Sentinel

Personal Financial Management Ideas

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Our New Charitable 'Fund Family'

By Larry M. Elkin, CPA, CFP

Americans are likely to give more than $210 billion to charity this year. A lot of that money will be diverted to additional fund-raising, or simply will be wasted by ill-managed, redundant or ineffective organizations.

But there are other reasons why donors often do not get their money's worth of good works. One is the sheer randomness of charitable giving. We typically choose to support an organization because it addresses a problem that has touched us personally, such as an illness that afflicts a family member; because we have some other personal connection to the charity, such as to the schools we attended; or because it just happens to approach us at the right moment with the right message.

All of us sometimes make gifts for these reasons. But what about giving because you really want to accomplish something, and have the means to do it? How do you get the most bang for your charitable buck? If you are deeply committed to, say, freedom of expression, or feeding the hungry, or environmental protection, how do you find the charities that best address your concerns?

In other words, how do you apply a scientific or businesslike approach to charitable giving? That is the problem my colleagues and I set out to solve when we created our own new and unique charity, Palisades Hudson Charitable Portfolio, Inc. (PHCP).

PHCP lets its donors make "big-picture" policy decisions by directing their gifts among six charitable portfolio programs. The programs support humanitarian relief, wildlife and the environment, human rights, education, science and health, and culture and the arts. The accompanying story describes the objectives we have established for each of these programs.

Our objectives are broad, such as the promotion of "freedom of expression" in the human rights portfolio. To turn that sentiment into something practical, we first have to set some specific priorities. Do we mean freedom of expression in the United States, which already has First Amendment protections, or in other developed countries, or in the Third World? Do we mean print, broadcast, or other media such as fine arts? Do we mean political, social or commercial expression? Once we know exactly what causes we want each portfolio to support, we will seek out and fund the charities that we believe address our priorities in the most *effective, efficient* and *innovative* ways.

We conceived PHCP as a sort of mutual fund family for philanthropy. Just as a mutual fund family allows investors to create diversified portfolios of professionally managed investments, we want PHCP to provide a diversified, professionally managed portfolio of charities that meet our donors' philanthropic goals.

PHCP's approach to philanthropy requires a great deal of hard work and soul-searching. Charities release a lot of data about their activities and finances, much like publicly traded corporations, but the tools for sifting and screening these data are not nearly as sophisticated. Just finding the charities you want to consider takes a lot of shoe leather.

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Foreign Brush Fires Likely To Preoccupy Bush

The 108th Congress reports for duty this month, with both the executive and legislative branches firmly in Republican hands for the first time in 50 years. So, is George W. Bush free to steer tax, regulatory and social policy sharply to the right?

I doubt it. The recent elections certainly were a political triumph for the president, as he led his party back to power in the Senate and boosted the GOP majority by a few seats in the House. Bush's bargaining power is increased not only by the Republicans' enhanced legislative numbers, but also by Democratic disarray as the opposition party struggles to find a message and a messenger for the post-Clinton era.

Still, the first half of the Bush II administration brought only a moderate tack to starboard for the ship of state. The same political headwinds that constrained the president during his first two years in office blow hard today. By next year, it will be difficult to accomplish much of anything on the legislative front, as the presidential campaign moves into high gear.

Notwithstanding December's purge of Treasury Secretary Paul O'Neill and economic adviser Lawrence Lindsey, the Bush II administration is being consumed by foreign affairs, particularly terrorism and Iraq. Every hour that the president's key people have to spend lining up international support for American action, or at least muting international opposition, is an hour that cannot be spent on domestic policy. Perhaps more important, every minute Congress spends debating foreign affairs is a minute that that cannot be spent passing domestic legislation the president may want to get passed.

So the irony continues: The former Texas governor, who came to office with almost no foreign experience and a long domestic to-do list, is seeing his administration become the most foreign-dominated White House since Vietnam swamped fellow Texan Lyndon B. Johnson.

I see no end to this. If he gets past al-Quaida, Iraq and the reconstruction of Afghanistan, Bush needs to deal with North Korea and its nukes, Pakistan and *its* nukes (and its simmering confrontation with nuclear-armed India), terrorism and instability across a huge belt from Palestine to the Philippines, China's designs on Taiwan, rising anti-Americanism in continental Europe and economic and political turmoil across Latin America.

