

## *A Dozen Important Estate Planning Concepts<sup>1</sup>*

There are, of course, many estate planning techniques to consider in appropriate circumstances. Some are designed to accomplish transfer tax savings, some to transfer or manage property efficiently, some both. This memorandum discusses twelve of the most commonly recommended estate planning techniques, particularly when estate tax planning is important. The discussion of each technique is necessarily a summary. If a specific technique is of particular interest, additional in depth information is available.

The techniques discussed in this memorandum are:

- I. Using Revocable Trusts
- II. Lifetime Giving
- III. Effective Use of the Estate Tax Exemption and Marital Deduction
- IV. Life Insurance Ownership
- V. Retirement Plans and Individual Retirement Accounts
- VI. Qualified Personal Residence Trusts
- VII. Generation-Skipping Planning
- VIII. Gifts of Property With Discount Valuation
- IX. Asset Protection Planning
- X. Charitable Remainder Trusts
- XI. Charitable Lead Trusts
- XII. Private Foundations

### *I. Using Revocable Trusts*

A revocable trust, sometimes called a “living trust”, is a trust you create during your lifetime. It is completely under your control at all times. In fact, you will typically serve as the trustee during your lifetime unless you suffer a disability. There is no tax consequence associated with the creation of the revocable trust and it is ignored for gift, estate and income tax purposes.

Why then has a revocable trust become the key document in most estate plans? That is because it contains, in a single document, the legal authority to manage your property during your lifetime if you suffer a disability, to accomplish tax planning objectives at your death, and to govern the division, form and time of distribution and management of property for your surviving spouse and children. The revocable trust will be accompanied by a last will, a durable power of attorney and an advance health care directive.

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Revocable trusts first became popular many years ago as a means of avoiding the probate process. They accomplish this through transfer of ownership of your property to your trust during your lifetime. Therefore, at your death title to your property is already in the name of your trust and no probate is needed to transfer title from your name. Probate avoidance is achieved only for that property the legal ownership of which has been formally transferred to the trust during your lifetime. What is required to transfer ownership in connection with a specific asset depends on the nature of the asset; for example, land must be conveyed by deed from you to the trust.

The second, and perhaps most important, reason to include a revocable trust in your estate plan is to provide a means of managing your property should you suffer a lifetime disability. While a durable power of attorney will give your agent the authority to act for you in many situations, management of property during a long term disability is far more efficient in a trust. Although you will typically begin as your own trustee, the trust will name alternate trustees who can assume responsibility in the event a disability occurs. The revocable trust will avoid the necessity to appoint a personal guardian with court supervision of property management. Even if you have a spouse, that spouse may not be able to act for you without property authority and planning.

In addition to the revocable trust, you will still need a last will, a durable power of attorney and an advance health directive. The last will names your revocable trust as the beneficiary of your estate—called a “pour-over” will—combining property passing through probate with assets transferred to the revocable trust during lifetime. The durable power of attorney names at least one person as your agent. Your agent can act on your behalf during your lifetime, usually to transfer property to your revocable trust in the event of your lifetime disability. Both the durable power of attorney and the advance health care directive contain provisions dealing with health care decisions to be made on your behalf during your disability.

## *II. Lifetime Giving*

For those who have the ability to take advantage of the tax benefits of lifetime giving, substantial tax savings can be achieved. Lifetime giving depends, of course, on your willingness to make complete and irrevocable gifts to the donees. No one should undertake a substantial lifetime giving program unless they are comfortable that their own needs will be met from the property they keep. Your revocable trust and durable power of attorney should authorize the continuation of a program of lifetime giving in the event of your incapacity or, in controlled circumstances, to make lifetime gifts on your behalf even where no formal program of giving has begun.

The federal gift and estate taxes are organized in such a way that you should think of them as a unified transfer tax. You are allowed to give up to \$11,000 in value in any kind of property to a single donee in one calendar year. This is called the *federal gift tax annual exclusion*. You may give up to \$22,000 of your own property to a single donee in one calendar year if your

spouse will consent to have the gift treated as made one-half by your spouse—this is known as a “split-gift.”

