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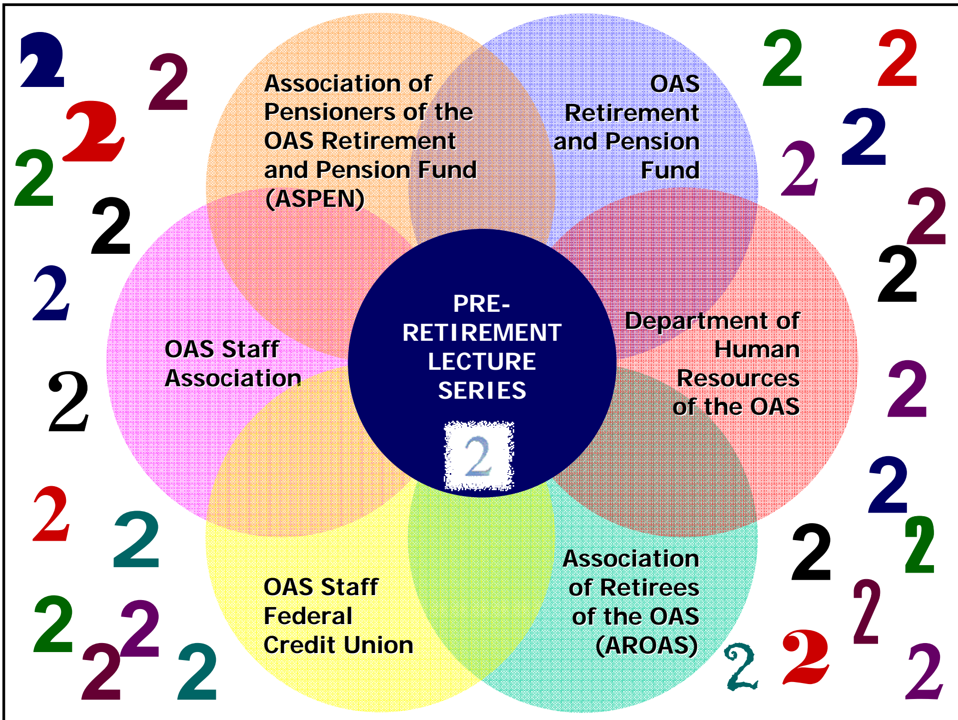
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Pre-Retirement Lecture Series:
II. Legal Matters

Presents:

William M. Berenson, Esq.

& the OAS Retirement and Pension Fund

November 16, 2006

Washington, DC

Observations on Estate Planning

CHAPTER I:
BASIC INSTRUMENTS AND WHYS AND WHEREFORES

I. What is Estate Planning?

II. Why Bother With an Estate Plan. Do you really Care? Should You?

a) Provide for orderly management of assets and affairs upon mental incompetence and or other mental or physical disability. (Powers of Attorney – Medical and Durable; Living Trust)
b) Provide for orderly management of disposition of assets upon death:

CHAPTER I (Continued)

III. If you do not want to think about dispositions at Death, at least do the following:

a) Inform several persons whom you trust where your important papers are kept
b) Think about whether you need Powers of Attorney While Alive

1. Medical Power of Attorney
2. General Durable Power of Attorney
3. Living "Inter-vivos" Trust

CHAPTER I (Continued)

IV. Do you Need a Will?

a) Advantages of Will
b) Disadvantage of Will
c) Will Substitutes

- Pension Plan: Direct Designation of Beneficiaries
- Insurance: Direct Designation of Beneficiaries
- Joint Tenancy with right of survivorship (but not tenancy in common): property automatically vested in survivor(s).
- Tenancy by the entirety – husband and wife only (residence, other real estate): property automatically vested in survivor.
- POD In Virginia, you can designate on brokerage accounts and bank accounts the "Payee on Death".
- IRA's: Roth and Traditional
- Law of Intestacy: State writes your will
- Living Trusts

CHAPTER I (Continued)

IV. Do you Need a Will? (continued)

d) More on Law of Intestacy: Statutory Examples
e) More on Living Trusts (Inter-vivos Trusts)

1. Revocable Trusts
2. Irrevocable Trusts

V. The Estate Plan

The Estate Plan is an attempt to coordinate all the above vehicles into disposing of your assets at death and for providing for their management in case of your incapacity during your life time. Very few people with the assets you have rely solely on a Will or solely on an Inter-vivos trust or the laws of intestacy to dispose of all their assets. They use some or nearly all the above vehicles to achieve their objectives.

CHAPTER I (Continued)

VI. Defeating or Rectifying the Undesirable Consequences of Bad (or no) Planning

a) Disclaimers
b) Forced Share
c) Other Post Mortem Planning Devises

1. Qualified Domestic Trust (QDOT)
2. Qualified Terminable Interest Trust (QTIP)

VII. The Importance of Selecting Trustworthy Fiduciaries

CHAPTER I (Continued)

VIII. Defeating or Rectifying the Undesirable Consequences of Bad (or no) Planning

A. Applicable to:

a) Persons domiciled outside U.S. with property in U.S.
b) Persons domiciled in U.S. with real estate outside U.S.

