Philadelphia Estate Planning Council

Vol. XXIII, No. 1 Fall 2013

President's Message

Kathleen S. Kinne

Much has changed since I last saw many of you at the Barnes Foundation for our wonderful annual meeting. My husband and I welcomed our fourth child, Flynn Evan Kinne, into the world. At the same time, I became President of this amazing organization and took on greater responsibility at my job. As an extremely busy woman, I am constantly looking for ways to multitask. Last year, as the co-chair of the Program Committee, one of my goals for this upcoming program year was to have topics and content that are useful to all of us both personally and professionally. I believe we have succeeded in accomplishing that goal.

Kicking off our first luncheon in September is Robert Keebler. Mr. Keebler will be discussing the Mathematics of Estate Planning. During his presentation, he will demonstrate and explain how popular estate planning transactions and techniques can be used in combination with each other. As a former history major, I always appreciate any help with mathematics.

The October luncheon speaker is Jean Chatzky. As the financial editor of the Today show, Ms. Chatzky will give us valuable financial advice to share with our clients. She will also broach the extremely important topic of What We Say Versus What Our Clients Hear. One of the reasons Ms. Chatzky is so successful in her career is that she says things in a way that the listener understands. I can't wait to borrow a few of her tips for my own client interactions.

Our November luncheon speaker is Doug Bauer. Mr. Bauer will talk with us about Trends in Philanthropy. Once again, this topic is important both to our clients and us. I am constantly looking for new and innovative ways to raise funds for my favorite charities. There are so many worthwhile organizations competing for charitable dollars. What works? What advice can we give our clients who are looking to make an impact?

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Estate Planning for Same-Sex Couples in Pennsylvania Following *Windsor*

Stanley A. Pelli and Benjamin L. Jerner

The recent U.S. Supreme Court decision in *United States v. Windsor*, 570 U.S. __ (2013) (Docket No. 12-307), declared Section 3 of the federal Defense of Marriage Act ("DOMA") unconstitutional.[1] Section 3 had prohibited the federal government from recognizing otherwise valid marriages of same-sex couples. The benefits for many same-sex married couples under *Windsor* are enormous. However, for same-sex couples residing in Pennsylvania, a state which does not recognize same-sex marriages, the impact of *Windsor* with respect to federal agencies is not yet clear; this is due, in large part, to the varying policies of federal agencies when it comes to determination of marital status.

As of August of 2013, fourteen jurisdictions in the United States permit and recognize same-sex marriages[2] and thirty-seven do not (including the seven that recognize civil unions or domestic partnerships). For same-sex couples who enter valid marriages in U.S. or foreign jurisdictions which permit

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2013-14
LUNCHEON PROGRAMS

The Union League
140 South Broad Street
Philadelphia, PA
www.unionleague.org

Times
11:45 - 12:00 p.m. Registration
12:00 - 12:30 p.m. Lunch
12:30 - 1:45 p.m. Program

Dates
Tuesday, September 17, 2013
Tuesday, October 15, 2013
Tuesday, November 19, 2013
Tuesday, January 21, 2014
Tuesday, February 18, 2014
Tuesday, March 18, 2014

Holiday Celebration
Monday, December 2, 2013
5:30 - 7:30 p.m.
Crystal Tea Room Atrium
100 E. Penn Square
Philadelphia, PA 19107

Welcome Back Party
Thursday, October 3, 2013
5:30 - 7:30 p.m.
The Racquet Club
215 South 16th Street
Philadelphia, PA 19102

For information contact the PEPC Office at 856-234-0330 or staff@philaepc.org

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same-sex marriages and who reside in one of these U.S. jurisdictions, their marriages will be recognized by their state of residence and by all federal agencies. However, there are thousands of couples who have married in jurisdictions which permit same-sex marriage but who reside in states, such as Pennsylvania, which do not permit or recognize same-sex marriage. Although these marriages will not be recognized by their states of residence, these marriages will be recognized by some federal agencies.

Certain federal agencies, such as the U.S. Citizenship and Immigration Service, determine marital status by looking at whether the marriage was valid in the place of celebration. For these federal agencies, the law of the state of residence of the married couple is irrelevant to the determination of marital status. Other federal agencies, such as the Social Security Administration ("SSA"), have traditionally only recognized a marriage if the marriage was valid where celebrated and if the state where the wage owner is domiciled recognizes the marriage.[3]

All federal agencies have been directed by President Obama to review their policies with respect to same-sex marriage in light of the *Windsor* decision. To date, few agencies have finalized their review and/or announced their decision regarding whether they will look to place of celebration or place of residence.[4]

On August 29, the Internal Revenue Service ("IRS") issued Revenue Ruling 2013-17 and clarified that, in light of the *Windsor* decision and Rev. Rul. 58-66, 1958-1 C.B. 60 (which had recognized common law marriages based on place of celebration for income taxes), the IRS will recognize same sex marriages based on the place of celebration. Revenue Ruling 2013-17 also concluded that "marriage" does not include individuals (whether of the opposite sex or the same sex) who have entered into a registered domestic partnership, civil union, or other similar formal relationship that, while recognized under state law, is not denominated as a marriage under the laws of that state.

Despite having their marriages recognized by the IRS, while Pennsylvania's Defense of Marriage Act ("Pennsylvania's DOMA")[5] is in effect, the non-recognition of same-sex marriages of Pennsylvanian residents by the Commonwealth will continue to have negative consequences. These couples face the possibility that their marriages will not receive recognition by all federal agencies and they face the certainty that their marriages will not be recognized by the Commonwealth.

The full scope of the ramifications of non-recognition of these marriages is beyond the scope of this article. Instead, this article will focus on some of the issues that the Pennsylvania estate planner may face in these uncertain times following the *Windsor* decision.

Underscore Non-Recognition in Pennsylvania: An issue every estate planner who counsels same-sex couples residing in Pennsylvania will almost certainly face is clients who have married or who will enter into a valid same-sex marriage in another state.[6] An important first step when counseling these clients is to ensure that they understand that their marriage is not recognized in Pennsylvania. It is imperative that these clients have in place the same basic estate planning documents recommended for unmarried couples: durable powers of attorney, healthcare powers of attorney, living wills/advance directives, medical facility visitation and funeral authorizations, and wills (or revocable trusts and pour-over wills).[7] A same-sex couple married in another state will not enjoy any rights afforded a spouse in Pennsylvania for purposes of intestacy, elective share, family exemption, favorable inheritance tax rates,[8] or any preference for serving as a personal representative.

Avoid Using Husband/Wife/Spouse: When drafting documents, caution should be used when referring to the principal's same-sex spouse with words such as "my husband,"

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President's Message continued

The Committees of the Philadelphia Estate Planning Council have something planned for every month this year! In October, we will kick off the social calendar with our Welcome Back Party and VIP Reception for New Members. In November, we will have our second Drop-In Networking event. This event allows members to join colleagues and friends for good conversation and networking in a fun environment. In December, we will have our Holiday Party. I am thinking maybe we should try an Ugly Sweater Party this year. Any takers?

I am so excited about the upcoming year and I hope you are, too. Please stay tuned to the PEPC website for Round Table lunches and Women's Initiative events. I hope to have an opportunity to meet all of you at the events throughout the year. Please get involved! Please consider being a sponsor! Please bring a prospective member to one of our events. What makes the Philadelphia Estate Planning Council so fabulous is its members.

Windsor continued

"my wife," or "my spouse" in estate planning documents. Reliance upon these descriptive terms may leave a will open to challenge due to mistake or ambiguity. Additionally, because same-sex marriages are void in the Commonwealth, using such terms could be used to support a challenge to the testator's capacity to know the natural objects of the testator's bounty. There are instances of family members challenging the estate plans of same-sex couples, and all precautions should be taken to protect the plan and the supporting documents. For instance, (i) carefully observe the formalities of execution; (ii) use a positive statement about why a principal is benefitting his or her same-sex spouse over blood relatives; (iii) be mindful of a possible undue influence argument and consider having each spouse execute documents separately; (iv) consider executing another set of documents shortly after the first set to potentially invoke the application of the rule of dependent relative revocation.[9]

Define "Children": It is also important that a principal identify, or at least define, children or issue. This is particularly true where a testator makes a bequest to his or her same-sex partner's or spouse's natural child. Without this clarification, a bequest to a child who is not the natural or adopted child of the principal will likely fail.

