



# Advanced Planning Strategies

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Dear Reader,

The new year will bring a new series of tax debates, particularly with the change in the Senate that will soon provide a narrow majority to the Republican Party. Some issues that we expect will surface in these debates include: (1) tax cuts to stimulate the economy, (2) the acceleration of some of the tax cuts provided by EGTRRA in 2001 that currently are scheduled to phase in gradually, (3) the elimination of the "sunset" provision that terminates the EGTRRA tax-relief provisions in 2011, (4) additional simplification and benefits for tax-advantaged retirement plans, and (5) additional tax benefits for charitable contributions. As always, you can expect to be kept up-to-date with each issue of this letter and will receive a planning summary of the significant provisions of any tax legislation that is enacted.

One of the most interesting and controversial provisions of EGTRRA was the federal estate tax phase-out. After careful examination, the phase-out provisions that provide immediate relief do not necessarily cause a significant reduction in the total taxes paid by an estate, nor will the federal estate tax collected by the IRS initially drop off to any great extent. The reason for this observation is the mechanics of the federal estate tax calculation and the coordination of state estate or inheritance tax. All 50 states and the District of Columbia impose estate or inheritance taxes. A credit is currently allowable (subject to a maximum) against the federal estate tax payable for state estate/inheritance taxes paid. EGTRRA gradually reduces the state death tax credit (for example, the allowable credit for 2003 is only 50 percent of the credit allowable in 2001) and converts the credit to a deduction in 2005.

Many states have responded to these changes to avoid the loss of tax revenue. Some states have separate estate or inheritance taxes that are not coordinated in any manner with the federal estate tax. Other states have "decoupled" their estate taxes from the federal estate tax so the state estate tax will continue to be collected at the maximum allowable state death tax credit, as it existed prior to EGTRRA. This means some estates will face state estate taxes of as much as 16 percent, with only One-half of the state tax allowable as a credit against federal estate taxes in 2003. Finally, some states have provided that the state estate tax will survive even the total repeal of the federal estate tax. Thus, it is clear that individuals with substantial estates are not yet out of the woods with respect to estate or inheritance taxes.

*Knowledge is not power. Only knowledge in use is power.*

## **PRIVATE FOUNDATIONS**

A private foundation is a trust or corporation organized to support the charitable objectives of a family or a group of individuals. The most widely recognized type of private foundation is a family foundation, which is usually set up in trust form. Nonfamily foundations are more typically set up as corporations. Using a trust gives the grantors a greater degree of control over the foundation's affairs, and often avoids the need to observe corporate formalities. The purpose of this letter is to introduce the benefits and planning opportunities associated with family foundations.

### **TYPES OF FOUNDATIONS**

There are many types of private foundations. The most common type, a regular foundation, receives contributions and distributes a portion of its assets each year to various public charities or charitable causes. The primary benefit of a regular foundation is the ability to allow family members or a small group of like-minded individuals to have complete control over the organization and its charitable distributions. A supporting organization is a special type of foundation that is dedicated to supporting the operations of one charity, or several charities with similar objectives. In order to be classified as a supporting organization, control of the entity must be primarily in the hands of nonfamily members, or the foundation must receive financial support from a broad cross-section of the public. An operating foundation is a privately funded organization that is set up for the purpose of operating a charitable activity. Operating foundations may, for example, run museums, preserve historic properties, or conduct research and provide services for charitable purposes.

### **ADVANTAGES OF PRIVATE FOUNDATIONS**

Private foundations offer a number of tax and nontax advantages. The first and most obvious benefit of a private foundation is the ability to coordinate the charitable giving of a family or close group of individuals. Once a private foundation is established, family members can make gifts to the foundation, which in turn can make gifts to charities that support the family's charitable objectives. Centralizing the distribution of charitable funds helps the family clarify and focus its charitable efforts.

A second benefit of a private foundation is that, once created, a foundation can be used as a tool to instill the family's charitable philosophy in the children. Many private foundations allow the family's children to select a charity to receive a small contribution each year. This helps the children develop an ability to make choices among alternatives. A foundation could be used as a tool to teach children how to manage money by allowing them to participate (on an advisory basis only) in making investment decisions for the organization. The combination of these skills can help the younger generation develop the skills necessary to make wise financial decisions for the foundation and, in the future, themselves.

Finally, family members receive a charitable deduction on their personal income tax return. If the gift is made to a private foundation, the maximum amount that can be deducted as a charitable contribution for the year is 30 percent of the individual's contribution base (which equals adjusted gross income, not taking into consideration any net operating loss carrybacks) for gifts of cash, and 20 percent of the individual's contribution base for gifts of highly appreciated stock. Any part of the charitable contribution that could not be used due to the application of these limits can be carried forward to future income tax returns for up to 5 years. If a foundation receives contributions by bequest from an individual's will or by beneficiary designation from a life insurance policy or a retirement plan, the donor's estate will receive a federal estate tax deduction.

Perhaps the most tax-advantaged method for making a contribution to a private foundation is to transfer highly appreciated stock held for more than one year. Gifts of appreciated stock will not result in recognition of gain for income tax purposes, but will give the donor a charitable deduction equal to the fair market value of the stock at the date of the gift. One caution, however, is warranted. If an individual makes a gift of tangible personal property (such as artwork, land, etc.) to a private foundation, the charitable deduction is limited to his or her cost basis in the property. A deduction equal to the fair market value of the property donated only applies to gifts of highly appreciated stock to private foundations.