In addition to the annual exclusion, each individual has a lifetime gift tax exemption of \$1 million.<sup>2</sup> If you exceed the amount of the annual exclusion through gifts greater in value than \$11,000 (or \$22,000 split-gifts) to a single donee in a single year, the excess will be applied against your lifetime exemption. To the extent that the lifetime exemption has not been used during your lifetime, it will be available to shelter property being given at your death to beneficiaries other than a spouse or charity.

All annual exclusion gifts are removed from the transfer tax system and do not reduce your unified credit exemption. Therefore, it makes sense to make as many annual exclusion gifts as your budget and inclination will allow. These gifts would, if retained and taxed at death, otherwise be subject to the highest estate tax rate applicable to your estate.<sup>3</sup> Annual exclusion gifts do not require any tax return to be filed. To be effective, you need only deliver property to your donee irrevocably.

Many people use their unified credit exemption for lifetime gifts rather than waiting until death. There are often advantages to large lifetime gifts. First, advanced estate tax planning techniques, some of which are discussed in this memorandum, may allow for the lowest possible valuation to be placed on the property for gift tax purposes making a current gift desirable. Second, any growth which may occur in the value of the property after the date of the gift will already be owned by the donee and need not complicate the donor’s estate tax planning.

It may, in some cases, even make sense to make gifts so large that they cannot be fully sheltered from tax by both the annual exclusions available plus the unified credit exemption. This may be done where substantial future appreciation is expected and the property needs to be removed from the donor’s potential estate while the value is lower. Further, although the gift and estate taxes are combined and have the same cumulative rates, a quirk in how the two taxes are calculated make gift taxes cheaper in the long run than estate taxes.<sup>4</sup>

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<sup>2</sup> Unlike the estate tax exemption which increases gradually to as much as \$3.5 million in the year 2009, the gift tax exemption is not scheduled to increase. Nor is the gift tax scheduled for repeal along with the estate tax in 2010.

<sup>3</sup> The highest estate tax rate is currently 50%. The top rate bracket is scheduled to be reduced gradually over the next few years. Under current law, the estate tax is scheduled to be repealed in 2010 and then reinstated in 2011.

<sup>4</sup> At death, the estate tax is calculated on the value of the entire taxable estate including the amount which will be paid as the estate tax. If effect, there is an estate tax on the estate tax. If a taxable gift is made, the full value of the gift is received by the donee and the gift tax is paid

Planning for lifetime gifts includes planning for the form of the gift. For example, if the gift is to a minor, the gift can be made to a custodian under the Uniform Transfers to Minors Act or to the trustee of certain types of trusts. Trusts may also be appropriate for gifts to adults where the donor wants continued control over the property, when special management or business requirements exist with respect to the property given, or when asset protection planning is important. Whenever trusts are used, special planning techniques are required to qualify gifts in trust for the gift tax annual exclusion.

### *III. Effective Use of the Estate Tax Exemption and Marital Deduction*

The full value of property given to a spouse, either during lifetime or at death, is deductible under the gift and estate taxes. Therefore, there is typically no transfer tax until the death of the surviving spouse. Property given to a spouse can take many forms. It can be an outright gift or in trust. However, if the gift is in trust, care must be taken to insure that the gift in trust will qualify for the marital deduction.

Generally, a gift into a marital trust must require that all of the income must be distributed to the spouse (and only to the spouse) at least annually. The spouse must have the power to require that the trust be invested in property which will produce a reasonable income. In addition to this income right, the spouse must have either the unrestricted right to control the ultimate disposition of the property or the trust must be structured as a qualified terminable interest property trust (commonly referred to as a "QTIP" trust). Under a QTIP trust, the donor spouse may stipulate in the trust document the beneficiaries who are to receive the unused property at the surviving spouse's death. No one other than the spouse can receive any direct benefit from the QTIP trust during the surviving spouse's lifetime.

In addition to property qualifying for the marital deduction, the remaining part of the unified credit exemption not used for lifetime giving can shelter property passing at death. Therefore, for persons dying in 2002, up to \$1 million can be sheltered. If all property passes to the surviving spouse under the marital deduction no estate tax is paid but the opportunity to use any remaining part of the \$1 million exemption is lost. Therefore, basic estate tax planning plans to make use of the remaining unified credit exemption the first priority.

