

Advisor Update

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A professional advisor resource courtesy of Advocate Charitable Foundation

■ Latest rulings from the courts and the IRS

IRS Approves Donor-Invested Gift Account with 10-Year Term, Ltr. Rul. 2004 (citation pending)

In a July letter ruling which has been widely covered in the financial press, the IRS approved a donor's gift to a college subject to an agreement which provided for a limited power of attorney permitting the donor to direct investment of the contributed funds for up to 10 years. The investment consulting firm that designed the account — Winklevoss Consultants of Greenwich, Conn. — intends to call the arrangement a Donor Managed Investment Account. The goal is to allow the donor a charitable income tax deduction in the year of the gift while also permitting him to invest the contributed amount in a tax-free environment. The agreement sets parameters for permissible investments (these include domestic equities, domestic mutual funds, domestic fixed income assets, offshore/onshore hedge funds, REITs and private placements), restricts investment in any company in which the donor owns more than 5 percent of the outstanding shares and gives the college the right to withdraw the assets or terminate the agreement at any time during the term. If severe losses should occur, the agreement will automatically terminate.

The IRS approved a similar arrangement in Letter Ruling 8152072 (September 30, 1981) where the donor contributed property to a charity and retained investment control. In that ruling, the IRS stated the retention of control was not substantial enough to affect the deductibility of the property contributed.

IRS Imposes Intermediate Sanctions for Excess Benefit Transactions On Church Founder, TAM 200435020; Similar Penalties for Involved Family Members, TAMs, 200435018, -19, -21, -22

In these facts, the taxpayer/founder secured tax-exempt status for a church organized as a nonprofit corporation. The taxpayer served as president/director, his wife as secretary-treasurer/director, one of his sons as vice president/director and another son as director. Following award of tax-exempt status, the church's by-laws were revised to give the founder the power to appoint and remove all directors. The IRS audited the church's returns and made the following determinations: the church property was occupied as a residence; the residence furnishings and utilities were paid for by the church; a church investment property was occupied rent free by the son serving as vice president, and the directors' personal expenses (such as meals, gasoline and similar items) were paid with church credit cards. The IRS determined the founder was a disqualified person (as defined under IRC § 4958) and should pay tax on the excess benefit transactions (under IRC § 4958) for transactions creating personal benefit. In separate Technical Advice Memoranda, the other involved family members (spouse, two sons and a son-in-law) were also found to be disqualified persons and assessed for excess benefit transactions.

Intermediate Sanctions Imposed for Political Intervention; Church Retains Tax-Exempt Status but Is No Longer a Church, TAM 200437040

In a similar enforcement action, the IRS audited a church where the church's founder, his wife and several of his family members were directors and ordained ministers. The church owned a number of real estate interests and had invested in a growing for-profit broadcast subsidiary. The church's by-laws gave the founder and his family control of the church and its subsidiary. In the audit, the IRS found the church no longer conducted regular religious services, although it did conduct counseling sessions, discussion groups, seminars and regular broadcasts featuring the founder. The IRS determined that transactions between the founder, his family and the church were automatic excess benefit transactions and that broadcasts in which the founder urged listeners to support a specific political candidate were improper political activities. Both the individuals involved and the church were taxed. While these violations were not sufficient to cause loss of tax-exempt status, the church was reclassified as a religious organization since there was no evidence the charity had a body of believers or communicants assembling for regular worship.

Depleted CRAT exchanged for gift annuity

Facing retirement and a need to shelter gains from exercising stock options, a donor to an Advocate hospital established a charitable remainder annuity trust (CRAT) in 1999 with almost a 9 percent payout rate. The trust was self-trusted, and the trustee/income beneficiary was reluctant to part with the company stock. Within four years, the combination of market value decline in the sole stock held by the trust and high required payouts reduced the value of the trust by over 80 percent. The charitable remainder, which was for an Advocate hospital, was reduced to zero.