A principal may be under the impression that a natural child of his or her spouse is the principal's child. If the child is born in Pennsylvania to a same-sex married couple, there will be no marital presumption of parentage. In order to establish a parent-child relationship, the non-natural parent will need to pursue a second-parent adoption.

In certain states non-biological parents will be presumed to be parents if a child is conceived or born during a same-sex marriage. For instance, pursuant to a New Jersey statute, a child conceived by a married woman with use of donor sperm is deemed to be the natural child of the woman's husband.[10] A New Jersey Superior Court decision held that this presumption of parentage applies equally to same-sex female spouses. *In re Parentage of Robinson,* 383 N.J. Super. 165 (Ch.Div. 2005).

Although this presumption may be recognized by New Jersey or by other states which recognize same-sex marriages, it is unknown whether Pennsylvania would recognize the presumption of parentage. Given this uncertainty, it is inadvisable for clients to rely on Pennsylvania's recognition of the parent-child relationship since the underlying basis for the presumption, the relationship between the between biological mother and her same-sex spouse, will not be recognized by Pennsylvania. In such cases the non-natural parent of the child should be advised to complete a second-parent adoption to ensure recognition by the Commonwealth of the parent-child relationship.

Carefully Review Beneficiary Designations: These issues of parentage and the recognition of a parent-child relationship underscore the more general issue of the need to review and coordinate beneficiary designations in all instances where a beneficiary may be designated, like life insurance and retirement benefits. Although it is always undesirable to leave beneficiary designations to default rules, it is even more so for same-sex couples who will not receive any help from those rules, unless there is specific language in the underlying contract.

Carefully Select the Place of Celebration: For Pennsylvania couples who wish to enter into a same-sex marriage but have not yet done so, it is important to look carefully at the options available to them. In particular, these clients need to understand that choosing the wrong jurisdiction may leave them unable to divorce without moving out of Pennsylvania. Although no Pennsylvania appellate court has ruled on the issue, two Pennsylvania trial courts have considered the issue of same-sex divorce actions and both have dismissed the divorce complaints, citing Pennsylvania's DOMA.[11]

Most jurisdictions permitting same-sex marriage have residency requirements prior to filing for divorce in their courts. Of these, five of the fourteen jurisdictions that currently grant same-sex marriage licenses will permit non-residents whose state of residence will not permit divorce to return to the jurisdiction for a divorce. States permitting non-residents who married in those jurisdictions to return in order to file for divorce are California,[12] Delaware,[13] Minnesota,[14] Vermont,[15] and Washington, D.C.[16] Due to some curious wording in the Delaware marriage law, it seems that Delaware will permit non-residents who marry in Delaware to return to that state to divorce, but only if one or both of the spouses resided in Delaware at some point in time.[17]

Marriage After Civil Union: Another common scenario is the Pennsylvania (or New Jersey) couple who have entered into a New Jersey civil union and who wish to know if there is a benefit to getting married in a state that permits same-sex marriage. Because there is uncertainty about whether federal agencies will recognize civil unions as marriages, these couples *may* benefit by entering into a valid same-sex marriage, at least with respect to federal agencies that look to the place of celebration as determinative of the validity of the marriage. Of the jurisdictions which allow non-residents to return to the jurisdiction for purposes of divorce, neither Washington, D.C. nor Vermont requires that a civil union

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be dissolved prior to marriage, as long as the marriage is between the civil union partners. Thus, these jurisdictions may be good options for civil union partners who wish to enter into marriages with one another.

Use Life Insurance: One estate planning strategy that will continue to apply to same-sex couples in Pennsylvania regardless of the validity of Pennsylvania's DOMA is the use of life insurance. Life insurance is exempt from the inheritance tax, and while Pennsylvania's DOMA remains in effect, leaving the life insurance benefit to the survivor will avoid the 15% inheritance tax on the proceeds. Better yet, leaving the proceeds in a trust for the survivor could avoid inheritance tax at both deaths.

Leave the Commonwealth: For Pennsylvania same-sex couples with significant assets or for whom marriage recognition is key to deriving a benefit from federal agency, and for whom moving is a realistic alternative, the best estate planning advice may be to move to a state that recognizes same-sex marriage and to enter into a marriage if they have not already done so.[18]

Planning for Possible Invalidation of Pennsylvania DOMA: Estate planners may want to draft for flexibility to account for the possible invalidation of Pennsylvania's DOMA. Possible strategies the estate planner may wish to consider are:

1. Provide in a will or trust that it will not be affected by a marriage after execution and will be deemed to be made in contemplation of that marriage. Or, in the appropriate case, that the will or trust will not be affected by the recognition of the marriage by the state of residence.
2. Consider contingent planning. Ordinarily, a same-sex married couple with a child or children might use a trust for the survivor and the children to invoke a compromise of the inheritance tax. A will or trust could provide that if Pennsylvania's DOMA were invalidated, another trust would be used that would provide just for the survivor during the survivor's lifetime with the remainder for the children. If Pennsylvania's DOMA were invalidated, this type of trust would qualify as a spousal trust and allow a choice between no inheritance tax at the death of the first partner or a compromise tax.

Conclusion: The rules in this area are changing rapidly and clarification by federal agencies is occurring almost weekly. The key to estate planning of same-sex couples in Pennsylvania will be to keep abreast of these developments.

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Benjamin L. Jerner is a principal of Jerner & Palmer, P.C. Mr. Jerner's practice is focused on estate planning, adoption, probate and legal issues affecting lesbian, gay, bisexual and transgender clients.

FOOTNOTES

[1] Section 3 of DOMA amended the Dictionary Act as follows:

DEFINITION OF "MARRIAGE" AND "SPOUSE"

In determining the meaning of any Act of Congress, or of any ruling, regulation, or interpretation of the various administrative bureaus and agencies of the United States, the word "marriage" means only a legal union between one man and one woman as husband and wife, and the word "spouse" refers only to a person of the opposite sex who is a husband or a wife.

P.L. 104-199, § 3(a), 110 Stat. 2419, September 21, 1996 (codified at 1 U.S.C. § 7).

Section 2 of DOMA, which was not challenged in the Windsor case, allows states to refuse to recognize marriages performed in states where same-sex marriages are permitted. See 28 U.S.C. § 1738C.

[2] California, Connecticut, Delaware, the District of Columbia, Iowa, Maine, Maryland, Massachusetts, Minnesota, New Hampshire, New York, Rhode Island, Vermont and Washington.

[3] According to an August 9, 2013, update to the Program Management Operations Manual System ("POMS"), the SSA will recognize same-sex marriages if the wage earner lived in a state which recognizes same-sex marriages at the time of the filing or during the pendency of the SSA claim. However, while the SSA is "working with the Department of Justice to interpret the Windsor decision," SSA personnel are instructed to "hold" claims where, at the time of filing of the claim and during the pendency of the claim, the wage owner resides in a state that does not recognize same-sex marriages. POMS subchapter GN 00210.

[4] On August 14, 2013, the Department of Defense announced that it would recognize all marriages of military personnel if those marriages were valid where celebrated.

[5] Pennsylvania's DOMA provides:

It is hereby declared to be the strong and longstanding public policy of this Commonwealth that marriage shall be between one man and one woman. A marriage between persons of the same sex which was entered into in another state or foreign jurisdiction, even if valid where entered into, shall be void in this Commonwealth.

23 Pa. C.S. §1704 (2005). Pennsylvania's DOMA is currently the subject of federal constitutional challenge. *Whitewood, et al. v. Corbett et al., Case No. 1:2013cv01861 (M.D. Pa filed July 9, 2013)*.