Where there may be a surviving spouse who will need the use of all of the available property, the estate is split into two parts: a marital share and a family share. The family share is equal to the available unified credit exemption; the marital share is equal to the balance regardless of value. The family share would be left in trust, typically called a family trust, which is created after death. The terms of the family trust are found in the revocable trust instrument.

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from other assets. The gift tax is removed from the donor's potential estate and no tax is paid on the tax. Of course, this advantage should be considered against the time use of money with respect to the gift tax paid.

The family trust can be designed to be a tax-planned only trust, in which case the surviving spouse is given maximum control over the trust consistent with the goal of causing the property to be excluded from survivor's estate at the later death. This goal can be achieved and yet the survivor can (i) be the sole trustee with management power over the trust property; (ii) receive all the income from the trust; (iii) make lifetime gifts from the trust; (iv) revise the estate plan to be effective with respect to the property at the survivor's death; and (v) even consume the principal of the trust if necessary for the survivor's own health, education, maintenance or support. Since consumption of principal is authorized only when necessary, it is this limitation which keeps the property from being included in the survivor's estate. The survivor, as trustee, makes the determination as to necessity and the remainder beneficiaries (not the I.R.S.) have the only authority to question this decision.

Since the family trust will contain only the unused unified credit exemption, many families take advantage of this trust to add an additional objective: asset protection. The trust can be designed to provide substantial protection against creditors of the surviving spouse and from claims of future spouses. Such protection comes at the price of a reduction in the amount of control that the surviving spouse can exercise over the trust. If asset protection is a goal, the trustee during the surviving spouse's lifetime is an independent trustee, probably a bank or trust company.

#### *IV. Life Insurance Ownership*

Life insurance is treated differently for tax purposes from any other asset you may own. Therefore, planning techniques have been developed unique to life insurance policies. Use of these special techniques is especially important when the value of a life insurance policy causes the value of the taxable estate to exceed the available unified credit exemption.<sup>5</sup>

The difference in tax treatment is derived from the fact that an insurance policy is valued differently during the insured's lifetime from how it is valued at the insured's death. During the insured's lifetime, the value of the policy is simply its replacement value. This can be as little as the unexpired premium in the case of a term policy to the cash value in a whole life or universal life policy. At the insured's death, however, the value of the policy as an estate tax asset if included in the insured's estate is the full amount of the life insurance proceeds.

The simple but effective technique to employ with life insurance is that the insured should not be the owner of the policy. A second rule is that whoever does own the policy must also be the beneficiary. If the life insurance is intended to benefit the surviving spouse, the spouse could

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<sup>5</sup> Taxation of life insurance is frequently misunderstood. The proceeds of a life insurance policy are generally *income tax free* to the beneficiary. However, the proceeds are included in the taxable estate of the insured if deceased insured owned any interest in the policy at the time of the insured's death.

be the owner and beneficiary; however, the proceeds would then be included in the survivor's estate.

The best solution in many situations is to create a separate irrevocable trust which would own the insurance policy and be the beneficiary. The trust must be a separate irrevocable trust since the insured must have no ownership interest in the policy. Using a trust, the surviving spouse can be the beneficiary and have the benefit of the insurance proceeds while keeping the proceeds out of both the insured's and the surviving spouse's estates. Irrevocable life insurance trusts are one of the most effective estate tax planning options, especially for persons who have significant assets in addition to the life insurance.

#### *V. Retirement Plans and Individual Retirement Accounts*

The federal income and estate tax rules governing employee retirement benefits are very complex. Moreover, the interrelationship between the income tax rules and the estate tax rules sometimes cause choices where to favor the income tax result may cause an unwelcome estate tax result, and vice versa. Many persons nearing retirement age find that a significant part of their wealth is in the form of tax-qualified employee benefit plans and individual retirement accounts of one form or another.

It is beyond the scope of this memorandum to examine the complex rules governing income taxation of retirement accounts and distributions from them to the account owner. From an income tax perspective, it is enough to know that the eventual income tax liability does not evaporate with death. Your beneficiary will remain liable for income tax with respect to distributions to him after your death.