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Thank You For A Decade Of Sharing And Support

Exactly a decade ago, I left the security of the Big Accounting Firm to hang out my shingle. My wife, Linda, found a small office for me. There were no clients, there was no furniture, but there was a lot I wanted to do.

The Big Accounting Firm crumbled last year. Had I stayed at Arthur Andersen, my career might have crumbled with it. My dream was to build a financial planning business free of conflicts of interest, one that could outlive me to work with generations of clients. Even if I had managed to build such a practice at Andersen these past 10 years, I would not have owned it, and probably could not have kept it together after Andersen's collapse.

The real risk lay not in leaving what seemed like security, but in staying for security. I was only 35 in 1993. If my business had failed, I would have found another way to support Linda and our two small daughters while she stayed home with them. Had I remained at Andersen, I might be starting over today at 45, with our eldest already looking at colleges.

My work brings me very close to clients and their families. I see my share of infirmity and death, help plan for it in advance and deal with it when it happens. But that's the price of seeing the truly joyful things. Last year, two of our clients had miracle babies. I visited those two babies last month. If all goes well, I will still be working for them when they graduate from college. But I'm aiming to see *their* children.

I thank all of you whose support has made us successful these past 10 years, and wish you only wonderful things in 2003.

Larry Elkin

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INVESTMENT FOCUS

New Rules Return Flexibility To Fiduciaries

After more than 100 years, the Uniform Prudent Investor Act (UPIA) and similar prudent investor rules have opened up a whole new world of investing for fiduciaries.

Traditional "prudent man" standards — which were as antiquated as their name — prohibited trustees, executors and similar fiduciaries from making any investments that were deemed too risky, requiring them instead to seek the presumed safety of U.S. Treasury obligations and other highly secure debt instruments. Fiduciaries who sought more growth-oriented investments did so only when specifically authorized or required by their trust agreements, or otherwise proceeded at their own risk. A fiduciary who violated the prudent man standards could be forced to reimburse a trust for any investment losses, even those resulting from routine stock market fluctuations.

As a result, many trusts missed the great stock market run-up of the past two decades. Even after the bear market of the past three years, those trusts have performed far worse than typical well-diversified portfolios. This situation made fiduciaries and beneficiaries equally unhappy, which led to the recent about-face in the law.

The old standard all but ruled out any investments in stocks, options, mortgages, foreign securities and joint ventures. Today, thanks to the new law, it may be a fiduciary's *duty* to invest in most of these asset classes. Rather than measure a trustee's performance on an investment-by-investment basis, the new rules recognize that a trustee should be judged on how well he or she manages the trust's total portfolio.

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This significant change — that asset classes on their face are not prudent or imprudent — resulted largely from the investment community's acceptance of modern portfolio theory. This approach to investing attempts to construct an appropriate portfolio by considering the relationship between risk and return. Modern portfolio theory holds that some investors, including some trusts, have a greater tolerance for short-term fluctuations or long-term losses than others, and they can afford to take more risk in search of better returns.

Modern portfolio theory also holds that unsystematic risk, which is the risk of price change because of the unique circumstances of a specific security, can virtually be eliminated from a portfolio through diversification. A diversified portfolio will have winners and losers, but the risk of catastrophic losses such as a corporate bankruptcy can be diversified away.

The UPIA's five specific objectives are: 1) to consider the entire portfolio, rather than individual investments, when judging the prudence of the fiduciary's investments; 2) to focus the fiduciary's attention on the trade-off between risk and return; 3) to do away with restrictions on certain types of investments; 4) to incorporate the requirement of diversification into prudent investing standards; and 5) to provide the fiduciary with the ability to delegate investment and management functions.

Basically, the fiduciary now must diversify and be sensitive to risk and return. A fiduciary may choose not to diversify if he or she reasonably determines that the trust would be better served without diversification. This situation could arise if there were a significant amount of stock with extremely low basis or if the objective is to retain control of a family business. Returns correlate strongly with risk, but

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Moreover, setting charitable priorities is a very subjective process, as in the judgments we need to make in my example about freedom of expression. For another example, consider the issues that surround health care. Do we concentrate our resources on prevention, basic research to find new treatments, or distributing existing treatments to people who need them? Do we address health problems that are common, so we can help large numbers of people even though there may be numerous other charities trying to do the same, or do we deal with problems that affect fewer people and thus attract less attention?

