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FINANCIAL CONCEPTS INC
A MEMBER FIRM OF M FINANCIAL GROUP

Patrick J. McNamara, MSFS
President & CEO
pmcnamara@finconcepts.com

Kathy H. Barnett, CLU®, ChFC®
Vice President, Client Services
kbarnett@finconcepts.com

Kathleen M. Garber, CLU®
Vice President, Case Design
kgarber@finconcepts.com

24 Frank Lloyd Wright Drive
Suite 3050 H - PO Box 554
Ann Arbor, MI 48106-0554

Tel: (734) 214-9770 • Fax: (734) 214-9771

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Tax Deductions for Donating Art

If you collect art, donating a painting, sculpture, or other object of fine art to a museum or a favorite charity can be a great way to share your passion with a wider audience, support your institution of choice, and get a break on your Federal income taxes. But before donating artwork, it is important to consider the nature of the organization receiving the gift, as well as how the institution will handle the gift, as these factors can make a big difference in how much you are permitted to deduct from your taxes.

You can expect to receive a higher income tax deduction for your gift if you are donating an art object that has appreciated in value over the time you have owned it. Generally, you can deduct the full fair market value (FMV) of the donation as of the date of the contribution, if you have held the object for at least one year, and if the item's FMV sale on the date of the contribution would have resulted in a long-term capital gain.

In order to claim a deduction for the FMV, it is, however, imperative that you know what the organization or charity intends to do with your gift. The tax code provides incentives for taxpayers to donate works of art to tax-exempt organizations, such as qualified museums, universities, and other public charities, that display and use works of art to further their tax-exempt purposes. For an appreciated work of art to receive a full current value deduction, the donation must be "of related use," or it will be used in the ordinary course of the organization's tax-exempt activities, i.e., exhibits or displays of artwork.

If, however, the organization's purpose does not involve displaying artwork, or if the charity sells the object to raise money, your deduction will be limited to your cost basis, or the FMV, if it is less than the price you originally paid. This also applies if you have owned the object for less than a year, or if you are the artist who created the object.

If, for example, you paid $1,500 for a painting 10 years ago that is now valued at $5,000, you are allowed to take a $5,000 deduction if the work goes to a museum or to your alma mater's art department. If, however, you donate the painting to a local television station's auction and the item is sold, you are only permitted to take a $1,500 deduction. Similarly, if you donate the painting to a public charity, such as a hospital, which has an exempt purpose that is unrelated to the donated painting, you will only be able to claim a deduction of $1,500.

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Providing Incentives for Inherited Wealth

For many affluent individuals, estate planning extends well beyond tax planning and involves very personal decisions regarding the distribution of future wealth. In more traditional estate plans, the **spendthrift trust** is used as a vehicle for distributing trust income, while limiting immediate access to trust principal.

A spendthrift trust can help provide a financial head start for minor children and protect adult heirs from certain creditors and limitations in financial judgment. However, such trusts may provide heirs with little incentive to expand their own professional, academic, or philanthropic horizons. Thus, affluent individuals who are particularly sensitive to the potential ramifications of "handing over" considerable wealth to heirs may choose to establish an *incentive-based* estate plan.

One of the cornerstones of an incentive-based estate plan is the **family incentive trust (FIT)**. Like typical trusts associated with estate planning, a FIT guides trustees in the implementation of an affluent grantor's expectations regarding the uses of his or her estate. Similarly, a FIT can help ensure proper care and financial support if an heir falls on hard times or has special needs. However, a FIT is somewhat unique in that the general distribution of trust income is based on a series of pre-determined "incentives."

Promoting Success and Reinforcing Values

The incentives outlined in a FIT are at the discretion of the grantor. Each incentive provides the grantor with the opportunity to encourage specific, future behavior. For instance, the trust could have provisions that pay each heir $10,000 upon receipt of a bachelor's degree, $25,000 for a master's degree, and $50,000 for a doctorate. A FIT can also be an ideal tool to reward family members who pursue and/or distinguish themselves in a favored career path of the grantor's choosing, such as the family business, music, the arts, research, or teaching. A FIT can reward younger heirs for academic success or community involvement. In addition, the trust can match certain levels of income for heirs who are younger than a specified age.

A FIT may also be an appropriate vehicle for education funding. Unlike a custodial account, which generally becomes the property of the child once he or she attains the age of majority (determined by state law), a FIT can dictate that some trust assets be used to help cover education costs. Thus, the trust—rather than a young, inexperienced adult—can maintain control of monies earmarked for education.

Another interesting utilization of a FIT is using trust principal as a "family bank." The FIT can offer low interest rate loans for start-up business ventures or the purchase of a primary residence. To minimize risk to the trust, a lending process similar to that of a traditional lending institution can be established.