Even though a significant part of the account balance includes an income tax which will eventually be paid, 100% of the account balance is included in the tax base for estate and generation-skipping tax purposes. Therefore, the government is going to assess an estate tax on an income tax which will eventually be paid! Assume that an account owner dies in 2002, with an account balance of \$500,000, he has a taxable estate including the retirement account of \$3 million, and he has a combined federal and state income tax bracket of 40%. After payment of the applicable federal and state estate and income taxes, his beneficiaries receive only \$150,000 from the \$500,000 account!

Obviously, care must be taken when a retirement account is included as a significant part of the estate plan. Tax planning related to retirement accounts generally seek to continue the income tax deferral for as long as possible after the account owner's death. Using the retirement account as any part of the property which is used to fund a unified credit exemption gift, such as to fund a family trust, is also very sensitive and subject to complex rules; however, in many cases, the retirement account must be used if full advantage is taken of the available unified credit exemption. Sometimes favorable income tax planning (which may favor the surviving spouse who needs the largest fund for retirement) is inconsistent with estate tax planning (which preserves the

maximum amount for the next generation). The rules are very complex and the assistance of a qualified professional is indispensable in negotiating through the thicket.

## *VI. Qualified Personal Residence Trusts*

The qualified personal residence trust (sometimes called a “QPRT”) is a creature of an obscure exception to an exception found in the Internal Revenue Code. It permits a donor to make a gift today, retain the use of the donated property for a preselected term of years, with the donee receiving the property at the end of the term of years. The only property which can be used to fund this trust is a personal residence, which can be a primary residence or a vacation home. Only one residence can be used to fund one trust but a donor can create two such trusts.

The best way to explain this concept is by example. Assume that a donor is 55 years old and owns a home which has a value of \$250,000. The donor transfers title to a QPRT with a term of 10 years in August, 2001.<sup>6</sup> At the end of the term, ownership of the home will pass to the donor’s children. Although the gift is made when the transfer is made to the trust, because the children must wait 10 years to receive the property the value of the gift is not \$250,000 but rather \$123,812. Therefore, only \$123,812 of the donor’s unified credit exemption is used rather than \$250,000.

Assume that the property will appreciate at a rate of 4% per year during the term of the trust and that the donor’s potential estate tax bracket is 50%. At the end of the 10 year term, the value of the home would be \$370,061. The potential death tax savings is \$123,125 (the estate tax bracket of 50% times the value of the property less the taxable gift).

The amount of the discount is a function of two factors: the applicable discount interest rate which changes monthly and the term of the trust. The donor can pick any term and the longer the term the greater the discount. However, if the donor dies within the term the potential tax savings is lost and the property is included in the donor’s taxable estate. Therefore, the donor will typically pick a term of reasonable length and balance the potential savings against the risk of death during the term.

The trust is very flexible. The donor can sell the home during the term and repurchase another residence also owned by the trust. If any part of the proceeds are not reinvested in a residence, they can be invested in any other investment and the donor will receive an annuity of 5% of the invested value each year for the remainder of the trust term. If the donor wishes to continue to reside in the residence at the end of the term, he can lease the residence from the children (which is also a good estate planning technique to shift funds to the children).

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<sup>6</sup> The date of the transfer is important since the calculation of the amount of the gift is based upon an interest rate supplied by the IRS which changes monthly.

## *VII. Generation-Skipping Planning*

If a parent leaves property to his child, an estate tax is paid at the parent's death. The property is then included in the child's potential estate and is subject to another estate tax when it passes to the child's children. Thus, an estate tax is potentially due on the property at each generation level.

Families have attempted to avoid at least one level of estate tax by leaving property in trust for the life of a child, passing at the child's death to grandchildren. When the child dies the property is not included in the child's estate for estate tax purposes since the child did not own the property. Several years ago, Congress created a brand new transfer tax (called a generation-skipping or "GST" tax) designed to tax these types of arrangements. The GST tax is imposed at the death of the child in a trust arrangement or when property passes directly from a grandparent to a grandchild bypassing an intermediate generation.