[6] Planners may also have occasion to counsel clients who have recently married in Pennsylvania after obtaining a marriage license from the Register of Wills of Montgomery County. As the legal status of these marriages is uncertain, these estate planning documents are

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equally important to these couples.

[7] This advice is equally applicable to couples who marry after one or both of the spouses has changed sex. There is no nationwide standard for determining whether someone is legally "male" or "female." Rather, the standards and criteria differ from state to state, and in many states, including Pennsylvania, there is no definitive standard. There is no statute or reported appellate case in Pennsylvania setting forth the standard to determine legal sex. The only published opinion in Pennsylvania addressing a legal change of sex is *In re Dickinson*, 4 Pa. D & C. 3d 678 (Court of Common Pleas, Philadelphia County 1978), in which the Court of Common Pleas of Philadelphia County granted a change of name and sex to a male to female transsexual who had undergone sex reassignment surgery. Because there exists no definitive standard under Pennsylvania law, the legal sex of a transsexual residing in Pennsylvania may be difficult to determine (or may, arguably, change if the transsexual spouse and/or the non-transsexual spouse moves to a jurisdiction with different criteria for determining legal sex). Thus, clients who are entering or who have entered marriages after the change of sex of one or both of the spouses should be strongly encouraged to create an estate plan that will provide protection to the spouses in the event the marriage is found to be void. The marriages of couples who enter into otherwise valid herterosexual marriages prior to the change of sex of one or both of the spouses will contiune to be recognized by the Commonwealth since marriages in Pennsylvania can only be ended by death, divorce or annulment. *See In re Watt Estate*, 409 Pa. 44, 185 A.2d 781 (1962).

[8] Pennsylvania taxes property inherited by a decedent's surviving same-sex spouse at the highest inheritance tax rate, 15%.

[9] In re Luongo, 823 A.2d 942, 953-959 (Pa. Super. Ct. 2003).

[10] N.J.S.A. 9:17-44.

[11] See *Schlegelmilch v. Eckert*, Philadelphia County, August Term, 2009, No. 008528 (2011), and *Kern v. Taney*, Berks County, No. 09-10738 (2010).

[12] Cal. Fam. Code § 2320(b).

[13] Del. Code Ann. Title 13, § 216.

[14] 2013 Minn. Laws. Ch. 74, § 8 (to be codified at Minn. Stat. § 518.07).

[15] Vt. Stat. Ann. Title 15, § 592(b)-(c).

[16] D.C. Code § 16-902(b).

[17] Del. Code Ann. Title 13, § 216.

[18] This advice applies equally to same-sex couples who have entered into a civil union or domestic partnership. Even if such couples reside in a state, such as New Jersey, that permits or recognizes civil unions as marriage "equivalents", certain federal agencies, such as the IRS, will not recognize civil unions or domestic partnerships as marriages.

Once a Pennsylvania Trust Not Always a Pennsylvania Trust

Stewart M. Weintraub and David S. Kovsky

In *McNeil Trusts v. Commonwealth of Pennsylvania* the Commonwealth Court of Pennsylvania found unconstitutional Pennsylvania's taxation of so-called resident trusts (i.e. any inter-vivos trust whose settlor was a Pennsylvania resident at the time the trust was created). Pennsylvania taxes all of the Pennsylvania taxable income of resident trusts (61 PA Code §105.4(b)), while only taxing the income sourced back to Pennsylvania for non-resident trusts (61 PA Code §105.4(b)) .

In 1959, Robert McNeil, a resident of Pennsylvania, created separate inter vivos trusts for the benefit of his children. The trusts were established under Delaware law and Wilmington Trust Company was named as the sole administrative Trustee. Wilmington Trust Company had no offices in Pennsylvania, nor did it conduct trust matters or act as administrative Trustee in the Commonwealth. All books and records relating to the trusts were maintained in Wilmington, Delaware. In addition to the Administrative Trustee, the trusts had three general Trustees who were residents of New York, Florida and Wyoming, respectively.

Further separating themselves from the Commonwealth, the trusts had no assets or interest in Pennsylvania, nor did they have any income derived from Pennsylvania sources. The only ongoing connection to the Commonwealth was the residency of discretionary beneficiaries.

After making a single distribution to a resident discretionary beneficiary, the Trustee inadvertently paid Pennsylvania income tax ("PIT") and PIT assessments ensued. The PIT assessments were challenged and a refund was sought.

Relying upon the United States Supreme Court Commerce Clause jurisprudence, the Commonwealth Court held that a state or local tax must satisfy a four pronged test: (1) substantial nexus; (2) fair apportionment; (3) fairly related to the benefits conferred; and (4) no discrimination against interstate commerce.

As to the first prong, the Court found that neither the residence of the settlor nor the residence of the beneficiary was sufficient to establish substantial nexus (surely it helped that the Pennsylvania income tax regulations, themselves, provide that the residence of the beneficiaries is immaterial to the determination of trust residency).

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McNeil Trusts continued

As to the second prong, the Court held that imposing PIT on 100% of the trusts' income was out of proportion to the trusts' activity in Pennsylvania and was inherently arbitrary, producing an unreasonable result.

As to the third prong, the Court considered whether the tax was fairly related to the benefits conferred and determined that the trusts do not benefit from Pennsylvania's economy or government services.

The trusts did not challenge the fourth prong.

As a result of the Court's decision, it is no longer the case that the mere residency of the settlor at the time of creation will subject all of the income of the trust to PIT, in perpetuity. Navigating this new world will require some guidance from the Pennsylvania Department of Revenue, but there are some planning takeaways that should be on your radar. First, for trusts that fall squarely within the McNeil fact pattern and have paid PIT, consider filing refund claims if the refund claim is within the statute of limitations. Second, like our friends in New York that have established Delaware Incomplete Gift Non-Grantor Trusts ("DING Trusts"), there may now be an opportunity to establish DING Trusts for Pennsylvania clients that shifts income to a more favorable jurisdiction.

Stewart M. Weintraub is the Chair of the Chamberlain Hrdlicka State and Local Tax Practice Group and Co-Counsel for the McNeil trusts. David S. Kovsky is a Trusts and Estates lawyer in Chamberlain Hrdlicka's West Conshohocken office. Chamberlain Hrdlicka is a Houston based mid-size law firm with a significant focus on tax and estate planning practices.

Please be sure to connect with our Council through the PEPC LinkedIn group page.

Drafting Outside the Lines: Precatory Language and Letters of Intent

Holly Isdale

All lies and jest, still, a man hears what he wants to hear and disregards the rest. - Simon and Garfunkel, The Boxer

"It's not what you say, it's what they hear" is an important mantra in political campaigns (and most compliance discussions). Estate attorneys know this dilemma intuitively as we struggle to bridge the gap between the extremely technical and precise language of our documents required by the law and communicating these nuances to our clients. Planners also balance the reverse translation of documenting a client's wishes, which are often enumerated in excruciating detail, with the need to leave discretion in the hands of trustees, providing necessary flexibility for the administration of trusts decades hence. We try to communicate to clients through newsletters, exhaustive memos as to trust

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administration and conferences, yet many of these efforts fail to educate clients as to the implications of technical decisions they are making or re-focus our clients on the ramifications of the choices being made.

I have found that adding three simple items to an estate plan will greatly increase the client's satisfaction with the process as well as his understanding of the tradeoffs and can ensure that the eventual administration of the trust is in keeping with the client's goals. In short:

(1) Include letters of intent for all entities or trusts created,

(2) Incorporate precatory language in documents whenever possible, and

(3) Help the client draft direct letters to beneficiaries explaining the choices made.