To prevent the trust's total collapse and preserve some income for the donor, the donor's professional advisor approached Advocate's planned giving team. Together, we terminated the CRAT and exchanged the donor's income interest for an Advocate charitable gift annuity.

This exchange provides the donor with a stable, if reduced, lifetime income and secures a charitable remainder, thus fulfilling the donor's original goals.

■ Items of interest to planners

Spring 2004 Statistics of Income Report Provides Data on Retirement Plans, www.irs.gov

The IRS' Spring 2004 Statistics of Income Bulletin provides perspective on the importance of Individual Retirement Arrangements (IRAs) in planning. In 2000, 46.27 million Americans held \$2.63 trillion in IRAs. While the largest portions of these assets were held in traditional IRAs, the arrangement attracting the most new dollars in 2000 was the Roth IRA. Although IRAs are generally considered a way to shelter pre-tax income, non-deductible contributions to traditional and Roth IRAs accounted for one-third of the total \$36.48 billion deposited in IRAs in 2000.

TABLE 1: 2000 YEAR END ASSETS AND CONTRIBUTIONS FOR INDIVIDUAL RETIREMENT ARRANGEMENTS (IRAs)

	AMOUNT HELD IN PLANS	PERCENTAGE OF ALL IRA ASSETS	AMOUNT CONTRIBUTED IN 2000	PERCENTAGE OF 2000 IRA CONTRIBUTIONS
Traditional IRA	\$2.41 trillion	91.5%	\$10.04 billion	27.5%
Simplified Employee Pension (SEP)	\$134.05 billion	5.1%	\$10.11 billion	27.7%
Roth IRA	\$77.58 billion	3.0%	\$11.56 billion	31.7%
Savings Incentive Match Plans for Employees (SIMPLE)	\$10.35 billion	0.4%	\$4.70 billion	12.9%
Education IRA	\$307.64 million	Less than .05%	\$79.09 million	0.2%
All	\$2.63 trillion	100.0%	\$36.48 billion	100.0%

Statistics from Figure A, Statistics of Income Bulletin, Spring 2004

The 60 to 70 age group, representing 17 percent of all account owners, held \$835.94 billion in total assets, or an average of \$106,044 per taxpayer. The total holdings and average account sizes for various age bands is shown in Table 2.

TABLE 2: 2000 YEAR END IRA MARKET VALUES BY AGE

AGE	PERCENT OF ALL OWNERS	MARKET VALUE FOR GROUP	AVERAGE INDIVIDUAL HOLDINGS
Under 30	6.9%	\$14.48 billion	\$4,541
30 under 40	16.2%	\$138.53 billion	\$18,536
40 under 50	24.2%	\$410.70 billion	\$36,613
50 under 60	23.4%	\$700.21 billion	\$64,701
60 under 70	17.0%	\$835.94 billion	\$106,044
70 and older	12.3%	\$529.44 billion	\$93,144
All	100.0%	\$2.63 trillion	\$56,825

Statistics from Figure G, Statistics of Income Bulletin, Summer 2004

IRS Publishes 'Life Cycle of a Public Charity,' www.irs.gov

The IRS has posted "Life Cycle of a Public Charity" on its Web site to provide nonprofit organizations assistance in creating, maintaining and terminating a charitable entity. The data take readers through the process of creating a nonprofit entity, applying for tax-exempt status, making annual filings, engaging in ongoing compliance and addressing significant events, including termination. The life cycle resource is the result of a recommendation of the Advisory Committee on Tax Exempt and Government Entities. To access this information, go to the IRS website (www.irs.gov) and click on Charities & Nonprofits on the left side of the page. "Life Cycle of a Public Charity" will be listed among the articles appearing on that page.

