pooled Income Funds and Donor-Advised Funds.

Non-Charitable Gifts

What about gifts to non-charitable entities or persons? Your children or grandchildren, for instance. How can you make the most of your gifting and ensure that those gifts will increase your children's wealth and not be squandered?

People give to children and other beneficiaries basically for two reasons. First, is a desire to see the children enjoy some of the wealth that the parent has accumulated. Second, a need to reduce estate taxes. There are many techniques for making gifts to children and other beneficiaries, some more efficient than others.

It is important to begin with an understanding of the gifting limitations. Giving too much can create gift and/or estate tax problems and could incur an actual gift tax liability. There are two limitations you should understand.

Annual Exclusion Gifts

Each one of us is entitled to give up to \$11,000 per year to any number of other individuals without any gift tax consequence. This is called an *annual* exclusion gift. A couple can combine their exclusions and make a gift of \$22,000. It is important to note that the gift is not taxable to the donee, but is also not a deduction for income tax purposes for the donor.

Annual exclusion gifts are one of the most powerful and flexible of all estate tax savings techniques. It's flexible because if you make an \$11,000 gift this year, you can make a smaller gift or none at all next year. It's powerful because of its ability to save estate tax. If you have more than \$1,500,000 in assets today, you could very well be subject to estate tax of up to 47%. In that situation, you can make a gift of \$11,000 to a child, and that child will not only receive the \$11,000, but if the funds

are wisely invested, they may grow substantially before your death, and no amount of estate tax would have reduced the value of the gift. On the other hand, if you are in this situation, and you fail to make such a gift, then at your death, that \$11,000 would be reduced to \$5,830 in your child's hands.

Unlimited Tuition and Medical Exclusion Gifts

In addition to annual exclusions, you may also pay for medical expenses or tuition for a beneficiary. Amounts paid directly to the institutions do not count toward your gift limitations. So, you can write a check to the university for your grandchild's tuition this year and still send the grandchild a check for \$11,000 as an annual exclusion gift.

Lifetime Exemption Gifts

The second limitation, the lifetime exemption, allows an individual to utilize a portion of the estate tax exemption, up to \$1,000,000, to make gifts prior to death. If a parent gifted a \$300,000 house to a child in January 2004 and died in December 2005, there would still be \$1,200,000 of the \$1,500,000 estate tax exemption to protect the remaining assets. No gift tax would be paid on the \$300,000 house, and any appreciation will also escape tax. This is in addition to annual exclusion gifts.

Enhancing the Power of Gifts

Simple annual exclusion gifts, and gifts of the lifetime exemption, can go a long way to minimizing your estate tax. However, for individuals with substantial estates, there are more sophisticated ways of making gifts that can leverage the value of the exclusions as well as put some amount of control and limitations on how the gift is used.

Non-Charitable Gifts (continued)

529 College Savings Plans

A recent popular gifting technique allows you to maximize your annual exclusions while providing funds for a child or grandchild's education (or any other beneficiary). Section 529 of the IRS Code (hence the name of the technique) allows a couple to combine 5 years worth of annual exclusion gifts and contribute up to \$110,000 to a state administered fund for a beneficiary in one year. (If the donor dies within 5 years of making the gift, a portion of the gift, but none of the growth, will be added back into the estate for estate tax calculations.)

The funds grow tax deferred, and if used for qualified education expenses, are tax free. Amounts not used for qualified purposes are subject to income tax as well as a 10% penalty on any growth.

While most annual exclusion gifts are irrevocable with no strings attached, a 529 college savings plan gift is quite flexible. The donor may change the beneficiary (within a family radius), or may even recoup the funds (subject to the income tax and 10% penalty -- but only on the growth).

While every state has at least one such plan, individuals are not generally obligated to attend school within the state for which their plan is administered.

Family Limited Partnerships and Limited Liability Companies

Family Limited Partnerships (FLP), which offer an efficient way of leveraging the value of both the annual and lifetime exclusions while keeping some amount of control over the assets contributed to the entity, have come under much IRS scrutiny in the past few years, yet remain apparently valid techniques if properly executed.