Letters of Intent. In twenty-some years of reading thousands of legal documents from attorneys around the world (truly, I have no life), it is the rare situation where a robust letter of intent is created as part of the planning process. If done at all, the letter tends to be short, focused on one or two items, and often will quickly lapse into bland directions, which will be of little use to a trustee when confronted with a difficult decision. Worse yet, many letters turn out to be a form letter from the law firm that simply reiterates language already in the document, such as the discretion given to a trustee to determine income but without any guidance as to what matters to the grantor. While there are some nuances to drafting a "letter of intent" or "letter of wishes," I believe that this type of communication should be a key part of any estate or gifting process and should be written in clear language, as close to the grantor or testator's own language as possible.

Generally speaking, a letter of intent, also known as a "side letter," is a letter from the grantor to the trustee that provides guidance to the trustee in the exercise of some discretionary power. A well drafted letter of intent can allow the trustee to identify actions that would be in keeping with the grantor's intent at the time the trust was created; conversely, it can provide the trustee with comfort that the goals and objectives for the trust are being met when circumstances within the family have changed. Some tips on side letters include:

(a) Provide Clear guidance. A letter of intent allows the grantor to feel that their voice is being heard, often by allowing the grantor to put into plain English certain goals or actions which might be improper or confusing if included in the main documents. By allowing the grantor to state clearly their fears or concerns, it can provide the trustee with greater comfort in exercising distribution around concepts like HEMS ("Health, Education, Maintenance and Support"). For example, a recent trust I worked with included language directing the trustee to withhold payments if the beneficiaries were leading an "unproductive life." The grantor did not want to spell out in the trust his true concerns, which centered on the inability of his sibling to hold a steady job because the family wealth offered too many "distractions" and essentially eliminated any need to work. At the same time, he felt strongly that taking a less intense job which allowed more time for family and a better work-life balance was one of the benefits of the wealth created and did not want his children to have to feel they had to work at a job they disliked because the trust purse-strings were kept tightly closed. The side letter allowed him to put this into clear examples for the trustee as to when to make distributions or what caveats should be considered.

Guidance to the trustees should be clearly stated and provide examples where possible:

- "Do not give money outright to my son as I worry about his ability to make business investments on his own; I would prefer that you consider carefully before making distributions of principal and encourage you to request a business plan or structure the distribution as a loan to be collateralized by future income distributions," or
- "I would like to benefit my children and grandchildren more than future generations and do not want the trustees to be overly focused on preservation of principal," or
- "Travel has been a huge part of my life and is something I would do with our children if I were living; please make generous distributions for travel and educational opportunities. Even a pleasure trip can have tremendous advantages in terms of experience and maturity."

(b) Remember, These are Not Legally Binding. Letters of intent are not legally binding, a point which should be clearly communicated to the grantor as part of the drafting process. It is fairly well settled that the courts are unwilling to interfere or second-guess a trustee's exercise of discretion unless there is proof of bad faith or motive. As such, the trustee has broad latitude on whether to follow the settlor's guidance or to ignore it in favor of more current circumstances. It is important that the letter not become binding for a few reasons. First, providing too much legal direction in a side letter could be considered a revision or codicil to a will; I saw a side letter once that was longer than the will itself and exhaustively detailed in direction, yet hopelessly out of date with its expectations for the beneficiaries' lifestyles. It is better to avoid repeating the language of the trust or setting out a litany of "maintenance and support" discussions. Be clear

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about what you are expecting of the trustee. Second, and more importantly, if the letter was binding, and considered to be part of the trust documents, the side letter will be discoverable by beneficiaries and could be enforced by a court. I usually recommend that the side letters are not shared with beneficiaries and that the grantor draft a separate letter to the beneficiary for any direct communication with them. I had a client several years ago who directed in a side letter to his will that the trustee of the spousal trust (his son) be "exceedingly generous" with his surviving spouse (the stepmother), where the couple had married late in life and each had adult children (and adult grandchildren) from a prior marriage. The decedent had significant wealth and his wife was of very modest means. His intent had been to ensure that the wife was not limited to her pre-marital standard of living. The son-trustee shared the letter with his stepsister and then spent the next several years handling her demands for larger and larger payouts for her mother's care, conveniently couched in the form of significant renovations to the daughter's home!

(c) Provide Contemporaneous Benchmarks. When used, most attorneys seem to favor side letters for very long duration trusts or situations where there is (or may be) some family tension. I would encourage their use in shorter-duration trusts, such as ILITs where the letter can provide guidance on the intent of the policies, and, ideally, some contemporaneous guidance on the policy purchase or, perhaps, benchmarks for performance. I was working with a trust recently where several large policies were taken out to provide a repayment function for an installment sale, where the note had been repaid decades before. A side letter might have alerted the trustees to the grantor's intent and directed them to reconsider the policy coverage once the notes were repaid. I have also seen letters where the expectations for a life insurance policy (in terms of cost and payment) were laid out in the side letter; while it seems normal to expect that a trustee would understand the policy expectations and would review insurance policies on a regular basis, this sadly is not a common practice. Having guidance from a grantor that helps the trustee understand the expectations on returns might prompt a more proactive approach if the policy underperforms. Likewise, when gifts are made to trusts under which the trustee is given latitude to distribute income or principal, I like to provide contemporaneous references that may help a trustee in the administration of the trust. I have seen letters that presumed a rate of return on a portfolio that would seem aggressive today but was roughly equivalent to the then-prevalent yield of a moderate duration municipal bond portfolio. Consider, for example, the power of a letter that included guidance such as "at the time of funding, it is my expectation that the trust will generate sufficient income to pay for tuition for my children or to help them with the down payment on a home. Tuition is averaging about $50,000 per year at most private colleges, perhaps more, and a "starter home" in our area is about $450,000. I would expect that the children should be able to finance most of the home purchase but would ask that you be generous in making distributions outright to allow them to buy in a better neighborhood or perhaps a slightly larger home, if they seem to be financially responsible and you believe this is a good use of their inheritance." Certainly this type of language implies an active and engaged trustee (which may or may not be the case), but hopefully guidance like this can also lead to a better discussion with a trustee as to the expectations on their involvement with the family.

I have also encouraged the creation of side letters in long duration GST trusts where the older generation provides guidance to the trustees for succeeding generations. Again, as these letters are not legally binding there is no reason not to have a senior generation of beneficiaries write up a letter, and it often increases their sense of stewardship over the family resources. Moreover, the trustees are free to disregard the letters, but the letters can provide a way to update guidance on distributions and address concerns that will morph over generations.

Precatory Language. As side letters are not binding, it is important to remember the ability to include precatory language in documents to clarify the settlor's intent in a binding manner. In particular, when property is to be divided unequally or there are clear objectives for the disposition of property, or for how disclaimers will function, use of such language can be tremendously helpful in the event of unforeseen litigation among family members. A statement such as "I am fully aware of the challenges that come with shared ownership of property and hence, I intentionally leave the vacation home to my son, Jack, outright and in his sole name, with the expectation that it will pass to his children if he should predecease me" can stop a prolonged battle, or at least some long discussions with disgruntled siblings, and avoid challenges if the recipient of the asset happens to be the executor or the child that may be perceived to have had sway over an aging parent. Precatory language seems to be sporadically used around the country and varies widely from across practices, with some firms using it extensively but only for certain areas, while others incorporate precatory language throughout their documents. I believe the extra work in

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adding such guidance to standard documents can yield huge benefits in the eventual discussions with beneficiaries and often helps clients to focus on the implications of certain dispositive provisions that might otherwise go unexamined.

Direct Letters to Children. A great opportunity to use a side letter is when a settlor wants to avoid the hard discussion and leave the "bad cop" role to the trustee. It is difficult to look at a child and say "I really do not trust your wife and your marriage enough to leave you this money without lots of strings attached." At the same time, I strongly believe that drafting separate letters to be shared at the time of the gift, or at the testator's death, with their children, or (even better) their grandchildren, is a wonderful and compelling way for a settlor to convey his or her beliefs, wishes, and expectations for the money as well as share a bit of family history or wisdom. I have helped many clients write letters to their (grand) children, and these letters often become cherished family mementos, sometimes with the side benefit of motivating the beneficiaries to become more financially savvy, to take steps to preserve the wealth for another generation or to do bigger things with an inheritance of any size than they might have otherwise. I have also seen hard language of a will softened by these letters, particularly where adult children do not understand why assets were left to them in trust, rather than outright, and the parent has an opportunity to say again, "trust me, it seems like you need it now but you really will need it later. If you do need it now, you should be able to convince the trustee to give it to you but I want to think in terms of generations, not a kitchen renovation."

