LAW OFFICE OF GERALD R. NOWOTNY, PLLC

NOWOTNY KNOWS SQUAT!

Helping Advisors Build a Clientele and Assets Under Management (AUM)!

Looking back, I distinctly remember my introduction to the Iron Game (weightlifting). At around age 5, I lived in Balboa, in the Panama Canal Zone. Balboa High School was right down the street from my house. The high school was where all the summer activities took place. The weight room was as warm as a steam room. I wandered into the weight room on the second floor and lifted a 50-pound dumbbell (not over my head) but off the ground. From there it was a love for Hercules movies featuring the former Mr. Universe, Reg Park, as Hercules.

At age 13, I suffered a knee injury in football and discovered the weight room for real as part of my recovery. Thanks to one of my favorite coaches in the Canal Zone, Morris Finkelstein (of blessed memory), I never looked back or left the weight room. I ended up enjoying off season workouts more than the sports that I played.

The Republic of Panama had a great super heavy weight Olympic lifter named Henry Phillips. He was a Pan-American champion and competed in Olympics. His mother worked for my Dad in the Balboa Commissary. He occasionally worked out in the YMCA where I worked out. He invited me to come train as a fifteen-year-old in the gym in the Republic of Panama where the Olympic lifters trained. Unfortunately for me, it was in a horrible neighborhood and my parents were strong opposition. That was the end of a possible Olympic lifting career. Over the years as a competitive powerlifter into my 50's I developed a big-league squat and deadlift. Nevertheless, I was better suited for Olympic lifting because I was strong and very quick. So, at the end of the day, I really do know squat!

This is the first installment of a series in the new year to help financial advisors to build and retain a clientele and increase assets under management with cutting-edge ideas. Each article is designed to bring a creative planning idea that helps the financial advisor to demonstrate value while implementing solutions with financial products. This first article discusses how a customized pooled income fund (PIF) can be used as a creative method to assist a client in minimizing capital gains taxation on the sale of an appreciated asset while maintaining a lifetime income. The strategy allows the financial advisor to manage the assets within the PIF. Similar to a charitable remainder trust, the financial advisor may use life insurance as an asset to replace wealth passing from the PIF to the taxpayer’s donor advised fund.

The Customized Pooled Income Fund (PIF)

The presidential election is behind us and it's my bet that marginal tax rates for high-net-worth taxpayers will take a vertical leap upward. There isn't a tax technique that won't get a second look. The customized pooled income fund is a technique that may be unfamiliar with the exception of its similarity to the pooled income fund sponsored by large charities. Historically, pooled income funds have been the poor man’s version of the charitable remainder trust. Pooled income funds were regularly sponsored by larger public charities and have largely been wound down in recent years and eliminated as the charitable remainder trust proliferated in popularity.

The PIF that we are discussing is a customized version for the high-net-worth taxpayer and his/her family. This version is established with at least two participants in the pool of participants. The PIF established with a minimum of $250,000 and the taxpayer. An additional taxpayer will make a de minimis contribution into the PIF so that the PIF has at least two participants.

The pooled income fund is a charitable trust that is established and maintained by a public charity. The taxpayer retains an income interest for a single or joint lifetime or even multiple lifetimes. The remainder interest of the PIF is a public charity(ies) and even be the taxpayer’s donor advised fund. The pooled income fund receives contributions from individual donors that are commingled for investment purposes within the fund. These contributions can be made with cash or appreciated capital assets. Each donor is assigned "units of participation" in the fund that are based on the relationship of their contribution to the overall value of the fund at the time of contribution.

Each year, the fund's entire net investment income is distributed to fund participants according to their units of participation. Income distributions are made to each participant for their lifetime, after which the portion of the fund assets attributable to the participant is severed from the fund and used by the charity for its charitable purposes. The trust may avoid capital gains taxes by adding the capital gain income to trust principal or defining the definition of trust income within the PIF to include short term capital gain income.

The magic of the customized PIF lies in the method used to calculate the value of the remainder interest which passes to a public charity at the death of the taxpayer and any additional income beneficiaries. This calculation provides the taxpayer with an income tax deduction that is at least two-three times higher than it would be for a charitable remainder trust. If a pooled income fund has existed for less than three taxable years, the charity is able to use an interest rate in calculating the charitable deduction by first calculating the average annual Applicable Federal Midterm Rate (as described in IRC §7520 for each of the three taxable years preceding the year of the transfer. That rate has risen over the last several years to 2.2 percent for the 2021 tax year.

Unlike a charitable remainder trust, the PIF is not subject to unrelated business taxable income (UBTI) treatment. The PIF may own real estate that is subject to debt-financing or a business interest that would ordinarily create UBTI for a public charity.

So Where Do I Benefit?

A financial advisor always benefits himself professionally when he brings planning ideas that no one else is bring to the client. No doubt increasing taxes must be on every high-net-worth taxpayer's mind. Very few public charities are familiar with this customized version of the PIF. This approach should allow the advisor to be the leading thinker in the planning mix with the ability to manage and control assets within the PIF for the client and charity. Assets ultimately passing to charity can be replaced for the taxpayer's family using life insurance. A client can benefit from the substantial tax deduction for the contribution while retaining a lifetime income interest. The charity will benefit from the future gift of the remainder interest at the client's death. The advisor benefits from having a satisfied client and having more assets to manage from the client. The client's family benefits from the life insurance that replaces the assets passing to charity.

Summary

At the end of the day, the PIF is a creative tax solution. It can generate a substantial tax deduction while allowing the taxpayer to retain an income interest. The PIF discussed in this article can provide the financial advisor with the ability to manage the investments within the PIF. For appreciated capital assets, it can mitigate capital gains consequences. For cash contributions, the PIF can operate as a partially deductible supplemental retirement plan with customized investment options managed by the financial advisor. The financial advisor can utilize life insurance to replace PIF assets that ultimately pass to the taxpayer's donor advised fund. Of course, there has to be a catch and there is in this case. To the best of my knowledge, very few charities are aware or participating in the customized PIF realm. This is an idea that every advisor who still needs and wants new clients and still has an interest in growing his assets under management.

Operators are waiting to take your call!