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a business, tax, and financial newsletter

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For many individuals with accumulated wealth, occasional gifts to a favorite charity may satisfy their charitable inclinations. The added incentive of an often substantial tax deduction, coupled with various estate planning benefits, can be the driving force behind such charitable gifts. However, for some individuals, philanthropy is a far more serious endeavor, often involving a *succession* of substantial gifts of at least $5 to $10 million, which may necessitate the need for control and general oversight. In these situations, a **private foundation** can be an ideal venue for managing a large, continuous charitable giving program.

The Basics

In its simplest form, a private foundation is a charitable, grant-making organization that is privately funded and controlled. When properly arranged and operated, a private foundation can be an income tax-exempt entity, whereby tax deductions are permitted for individuals (or donors) who donate to them.

Contributions to a private foundation are deductible for gift and estate tax purposes. However, the income tax deduction of gifts to a private foundation is a bit more complex. Generally, the deduction is based on the fair market value of the gift (at the time of the gift), and it is limited by the donor's **adjusted gross income (AGI)**. The charitable deduction will also be limited (to 20%, 30%, or 50% of AGI) depending on the type of charitable organization that is ultimately receiving the gift from the private foundation *and* the type of gift being made. Gifts that are not cash or publicly traded securities, and that are valued at more than $5,000, require adherence to additional rules in order to ensure deductibility.

In addition to the advantages of a tax deduction (which is usually not exclusive to private foundations), private foundations may also offer an array of other benefits. Because a private foundation is typically established to manage a long-term charitable gifting program, it may in turn highlight the philanthropic presence and identity of the donor within the community and/or a particular charitable cause. It can also serve to create a family charitable legacy while, at the same time, protecting individual family members

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Touching All the Bases with Policy Ownership

While many of us think of **life insurance** planning in relation to *type* and *amount* of coverage, a more complete analysis also includes **policy ownership**. In many cases, the proceeds of a life insurance policy may be unnecessarily included in your estate—unless you plan ahead.

Without insurance, many estates fall below the level at which they are subject to Federal estate taxes. For 2014, the **applicable exclusion amount** is $5.34 million per individual (annually indexed for inflation). Estates that exceed this amount are subject to Federal estate taxes at a top rate of 40% in 2014. The proceeds of life insurance can increase the value of your estate to a level where it could become subject to Federal estate tax.

Fortunately, you can prepare for the possibility of Federal estate taxes. There are two ways to keep insurance proceeds out of your estate:

1. Transfer ownership of your insurance policies to someone else, generally your **beneficiary(ies)**.

2. Transfer the policies to a **trust**.

Either option, if executed properly and in a timely manner, can decrease your Federal estate tax. You may not have to change ownership of a policy that names your spouse as the ***sole* beneficiary** because the **unlimited marital deduction** allows your spouse to inherit the policy proceeds without estate taxation. However, you may benefit from transferring your policy out of your estate if the purpose of the insurance is to help pay estate taxes or provide for heirs other than your spouse.

The paperwork involved in changing insurance policy ownership is relatively simple. You do have to sign away all rights to your policies, however, making this decision *absolute* and *irrevocable*. Also, you cannot change your beneficiaries, and in the case of policies with **cash value**, you no longer have the right to borrow against them or surrender them for their cash value.

Keep in mind that if the transfer is done within three years of your death, the policy proceeds are generally still considered part of your estate, regardless of ownership. Therefore, proper planning is necessary to help ensure that you achieve your desired results.

Ownership of an individual group insurance policy can generally be transferred to anyone who is old enough to handle money. Depending on your particular circumstances, it may be advisable to transfer a policy directly to a beneficiary or, in the case of a minor, to a **trust** that is designed for the benefit of a child.

Before signing away insurance, it is important to carefully review the consequences. Gifting insurance may have **gift tax** consequences if the transfer is to anyone other than your spouse. In 2014, the **annual gift tax exclusion** is $14,000 per gift to any single donee and $28,000 for gifts made jointly by a married couple.

For those in higher tax brackets, one useful technique to shelter large policies from estate taxes—and to protect the interests of minor beneficiaries—may be to transfer ownership to an **irrevocable life insurance trust (ILIT)**. When you die, the **trustee** named by you can distribute income to your beneficiaries or, if necessary, use the proceeds to pay estate taxes. For specific guidance, be sure to consult with your qualified tax, insurance, and legal professionals.

The decisions you make regarding policy ownership are no less important than the decisions you make regarding what type of policy and how much insurance you need to fulfill your overall objectives. So, when planning your insurance strategy, make sure to cover all the bases. ■

Wealth-Transfer Taxes Can Take a Toll on Small Businesses

Most business owners become wealthy the "old-fashioned" way—they work hard. But, suppose a business owner and his or her spouse were to die unexpectedly. Undoubtedly, they would hope their children or other family members involved in the business would reap the benefits of all their hard work.

Unfortunately for surviving family members who depend on the business for their livelihoods, their troubles may have just begun. Although estate planning concerns may arise for business owners from time to time, they are often relegated to the "back burner" due to the more pressing day-to-day demands of the business.