Generally, a FLP is formed by a family with business, real estate or investment property for the purpose of managing those assets among the family. Typically the entity is governed by a 1 or 2% general partnership interest (or managing member of a LLC). The other 99% are limited interests with no right in the management of the entity. Because of this lack of control and other factors, the value of the partnership interests is often much less than the underlying value of the assets composing the entity. For example, if a family farm is worth \$1,000,000, but is owned within a FLP, a 3% interest in the farm may not be actually worth \$30,000, but might instead be discounted by 35% to \$19,500. Now the original owner and spouse can make a gift of 3% without exceeding their annual exclusion.

Other Gifting Techniques

- Gift Annuities/Pooled Income Funds
- Generation Skipping Trust
- Qualified Personal Residence Trust
- Donor Advised Funds
- Grantor-retained Annuity Trust
- Private Annuity

Act NOW to secure benefits for the 2005 tax year!

- Is a large percentage of your net worth concentrated in a current or former employer's company stock?
 - Are your investment objectives shifting to income needs rather than growth despite your having a highly appreciated stock portfolio?
 - Are you a business owner whose heirs are geographically dispersed and likely to sell the business after inheriting it?
 - Do you have a large qualified retirement plan from your employer and wish to improve control of distributions to heirs?
 - Do you need to establish a secure lifetime income for a disabled or financially irresponsible child?
 - Would you like to create an ongoing family philanthropic program?
 - Has it been more than three years since you last reviewed for estate and gifting plans?
- If you answered "yes" to any of these questions, consult with your Commerce Trust representative today to see how you may benefit from one or more gifting strategies.**

Locations

ST. LOUIS

METROPOLITAN OFFICES

CLAYTON

8000 Forsyth Boulevard
Clayton, MO 63105-0156
TEL 314-746-7329

DOWNTOWN

One Metropolitan Square
211 North Broadway
St. Louis, MO 63102-2733
TEL 314-746-8921

TOWN & COUNTRY

1090 S. Woodsmill Plaza
Suite 200
Town and Country, MO 63017-
0606
TEL 314-746-5070

ST. PETERS

435 Mid Rivers Mall Drive
St. Peters, MO 63376
TEL 636-949-8409

MISSOURI OFFICES

COLUMBIA

2000 Bernadette Drive
Columbia, MO 65203
TEL 573-886-5324

JOPLIN

211 S. Main Street
Joplin, MO 64801
TEL 417-626-4000

SPRINGFIELD

1345 E. Battlefield
Springfield, MO 65804-3603
TEL 417-837-5261

ST. JOSEPH

328 Felix
St. Joseph, MO 64501
TEL 816-236-5700

ILLINOIS OFFICES

BLOOMINGTON

120 North Center Street
Bloomington, IL 61701
TEL 309-823-7000

PEORIA

416 Main Street
Peoria, IL 61602
TEL 309-676-1311

KANSAS CITY

METROPOLITAN OFFICES

DOWNTOWN

922 Walnut
Kansas City, MO 64106
TEL 816-234-2552

COUNTRY CLUB PLAZA

118 West 47th Street
Kansas City, MO 64112
TEL 816-234-2900

LEAWOOD

11405 Nall Avenue
Suite 200
Leawood, KS 66211
TEL 816-234-1916

KANSAS OFFICES

GARDEN CITY

215 North Main
Garden City, KS 67846
TEL 620-276-5600

HUTCHINSON

101 E. 30th
Hutchinson, KS 67502
TEL 620-669-3000

LAWRENCE

1500 Wakarusa Drive
Lawrence, KS 66047
TEL 785-865-4748

MANHATTAN

727 Poyntz Avenue
Manhattan, KS 66502
TEL 785-587-1541

PITTSBURG

100 S. Broadway
Pittsburg, KS 66762-0326
TEL 620-231-8400

WICHITA

1551 N. Waterfront Parkway
P.O. Box 637
Wichita, KS 67201
TEL 316-261-4918

July 2005