Letters of intent can take many forms and can often tip into unfamiliar territory for some practitioners as they move beyond legal structure into more emotional areas of planning. However, a well-crafted letter of intent can do more for your clients' peace of mind than many other actions we take as advisors. This is a great opportunity to work with your clients and provide a reason to re-engage with them periodically to update letters.

Holly Isdale is the founder of Wealthaven, a consulting and family office practice based in Bryn Mawr. Holly would like to thank Allison Nicklin of Villanova Law (Class of 2014) for her help in preparing this article but takes full responsibility for any errors and omissions. Samples of the letters discussed above are available upon request at holly.isdale@wealthaven.com.

Leveraging Family Opportunity Trusts

Martyn S. Babitz

In 2012, many individuals and families took advantage of their federal gift tax and generation skipping transfer ("GST") tax exemptions (collectively, the "transfer tax" exemptions), which they feared were going to default to much lower levels this year, by establishing "Family Opportunity Trusts." In many cases, such trusts and the corresponding gifts were completed near the end of 2012, with the result that the best that could be accomplished was only the creation of the trust and a gift of relatively straightforward assets such as cash or marketable securities.

A Family Opportunity Trust is characterized by these important features:

- The trust is **irrevocable**.
- The trust is **perpetual** (the grantor's federal GST exemption is applied to assets transferred to the trust; growth of these assets will be shielded from inclusion in the taxable estates of multiple generations of beneficiaries in the majority of states that now permit perpetual trusts).
- The trust is an **Intentionally Defective Grantor Trust** (the trust is considered owned by the grantor for income tax purposes, but not for estate tax purposes)
- Although not required for the techniques discussed in this Article, it is recommended that the trust has a situs in a trust-friendly state such as Delaware (in addition to allowing for a trust's perpetual existence, Delaware trust law also provides additional asset protection, flexibility, ease of administration, accessible court system, potential for grantor to receive distributions, etc.).

In light of the American Taxpayer Relief Act of 2012 (ATRA) and the corresponding preservation of the $5 Million base transfer tax exemptions, indexed annually for inflation, individuals and their advisors may now wish to reflect on what may be possible for further leveraging these exemptions with this type of trust. Trusts with the four key characteristics of Family Opportunity Trusts are powerful tools that can be leveraged to significantly enhance multi-generational wealth transfer through utilization of post-ATRA transfer tax exemptions. This article will outline two such leveraging possibilities: the grantor's "swap" of higher potential growth assets for the existing cash or marketable securities held in such a trust, and the sale of additional assets to this type of trust.

Asset Swaps

With Intentionally Defective Grantor Trusts (IDGTs) such as Family Opportunity Trusts, transfers of assets between trust and grantor are not subject to recognition of gain or loss or to other income tax consequences. No gain is recognized, and the basis of the assets is not adjusted.

To allow for asset swaps, such a trust typically includes a provision allowing for the grantor's substitution of assets of equal value.[1] Even though no gain or loss is recognized on unequal exchanges of assets between grantor and trust, one must be careful that any such swaps are, in fact, of equal value in order to ensure that the safe harbor for equal-value swaps is satisfied. Failure to do so will cause inclusion of the trust assets in the grantor's taxable estate (IRC Section 2036(a)).

In addition to swapping high-growth potential assets for more conservative cash or marketable securities in the trust, a grantor might also take advantage of valuation-discounted assets in a swap with his or her Family Opportunity Trust. By so doing, further leverage could be attained.

For example, assume a grantor created a Family Opportunity Trust in 2012 funded with $10 million of blue chip stock with a tax cost basis of $2 million. Assume that grantor's spouse made a consent election to use $5 million of her available $5.12 million gift tax exemption, thus resulting in each the grantor and grantor's spouse making $5 million gifts to the trust, within their available $5.12 million exemptions.[2] The grantor and the grantor's spouse also apply $5 million of their available $5.12 million GST tax exemptions to the transfer, thus creating GST tax-exempt status for the trust. Although the same assets can be exempt from both federal gift tax and GST tax, allowing for exemption of the trust assets from the taxable estates of the grantor, his or her children and subsequent generations, a separate allocation of both exemptions is necessary to accomplish this objective.

In 2013, grantor creates a single member Limited Liability Corporation (LLC), contributing $150,000 cash to the LLC in exchange for all of the membership interests. The grantor then forms a Family Limited Partnership (FLP), contributing $14.85 million of commercial real estate properties in exchange for the 99% limited partnership interests. The LLC contributes its $150,000 cash in exchange for the 1% general partnership interest in the FLP. Utilizing an LLC as owner of the general partnership interest allows for insulation of individuals, such as the grantor in this example, from liability to which that interest may be subject.

The grantor then "swaps" his 99% limited partnership interests in the FLP with the Family Opportunity Trust in exchange for the $10 million of marketable securities therein, taking

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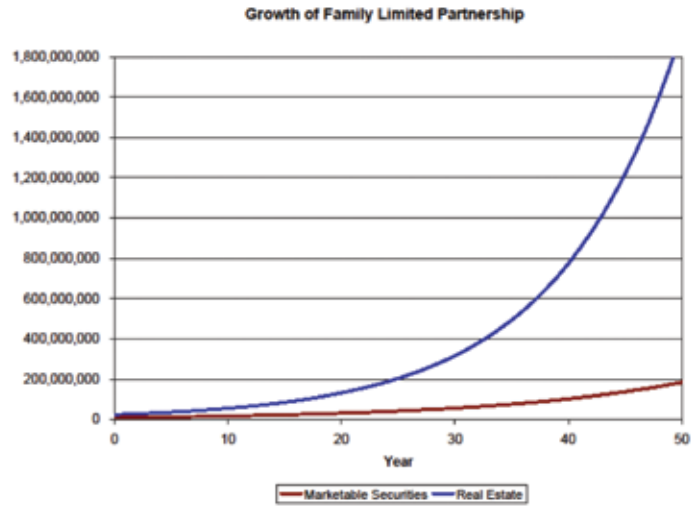
a 32.66% valuation discount[3] for lack of marketability and control with respect to those limited partnership interests,[4] making the exchange an equal trade ($10 million of limited partnership interests, as discounted, for $10 million of stock).

No gain or loss is recognized for federal tax purposes by the grantor or the trust in this exchange, even though both assets may have built-in capital gain well in excess of their tax cost basis, because transactions between a grantor and a grantor trust are ignored for federal income tax purposes. Rather, the tax cost basis of the assets carries over to the transferee. In addition, even though the underlying assets in the LLC are of significantly greater value than the discounted value of the LLC interests, it is the discounted value, (taking into account the restrictions in the FLP agreement) that controls in determining the appropriate equal swap value for the assets in the trust.[5]

Assume the underlying real estate in the LLC has a true value of $14.85 million (as compared with the marketable securities originally in the trust worth just $10 million) and appreciates at 10% annually. If the stock it is exchanged for enjoys a 6% annual return, either with or without the swap, the difference in growth of these two assets can be illustrated as in Chart 1.

Chart 1: Providing a Tool for Long-Term Wealth Transfer and Growth



(Source: Hawthorn/Babitz/Petrunia)

Selling Assets to a Family Opportunity Trust

By taking advantage of the income tax neutral aspect of transactions between grantors and grantor trusts, and using assets gifted to a Family Opportunity Trust as collateral, the trust could purchase additional assets from the grantor. If those assets sold to the trust are (i) highly appreciating; (ii) possibly discounted in value (for example, limited partnership interests in an FLP); and (iii) the consideration provided by the trust to purchase those assets is a promissory note utilizing the current ultra-low interest rates available for intra-family loans, the wealth transfer results could be quite favorable.