Philanthropy creates another possibility for an incentive-based estate plan. Certainly, many affluent individuals consider philanthropic pursuits to be important endeavors. A FIT can be used to match the charitable contributions of a beneficiary. If so desired, the FIT's matching contribution can be arranged as a distribution to the beneficiary, which is then contributed to the charity. Thus, the beneficiary can reap the benefits of a charitable deduction on his or her contribution, as well as the FIT's matching contribution. As an alternative, any remaining trust income that has not been distributed through incentives may be used to make a charitable contribution. Such contributions can also be arranged to be made on behalf of trust beneficiaries.

Sometimes, the effects of inherited wealth can have a negative impact on the motivation of heirs. For instance, when some heirs receive a substantial inheritance, they may be content with a life of leisure. Thus, the reasoning behind incentive-based estate planning is fairly straightforward. Assets and income are distributed to assist heirs who are realizing career or academic goals, and/or whose actions are consistent with the expectations of an affluent grantor. By adopting some of the principles of incentive-based estate planning, the affluent grantor can promote a family legacy of excellence and productivity for generations to come.

Divorce and Life Insurance Concerns

Sometimes in life, things don't work out as planned. One of the most trying examples is when a couple decides they can't make their marriage work and, subsequently, files for divorce. Divorce can take a significant financial and emotional toll on a couple, their children, and other family members. In the midst of immediate financial and legal concerns, couples also need to consider ways to help protect their individual financial futures and that of their children's in the event of death. Life insurance may offer a solution.

Let's take a look at several different scenarios. After divorce, if the non-custodial parent who is paying alimony and/or child support were to die, then the custodial parent may be unable to maintain the children's lifestyle or save for a future college education. On the other hand, if the custodial parent were to die, the non-custodial parent may be unable to afford childcare expenses. Consequently, divorcing couples may want to consider making life insurance policies part of the divorce decree.

The custodial parent may want to purchase a life insurance policy on the non-custodial parent, but if not, transferring ownership and beneficiary arrangements on an existing policy may be another option. The custodial parent may request alimony or child support increases to cover the cost of policy premiums. If the non-custodial parent remains the policy owner, the divorce decree can include arrangements to ensure that the custodial parent is named as the irrevocable beneficiary, and that he or she receives ongoing proof that the payments are made and the policy remains in force.

The non-custodial parent may wish to keep the policies he or she already has to protect other financial interests. To ensure protection for children from a previous marriage, the non-custodial parent may consider purchasing a new policy on his or her life, naming the former spouse as the owner and beneficiary. If this is done before or during the divorce proceedings, gift tax will not be owed. If the custodial parent is the policy owner, premiums may be tax deductible as alimony.

For existing policies, it is important to remember that the insurance company must be notified of any beneficiary changes. A will cannot be used for this purpose. In addition, should the insured remarry and the policy names the "husband" or "wife" of the insured as the beneficiary, the new spouse may receive the proceeds. If the insured does not remarry and the same policy language is in force, then the proceeds may be paid to the secondary beneficiary. If the insured's estate is named as the new beneficiary, insurance proceeds may be delayed by the probate process. If minor children are named as beneficiaries, additional problems may arise, as insurance companies generally do not pay minors directly. For this reason, you may want to consider creating a trust for minor children and naming the trust as the beneficiary of the policy proceeds.

Divorce is rarely easy, but with a well-planned strategy, the short- and long-term financial needs of your loved ones can be met. Since laws vary from state to state, be sure to consult with your team of qualified tax and legal professionals about your unique circumstances.

tax deductions for donating art

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Before making a donation, be sure that the institution wants the artwork for its collection. After discussing the prospective donation with representatives of the organization, you should ask them to provide you with a written acceptance indicating that the organization is a qualified public charity, and that it satisfies the related use rule regarding the particular donation.

The IRS requires any deducted item over $5,000 to be appraised by a qualified appraiser no earlier than 60 days before the gift is transacted. The appraiser should be encouraged to be conservative in estimating the value of the artwork, as larger donations may be audited, and the value could be adjusted downward. Additional documentation is generally required for objects appraised at $20,000 or more.

In order to qualify for a tax deduction, you must donate the artwork as an outright gift, not as a permanent loan. But instead of making the entire donation at one time, you also have the option of transferring a percentage, or "fractional interest," in the artwork each year. This method is useful if the total deduction exceeds 30% of your adjusted gross income (AGI), the maximum for charitable deductions. However, all of your fractions must be donated within 10 years, and the receiving institution must take substantial physical possession or make use of the object during its allotted time period each year, or penalties may apply. Other planned giving strategies for donating artwork while maximizing tax deductions include the use of charitable remainder trusts, charitable gift annuities, and donor-advised funds.

If a qualified charitable organization is interested in purchasing your artwork, you may also want to consider a bargain sale, which will provide you with both a lump sum of cash and a charitable tax deduction. A bargain sale, which involves the sale or exchange of the item for less than its FMV, is partly a charitable contribution, and partly a sale or exchange. In addition to collecting cash for the sale, you can take a charitable income tax deduction for the difference between the amount you received for the sale, and what you could have received if you had sold the object for its full FMV.

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