B. General Rule: Law of where Real Estate is located governs its disposition; law of domicile of owner governs disposition of personal property, regardless of its location.

CHAPTER I (Continued)

C. Consult lawyer of your domicile if you are domiciled outside U.S.

1. Whether country of domicile will honor U.S. Will and/or Will Substitutes for personal property and real estate in the United States
2. Whether by way of Will in country of domicile, you can overrule law of intestacy or community property in that country, and if so, to what extent.
3. Estate tax obligations under the laws of that country

D. For U.S. Domiciles with real estate outside the U.S., consult with lawyer of country where real estate is located:

1. Whether that country will honor a U.S. Will and/or will substitute for disposition of that property.
2. Whether you can use a Will executed in that country to overrule law of intestacy or community property of that country.
3. Estate tax obligations under the laws of that country.

CHAPTER II: Tax Planning

Gross Estate:

The value of all property in decedent's estate on date of death. It also includes value of all gifts given by descendent in his lifetime, less those exempted as described below (spousal gifts, individual gifts up to $11thousand each per year, charitable donations).

Taxable Estate

Amount of estate subject to taxation after adjusting the Gross Estate for administrative expenses and other deductions.

CHAPTER II: Tax Planning (continued)

Federal Estate and Gift Tax

- This is a tax imposed by U.S. Government on the Taxable Estate of an Individual.
- The tax is graduated: For example, if taxable estate is less than $10,000, it is 18%; $750,000 but not over $1,000,000, the tax is $248,300 plus 39% of the amount over $750,000; if the estate is over $2,000,000, the tax is $780,800 plus 46% of the excess over $2,000,000. See Section 2001 of the Internal Revenue Code ("IRC"), 26 U.S.C. Sec. 2001 for other tax brackets. [1]

Resident alien for Estate Taxes:

An alien (non-U.S. Citizen) "domiciled" in the United States at time of death. "A person acquires a domicile in a place living there, even for even a brief period of time, with no definite present intention of late removing therefrom. See 26 CFR Sect. 20.0.1(b)(1**Most G-4s are considered residents for estate tax purposes under this definition.**

[1] These rates are in force for 2005. The top rate will decrease to 45% by 2007.

CHAPTER II: Tax Planning (continued)

Non-Resident Alien for Estate Taxes:

Individual who is not a U.S. Citizen or not a Permanent Resident (green card) and is domiciled outside United States.

Non-U.S. Citizen Spouse:

Spouse of decedent who is not a U.S. citizen.

Assets Located Outside the United States:

For Non-resident alien, includes all property physically outside the United States and the following property physically located in the United States: proceeds of insurance policies; most bank accounts, certificates of deposit, and other interest bearing portfolio debt instruments; works of art on loan in exhibition. See IRC, Secs. 2105 and 870(h)

CHAPTER II: Tax Planning (continued)

Joint Interests in Property:

Property held jointly with right of survivorship, including tenancies by the entirety. Does not include tenancies in common (divided interests in same property without right of survivorship). The value of entire property is included in decedent's gross estate, less part attributed to consideration paid by survivor. See IRC, Sec. 2040(a)

Qualified Joint Interests:

Joint Interest in Property held by Husband and Wife.. Half of value is included in gross estate of decedent. Where spouse is non-U.S. Citizen, there can be no "qualified joint interest" in property acquired jointly after 1988. See IRC, Sections 2040(b) and 2056(d)(1)(B).

CHAPTER II: Tax Planning (continued)

Powers of Appointment:

A General Power is a power of decision over assets which the decedent can exercise in his own favor, in favor of his creditors, or of his estate. *The value of the assets subject to the power are includible in the decedent's gross estate, unless they lapse prior to death or are otherwise limited as follows*: (i) by an ascertainable standard relating to the health, education, support, or maintenance of the decedent, or (b) may be exercise only in conjunction with another person who is either the original grantor of the power or has adverse interests to those of the decedent.

Marital Deduction:

All direct gifts and gifts in trust to spouses by way of a qualified trusts for the benefit of the spouse are eligible for the marital deduction. The deduction is the value of the gift. It is deducted from the gross estate so as not to be included in the final taxable estate.

CHAPTER II: Tax Planning (continued)

Qualified Domestic Trust:

Trust established for benefit of Non-U.S. Citizen Spouse in will, trust document, or within nine months following death of decedent. Amount placed in trust – the Principal -- is exempt from Estate Tax until withdrawn or surviving spouse dies.

Tax-free Gifts:

These include annual gifts of up to $11,000 ($22,000 if made by husband and wife) per donee; payment of another's educational expenses and medical expenses; gifts to qualified charities.