However, without prior planning, there may be no provisions in place to help pay estate taxes, which can be significant—as high as 40% for amounts over the **applicable exclusion amount** of $5.34 million in 2014. Without any plans in place, selling or liquidating the business may be required to raise the cash to help pay these taxes.

Potential Safeguards

Under the current estate tax laws, there are several steps a business owner can take to help prevent his or her business from being liquidated to raise cash to help pay estate taxes.

One option is to *transfer* business ownership to family members using certain gifting or sales techniques. Your tax professional can provide guidance regarding your gift tax liabilities. Although relinquishing some control and becoming a minor stockholder is not easy, it can help reduce a business owner's assets and

thus, possibly, minimize the tax bite. In addition, a business owner could establish a **trust** to help ensure the estate is passed on to his or her heirs, avoiding probate.

Another option is to *defer* estate taxes. Estate taxes are due within nine months. However, the Internal Revenue Service (IRS) allows qualifying closely held businesses to defer taxes and then pay in installments (with interest) over a period as long as 10 years. In this case, the estate must remain open until all estate taxes have been paid. Therefore, according to IRS records, very few businesses choose this option. Still, family-held businesses may wish to consider taking this step as a way to help avoid a likely drain on valuable assets and the possibility of a closely held ownership coming to an abrupt end.

Benefits of Planning

One effective tool that estate planners often use to help fund estate taxes is life insurance. The business owner can establish an **irrevocable life insurance trust (ILIT)**, which purchases a life insurance policy on his or her life. The policy premiums can be funded by annual gifts made to the ILIT by the business owner, who can use his or her annual gift tax exclusion ($14,000 to each recipient for 2014) in accordance with rules pertaining to Crummey withdrawal powers (Crummey v. Comm, 397 F.2d 82 (9th Cir. 1968)).

Most business owners work long and hard to build their business and want to do all they can to help protect their heirs from a heavy estate tax burden, particularly if the company's continued operations may be in jeopardy. Therefore, it is important to develop a plan *before* the need arises.

Keep informed about any changes in estate tax laws and maintain a strategy that works for your business and your family. Be sure to consult with a team of qualified estate professionals, including your legal, tax, and financial professionals. While there are obvious up-front costs involved in establishing an estate plan, in the long run, business owners generally find that it is money well spent. ■

private foundations—an alternative to charitable giving

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from the pressures of other charitable appeals. Finally, a private foundation can serve as an appropriate mechanism for controlling distributions to charities, as well as determining which charities the foundation will benefit.

The Technicalities

When a private foundation is established, there are two important questions that need to be asked. First, what type of private foundation should the donor establish? And second, how should the private foundation be structured? There are generally three types of private foundations: 1) **non operating**, 2) **operating**, and 3) **company-sponsored**. Each type of foundation has specific characteristics that make it appropriate for a particular situation. There are also strict requirements and guidelines that must be followed for each type of foundation.

The most common type of foundation is *nonoperating*. Essentially, a donor, or group of donors, makes contributions to the foundation, which in turn, makes grants to a charity. In this case, the donor has no direct participation in any charitable work. There are several variations of this type of foundation.

On the other hand, in an *operating* foundation, the foundation may have direct involvement in charitable causes (e.g., an inner-city youth center) while retaining the tax benefits of a "private" foundation (in some respects, operating similarly to a "public" charity). In order to qualify as an operating foundation, several requirements and tests need to be met.

A *company-sponsored* foundation can be used when the majority of contributions are from a for-profit corporate donor. Typically, this type of foundation operates similarly to a nonoperating foundation. It is usually managed by corporate officers, and it has the added benefit of allowing some contributions to accumulate over time. This can help the foundation make continual grants when corporate profits are low.

After careful thought is given to the type of foundation to be established, the decision for which structure is next. There are three ways in which a foundation can be structured: 1) a **nonprofit corporation**, 2) a **trust**, or 3) an **unincorporated association**.

There are a number of factors to consider for determining which structure is best. Generally, if the donor intends to keep the foundation in existence permanently, a nonprofit corporation or trust may be a better choice. Additional considerations include state and local laws governing private foundations, the type of foundation, the type of donor, the need or desire to make future changes or delegate responsibilities, and personal liability issues.

The Cost

Creating and maintaining a private foundation is much more involved than the use of more traditional charitable giving vehicles (e.g., CRTs). Therefore, legal and accounting professionals who have experience with private foundations must play a significant role in such an endeavor. In addition, due to the added complexity and need for highly specialized legal and tax expertise, the expenses for design, set-up, management, and grant administration in a private foundation will generally be substantial. Typically, a private foundation is only viable for individuals who intend on making periodic gifts in excess of $5 million.

Certainly, the private foundation allows today's philanthropist the opportunity to manage substantial charitable gifts, as well as the ability to actually become involved in charitable work if he or she so chooses. It also affords the donor the opportunity to be recognized for charitable giving, while solidifying his or her philanthropic legacy. As with all advanced estate and tax planning, consult with your team of qualified legal, estate, and tax professionals to help ensure that you meet the goals and objectives of all involved parties.

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