An exchange between a grantor and grantor trust is not recognized for federal income tax purposes. Accordingly, such a trust's exchange of a promissory note for assets from the grantor would not be recognized as a taxable exchange as well. The IRS has specifically ruled that a grantor's sale of appreciated assets to a grantor trust in exchange for the trust's promissory note will not cause the recognition of taxable capital gain (Private Letter Rulings 9535026 and 200434012).[6]

The IRS has also ruled that loans between a grantor and grantor trust do not trigger taxable interest income because, for tax purposes, the grantor is deemed to have made a loan to himself or herself (Technical Advice Memorandum 9604005). Accordingly, not only will no gain recognition result from the sale of assets by a grantor to his or her grantor trust, but interest payments made by the trust to the grantor with respect to a promissory note given in exchange for the assets will also not be considered federal taxable income to the grantor.

A primary wealth transfer objective in a grantor's sale of assets to his or her grantor trust is that the assets sold to the trust grow at a greater rate than the payments of principal and interest on the promissory note received by the grantor in exchange for the assets. Thus, the interest rate on the promissory note acts as a "hurdle rate". To the extent the growth of the assets transferred to the trust exceed this rate, wealth is effectively transferred to the Family Opportunity Trust without use of transfer tax exemptions or payment of gift tax. The Internal Revenue Code governs the minimum interest rate that must be charged for intra-family loans (the interest rate on a promissory note issued to a grantor by a grantor trust, whose beneficiaries are family members of the grantor, would be subject to these provisions) to avoid imputation of interest and corresponding adverse tax consequences (IRC Section 7872 (a) and (f)). Fortunately, in the current interest rate environment, these required interest rates are quite attractive: for June 2013, the short-term (3 years or less) rate was 0.18%, the mid-term (between 3 and 9 years) rate was 0.95%, and the long-term (greater than 9 years rate) was 2.44%.

To be respected as a sale rather than a disguised gift, the

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grantor's transfer of assets to a Family Opportunity Trust in exchange for a promissory note must satisfy the same specific criteria as a bona fide sale.[7] Otherwise, the IRS could potentially recharacterize the transaction as a gift, or part sale and part gift, resulting in a taxable gift requiring the use of all or a portion of the grantor's remaining gift tax and GST tax exemptions, payment of gift tax liability (and possibly GST tax liability), or both.

Along these lines, the promissory note should be in writing, have no provisions that would prevent enforcement in the event of default, and provide for at least the required interest rate for intra-family loans.[8]

In addition, the promissory note should be secured by collateral or personal guaranties by the trust beneficiaries. In the case of those who have established Family Opportunity Trusts and gifted all or a portion of their gift tax and GST tax exemption amounts to the trust (or intend to do so), such gifted amounts provide "seed" assets to collateralize a promissory note to purchase additional assets from the grantor.

As an example, assume that in June 2013 a grantor transfers $10 million to a Family Opportunity Trust, to which his wife consents, utilizing $5 million each of their federal gift tax and GST tax exemptions. The grantor could then sell as much as $90 million of additional assets (a 9:1 debt to equity ratio which in Private Letter Rulings, and related developed and generally accepted guidelines in the estate planning advisory community, seems to be the maximum acceptable debt leverage in such transactions) in exchange for a promissory note with a nine-year term at the required 0.95% interest rate. The promissory note could be structured to provide for interest only, equaling $855,000 annually, with a balloon payment at the end of the term. The interest payment to the grantor would not be taxable income to him or her, but whatever taxable interest, gains, or other tax items were earned by the trust assets would be taxable to the grantor on his or her personal tax return. At the end of the nine-year term, the trust could repay the $90 million balloon principal amount in cash or in kind (that is, with actual trust assets). Paying off the balloon amount in kind would not create any federal taxable gain or loss to the grantor or the trust as they are treated as the same person for federal income tax purposes. Assuming an annual rate of return on the trust assets in excess of the interest rate on the note, the transaction can remove substantial appreciation of the trust's assets from beneficiaries' estates for generations to come.

Although beyond the scope of this article, there is concern that the promissory note may be subject to income tax if the grantor dies while still holding it. Possible options to mitigate this risk include having the promissory note terminate upon the holder's death through structuring the note as a Self-Cancelling Installment Note (SCIN) or private annuities.

Conclusion

In addition to effectively transferring, managing, preserving, and growing family wealth for many future generations, a Family Opportunity Trust provides the opportunity for substantial leveraged wealth transfer in concert with the current advantageous federal gift tax and GST tax exemptions (and low interest rate environment) and availability of related techniques to amplify their value.

For those who have already established these trusts, the capacity to magnify the transfers already made and to make additional leveraged wealth transfers on an annual basis (utilizing the annual inflation adjustment to the federal gift tax and GST tax exemption) is in place. For others, the opportunity to establish and maximize the value of such a trust for the benefit of one's family, both now and for generations to come, is knocking at the door.

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FOOTNOTES

1 Revenue Ruling 2008-22, I.R.B. 2008-16 (2008) ruled that a power reserved by the grantor in a nonfiduciary capacity to reacquire trust assets by substituting assets of equivalent value under IRC Section 675(4)(C) does not cause inclusion of the trust assets in the grantor's taxable estate under IRC Sections 2036 (power to enjoy or control enjoyment of trust assets) or 2038 (power to revoke trust).

2 The 2010 Tax Act, which originally instituted the $5 million base exemption, indexed for inflation, for the three transfer taxes, was extended as to this provision by ATRA. The inflation indexed exemption amount was $5.12 million for 2012.

3 Valuation discounts should only be taken with the guidance of tax and legal professionals, backed by a professional valuation report.

4 The limited partnership agreement, especially a family limited partnership agreement, generally provides substantial restrictions on the limited partners' ability to sell or liquidate the interest, or to compel distributions or exercise other control over the partnership, making the interest worth less than the proportionate share of the underlying assets were they owned directly.

5 Valuation of the proper discount for the restrictions attributable to limited partnership interests, as well as the value of sometimes difficult-to-value underlying assets in the partnership, is an inexact, subjective science subject to a dispute by the IRS even with the assistance of the best valuation, legal and tax advisors. Accordingly, the use of formula valuation clauses to provide that any excess value attributable to such

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interests, after settlement or adjudication with the IRS, instead pass to charity or other recipients not subject to Gift taxation, can be effective in mitigating the risk of undesired and unintended transfer tax liability. Full analysis of the subject of formula value clauses, and the two general types (formula transfer clauses and formula allocation clauses) is outside the scope of this paper.

6 Private letter rulings are not binding on the IRS, but under the Taxpayer Bill of Rights can be cited for support by a taxpayer to avoid penalty and interest on disputed tax liabilities.

7 Although the Internal Revenue Code does not specify what these requirements are, general guidelines have evolved through various court rulings, IRS rulings, and derivation from general Tax Code principles.

8 Some commentators suggest the interest rate be set above the required intra-family loan rate in order to bring the transaction more in line with what a third-party sale transaction would resemble.

The ABCs of Private Foundations

Andrew Schulz, J.D. and Mary Ann Stover

According to a 2012 Bank of America study, 95% of households with a net worth in excess of $1 million give to charity annually, as do 98% of families with a net worth in excess of $5 million. Further, according to *Financial Advisor Magazine*, 75% of affluent investors are interested in learning about private foundations. Yet a surprising number of attorneys are reluctant to engage their clients in conversations about philanthropy, even though many studies show that most clients would actually welcome advice in this area.

Many advisors don't discuss philanthropy in general, or private foundations specifically, because they don't think these topics matter to their clients, they don't think it's their business, or they don't know how (or lack the confidence) to start the conversation. Clients may not raise the topic of charitable planning because they don't know what they can accomplish through the estate planning process. They may also mistakenly believe that foundations are available only to philanthropists with names like Rockefeller and Gates.