CHAPTER II: Tax Planning (continued)

Unified Credit (Applicable Credit Amount):

Credit to be taken by every individual against the tax owed on his/her taxable estate.

a)For non-resident alien, it is $13,000, thus exempting $60,000 of the taxable estate from taxation.

b)For U.S. Citizen and resident alien (U.S. domicile, including most G-4s), it is presently the amount which would result in the exclusion of $2 million from the taxable estate.

State Death Tax (Often a Sponge Tax).

Today in most states, the State Death Tax is the amount of the Federal State Death Tax Credit. For an estate of $2 million, it is about 8%. The maximum is 16%.

State Inheritance Tax (Maryland):

Maryland has a 10% inheritance tax that applies to all assets left to persons other than lineal heirs. Lineal heirs are children and grandchildren and parents; not brothers, nieces, friends, etc. The 10% tax may be taken as a credit against the Estate Tax.

Example
Computation of Federal Estate Tax
(SEE SPECIAL MATERIALS)

Federal Estate Tax Computation: Simple Case

US CITIZEN OR RESIDENT WITH US CITIZEN SPOUSE

Ana Banana, a former OAS employee residing in the United States of America, dies in 2006 with $3.1 million in assets. Her husband Ben has $2 million in assets in his own name at the time of her death. Expenses of probate, funeral expenses, and other deductions amount to $100,000. She is survived by Ben, a U.S. Citizen. Ben dies in 2007. He has $150,000 in deductions at death and had made $50,000 in lifetime gifts not exempt from the gift tax.

Federal Estate Tax Computation: Simple Case

Variation No. 1

Ana has an "I Love You" Will and leaves everything to her dearly beloved husband Ben, and if he does not survive her, to her two dear children, Ripe and Rotten.

Upon Ana's Death	
Gross Estate	$3,100,000
Deductions	
Charitable Gifts	$75,000
Funeral, Probate	$25,000
Marital Deduction	$3,000,000
TOTAL	($3,100,000)
Taxable Estate	$0
Estate Tax Due	$0

Upon Ben's Death	
Gross Estate	
Remaining from what Ana Left	$3,000,000
Ben's Other Assets	$2,000,000
Ben's Lifetime Gifts	$50,000
TOTAL	$5,050,000
Deductions	
Charitable Gifts	$100,000
Funeral, Probate	$50,000
TOTAL	($150,000)
Taxable Estate	$4,900,000
Before Credit Tax	$2,085,800
Credit	($780,800)
After Credit Tax Owed	$1,305,000

Federal Estate Tax Computation: Simple Case

Variation No. 2

Same facts as Variation No. 1, but Ben disclaims $2 million that then passes, by the will in equal shares to the children and he remains with her $1 million inheritance.

Upon Ana's Death	
Gross Estate	$3,100,000
Deductions	
Charitable Gifts	$75,000
Funeral, Probate	$25,000
Marital Deduction	$1,000,000
TOTAL	($1,100,000)
Taxable Estate	$2,000,000
Before Credit Tax	$780,800
Unified Credit	($780,800)
After Credit Tax Owed	$0

Upon Ben's Death	
Gross Estate	
Remaining from what Ana Left	$1,000,000
Ben's Other Assets	$2,000,000
Ben's Lifetime Gifts	$50,000
TOTAL	$3,050,000
Deductions	
Charitable Gifts	$100,000
Funeral, Probate	$50,000
TOTAL	($150,000)
Taxable Estate	$2,900,000
Before Credit Tax	$1,085,800
Credit	($780,800)
After Credit Tax Owed	$405,000

Federal Estate Tax Computation: Simple Case

Variation No. 3

Same as Previous Example, but Anna leaves $2 million to family trust, income to Ben for Life, principal to children in equal shares upon Ben's Death and $1 million in Marital Trust (or outright gift) to Ben.

Upon Ana's Death	
Gross Estate	$3,100,000
Deductions	
Charitable Gifts	$75,000
Funeral, Probate	$25,000
Marital Deduction	$1,000,000
TOTAL	($1,100,000)
Taxable Estate	$2,000,000
Before Credit Tax	$780,800
Unified Credit	($780,800)
After Credit Tax Owed	$0

Upon Ben's Death	
Gross Estate	
Remaining from what Ana Left	$1,000,000
Ben's Other Assets	$2,000,000
Ben's Lifetime Gifts	$50,000
TOTAL	$3,050,000
Deductions	
Charitable Gifts	$100,000
Funeral, Probate	$50,000
TOTAL	($150,000)
Taxable Estate	$2,900,000
Before Credit Tax	$1,085,800
Credit	($780,800)
After Credit Tax Owed	$405,000

NOTE DIFFERENCE WITH PRE OR POST MORTEM PLANNING:
SAVINGS: $900,000 IN FEDERAL ESTATE TAXES

Federal Estate Tax Computation: Resident Alien/U.S. Citizen with Non-U.S. Citizen Spouse

Variation No. 4

Same fact as variation No. 1 except that Ben is not U.S. Citizen. There is an I Love You Will without a QDOT.