## **CREATING A FOUNDATION**

Creating a foundation is not very difficult, and many people create foundations with modest initial contributions. To create a foundation, an attorney should draft a trust or create a corporation, and file IRS Form 1023, Application for Exempt Determination Letter. Once this is completed, contributions can be made to the foundation. To manage a private foundation, only a few things have to be done on an annual basis: (1) Funds contributed to the foundation must be invested, (2) a tax return must be filed (the tax on a private foundation is 2 percent of its net investment income), and (3) a distribution of at least 5 percent of the foundation's assets must be made each year to public charities or to fund charitable activities. There is also a public notice requirement, but this easily can be met by registering the foundation on [www.guidestar.org](http://www.guidestar.org). Individuals who create a foundation and are able to complete the three tasks listed above might be able to manage the foundation at a relatively modest cost.

## **USING THE FOUNDATION IN COORDINATION WITH OTHER CHARITABLE TECHNIQUES**

Once a foundation is created for a family, it can serve as the coordinating vehicle for all of the family's charitable gifts. For example, if a family member creates a charitable remainder trust (CRT), the individual's private foundation can be named as the remainder beneficiary of the charitable gift. Even when the CRT expires, the family will still have control over the charitable funds that are distributed to the foundation. Likewise, if a charitable lead trust (CLT) is used in planning, the annual charitable distributions can be made to the family's foundation.

Use of a CLT can generate a substantial reduction in gift and estate taxes, but keep control of the funds within the family. For example, suppose Harry's will makes a bequest of all of his assets at his death to a CLT that will pay a 5 percent annuity interest to Harry's family foundation for a period of 20 years, with the remainder interest to his children. Harry's estate might otherwise be subject to substantial estate taxes. The bequest to the CLT could eliminate or dramatically reduce the federal estate taxes his estate would have to pay. This calculation is dependent on prevailing interest rates, the term of the charitable lead interest, and the size of the annual charitable distribution. While use of a CLT will save taxes, in this case Harry's children will not receive any property for 20 years. However, if a life insurance trust is coupled with a charitable lead trust, the life insurance trust will provide a benefit for Harry's children at the time of his death, and, 20 years later, the children get a distribution from the CLT of all its remaining assets. Furthermore, because the distributions from the CLT during the 20-year term go to Harry's family foundation, the children can control those funds and can distribute the required amount to deserving charities. Thus, the family will contribute funds to selected charities that would otherwise have been paid to the IRS in the form of federal estate taxes.

Private foundations are powerful tools for charitable planning that facilitate family cooperation for meeting charitable goals. In addition, foundations provide income tax, gift tax, and estate tax benefits.

## RECENT CASES AND RULINGS

### Revenue Ruling Clarifies Licensing Requirement For Viatical Settlement Providers

Section 101(g) of the Internal Revenue Code permits amounts received in a viatical settlement (the purchase of a policy while the insured is still alive with impaired health) of a life insurance policy in some instances to be treated as amounts received by reason of the death of the insured. Thus, a qualifying sale of the policy to a viatical settlement company will result in the exclusion of the amounts received from income taxes. To qualify for favorable tax treatment, the insured must be terminally or chronically ill as defined by the code. In addition, the policy purchaser must meet the definition of a viatical settlement provider. This definition is clouded by the fact that insurers are subject to state regulation; individual state regulation of viatical settlement companies is still developing and subject to significant variation from state to state. The IRS recently released Revenue Ruling 2002-82, I.R.B. 2002-51, to state its position with respect to the licensing requirement for viatical settlement providers as states develop licensing procedures.

The revenue ruling discusses three fact patterns for the potential qualification of the viatical settlement company. First, a state that has a licensing procedure in place might issue a letter from its regulatory authority permitting the viatical settlement company to engage in its business of purchasing life insurance policies while its license application is pending. In this instance the sale of a life insurance policy to such a company will qualify for favorable tax treatment.

Second, a state may have a licensing statute but no procedure in place for licensing viatical settlement companies. However, the regulatory authority provides notice that all viatical settlement companies can engage in business until the licensing procedure is established. In this instance, the sale of the policy to a company operating under the authority of such notice qualifies for favorable tax treatment.

Finally, a state may have a licensing statute but no procedure in place for licensing viatical settlement companies, and the regulatory authority has not granted even temporary permission to viatical settlement companies to engage in business in the state until licensing procedure is established. In this instance, the sale of the policy to a company operating without authority in the state will subject the seller to ordinary income taxes for any gain on the sale of the policy.

This letter prepared, with the help of a nationally recognized tax authority, intends to promote interest in more comprehensive tax and estate planning. References are intentionally brief. If a topic interests you, you should investigate it more thoroughly with your qualified tax advisor. Effective tax and estate planning should involve competent advisors in relevant law, accounting, trusts, life insurance and investments. The knowledge and experience of each in their specialties can make the difference between a wealth transfer that works as intended and one that does not. Please seek competent counsel to determine and satisfy your individual needs.

*Positioning our clients  
for the future*



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