This article covers the essential information that you need to know about private foundations to speak confidently and knowledgeably about private foundations with your clients. Beyond providing better service for your clients, a discussion about philanthropy provides an opportunity for you to connect with their core aspirations and values, and over time, with their families (and heirs).

What Is a Private Foundation?

Technically, a private foundation is a not-for-profit entity that is organized exclusively for charitable, educational, religious, scientific, or literary purposes under Section 501(c)(3) of the Internal Revenue Code. As such, contributions to the foundation allow a living donor to claim a charitable deduction for purposes of federal income taxes. Testamentary gifts are fully deductible for estate tax purposes. Once a foundation is funded, investment and other income earned by the foundation are generally exempt from tax, and assets sold by the foundation are exempt from capital gains taxes.

A private foundation differs from other charities in that it receives most of its funding from, and is controlled by, a single individual, family, or business. Private foundations are incredibly flexible and can engage in a wide variety of activities so long as they further the foundation's charitable mission. Most private foundations make grants to other

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organizations (public charities). However, foundations may also make grants directly to individuals, conduct their own charitable programs, and put their endowments to work through "program-related investments."

What Are the Benefits of a Private Foundation?

When compared to other philanthropic vehicles, a private foundation offers distinct advantages. Some of the benefits that founders of private foundations find most compelling include:

- Control: Unlike public charities, where the donor must surrender control at the time the gift is made, a private foundation enables the donor and her family to retain significant control over the assets, grants, programs, governance, and operations of the foundation.
- Legacy: A private foundation establishes a tradition of giving that can burnish the founder's name now and for generations to come.
- Family involvement: A private foundation enables you to involve your spouse, children and other relatives in philanthropy and pass on core values to future generations.
- Tax Advantages: Contributions to the foundation are immediately deductible from current income taxes and are exempt from capital gains taxes. Assets contributed to the foundation now are also removed from the donor's taxable estate. If contributed at death, assets that go into the foundation are fully deductible from the estate.
- Adaptability: Current contributions to the foundation may be distributed over time, giving donors time to determine how best to achieve their charitable goals and giving them the flexibility to adapt their philanthropy as their own strategies and community needs change.
- Flexibility: In addition to supporting U.S. public charities, private foundations may grant internationally, award scholarships (and choose their recipients), make grants directly to individuals for emergency relief and hardship assistance, provide loans to nonprofits that are repaid to the foundation, and run their own charitable programs. A private foundation can even provide funds to a for-profit business, as long as it's for a charitable purpose.

When Is a Private Foundation a Good Fit?

Clients who might benefit from establishing a private foundation are those who have:

- At least $1 million in investable assets or a net worth of at least $5 million
- Personal financial and philanthropic goals that would be advanced by philanthropic planning
- The desire to avoid taxes on the sale or transfer of assets
- The desire to avoid estate tax liability
- Children or heirs they wish to inculcate in philanthropy
- No inheritors and wish to leave their wealth to charitable causes
- A CLT, CRT, or other planned giving vehicle
- A desire to create an enduring legacy

How Is a Private Foundation Created?

There are two steps to creating a private foundation. The first step is to create a legal entity under state law that will serve as the structure of the foundation. Often, this is a non-stock corporation, but many foundations are created as trusts. Where to form the foundation is often a matter of personal choice, with many donors choosing to create the corporation or trust in the state in which they live. However, because states do vary on how they regulate the charities that fall under their jurisdiction, careful consideration should be given to which state the foundation will call home based on the expected activities of the foundation and the potential regulatory burden imposed by the state.

Once created, the foundation must then apply for and be granted recognition from the IRS that it satisfies the requirements to be treated as a charitable organization. To apply for recognition of exemption, the foundation must complete and submit IRS Form 1023. The IRS then reviews the application and either grants exempt status, denies the application, or raises additional questions that need to be answered before a determination can be made.

The whole process, from creating the legal entity to submitting IRS Form 1023, can be completed in as little as a week by some experts but may take substantially longer for those who do not create foundations regularly. Once submitted, applications for exemption prepared by experts can take as little as two months to be processed by the IRS. Less skillfully prepared applications, or those that indicate the foundation will be funded by unusual assets or will undertake complicated activities, could take as long as a year or more for the IRS to process.

What Is the Tax Deduction for Donations to a Private Foundation?

Typically, lifetime donations to a private foundation are deductible for income tax purposes up to 30% of adjusted

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gross income (AGI) for cash, and up to 20% of AGI for appreciated securities, with a five-year carry forward. Other types of assets, including real estate, art, rare coins, jewelry, closely held stock, etc. may be donated to the foundation, but are subject to different deduction rules depending on the type of asset and specific characteristics such as how long the asset has been owned, whether it is marketable, and if it has gone up or down in value since it was acquired by the donor

Contributions to private foundations qualify for an unlimited estate tax deduction. Although the limitations on deductions for lifetime gifts may appear to make such contributions less attractive, lifetime giving not only allows an income tax deduction, but also removes the asset from the taxable estate. To take advantage of these benefits, many donors create and at least partially fund foundations during their lives, often providing substantial additional funding at death.

What Do Private Foundations Do?

Private foundations typically carry out their philanthropy by making grants to recognized public charities. These include religious, educational, scientific, and cultural institutions; poverty relief agencies; and other organizations that qualify as 501(c)(3) charities according to the IRS. Federal, state, and local governments are treated as the equivalent of a public charity if the donated funds are used strictly for charitable purposes. Private foundations also may provide scholarships and make grants directly to individuals for hardship, emergency assistance, and medical distress if certain IRS criteria are met.

Grants may be made to for-profit entities (e.g., a for-profit bakery that employs homeless individuals) if those funds are applied solely to charitable purposes and the foundation adheres to specific IRS procedures, exercising oversight over the use of the funds after they are granted.

A growing number of foundations have chosen to get more hands-on by running their own programs. As long as a foundation's program would be regarded by the IRS as charitable—such as a soup kitchen for the needy—a foundation may directly conduct its own program and treat its related expenses (supplies, salary, rent, etc.) as the equivalent of a grant to a public charity. We recommend that a foundation consult counsel to ensure that a program would be regarded by the IRS as charitable before proceeding.

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More foundations have also begun exploring how to leverage their endowments beyond simply funding grants and programs. Strategies include making loans to nonprofits, "program-related investments," mission-related investments, and even entering into complex partnerships with other nonprofits and even for-profit businesses. Although the flexibility inherent to private foundations makes these advanced strategies possible, careful planning and expert advice is required to ensure legal compliance.

What Activities Are Prohibited?

The IRS forbids using one's position within the foundation for personal gain ("self-dealing"). Foundation insiders ("disqualified persons") cannot transact with the foundation other than to make donations to it, or under limited circumstances, receive reasonable compensation for personal services." Examples of self-dealing include:

- Purchasing items from or selling items to the foundation
- Personal use of foundation assets or income
- Borrowing money from the foundation
- Retaining foundation assets (e.g., paintings) on private premises
- Leasing space to or from the foundation
- Using foundation assets to honor the personal pledge of a disqualified person

IRS rules also generally prohibit private foundations from lobbying. However, foundations may engage in advocacy and otherwise attempt to influence public policy. They may support (with some limitations) other charities that lobby or engage in public policy work. All private foundations are strictly prohibited from contributing to political campaigns or making any other attempts to influence elections.

Finally, private foundations may not own a significant stake in a family business or any other business enterprise. The "excess business holding" rules generally limit foundations to owning no more than 30% of a business and the limit can be as low 2% depending on whether and to what extent disqualified persons own an interest in the business.

In sum, a discussion around your clients' charitable giving positions you as their trusted advisor. When you explain the benefits of a private foundation, and how it enables clients to achieve their philanthropic goals, engage successive generations in a family legacy of giving, and achieve estate and wealth planning goals, you can start to play a more vital and active role in their estate planning strategy.