We cannot take the subjectivity out of the process, but we can eliminate the randomness. For each portfolio, we are developing a set of priorities to define the portfolio's key objectives for the coming year. Those priorities will let us screen for charities that we want to consider funding. Some charities will be eliminated because the problems they address are not among our priorities.

Charities that get past this screening will be closely examined to see how well they address our priorities (the effectiveness test), how well they use their resources (the efficiency test) and whether they address our priorities in a novel way that can set an example for other donors and charities to follow (the innovation test). All of our recipient charities must be effective and efficient. Innovation, while not a must-have characteristic, will be useful as a tiebreaker. By supporting innovative organizations that set an example, we hope to make charitable giving in general more productive.

Who will make these decisions for PHCP? A three-member board consisting of Jonathan Bergman, Linda Elkin and I. We are the three most senior people at Palisades Hudson Financial Group LLC. We share a deep commitment to our firm's core principle of providing unbiased, independent advice to our financial planning clients. We plan to make PHCP an extension of that service by helping clients implement their philanthropic programs as effectively as possible. However, PHCP is open to any donor, not just to those who are clients of Palisades Hudson Financial Group or our investment advisor affiliate, Palisades Hudson Asset Management, Inc.

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Our staff support includes Shomari Hearn, a professional who already has extensive experience with many tax and investment issues that PHCP will confront, and Ana Diaz, an associate who has experienced the non-profit world firsthand in her work as a child care social worker before she came to Palisades Hudson last year.

Several dozen investment advisory firms, including major players such as Fidelity, Vanguard and Charles Schwab, sponsor "donor advised funds" to facilitate charitable giving by their patrons. In a donor advised fund, a donor might make a contribution in 2003 and thus claim a tax deduction this year, while waiting until 2004 or later to specify one or more charities that ultimately will receive the money. Donor advised funds are useful, especially for year-end tax planning purposes, but they still leave the donor responsible for selecting the ultimate charitable recipient.

PHCP has a donor advised option, too. We think ours is a more powerful and flexible tool because it can be paired with our six actively managed charitable portfolios. A donor can initially place money in PHCP's donor advised fund, and then gradually transfer funds to support our other options, as we announce plans for those options that the donor finds attractive. Or the donor can use the donor advised fund in the traditional way, directing disbursements to charities that address the donor's personal preferences.

Every six months, PHCP will release a disbursement program that spells out the charitable priorities we have established for each portfolio option, and identifies specific charities that we intend to fund in the upcoming period. Our first disbursement program will be released in May. If we attract enough support, our first disbursements will be made in July. Donors and prospective donors generally will have six weeks after the release of a disbursement program to reallocate funds from one PHCP option to another, or to modify any previously scheduled disbursement program.

PHCP's minimum initial gift is $10,000 in cash or publicly

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traded securities, including mutual funds. Subsequent gifts must be at least $5,000, and must bring the donor's fund balance back to at least $10,000. Donors will be required to disburse at least $10,000 or 5% of their PHCP fund balance, whichever is greater, each year. Each donor can establish a disbursement program based on the size of the donor's PHCP fund balance and charitable objectives, and an investment program to keep the donor's PHCP fund balance invested at a level of risk that is appropriate to the donor's disbursement plans and risk tolerance. We will provide a set of investment management options for donors to choose among.

Donors who give through PHCP can be completely anonymous to the ultimate charitable recipients, or they can receive recognition of their gifts by naming their PHCP fund balance, such as the Doe Family Fund at Palisades Hudson Charitable Portfolio.

Of course, it would not make sense for PHCP to try to fund efficient charities if PHCP is not itself economically efficient. Considering the active charitable management it provides, PHCP is designed to be an extremely low-cost vehicle. The organization pays standard investment management fees to Palisades Hudson Asset Management, Inc., of up to 0.9% of assets per year, depending upon PHCP's overall asset base. It also pays Palisades Hudson Financial Group LLC 1 percent of assets per year, plus out-of-pocket expenses, to provide all staff, facilities and other overhead and operating costs. That's it.