Resources for information on charities

One of the most effective ways to create accountability in giving is to research a charity's expense ratios, compensation schedules and allocation of funds for charitable purposes through the many resources available on the Internet. The top resources are listed below:

SOURCE	INTERNET ADDRESS	RESOURCES
Guidestar	www.guidestar.org	Download copies of Form 990 and Form 990 PF
Charity Navigator	www.charitynavigator.org	Search a database of over 3,100 charities with ratings
BBB Wise Giving Alliance	www.bbb.org	Research charities that solicit gifts nationwide

■ Legislative developments

President Signs Working Families Tax Relief Act of 2004, Pub. Law No. 108-311, 118 Stat. 1166; IRA Charitable Rollover Provisions Not Included

On October 4, 2004, President Bush signed the Working Families Tax Relief Act of 2004 (H.R. 1308), extending tax benefits such as marriage penalty relief, the 10 percent income tax bracket and the \$1,000 child tax credit. This \$146 billion tax cut — billed as a benefit to the middle class — was overwhelmingly approved by the House (339/65) and Senate (92/3). Despite strong urging from the charitable sector, the Working Families Tax Relief Act of 2004 did not contain charitable IRA rollover provisions. As previously reported, the CARE Act (S. 476) and the Charitable Giving Act (H.R. 7) contained charitable IRA rollover provisions as well as other charitable benefits such as the non-itemizer deduction. Rick Santorum (R-Pa.) and Roy Blunt (R-Mo.) have continued to push for a conference committee to resolve differences without success. Supporters had hoped to attach alternate legislation containing only the charitable IRA rollover provisions — The Public Good IRA Rollover Act, S. 283 and H.R. 4488 — but failed.

President Bush Signs American Jobs Creation Act of 2004 (H.R. 4520) Containing First Group of Tax Code Revisions on the Senate Finance Committee's To Do List

On October 22, 2004, President Bush signed H.R. 4520, the American Jobs Creation Act of 2004, containing the first collection of laws spawned by the June Senate Finance Committee Hearings and accompanying Staff Discussion Draft (reported in the Summer 2004 Advisor Update). Although the focus of this legislation is to repeal certain trade sanctions and lower corporate tax rates, the bill also contains provisions regulating non-cash gifts. Section 882 limits deductions of patents (and similar intellectual property) to the donor's basis and allows a deduction of Qualified Donee Income for up to 10 years after the date of the gift of intellectual property; Section 883 reduces the threshold for a qualified appraisal for non-publicly traded stock from greater than \$10,000 to greater than \$5,000 and requires donors to attach the full qualified appraisal to the tax return on which a non-marketable asset charitable deduction exceeding \$500,000 is claimed. Section 884 limits a donor's deduction for a vehicle (when the value exceeds \$500) to its sales value if it is to be sold within 30 days or requires a charity to explain use and duration of use of the vehicle if it is to be held. An unsuccessful effort was made to include the charitable IRA rollover provisions in the Conference Report of this bill as well; the failure to do so makes it unlikely the rollover legislation will pass in the 108th Congress.

■ Charitable planning in practice

Using the Charitable Lead Trust to Solve Planning Problems

As interest rates remain at historic lows, charitable lead trusts offer donors significant income tax deductions (for grantor lead trusts) or estate or gift tax deductions (for non-grantor lead trusts). Knowing when to use the lead trust — and in which form — can be challenging.

What is a charitable lead trust? A charitable lead trust is an irrevocable trust that pays a specified annuity or unitrust amount to one or more charities for a term, terminating either to the grantor/grantor's spouse (a grantor lead trust) or to individuals other than the grantor such as children or grandchildren (a non-grantor lead trust). A grantor lead trust generates a charitable income tax deduction in the year of the gift for the present value of the income stream paid to charity over the trust term. The trust is taxed as a grantor trust, allocating its income to a donor. The non-grantor lead trust generates a gift tax deduction (during life) or estate tax deduction (at death). The non-grantor lead trust is taxed as a complex trust, although the trust receives a deduction for its charitable distributions.