Andrew Schulz, J.D. is an Executive VP and National Director of Legal and Community Relations for Foundation Source. Mary Ann Stover is the Senior Managing Director, East Region, for Foundation Source. Foundation Source is the nation's largest provider of comprehensive support services for private foundations, at www.foundationsource.com.

FOOTNOTE

[1] Generally, disqualified persons include: (i) a foundation's officers, directors, trustees, and substantial contributors; (ii) individuals who own a significant stake in a company that is a substantial contributor; (iii) the family members of these individuals; and (iv) certain businesses partially or wholly owned by these individuals. Family members include a disqualified person's spouse, ancestors (e.g., parents, grandparents), lineal descendants (e.g., children, grandchildren) and their spouses.

Sign Up for a PEPC Committee

The Philadelphia Estate Planning Council offers many opportunities for member involvement. One of the most rewarding ways to get involved is through our many committees. The committees encompass all activities of the council including planning our social events, publishing our highly informative newsletter, enhancing our website and developing our education programs.

All members are encouraged to actively participate on a committee. Committee participation provides the opportunity to expand your professional relationships and increase your leadership skills.

To sign up, please contact the PEPC Office at staff@philaepc.org.

PEPC Annual Seminar and Reception

This year the annual seminar and reception was held on May 9 at the Barnes Foundation which recently moved to the Ben Franklin Parkway. The topic of the seminar presentation was "Why Art is Different: The Life-Cycle of Art Ownership." The speakers were two of the country's leading experts on the art law: Jo Backer Laird, Patterson Belknap Webb & Tyler, LLP and Peter Stern, McLaughlin & Stern, LLP, both of New York City. The program focused on planning issues associated with the "life cycle" of collecting, owning and disposing of artwork and other collectibles. Following the meeting a cocktail reception was held and the members and their guests were able to visit the galleries at the Barnes.

Director Andrew Haas, Justin Esposito, Director Richard Schwartz and David Bloom

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2013-2014 Board of Directors

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PEPC Annual Golf and Tennis Outing

The Annual Golf and Tennis Outing had to be rescheduled to July 29 due to inclement weather for the original date of June 3. Golf was held at St. David's Golf Club and Tennis was played at Merion Cricket Club.

Tom Forrest, Geoffrey Rogers, Michael Gordon, Norris Wright

Past President Chris Gleeson, Howard Soloway, Vince Mitchell with Past President Michael Bonventure

President Mark Eskin, with David Elliott, Director Richard Schwartz and Justin Esposito

PEPC Annual Golf and Tennis Outing continued

Tennis Outing

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PEPC Volunteers and Past Presidents Melinda Rath and Dave Watson

PEPC Drop-In Networking Event

PEPC sponsored a drop-in networking event for members and non-members on June 20 at the Public House on Logan Square. Good conversation and networking in a casual, fun atmosphere prevailed.

Networking at the event

Director John Boxer, President Mark Eskin and Secretary Doug Simon

Kit McCarty and Director Mary Lefever

Director Jay Perlman and Lou Horvath

Welcome New Members

Rebecca Berdugo	Berdugo Law
Beverly Bernstein Joie	Complete Care Strategies
Jeffrey Blaker, Esq., CPA	
Christopher Borden	Stedmark Partners at Janney Montgomery Scott LLC
Kirstin Bosch	LGL Partners
Keith R. Brabec	
Eileen D. Chambers	Haverford Trust Company
Brian Cohen	Wescott Financial Advisory Group LLC
Peter T. Commons	Commons & Commons LLP
Daniel R. Cooper	Morgan, Lewis & Bockius LLP
Vincent DiLorenzo	Lifetime Horizons, LLC
Elijah Dornstreich	Bernstein Global Wealth Management
Griffin B. Evans	Evans Law Office
Karen A. Fahrner, JD, LLM, AEP	PNC Delaware Trust Company
Michele S. Fenkin	Hangley Aronchick Segal Pudlin & Schiller
Michael D. Fox	Goldman Sachs Trust Company
Russell Gordon	Shechtman Marks Devor PC
Susan Green, Esq.	Wescott Financial
Drew M. Grifo	Commonwealth Capital Brokerage
Alan M. Kalish	Kalish Financial Services, LLC
Leanne Karr, CFP	Deutsche Bank
Jillian Kukucka	
Fran Lane	Deutsche Bank
Ladidas Lumpkins	Grant Thornton LLP
Dolores Magid, MEd, CMC	Complete Care Strategies
Michael Mallick	Valley Forge Financial Group
Shannon McNulty	McNulty Law Offices
Erik D. Michael	American Red Cross
Thomas J. Mihok	Tompkins Financial Advisors
Brian P. Murray	Merrill Lynch
Joseph D. Perna	Wells Fargo Advisors
Jim Powers	Melmark
Seth R. Raivetz	Alexander & Pelli, LLC
Brett Rhode	UBS Financial Services
Alan M. Rhode	Janney Montgomery Scott
Stephen Ruggieri	Commonwealth Capital Brokerage
Jeffrey T. Sloan, CFP, ChFC	Deutsche Bank Securities
Anthony Smedley	PNC Wealth Management
Wilson L. Smith	Burlington Consulting

From the Editors:

We are excited to announce that the Newsletter is now being offered in a fully digital format. The Philadelphia Estate Planning Council continues to incorporate technology more and more into its membership experience, such as through our constantly expanding website (www.philaepc.org) or via social media (LinkedIn), and the Newsletter Committee is pleased to continue that trend. As a reminder, the Issues of the Newsletter from the past fifteen plus years are now available on the Council's website.

This issue will be distributed to the Members in both hard copy via regular mail and in digital format via email. Beginning with this year's Winter Issue, Members will receive the Newsletter only in digital format. However, in an effort to provide Members with a voice in this change in format, each Member has the ability to indicate his or her preference to continue to receive the Newsletter in hard copy via regular mail as a new item on the 2013-2014 Membership Renewal forms. We will continue to provide hard copies to those Members who indicate that as their preference as long as the economics of printing reduced numbers of the Newsletter complies with the budget and the goals and objectives of the Council as a whole.

We hope all of the Members continue to enjoy the Newsletter in this updated format and we will continue to strive to provide the Members with timely and relevant content to enhance their professional endeavors.

Andrew J. Haas and David J. Bloom

PEPC Classifieds

Is your company hiring? Are you looking for a new position? Be sure to check out the PEPC Classified listing on the PEPC website. There are currently several jobs posted. It is free to view all available jobs and it costs $100 for PEPC members ($200 for non-members) to post a job on our site.

Philadelphia Estate Planning Council
P.O. Box 579
Moorestown, NJ 08057-0579

Mark Your Calendar

2013-2014 Luncheon Programs – 11:45 – 1:45 p.m.
All education programs are held at The Union League,
140 South Broad Street, Philadelphia.

September 17, 2013
Topic: Mathematics of Estate Planning
Speaker: Robert S. Keebler
Keebler & Associates, Green Bay, WI
Sponsor: Hawthorn, PNC Family Wealth

October 15, 2013
Topic: What You Say To Your Client...What They Hear
Speaker: Jean Chatzky
Sponsor: Stedmark Partners at Janney Montgomery Scott

November 19, 2013
Topic: Trends in Philanthropy
Speaker: Doug Bauer
Clark Foundation, New York, NY
Sponsor: Goldman Sachs Philanthropy

January 21, 2014
Topic: Digital Death and Estate Planning for Social Media
Speaker: Robert Kirkland
Kirkland Woods, Liberty, MO
Sponsor: Please contact PEPC to sponsor this event

February 18, 2014
Topic: Spousal Transfers – During Life, at Death, and Beyond
Speaker: Barbara Sloan
McLaughlin & Stern LLP, New York, NY
Sponsor: Please contact PEPC to sponsor this event

March 18, 2014
Topic: Ethical Issues of Multi-disciplinary Teams
Speaker: Bruce Stone
Goldman Felcoski & Stone, PA, Coral Gables, FL
Sponsor: Wells Fargo - The Private Bank