We believe these costs will be well below what it would cost large donors to operate a comparable private foundation, which is the traditional vehicle for families who want to engage in active philanthropy. Of course, there are important differences between PHCP and a private foundation. PHCP's charitable programs reflect our philanthropic priorities, which are not necessarily always the same as the donor's (except for the donor advised fund). PHCP will not employ members of the donor's family, which sometimes occurs with private foundations. On the other hand, because PHCP is a public charity, its donors receive more liberal tax treatment than do donors to private foundations.

For a large donor, meaning someone who wants to give away $500,000 or more, the choice between PHCP and a private foundation or a different donor advised fund depends on circumstances and objectives. But for smaller donors who want our style of active philanthropic management while still maintaining that big-picture control, PHCP is virtually one of a kind.

By publishing our charitable giving programs in advance and giving donors the one-stop ability to choose our programs or develop their own through the donor advised option, we give our donors a chance to do much more good, however *they* define "good," with their charitable dollars.

A Look Inside PHCP's Portfolio

Palisades Hudson Charitable Portfolio, Inc. (PHCP), is, as its name implies, a "portfolio" of charitable options. Besides a conventional donor advised arrangement, we are establishing our own philanthropic program in the following areas:

Humanitarian Relief: To alleviate human suffering caused by war, civil strife, famine, drought or natural disaster, and to restore infrastructure for normal economic activity.

Human Rights: To promote and protect basic human freedoms, including freedom of expression, freedom of association in personal and political affairs, and freedom of conscience in matters of moral and religious choice. Also, to assist those who confront violence, coercion and discrimination in pursuit of these freedoms.

Wildlife and the Environment: To protect, preserve and restore natural balance and wildlife diversity and to promote economic activity that is compatible with these goals.

Science and Health: To support the discovery and application of advances in knowledge to prolong healthy life, reduce suffering and enhance opportunities for personal development.

Education: To provide opportunities for personal growth and development and for the achievement of human potential.

Arts and Culture: To support and enhance creative endeavors and artistic expression.

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...*Bush*

When an American president's two best friends abroad are the prime minister of Britain and the president of Russia, you know he has his hands full. The years Franklin Roosevelt spent in a similar position are not remembered for domestic policy.

Oh, we will see some action on the home front. Congress may well summon the courage to pass another tax cut this year. But Bush still may need 60 Senate votes to make the cockamamie 2001 tax law — which reverses itself in 2011 — permanent, and he still probably does not have them.

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Some conservative judicial nominees are likely to be confirmed. But at the Supreme Court level, the more liberal justices considering retirement such as John Paul Stevens and Ruth Bader Ginsburg might try to hang on until Democrats have a chance to retake the Senate, if not the White House, in 2004. Meanwhile, conservative justices such as Sandra Day O'Connor may go ahead and quit, but on most issues — except for abortion rights, where O'Connor has provided moderate support — a Bush replacement would not likely change much. If Bush nominates someone too extremely right wing to the high court, he probably will lose a couple of moderate Republican votes in the Senate that would jeopardize confirmation, so he is more or less constrained to the conservative mainstream. This president does not want to be Borked.

I'll be looking for this year's big news to be on the foreign pages. Will Bush go into Iraq and remove Saddam for something other than the good, but internationally unpalatable, reason that the world and Iraq are better off without him? Will unreliable allies such as Pakistan and Saudi Arabia provide enough help against terrorism to avoid triggering a crisis in our relations with them? Will China try to capitalize on our preoccupation elsewhere to dispose of Taiwan? Will North Korea provoke a confrontation in a desperate bid to have us buy our way out of it with financial aid?

George W. Bush has discovered that whatever power comes with his office does not include the power to choose his biggest problems. They have, instead, chosen him — and most of them have a distinct foreign accent.

Larry Elkin

Jacobs Becomes Newest Palisades Hudson Associate

Paul Jacobs, a 2002 graduate of New York University's Stern School of Business, has joined Palisades Hudson Financial Group as an associate in our tax and financial planning practice.

Paul Jacobs

Paul, 22, won the 2001 Deloitte & Touche/NYU Stern School of Business Tax Tournament as well as a University Merit Scholarship. He is a member of Beta Gamma Sigma, a national honor society for business students, and Beta Alpha Psi, a national honors fraternity for financial information professionals. While at NYU, Paul interned at New York Life and at two smaller companies that focus on marketing and investor relations.

He received his bachelor of science degree in finance and accounting in May 2002. After taking the summer off to travel and visit relatives, Paul joined Palisades Hudson in September.

