November 6, 2005

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Using Charitable Trusts to Build Family Wealth

There is crispness in the air these days and, to me, this means one thing – the Holiday Season is upon us!

The next several months, for many people, is a special time; a time when people are a little nicer, a little friendlier and a little kinder. It's a time when we focus less on what we don't have and instead find ourselves grateful for what we have. It is a time for family and friends; and a time for goodness and giving. This truly is my favorite time of the year!

Giving is, perhaps, the most basic expression of personal and family values. However, not enough people seem to comprehend the vast benefits that charitable giving can bring to one's self and family. It can be one of the most self-satisfying acts a person can perform and the practice can provide a family much benefit in return for any effort expended. It is the sharing that makes philanthropy a critical factor in the development and preservation of family values – for both their "human" and "intellectual" capital.

Philanthropy, or in the original Greek translation *philosanthropos*, means love of my fellow man. Modern definition would describe a philanthropist as an individual who is a significant supporter of charitable organizations. Yet, I'm sure many people associate the word philanthropy as only relating to the wealthy. Well that's just not true! When we focus on the word "significant", a person can be defined as a philanthropist whenever he or she is doing what is charitably possible according to his or her individual situation.

Wealthy families, however, have less choice in the matter because almost all practice some form of philanthropy. For wealthy families, philanthropy can be voluntary or involuntary and the choice is quite simple. About half of a wealthy person's estate will go to their heirs. And, the other half can either go to the government as taxes or it can go to charity. When it goes to the government, this type of philanthropy is involuntary.

By contrast, doesn't the voluntary kind seem more rewarding and valuable?

As readers of my newsletters well know, wealth management is the ultimate goal of all that we do at Hoffman, White and Kaelber. Yes, we promote our services; yet, you will find that we always seek to present thought provoking topics that are relevant to our wide audience.

This month's newsletter will reflect how one facet of charitable estate planning can offer affluent families more than mere estate planning. Then, as always, we will finish with a review of the economic and investing climate for the month past, the current market outlook and our investment performance.

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Charitable Remainder Trusts

It was 1917 when the US Government first provided an income tax deduction for gifts to religious, charitable, scientific or educational organizations. What was positive about this was that it provided a financial incentive for people to contribute to charitable causes; what made it less than positive was that it became a financial decision from a tax standpoint when and if to give to charity.

Thereafter, it wasn't until the Tax Reform Act of 1969, that Congress gave a clear definition to a tax advantaged arrangement known today as the charitable remainder thrust (CRT).

A charitable remainder trust is a legal arrangement that provides for specified payments to one or more non-charitable entities (the "income beneficiary"), with an irrevocable remainder interest in the trust property to be paid to a charity or charities (the "charitable remainder beneficiary"). Ordinarily, one must contribute total ownership in an asset to receive a charitable tax deduction. However, a handful of exceptions may apply and a CRT is one of them. Assuming that the CRT meets all the IRS requirements, contributions to it generally qualify for a charitable deduction for income, estate and gift tax purposes.

There are two basic types of CRTs – charitable remainder annuity trusts (CRATs) and charitable remainder unitrusts (CRUTs). The major difference between the two relates to how the income beneficiaries are to be paid: A CRAT would pay a fixed amount to income beneficiaries, at least annually, of a sum certain that cannot be less than 5% nor more than 50% of the initial fair market value of all property placed in the trust. Whereas, a CRUT provides for a varying payout, at least annually, based upon a fixed percentage of not less than 5% or nor more than 50% of the net fair market value of its assets as valued annually.

In the case of both trusts:

- There can be to one or more income beneficiaries.
- The term of the payout can be made as either the life or lives of an individual or individuals living at the time the trust is created, or for a term of up to 20 years.
- For new trusts, the remainder interest must meet a minimum value requirement. The value of the remainder interest must equal at least 10% of the: (a) initial fair market value of the property placed in the trust, for CRATs; or, (b) net fair market value of the net fair market value of each contribution as of the date the property is contributed, for CRUTs. The IRS Code provides guidance for calculating these numbers.
- After the term of the payout is completed, the trust principal is irrevocably transferred to the charitable organization.

What Are Some of the Benefits?

Philanthropic. Understanding how to use a CRT in the financial planning process can allow people to create something that lives on long after they are gone. Many people would like to make a charitable gift for various reasons but are not in a financial position to do so or simply do not know how. For a person who has charitable intent, the CRT provides the opportunity to express this desire.

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Tax advantages. Since a CRT is a tax-exempt vehicle, it can sell highly appreciated property without being taxed on the capital gain or ordinary income. Also, just like any other charitable contribution, the CRT gives the donor a current income tax deduction in the amount of the present value of the remainder interest and any of that deduction that is not used in the current year can be carried forward to future years. As an estate planning tool, assets placed in a CRT are not included in the estate of the donor, nor subject to gift taxes. Since the assets would be outside of the estate, this could cause the overall estate to be smaller, which could create compounded tax savings.

Investment advantages. From the perspective of managing one's investments, an individual may own highly appreciated assets in the form of real estate or a closely held business. Often an investor may be reluctant to sell some of their investments in order to diversify or to generate more income because they do not want to recognize a capital gain. If you knew that the value of your assets would drop 20% or more the moment you sold, wouldn't you think twice about selling? Historically, it has been shown that a lack of diversification increases the risk of a portfolio more than the character of the actual investments. Using a CRT allows one to reposition the portfolio without loss due to taxes.