Upon Ana's Death	
Gross Estate	$3,100,000
Deductions	
Charitable Gifts	$75,000
Funeral, Probate	$25,000
Marital Deduction	$0
TOTAL	($100,000)
Taxable Estate	$3,000,000
Before Credit Tax	$1,230,800
Credit	$780,800
After Credit Tax Owed	$450,000

Upon Ben's Death	
Gross Estate	
Remaining from what Ana Left	$2,650,000
Ben's Other Assets	$2,000,000
Ben's Lifetime Gifts	$50,000
TOTAL	$4,700,000
Deductions	
Charitable Gifts	$100,000
Funeral, Probate	$50,000
TOTAL	($150,000)
Taxable Estate	$4,550,000
Before Credit Tax	$1,928,300
Credit	($780,800)
After Credit Tax Owed	$1,147,500
Total Ana & Ben Taxes	$1,597,500

Federal Estate Tax Computation: Resident Alien/U.S. Citizen with Non-U.S. Citizen Spouse

Variation No. 5

Same as above Variations Nos. 2 and 3 , but Ben is not a U.S. Citizen and Ana leaves $2 million to family Trust, income to Ben for life, principal to children in equal shares upon Ben's death and $1 million in QDOT to Ben and Ben becomes citizen.

Upon Ana's Death	
Gross Estate	$3,100,000
Deductions	
Charitable Gifts	$75,000
Funeral, Probate	$25,000
Marital Deduction	$1,000,000
TOTAL	($1,100,000)
Taxable Estate	$2,000,000
Before Credit Tax	$780,800
Unified Credit	($780,800)
After Credit Tax Owed	$0

Upon Ben's Death	
Gross Estate	
Remaining from what Ana Left	$1,000,000
Ben's Other Assets	$2,000,000
Ben's Lifetime Gifts	$50,000
TOTAL	$3,050,000
Deductions	
Charitable Gifts	$100,000
Funeral, Probate	$50,000
TOTAL	($150,000)
Taxable Estate	$2,900,000
Before Credit Tax	$1,085,800
Credit	($780,800)
After Credit Tax Owed	$405,000

Federal Estate Tax Computation: Resident Alien/U.S. Citizen with Non-U.S. Citizen Spouse

Variation No. 6

Same as Variation No. 5 except that Ben never becomes Citizen before his death.

Upon Ana's Death	
Gross Estate	$3,100,000
Deductions	
Charitable Gifts	$75,000
Funeral, Probate	$25,000
Amount in QDOT	$1,000,000
TOTAL	($1,100,000)
Taxable Estate	$2,000,000
Before Credit Tax	$780,000
Unified Credit	($780,800)
After Credit Tax Owed	$0

Upon Ben's Death	
Gross Estate	
Principal in QDOT	$1,000,000
Ben's Other Assets	$2,000,000
Ben's Lifetime Gifts	$50,000
TOTAL	$3,050,000
Deductions	
Charitable Gifts	$100,000
Funeral, Probate	$50,000
TOTAL	($150,000)
Taxable Estate	$2,900,000
Principal of QDOT	$1,000,000
Tax on Principal of QDOT	$450,000
Rest of Taxable Estate	$1,900,000
Tax on Rest of Taxable Estate	$735,800
Credit	($780,800)
After Credit Tax on Rest of Estat	$0
Total Estate Tax Owed	$450,000

Federal Estate Tax Computation: Non-Resident With Assets in the U.S.

Variation No. 7

Assume Ana and Ben move back to Montevideo and they are both Uruguayan Nationals and neither is a U.S. Citizen or Permanent Resident. Both maintain joint ownership of a condominium house in McLean with $1,000,000. Their Condominium in Pocitos is worth $300,000. Ana has another $800,000 in an off shore stock fund and $1 million in bonds and income bearing instruments in the United States. Ben has an off-shore stock fund of $1,000,000, U.S. stocks worth $200,000, and U.S. certificates of deposit worth $300,00. Ana dies first in 2006. Ben dies in 2007.

Federal Estate Tax Computation: Non-Resident With Assets in the U.S.

