

THE BERNSTEIN REPORT

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Dear Reader,

The process of developing and passing a Budget for 2012 may become the most delayed and contentious ever. The Senate recently failed to pass the Ryan Budget (passed earlier by the house) by a vote of 57 to 40 against. At the same time, the budget proposed by President Obama was rejected by a vote of 97 to 0. We'll continue to watch all of this closely since the Budget agreement generally include some significant tax legislation.

Senators Herb Kohl and Mike Enzi introduced legislation that would help preserve retirement accounts to last through an individual's retirement. The "Savings Enhancement by Alleviating Leakage in 401(k) Savings Act of 2011" (S. 1020) is aimed at mitigating the impact of the use of an individual's retirement account through the use of hardship or loan provisions. Recent estimates indicate that 28 percent of active participants in account balance type defined contribution plans, such as Sec. 401(k) plans, have outstanding loans.

The legislation was introduced as a result of a GAO study that revealed the impact of the so-called 401(k) leakage on retirement security. The proposed bill would address the problem by:

- limit loans taken by a participant to three at any point in time
- prevent the use of credit or debit cards as the form of distributing loans
- modify hardship withdrawal regulations to permit elective contributions to the retirement plan following a hardship withdrawal
- provide additional time for a terminated worker to contribute the loan balance to an IRA without incurring tax penalties.

We'll let you know as soon as any new developments occur with tax policy.

Cordially,

Richard S. Bernstein

**A Second Opinion Costs You NOTHING,
But Could Save You MILLIONS!**

**WHEN IT COMES TO YOUR HEALTH, YOU GET A SECOND OPINION,
SHOULD YOUR FINANCIAL WEALTH BE ANY DIFFERENT?**

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 119 pages (including attachments) in its most recently available 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

State of California Refuses to Disclose Real Property Transfers to the IRS for the Purposes of a Gift Tax Compliance Initiative

We recently reported the intention of the IRS to launch an initiative to pursue taxpayers who failed to file gift tax returns with respect to transfers of real estate to family members. Provisions of the Internal Revenue Code (Sec. 7602(a)) empower the IRS to summon not only a taxpayer who fails to comply, but also any person having possession, custody, or care of books of account containing entries related to the business of the person liable for tax or the filing of a return. This power even applies to situations where the identity of a specific taxpayer is unknown. In a recent case, California authorities refused to provide the IRS with information concerning the transfer of real property by unknown taxpayers to children or grandchildren.

With respect to the pursuit of such information concerning transactions of unknown taxpayers, the statute requires that the IRS must demonstrate that such information cannot be obtained from any other readily available source. The District Court determined that the IRS had not met this burden in its petition and denied the request to enforce the summons. (*In Re: Does*, 107 AFTR 2d 2011 (5/20/2011)). California law prohibits the disclosure of this personal information without written consent unless required by law. It is quite possible that other states will not prevent the IRS from obtaining information regarding property transfers. It is important to determine the compliance requirements for gratuitous transfers that may require the filing of Form 709 to report gifts. We have discussed these requirements in past newsletters.

This Tax Letter is intended to assist you to conserve your estate and to protect the interests of your family and business associates. Estate planning involves the joint services of a competent Trust Officer, Attorney, Accountant, and Life Underwriter. The experience and advice of each is generally essential.

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