



Advanced Planning Strategies

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The upcoming election will have an enormous impact on tax policy. We all should be aware that many of the tax provisions passed during the Bush administration will expire within the next two or three years. Many provisions had only a one or two year lifespan, but have already been extended on a year-to-year basis through so-called extenders legislation. There is a lot of information currently available through websites, but be aware that many are provided by think tanks and have a specific agenda. It behooves all voters to get informed and receive independent information. We'll do our best to provide you this information before the election as the candidates get more specific.

An important component of each candidate's platform involves the funding of Social Security. It is possible that this issue is so volatile that the candidates will be very careful about providing details. Senator Obama has indicated an opposition to the private accounts plan that proved to be a nonstarter under President Bush. He would increase the burden on those whose contributions are currently capped by the wage base. Senator McCain favors private accounts, but stresses addressing the benefit promises that have already been made.

A constant debate concerns the corporate income tax and whether the tax is too high to keep U.S. companies competitive. The Government Accountability Office (GAO) released a report with some interesting findings. In an eight-year span, the GAO reported that 55 percent of U.S. companies and 72 percent of foreign companies had zero taxes in at least one year. In 2005, about 80 percent of the largest corporations reported zero tax liability. The corporate deductions were primarily responsible for lowering or eliminating tax. One of the largest deductions, of course, is for salaries and wages paid by the corporations.

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. Non-family 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. However, there are compliance requirements that must be followed in any form of organization. All charitable organizations have to make a Form 990 available to the public. The Bill and Melinda Gates Foundation Trust's return consisted of 421 pages (including attachments) in its most recently reported year.

The purpose of this article is to introduce the benefits and planning opportunities associated with family foundations and it is not intended to provide an exhaustive analysis of tax compliance.

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 non-family 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 non-tax 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 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. 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 fall below the applicable (unified) credit amount (current exempts \$2 million from estate taxes). 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 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 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

Early Termination of A Charitable Remainder Trust (CRT) Results In Favorable Tax Consequences

A married couple created a charitable remainder unitrust that was designed with a special net income limitation. The trust would provide them annually with the lesser of (1) the actual net income of the trust or (2) a stated percentage of the fair market value of the trust's principal. If the net income limitation is below the stated unitrust percentage in certain years, the shortfalls can be made up in years when income exceeds the stated percentage. The remainder of the principal is distributed to public charities when the CRT terminates at the second death.

The couple terminated the trust early and paid the actuarial value of the remainder to the public charities. The couple received an amount equal to the actuarial value of their lifetime interest. Their physicians indicated that they were in good health and the IRS regulations were followed carefully with respect to calculating the life interest and the remainder. The IRS ruled (Ltr. 200833012) that this transaction would not disqualify the trust as a CRT under IRC Sec. 664. Furthermore, the transaction would not result in a termination tax or be treated as running afoul of the self-dealing rules applicable to private foundations. Finally, this transaction will be treated in substance as a sale between the charities and the donors and the amount realized by the donors will be taxed as a long-term capital gain.

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. Securities and Investment Advisory Services offered through Capital Analysts Incorporated, Member FINRA/SIPC. AEG and CAI are independent non-affiliated entities.

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for the future*



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