There is currently a \$1,100,000 million per transferor lifetime exemption from the GST tax. Thus, a parent can create a trust funded with up to \$1.1 million in property to be held in trust for the life of a child, passing at the child's death to grandchildren. This trust, including any appreciation in value during the child's lifetime, is not taxed at the death of the child. This represents a significant tax savings at the child's level, especially if the child has other property which will incur the estate tax at his death. During the child's lifetime, the property is available to him if needed but, if not, it will pass estate and GST tax free to the grandchildren.

With a married couple, each spouse has a \$1.1 million GST exemption. In larger estates, some families create what has become known as a "dynasty" trust with the \$2 million being left in a single trust fund for the benefit of all lineal descendants. The trust is designed to continue for the longest time possible under the applicable law. In most states, a private trust must end no later than the death of the last surviving person who was alive when the trust was created plus a term of 21 years. A few states now permit private trusts to continue indefinitely.

The \$1.1 million GST exemption does not allow more property to pass to a child tax free and is unrelated to the \$1 million estate tax exemption. Planning for effective use of the GST exemption can, however, save significant tax at the child's death for the benefit of grandchildren. At a minimum, GST planning will require creating a trust fund for the life of a child. In more complex situations, the dynasty trust may be appropriate.

## *VIII. Gifts of Property With Discount Valuation*

Assume that you own property with a value of \$1 million. If you give 10% of that property to a child, you have made a gift of \$100,000 for federal gift tax purposes. Assume instead that you contribute the same property to a limited partnership which you create with you and your spouse as the partners. Ten percent of the partnership interest (5% each) is held by you

and your spouse as general partners and 90% (45% each) is held as limited partners. Then, instead of gifting your child \$100,000 outright in property, you give him a 10% limited partnership interest in your new partnership.

The 10% limited partnership interest in the new partnership represents the same \$100,000 value, right? Wrong. The limited partnership interest is subject to many restrictions which affect the ability of the child to access the underlying property. The partnership agreement restricts the child's right to sell the partnership interest for cash from a third party. He cannot force a liquidation of the partnership and obtain access to the money inside the partnership. As a limited partner, he has no right to participate in management of the partnership. If the child were able to sell the partnership interest to a third party, no outside party will pay \$100,000 but will purchase the partnership interest only at a considerable discount to reflect the restrictions on sale and the limitations on management rights. Typically such discounts will reduce the value of the partnership interest by one-third to one-half or more of the value of the underlying property. Since the discounted value represents the true fair market value of the partnership interest in an arms-length sale to a third party, that is also the gift tax value. By changing the form of the gift, the gift tax value has been reduced from \$100,000 to perhaps as little as \$50,000.

The creation of family limited partnerships or limited liability companies is increasingly popular for a number of reasons. Not only do gifts of the partnership or LLC interests qualify as gifts of lesser value, but it is one of the few ways that a parent can transfer value out of his estate to that of a child while retaining the ability to control the property. As general partners, the parents continue to control all of the property held in the partnership. In some cases, the family may own a business which can be transferred to the children using this technique. In other cases, the parents may transfer different family assets to a partnership to consolidate them for management and family use purposes. Partnerships and limited liability companies are also useful in asset protection planning as discussed below in this memorandum.

It must be said that the IRS will closely scrutinize discount valuation gifts. They must be specifically identified to the IRS on the gift tax return. The discount may be disallowed if certain technical tax rule requirements are not strictly followed. Also, the IRS may not recognize the partnership unless the family strictly follows the formalities involved in management and maintaining the entity. Nevertheless, in appropriate circumstances and with attention to detail, the use of family owned limited partnerships and limited liability companies can contribute significantly to the estate plan.

## *IX. Asset Protection Planning*

Asset protection planning generally means shielding property from seizure by creditors. Claims of creditors can arise from accidents, business relationships, divorce and other situations. No one doubts that we live in a society in which litigation is frequent and the consequences of which can be a financial disaster. Many professionals are concerned with liability arising from their professional career. Many people who have owned oil and gas or other environmentally

sensitive property are concerned with the growing risk of liability over environmental issues. No asset protection strategy can completely immunize your property from claims. However, several strategies are available which can help to protect property by making its seizure more difficult or by reducing its value to the creditor.