PUTTING THE LEAD TRUST TO WORK

To understand how lead trusts can be used to solve problems, consider this story. Tom, a retired CEO of a Fortune 500 Company, had \$20 million in assets comprised of \$17 million in company stock (with a low tax basis), a \$2 million vacation home and a \$1 million residence. Tom was philanthropic, giving at least \$50,000 a year to charitable causes. Tom had been retired for two years, and while his first planning priority was to position for retirement, he had recently

Charitable Mid-Term Federal Rates

The charitable mid-term federal rates under IRC § 7520 for gifts made in November 2004 are set out below. These rates are used to determine the present value of an annuity, an interest for a life or term of years or a remainder or reversionary interest. Call Elizabeth Roghair, Vice President of Planned Giving, or Michael Bell, Director of Planned Giving, and we will gladly provide you with deduction calculations.

November 2004	4.2%
October 2004	4.4%
September 2004	4.6%

Great news! Gift annuities with tax deductions still great deals!

With the end of the year rapidly approaching, now is the perfect time to suggest to your older clients that they establish charitable gift annuities with Advocate Health Care. Advocate's gift annuities offer high payment rates (based upon age), lifetime payments and favorable tax deductions. In addition, Advocate maintains high-quality bond ratings which indicate Advocate's financial stability. Advocate Health Care's long-term bond ratings are AA (Standard & Poor's), Aa3 (Moody's Investors Service) and AA- (Fitch Ratings). These high-grade bond ratings indicate a stable outlook for Advocate and confirm these rating agencies' confidence in Advocate's future ability to meet its long-term obligations, including gift annuity payments.

Why not suggest to older clients — particularly those with underperforming stocks or bonds — that they use some of these assets to generate increased income through gift annuities? December 31 is almost here, and gift annuities are the ideal vehicles to combine the stability of regular income with the money-saving advantages of favorable tax deductions.

Charitable giving in practice *Continued from page 3*

approached his planner about making a significant gift to a local charity's capital campaign. Just before his meeting with his advisor, Tom sold his stock and purchased tax-exempt bonds (generating \$2.4 million in capital gains tax on the \$16 million gain); he also executed a contract for sale of his vacation home, generating additional gains. He felt these gains would be offset in part by the significant charitable contribution he planned to make. Needless to say, the planner was astounded that Tom had sold the appreciated assets. He had planned to suggest a charitable remainder trust that would avoid the capital gains on the amount Tom contributed, generate a substantial income tax deduction and increase Tom's retirement income.

The charitable lead trust offered a planning alternative. In October 2004, Tom created two lead trusts. The first was a 20-year, 5 percent, \$1,000,000 grantor charitable lead annuity trust distributing \$50,000 per year to the charities he currently supported. He received a charitable income tax deduction of \$656,070 for the gift. He used tax-exempt bonds to fund the trust so that his attributed income over the trust term would be tax-exempt. The second trust was a 10-year, 5 percent, \$1,000,000 non-grantor charitable lead annuity trust terminating to his children. Tom funded this trust with a portion of the vacation home sales proceeds and used the trust's annual distributions to fund 10 years of payments to the charity's capital campaign. This non-grantor lead trust generated a gift tax deduction of \$397,590 and will distribute an estimated \$1,131,808 to his children at termination if the trust generates annual income of 3 percent and principal growth of 3 percent over the trust term.

LEAD TRUSTS PROVIDE FLEXIBILITY IN TESTAMENTARY PLANNING

Charitable lead trusts may also provide flexibility in testamentary planning for large taxable estates. Creating a lead trust under a will and including formula language allowing the executor to select a rate or term that will maximize the tax result or creating provisions funding a lead trust in the event of a disclaimer by named heirs will allow the executor and family to make the most of post mortem planning decisions.

Contact information

For assistance in structuring gifts to Advocate Health Care hospitals, sites and programs, contact the Office of Planned Giving at Advocate Charitable Foundation.

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Also, visit our Web site at
www.advocatehealth.org/foundation

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