Variation No. 7

Upon Ana's Death (dies in 2006)	
Gross Estate	
Condo in McLean	$1,000,000
Condo in Pocitos ($300K)	Excluded
Off shore fund ($800K)	Excluded
Bonds and interest bearing ($1M)	Excluded
TOTAL	$1,000,000
Deductions	
Charitable Gifts	$75,000
Funeral, Probate	$25,000
TOTAL	($100,000)
Taxable Estate	$900,000
Before Credit Tax	$306,800
Unified Credit	($13,000)
Credit for Foreign Death Tax	($30,000)
After Credit Tax Owed	$213,000

Upon Ben's Death (dies in 2007)	
Gross Estate	
Condo in Pocitos	Excluded
Condo in McLean	$1,000,000
Off Shore Stock Funds ($1.8M)	Excluded
U.S. Stocks	$200,000
U.S. CDs and Bonds ($1.07 M)	Excluded
Gifts Made in U.S.	$50,000
TOTAL	$1,250,000
Deductions	
Charitable Deductions	$125,000
Funeral, Probate	$25,000
TOTAL	($150,000)
Taxable Estate	$1,100,000
Before Credit Tax	$406,300
Unified Credit	($13,000)
Credit for Foreign Death Tax	($30,000)
After Credit Tax Owed	$373,300
Total Tax Paid by Ana and Ben	$586,300

Recommendation: To minimize Estate Tax Liability, Non-U.S. residents should move assets out of U.S. property in nontaxable items-bonds and interests bearing certificates. Real property and stocks in U.S. will generate unwanted Estate Tax and Income Tax Liability

Federal Estate Tax Computation: Comparative Table

TOTAL FEDERAL ESTATE TAX PAID BY THE BANANA FAMILY

Var. 1	Var. 2 & 3	Var. 4	Var. 5	Var. 6	Var. 7
$1,305,000	$405,000	$1,597,500	$405,000	$450,000	$586,000

Var. 1: U.S. Citizen Surviving Spouse, Both Residents, No Planning

Var. 2: U.S. Citizen Surviving Spouse, Both Residents, Planning with Disclaimers

Var. 3: U.S. Citizen Surviving Spouse Both Residents, Planning with Trusts

Var. 4: Non-U.S. Citizen Surviving Spouse, Both Residents, No Planning

Var. 5: Non-U.S. Citizen Surviving Spouse with QDOT, Surviving Spouse Becomes Citizen Prior to Distribution of Principal

Var.6: Non-U.S. Citizen Surviving Spouse with QDOT, Surviving Spouse Does Not Become Citizen Prior to Distribution of Principal

Var. 7: Both non-U.S. Residents and Non-U.S. Citizens Living in Uruguay with Real Estate and Some Stock in U.S.

Basic Estate & Gift Tax Planning Tips

Basic Estate and Gift Tax Planning Tips

Basic Rule:

YOUR OBJECTIVE IS TO MINIMIZE YOUR ESTATE AND GIFT TAX OBLIGATION

Reduce Gross Estate:

The smaller the gross estate, the smaller the tax. (These Comments are applicable principally to U.S. Citizens, Permanent Residents, and other Resident Aliens – i.e., G-4s)

Basic Estate and Gift Tax Planning Tips (continued)

Basic Rule:

YOUR OBJECTIVE IS TO MINIMIZE YOUR ESTATE AND GIFT TAX OBLIGATION

Reduce Gross Estate:

The smaller the gross estate, the smaller the tax. (These Comments are applicable principally to U.S. Citizens, Permanent Residents, and other Resident Aliens – i.e., G-4s)

The basic strategy is to move assets you own out of your estate during your lifetime by inter-vivos transfers. Most gifts you make to your wife, although exempt from the gift tax, will be included in her gross estate if she does not consume them or give them away to another prior to her death. Thus, the best strategy is to give them to someone other than your spouse. Of course, in most cases, gifts should be made only of items you and your spouse will not need.

Basic Estate and Gift Tax Planning Tips

The Basic Strategy (continued)

- ✓ Give away life insurance policies to children or to irrevocable life insurance trust (Crummy Trust).
- ✓ Make Annual Gifts up to the limits allowed ($11,000/$22,000).
- ✓ Pay for medical expenses of parents and other dear ones.
- ✓ Pay for educational expenses of grandchildren, other dear ones.
- ✓ Make Charitable Gifts.
- ✓ Make gifts of appreciating assets at their present value so that the appreciated value will not soak up your unified credit.
- ✓ Establish an inter-vivos Charitable Remainder Trust.
- ✓ Establish Qualified Personal Residence Trust

Basic Estate and Gift Tax Planning Tips

The Basic Strategy (continued)

- ✓ Establish Other kinds of Irrevocable Trusts which will result in appreciating asset having lower value at time of your death but from which you may enjoy the income prior to death: GRITS, GRUTS, etc.
- ✓ Establish Family limited Partnership: Gift of assets into partnership results in substantial discounts in valuation for gift tax valuation.
- ✓ Sell your residence to your children for arms length price and rent it back from them at arms length rent, hopefully, so as to pay mortgage loan. You can be the mortgage lender and forgive up to $22,000 of mortgage owed each year for each child who bought the house from you as an annual tax free gift.