Asset protection planning can run from the simple to the complex. It is often done in connection with other estate planning objectives. One simple strategy is to transfer property from a family member with a high risk for litigation or claims to another family member with less risk. For example, a surgeon might transfer ownership of property to his spouse on the theory that he is more at risk for claims than she. Another simple strategy is to invest more of your wealth in property which is exempt by law from creditor claims. The best example of an exempt asset is typically homestead property.

Property held through a partnership or limited liability company also enjoys a degree of asset protection. If a creditor has a claim against an individual partner, the creditor cannot seize assets held in the partnership. Instead, the creditor obtains what is known as a charging order which permits the creditor to seize distributions from the partnership. However, in family partnership situations, the family controls the distributions and may direct that no distributions are to be made. Nevertheless, since the partnership is disregarded for income tax purposes it is possible that the creditor will be charged with a proportionate share of income by the IRS even though the creditor receives none of the cash from the partnership! For these reasons, many creditors will not attempt to enforce collection of their claims from a debtor's partnership interest.

Finally, asset protection trusts have been increasingly popular. An asset protection trust is one which is irrevocable and is typically created in a jurisdiction with laws friendly to debtors. The best jurisdictions for creation of asset protection trusts are outside the United States with several Caribbean nations being popular, especially the Cayman Islands, the Bahamas and Bermuda.<sup>7</sup>

Contrary to popular myth, offshore asset protection trusts do not usually offer any U.S. income, gift or estate tax advantage. Another misconception is that the existence of an offshore trust can be kept so secret that no potential creditor will learn of its existence. The reality is that the offshore asset protection trust is generally treated the same as a domestic trust for U.S. tax purposes and that a creditor will learn of its existence in litigation discovery procedures. Nevertheless, even when the creditor knows of its existence, the laws of the offshore jurisdiction

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<sup>7</sup> Some U.S. states, notable Alaska and Delaware, are changing their creditor protection laws and trust administration laws to offer some of the advantages of offshore trusts. While formation of trusts under the laws of a U.S. state may offer some of the protections of offshore trusts, the true offshore asset protection trust remains the best solution if maximum protection is sought.

and other practical problems make it difficult for a creditor to enforce his claim against the property in the trust.

### *X. Charitable Remainder Trusts*

A charitable split-interest trust is one in which both a charity and at least one person have an interest. The two interests are divided into an income interest (a right to receive an income from the trust for a period of time) and a remainder interest (the right to receive what's left when the income interest terminates). Each of these two interests has a value. The sum of those values is the value of the property contributed to the trust. There are two types of split-interest trusts: one in which the person owns the income interest (the charitable remainder trust) and one in which the charity owns the income interest (the charitable lead trust).

With a charitable remainder trust, a donor transfers property to an irrevocable trust. He, or he and his spouse, retain the right to receive an annuity from the trust for life or for a term of years. At death, or when the term expires, the trust terminates and the charity receives everything left in the trust at that time. Until the trust terminates, the charity receives nothing from the trust.

The donor can be the trustee and retain the right to manage the property. He can retain the right to name additional charities or delete charities from the list of those which are to receive the trust fund when the trust terminates. The trust is considered to be a charitable trust even though the donor retains the right to the annuity; therefore, any capital gains from sales of assets by the trust are not taxed. Finally, because the value of the remainder interest is irrevocably given to charity when the trust is created, the donor receives an income tax deduction in the year of the gift for the value of the charities remainder interest.

For example, assume a husband and wife aged 55 and 53 respectively give \$100,000 to a charitable remainder trust retaining the right to receive a 5% annuity for the remainder of their lives. If this gift were made in April, 1998, the value of the charity's remainder interest is \$22,624 and the couple would receive an income tax deduction in that amount. The amount of the income tax deduction is a function of several variables including the IRS discount interest rate for the month of the gift and the ages of the annuity recipients. For a second example, a single donor age 70 who contributes the same \$100,000 would receive an income tax deduction of \$54,417.

The charitable remainder trust is often coupled with a concept called a "wealth replacement trust." Under this plan, the donor uses the cash saved with the income tax deduction to purchase life insurance on his life. This life insurance is owned by a separate irrevocable life insurance trust so that the proceeds of the life insurance will be income and estate tax free at the donor's death. Therefore, while the charitable remainder trust fund will pass to the charity, the insurance proceeds will be used to replace for the family the wealth passing to charity. This is said to be a "win-win" plan; however, it is unusual that the income tax savings alone will be enough to purchase insurance which can fully replace the charitable gift.