Of course, if taxes and portfolio diversification were the only objectives, a person could employ other strategies that would not involve surrendering ownership of the assets to a charity. However, the CRT makes good sense for the individual who wants to make a charitable gift and has appreciated assets.

Wealth Replacement Example

More often than not, life insurance is purchased to provide financial relief to dependents in the event that a family's breadwinner(s) prematurely dies. This is the most significant use of that product. Yet, in the following example, we'll review an effective planning tool in which the income and/or tax savings from establishing a charitable remainder trust can be used buy life insurance to replace the asset given away. Also, life insurance, when held in an irrevocable insurance trust, allows the death benefit to pass to heirs free of estate taxes.

Example:

Mr. and Mrs. Smith, both age 55 and in excellent health, were recently offered $2 million for their closely held company and an additional $1 million, each year, for a 2 year consulting agreement. Their cost basis in the stock is almost zero and even at a reduced rate of 15%, for federal taxes, and 5.75%, for Virginia state taxes, the tax on capital gains portion would be $415,000. On top of that, they can expect to pay another $450,000 in taxes on the ordinary income generated from the consulting agreement. In addition, they care for their community and would like to make a substantial gift to their favorite charities to support some community needs they feel passionate about.

Their creative thinking financial advisor suggested that they look at a charitable remainder trust to alleviate the tax burden and support their philanthropic wishes. They decide to establish a $2 million charitable remainder unitrust and, using their after-tax income, buy a $2 million second-to-die life insurance policy naming their heirs as beneficiaries.

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November 6, 2005

The suggested action steps look like this:

1. The Smiths create a CRT and transfer their company stock to the trust. At the same time, they arrange for an independent trustee and money manager.
2. When the company is sold, the trust receives $2 million in cash for the company stock.
3. The money manager conservatively invests the cash in a portfolio designed to preserve capital and generate returns to pay the Smiths 7.5% annually.
4. The Smiths contribute approximately $22,000 each year to a wealth replacement trust in order to fund a $2 million second to die life insurance policy.
5. After Mr. & Mrs. Smith are deceased, the remainder interest will be transferred directly to the charities or to a private family foundation designed to assist with the community's charitable needs. And, at the same time, the heirs will receive $2 million on life insurance proceeds tax free.

And, the expected tax and cash flow benefits look like this:

	No CRT	With CRT
Current value of company stock	$ 2,000,000	$ 2,000,000
Taxable cost basis	$ 0	$ 0
Capital gain on stock	$ 2,000,000	$ 2,000,000
Capital gains tax (20.75%)	$ (415,000)	$ -
Capital left for reinvestment (net)	$ 1,585,000	$ 2,000,000
Annual payout (7.50%)	$ 118,875	$ 150,000
Annual life insurance premium	$ -	$ (22,000)
Payout less insurance premium	$ 118,875	$ 128,000
Charitable tax deduction	$ -	$ 238,540
Income tax savings	$ -	$ 107,343
Amount included in estate	$ 1,585,000	$ -
Estate tax (50%)	$ (792,500)	$ -
Life insurance benefit	$ -	$ 2,000,000
Amount passed on to heirs	$ 792,500	$ 2,000,000
Total tax Savings Using the CRT		
Capital gains tax		$ 415,000
Income tax		$ 107,343
Estate tax		$ 792,500
Total savings		$ 1,314,843

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Concluding Thoughts

One of the first axioms of financial planning states, "It's not how much you make that counts; it's how much you keep." In charitable gift planning that phrase could be modified to, "It's not how much you give that counts; it's how much it costs you to give!" This is not to suggest that charitable giving is motivated primarily by tax considerations; however, it does suggest that to be good philanthropic stewards, donors should take full advantage of the tax laws to optimize their gifts.

Hoffman, White & Kaelber Financial Services Investment Performance Update

How much have we been impacted by oil prices? And, are we immune from these effects? I've read and heard arguments that the US and most non US economies have been able to absorb the huge rise in energy prices without much pain. This may be so, yet, we are now approaching winter season and consumers are about feel another pinch from increased costs to heat our homes. So, why do the economists think we haven't felt much pain?

US Gross Domestic Product (GDP), one of our broadest measures of economic activity, was reported to be 3.8% for 3Q 2005. And, given the expectation from higher oil prices and hurricane season, the markets looked at this number as very bullish. Increases in spending by consumers, business and the federal government – hurricanes Katrina and Rita related – contributed to the higher than expected increase in GDP. What is significant is that people kept spending! Spending didn't slow down!

One word of caution in the GDP estimate, however, was that expanding business inventories also contributed to the increase. While inventory increases can signal strength in an economy, it can also signal weakness as well. It can signal weakness when increases in inventories are due to slowing turnover and business hasn't gotten the message yet.

Also this month, the Consumer Price Index (CPI) – including energy and food prices – for September registered up 1.22%. This is its largest monthly increase in over ten years and the measure and is now up 4.47% on a year to date basis. CPI is the most widely cited inflation indicator and is the basis for calculating cost of living adjustments for most US government programs. Inflation is the result of too many dollars chasing too few goods!

For the month ended October 31, 2005, our one-month performance is down 0.17%, our year-to-date return is up 4.03%, and our average annualized return since inception is up 8.36%. By comparison, the S&P500 and Russell 2000 were down 1.77% and down 3.17%, respectively, for the month and both are in negative territory for the year. As well, our portfolio volatility continued to edge down to +/- 5.54% while volatility continued to increase in the equity markets. For more performance information, please see our web site for details.

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