Basic Estate and Gift Tax Planning Tips

Special Tips for Non Resident Aliens for reducing Gross Estate

- Keep stocks and other taxable assets outside United States, in off shore trusts or in home country. An off-shore trust is a trust over which a foreign fiduciary has substantial control regarding trust decisions and which is not subject to the administrative supervision of a U.S. court. In short, it is a trust outside the territory of the United States (Cayman, Bahamas, etc.) with a non-U.S. citizen/resident trustee.
- Limit assets in United States to those which are not taxable: insurance, portfolio interest bearing debt (mortgages, bonds), certificates of deposit, bank and credit union accounts, insurance policies.
- Sell or make annual tax free gifts of your real estate in the United States.

Basic Estate and Gift Tax Planning Tips

Take advantage of Most Favorable Valuation Date: Six months after date of death, date of sale within six months after date of death, date of death

Make Sure You Maximize Your Unified Credit

1. If you leave everything to your spouse, you will waste your unified credit, because everything your spouse receives is deducted from your gross estate to arrive at your taxable estate against which to apply the credit.
2. If you leave everything to a charity, you will waste your unified credit because gifts made to qualified charities, religious, and educational institutions are deducted from your gross estate to arrive at your taxable estate. If you have no gross estate, you will have no taxable estate against which to apply the credit.

Basic Estate and Gift Tax Planning Tips

Make Sure You Maximize Your Unified Credit (Continued)

3. Make sure you have enough in your estate to fund testamentary and life time gifts to exhaust your unified credit (presently $2 million).

4. Make sure your spouse has enough in her present estate to fund life-time and testamentary gifts to exhaust her unified credit if she/he pre-deceased. This may require shifting assets between spouses and dividing property currently held in joint tenancy with right of survivorship or by the entirety with your spouse – i.e. retitle home in name of with less assets, title your brokerage account in your name; name beneficiaries to IRA or pension other than your spouse.

Basic Estate and Gift Tax Planning Tips

Vehicles for Maximizing Unified Credit

1. Family Trust as in a Living Trust (Intervivos trust) funded all or in part during lifetime or all or in part by way of a Pour-Over Will or the proceeds of an IRA or insurance policies naming the Trust the beneficiary in amount of Unified Credit (formula): Income to spouse and children while spouse is alive, principal to children or grandchildren if children do not survive decedent.
2. Testamentary gifts made directly to individuals other than spouse upon death up to amount of Unified Credit (including a testamentary family trust established in will and funded with assets passing under will, insurance policies, IRAs, etc).
3. Inter-vivos gifts against Unified Credit
4. Combination of all of the following.

Basic Estate and Gift Tax Planning Tips

Vehicles for Maximizing Unified Credit (continued)

5. Example of Savings that can be achieved through maximizing use of Unified Credit for a Couple with a $4,000,000 Taxable Estate.

Year	Unified Credit Credits of Both	Tax When Using Both Credits	Tax When Using Only one Credit	Tax Savings From Use of Two
2006	$4,000,000	$0	$780,800	$780,800

6. Other Exemptions:
The Code provides for additional exemptions with regard to certain businesses, such as the family farm. These are covered in Section 2032A of the Code and are beyond the scope of this summary.

Basic Estate and Gift Tax Planning Tips

After assuring You have Maximized Universal Credit, Maximize your Marital Deductions

1. Leave balance of estate to Spouse outright.
2. Leave balance of estate to Spouse outright in Qualified Terminable Interest Trust or other form of qualified trust.

Charitable Deductions:

After assuring you have used spousal deductions to the fullest extent you wish, or if you have no spouse, consider providing charitable deductions by way of will, or inter-vivos gifts outright or in trust to charitable organizations: schools, churches, hospitals and other qualified non-profit organizations (IRC, Sections 501(C)(3), 170, 2055

Basic Estate and Gift Tax Planning Tips

Other Issues:

- Avoiding Generation Skipping Tax Liability. Tax of 55% of disposition if gift is given to grandchildren directly intentionally bypassing children. Does not apply if parent of grandchild predeceased decedent or if parent voluntarily disclaims disposition and it possesses to grandchild by way of the disclaimer. Each person is entitled to a $1,000,000 exemption from the Generation Skipping Tax.
- Correcting mistakes or defeating tax planning by way of disclaimers.
- For persons with Non-Citizen spouses, IRS Rules in CFR set out procedures for placing Pension annuity and lump sum distributions in a Qualified Domestic Trust and for treatment of distributions so as to take advantage of the limited marital deduction for those benefits. See 20 CFR Sec. 2056A-4(b)(7).

Computing Taxable Amount of Lump Sum and Pension for U.S. Citizen/Resident

Computing Taxable Amount for Lump Sum/Pension for U.S. Citizen/Resident

Ana Banana retires at age 65 with $2,000,000 in the Fund. She purchases a pension of $5,000 per month for 1.1 million. The pension has a COLA feature and the expected adjustment over-time is expected to be 3% a year. The rest she takes out in cash. She was a U.S. taxpayer (resident who signed the waiver or U.S. citizen) during all her 30 years of participation in the Retirement and Pension Fund. Her own contributions to the Fund during the period were some$200,000 and those or the Organization amounted to $400,000.