## *XI. Charitable Lead Trusts*

The charitable lead trust is the opposite of the charitable remainder trust. In the lead trust, the annuity is given to charity for a term of years. Since there is no income tax deduction for the donor from a lead trust, it is typically created and funded only at the donor's death. The lead trust is designed to create an estate tax deduction at the donor's death but with the property returning to the family after a term of years.

The annuity must be at least 5% but can be larger. The larger the annuity and the longer the term the greater the estate tax deduction enjoyed by the donor's estate. In fact, the estate tax deduction can be as high as 100%. For example, if a donor died in April, 1998, leaving \$100,000 in a charitable lead trust paying a 7% annual annuity to charity for 20 years, the estate tax deduction would be \$75,325. If the annuity were 8.5% for 25 years, the estate tax deduction would be 100%.

By delaying the family's right to receive the property for a term of years and giving a portion of the income to charity, the property eventually comes back to the family with a significant estate tax savings. If in our example the donor had been in a 55% federal estate tax bracket, his family would have received only \$45,000 without the charitable lead trust. If the trust can earn an income sufficient to pay the 8.5% annuity annually for 25 years, the family will receive the full \$100,000 plus income in excess of the annuity compounded over the term of the trust. Meanwhile, the family controls the investment of the trust fund and the selection of the charities which receive the annual annuity. This technique is particularly attractive in larger estates where the family can afford to do without the personal benefit of the trust fund for the term of years.

## *XII. Private Foundations*

A family foundation may be used in connection with a charitable split-interest trust. If so, the charitable distributions, whether the lead income interest or the remainder interest, can be directed to the family foundation. Or, the family foundation may be established as the direct beneficiary of a lifetime gift or of a gift at death. Generally, the foundation should be established and funded during lifetime, but occasionally the foundation is created at death under the terms of a last will or revocable trust.

The estate tax advantage of the family foundation is that 100% of the value of the donor's gift to the foundation is deductible. By judiciously using the foundation and split-interest trusts, the estate tax can be significantly reduced. Of course, the funds that go to the foundation must be used exclusively for charitable purposes—thus transferring money that otherwise would go to the federal government in the form of tax payments to a charitable vehicle that can be controlled by the family. Hence its name: "family" foundation.

A family foundation must qualify as a charitable organization under the Internal Revenue Code. All of its interests must be held for the benefit of one or more charitable, religious, educational or other organizations which are themselves listed as tax-exempt by the IRS. The trustees of the foundation trust (or directors if the foundation is formed as a corporation) are authorized to invest and distribute the funds to qualifying charitable recipients.

A family foundation generally is treated as a “private foundation” which is a specifically defined type of charitable organization under the tax laws. It will be a private foundation because it will typically not have a sufficiently broad source of support to qualify as a public charity. When classified as a private foundation, it must distribute at least 5% of its net investment assets each year, pay a 2% excise tax on net investment income, not make investments which would jeopardize its charitable purpose, not engage in self-dealing with principal donors or others who are disqualified, not make taxable expenditures (including certain contributions to individuals) and may not hold more than 20% of the stock of a closely-held business enterprise. Failure to comply with these rules will result in substantial excise taxes and could result in the loss of its qualified status as a tax-exempt foundation. In addition, a private foundation may not engage in lobbying and must file annual tax returns.

In spite of these onerous requirements, many families choose to establish and contribute to their family foundations during their lifetimes and may make substantial gifts at death. One reason for the popularity of family foundations is the ability of the family to control the disposition of the dollars set aside in the foundation for charitable purposes. Many people believe that their children and heirs should be taught the principles of philanthropy and be expected to give back to society some of the wealth which the family has been able to accumulate. Family members may not only serve as trustees or directors (with the ability to manage the foundations assets and to choose the charitable beneficiaries annually) but may also, with some limitations, receive a salary for serving. Family foundations may be designed to exist perpetually, creating a memorial to the family and a vehicle for charitable giving which can serve the family for many generations.