



Advanced Planning Strategies

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Dear Reader,

The Senate had passed a tax relief bill at the time this letter was prepared. The House will need to take action (and, no doubt, there will be a conference committee compromise) before the tax bill will be final. At this point, the Senate agreed to extend alternative minimum tax relief through an increased exemption and provide the deduction for state and local sales taxes for one more year. There was an attempt to further extend (beyond 2008) the lower rates on dividends and long-term capital gains, but there were not enough votes at this point. We expect that some action will be finalized to extend selected expiring provisions and will fill you in next month.

The "Pension Security and Transparency Act of 2005" (S. 1783) was approved by the Senate by a 92 to 2 vote. The House is considering a similar bill (HR. 2830). The amendment would toughen the funding requirements of employer-defined benefit plans to provide some relief in an attempt to keep financially troubled plans from being terminated. The well-documented terminations of large defined-benefit pension plans have left the Pension Benefit Guaranty Corporation with a reported deficit in excess of \$22 billion.

The President's Tax Reform Panel issued its final report last month. The stated purpose was to identify the major problems with the tax code and recommend options to make the law simpler, fairer, and more conducive to economic growth. The report was more than 270 pages and immediately criticized on many fronts because all recommendations inevitably threaten someone's favored tax benefit.

Many tax numbers are subject to inflation indexing or statutorily scheduled adjustments. For estate and gift tax purposes, the 2006 tax numbers are: (1) The annual gift tax exclusion rises to \$12,000 per donee; (2) the applicable exemption amount for estate taxes increases to \$2 million per decedent; (3) annual exclusion gifts to a noncitizen spouse increase to \$120,000; (4) the maximum estate tax value reduction for real property used in a closely held business or farm increases \$900,000; and (5) the amount of business value eligible for a 2 percent interest rate on estate taxes deferred under Code Sec. 6166 increases to \$1.2 million.

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 rather than a corporation gives the grantors a greater degree of control over the foundation's affairs, and it 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. 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 children and succeeding generations. 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 expertise necessary to make wise financial decisions for the foundation and, in the future, themselves.

Finally, family members who contribute assets to the foundation 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 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 for the entire amount of the gift without limitations that apply to income tax deductibility.

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 applies only to gifts of unrestricted, publicly traded stock to private foundations.

CREATING A FOUNDATION

Creating a foundation is not very difficult, and many people create foundations with modest initial contributions. To establish 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 held for charitable purposes must be made each year to public charities or to fund charitable activities. Some of the operational expenses associated with foundation management can be included in calculating the 5 percent required minimum distribution amount. There is also a public notice requirement, but this easily can be met by registering the foundation on 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 a 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 fall below the applicable (unified) credit amount (exempts \$1.5 million from estate taxes in 2005; \$2 million in 2006, 2007, and 2008). The bequest to the CLT would 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 will receive 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 have control over 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

PROCEEDS FROM SALE OF RIGHTS TO LOTTERY INSTALLMENT PAYMENTS TREATED AS ORDINARY INCOME

The taxpayer won \$17.5 million in a state lottery receivable over 26 annual payments. After receiving three annual payments reported as ordinary income, the taxpayer sold the remaining lottery rights for a lump-sum payment of \$7.5 million. The taxpayer received a 1099-B for the amount of the proceeds and reported the proceeds as a capital gain.

The court (*Prebola v. Commissioner*, T.C. Memo 2005-261) determined that the sale proceeds were not from the sale of a “capital asset” and the proceeds should have been reported as ordinary income. The taxpayer argued that the purchase of a lottery ticket was an investment in capital. The court rejected this argument following existing authority that the purchase of a lottery ticket is not a capital investment. In addition, because there is no cost to the taxpayer to receive the future installment payments, the proceeds could not be treated as reflecting the increase in value of an asset above its underlying cost. The tax deficiency was over \$1.3 million.

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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