Computing Taxable Amount for Lump Sum/Pension for U.S. Citizen/Resident

Information Needed:

Total Amount in Pension Fund	$2,000,000
Institutional Contribution	$400,000
Personal Contribution	$200,000
Amount of Lump Sum Payment	$900,000
Amount of Fund Account Used to Fund Pension	$1,100.000
Amount of Annual Pension in first year $60,000	($5,000 per month)

Actuarial Number from Table 1 of IRS Publication No. 175, p. 12[1]: 260
COLA: average of 3%

[1] Table 1 is a simplified actuarial table for single life pensions. If Ms. Banana were also opting for a pension annuity based on her life and the life of her spouse or another dependent, she would have to opt for Table 2 on that same page. The number 260 is an the number of months she is expected to live after reaching age 65, based on US government actuarial tables.

Computing Taxable Amount for Lump Sum/Pension for U.S. Citizen/Resident

Computations:

- Ratio of Her After Tax Cost of Pension Fund Account to total Amount in Account

$$\text{Ratio} = \frac{\text{Personal Contribution}}{\text{Total Account}} = \frac{200{,}000}{2{,}000{,}000} = 0.10$$

- Computation of Tax free portion of lump-sum = Ratio computed in Line #1 above multiplied by amount of lump sum = 900,000 X 0.10 = 90,000. Thus, taxable portion is = 900,000 – 90,000 = 810,000.

Computing Taxable Amount for Lump Sum/Pension for U.S. Citizen/Resident

- To compute the taxable amount of the Pension, she must use the Simplified Method set out in IRS Publication 575, NOT the "General Rule" set out in IRS Publication 939. The Simplified Method is for pensions from Qualified Pension Plans, like our OAS Plan; the General Rule is for non-qualified plan. The Simplified Method works with simplified actuarial tables and can be prejudicial to some recipients and relatively beneficial to others. But the IRS has left us no choice in the matter. We and Ms. Banana must use the Simplified Method.
  a) Cost of Pension = Cost of entire account (her individual contribution) of $200,000 less the cost credited to the lump some distribution ($90,000) = $110,000.
  b) Divide cost of Pension by the corresponding Actuarial Number = 110,000 / 260 = 423. This is the estimated cost basis for Ms. Banana's pension for every month she expects to receive it for her life expectancy
  c) Compute the cost of the pension received in the first year by multiplying the estimated monthly cost, $423, by the monthly payments received. In this case assume 12 monthly payments. $423 X 12 = $5,076

Computing Taxable Amount for Lump Sum/Pension for U.S. Citizen/Resident

d) To compute taxable amount of $60,000 Pension, subtract the $5,076 cost for the year. Thus, taxable amount = $60,000 – $5,076 = $54,924.
e) Note, that if Ms. Banana lives more than 260 months, she will have exhausted her cost basis and the total amount in pension payments she receives thereafter will be fully taxable.

- Taxable amount of Pension for second year. Assume there was a 3% increase in the Pension due to the COLA (60,000 x 0.03 = 1800).

  Taxable amount = Taxable amount for First Year plus 3% COLA = $54,924 + $1800 = $56,224

Computing Taxable Amount for Lump Sum/Pension for U.S. Citizen/Resident

NOW, LET'S CHANGE THE HYPOTHETICAL A BIT AND ASSUME ANA BANANA WAS A G-4 DURING THE TIME SHE PARTICIPATED IN THE FUND BUT PLANS TO APPLY FOR RESIDENCE IN THE U.S. AND RECEIVE HER PENSION AS A U.S. RESIDENT.

The difference would be that the after tax cost of her Fund would be computed not only on the basis of her personal contribution, but the institutional contribution as well, because both were exempt from tax when paid to her account and retain their exempt status.

Computing Taxable Amount for Lump Sum/Pension for U.S. Citizen/Resident

Computations:

- Ratio of Her After Tax Cost of Pension Fund Account to total Amount in Account

$$\text{Ratio} = \frac{\text{Personal Contribution}^3}{\text{Total Account}} = \frac{600{,}000}{2{,}000{,}000} = 0.30$$

- Amount of Lump Sum Payment subject to tax = NONE (in accordance to UN guidelines which we follow), provided Ana still has a G-4 visa when she receives it; or if she does not have the G-4 visa at time of receipt, she is in the USA for less than 183 days in the year of receipt. (For purposes of this calculation, her days in the country with a G-4 visa do not count).

- Computation of part of Pension Fund Account cost allocated to Lump Sum. Multiply Ratio computed in Line #1 above multiplied by amount of lump sum = 900,000 X 0.30 = 270,000.

Computing Taxable Amount for Lump Sum/Pension for U.S. Citizen/Resident

Computations:

- To compute the taxable amount of the Pension, she must use the Simplified Method set out in IRS Publication 575, NOT the "General Rule" set out in IRS Publication 939. The Simplified Method is for pensions from Qualified Pension Plans, like our OAS Plan; the General Rule is for non-qualified plan. The Simplified Plan works with simplified actuarial tables and can be prejudicial to some recipients and relatively prejudicial to others. But the IRS has left us no choice in the matter. We and Ms. Banana must use the Simplified Method.

  a) Cost of Pension = Cost of entire account (her individual contribution of $200,000 and the OAS Institutional Contribution of $400,000) of $600,000 less the cost credited to the lump sum distribution ($270,000) = $600,000 – $270,000 = $330,000.

  b) Divide cost of Pension by the corresponding Actuarial Number = 330,000 / 260 = 1,269. This is the estimated monthly cost basis for Ms. Banana's pension for every month she expects to receive it for her life expectancy

Computing Taxable Amount for Lump Sum/Pension for U.S. Citizen/Resident

Computations:

c) Compute the cost of the pension received in the first year by multiplying the estimated monthly cost, $1,269, by the monthly payments received. In this case assume 12 monthly payments. $1,269 X 12 = $15,228

d) To compute taxable amount of $60,000 Pension, subtract the $15,228 cost for the year. Thus, taxable amount = $60,000 less $15,228 = $44,772.

e) Note, that if Ms. Banana lives more than 260 months, she will have exhausted her cost basis and the total amount in pension payments she receives thereafter will be fully taxable.

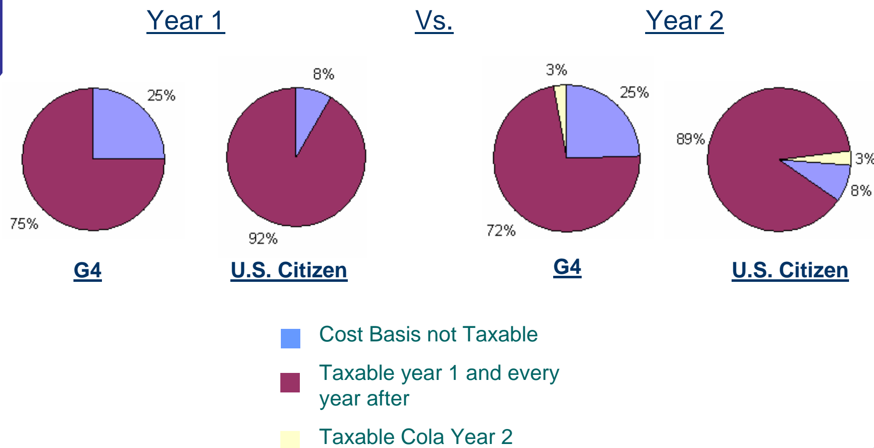
Computing Taxable Amount for Lump Sum/Pension for U.S. Citizen/Resident

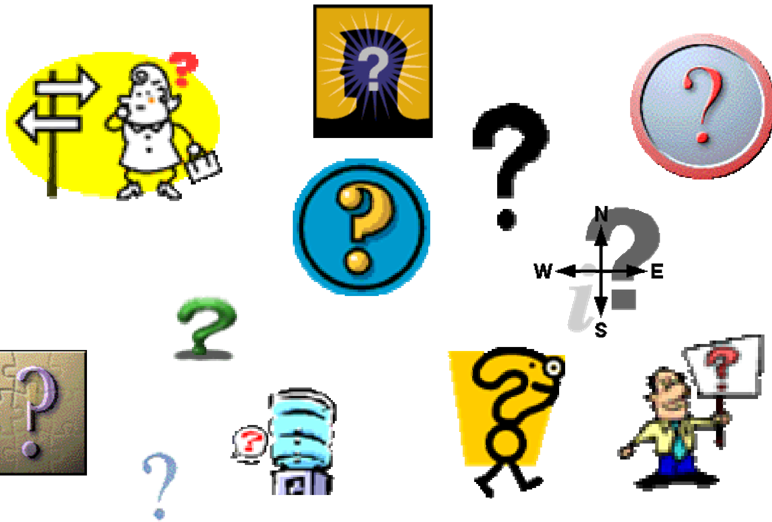
Computations:

- Taxable amount of Pension for second year. Assume there was a 3% increase in the Pension due to the COLA ($60,000 x 0.03 = $1,800). Taxable amount = Taxable amount for First Year plus 3% COLA = $44,728 + $1800 = $46,528

TAXABLE AMOUNT IN EACH CASE WILL VARY WITH TOTAL INCOME FROM OTHER SOURCES, MARITAL STATUS, DEDUCTIONS, EXEMPTION AND DEPENDENTS OF PENSIONER. DON'T FORGET YOU MUST TAKE INTO ACCOUNT STATE TAXES AS WELL – ALMOST 6% in VIRGINIA; OVER 7% IN MARYLAND; AND UP TO 11% in D.C.

Taxable Components of Annual Pension




Questions and Comments?
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