He is a native of Queens, N.Y., and lives in New York City.

...Rules

the tolerance for risk varies with the purpose of the trust and the circumstances of the beneficiary. Obviously, the risk tolerance for a trust that must provide cash for a surviving spouse's support is different from that of a trust that is intended to accumulate wealth for a child who already has been well provided for.

What else must a fiduciary do to be a prudent investor? A fiduciary should manage and invest assets with reasonable care while keeping in mind the purpose, terms and distribution requirements of the trust. The trustee should consider other circumstances including, but not limited to, the general economic environment; the effects of inflation and deflation; expected return from income and capital appreciation; other resources of the beneficiary; needs for liquidity, regular income, and preservation of capital; tax consequences; and the special relationship or value of an asset. In addition, a trustee must manage and invest the assets solely in the impartial interest of the beneficiaries.

Another change in the law empowered fiduciaries to delegate. In fact, some cases may require delegation, such as when the fiduciary does not have investment management knowledge or when a professional fiduciary lacks experience in a particular type of investment. However, the fiduciary's obligation to be prudent does not end with delegation of investment and management responsibilities. A fiduciary must use care when selecting a manager, must establish the terms of the delegation and periodically review the agent's actions. Compliance with the prudent investor rule is judged in light of the facts and circumstances that existed when a decision or action was taken, not in hindsight.

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Thirty-six states and the District of Columbia have formally adopted the UPIA. This does not include states such as New York and Florida that were ahead of their time and passed substantially similar laws before the UPIA was written by the National Conference of Commissioners on Uniform State Laws and approved in 1994. When a state adopts the UPIA and similar rules, the new standards generally apply to all trusts existing on or created after the effective date except for those that explicitly opt out.

As we are often told, history repeats itself. The UPIA has restored the flexibility intended by Massachusetts Supreme Court Judge J. Putnam, who wrote the first version of the prudent investor rule when he decided the case of *Harvard College and Massachusetts General Hospital v. Francis Amory* in 1830. He wrote, "All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested."

Rebecca Pavese

...Portfolio

Donor advised option: Donors indicate qualified public charities to which they wish PHCP to make disbursements. Each disbursement must be at least $500. Donors may not make "quid pro quo" disbursements to charities from which they receive a direct or indirect benefit in return.

The Internal Revenue Service has recognized PHCP as a public charity that is exempt from tax under Section 501(c)(3) of the Internal Revenue Code. Contributions to PHCP are deductible for federal income, gift and estate taxes, subject to limitations in the tax code. Consult your tax adviser for details, including state and local tax treatment, which varies by jurisdiction.

PHCP accepts contributions of cash and publicly traded securities, with a $10,000 initial minimum. Additional contributions of $5,000 or more are permitted. Each donor's fund must disburse the greater of $10,000 or 5% of the fund's beginning balance each year. Donors can establish disbursement programs and can reallocate their disbursements among the various portfolio options.

Gifts to PHCP are irrevocable. Final authority over all matters, including disbursements, rests with PHCP.

Larry Elkin

Duly Noted

IRS Wins §2036 Argument Against FLP. The estate of a decedent who transferred nearly all his wealth to a family limited partnership includes the assets he transferred, not just the partnership interest he received in return, the Tax Court ruled. The decision by Judge Julian I. Jacobs marks the first time the Service, in its long-running battle against family partnership discounts, has succeeded in disregarding the partnership entity under §2036(a), which requires estates to include transferred assets in which the decedent retained an interest. Judge Jacobs ruled that when the decedent transferred his wealth to a partnership controlled by his children, "there was an implied agreement or understanding that decedent would retain the enjoyment and economic benefit of the property he had transferred." *Estate of Theodore R. Thompson et. al. v. Commissioner,* T.C. Memo 2002-246.

Roth Conversion Yields Tax On Social Security. The taxable income generated by a couple's conversion of regular IRA assets to a Roth IRA counts in determining whether the couple's Social Security benefits are taxable, according to the Tax Court. Robert and Sara Helm argued that the IRS "used our conversion of our IRAs from traditional to Roth as an excuse to cause our Social Security benefits to become taxable…This was not the intent of the Roth IRA law." Excuse or not, ruled Judge Robert N. Armen Jr., the IRS is correctly applying the law. *Robert L. Helm v. Commissioner,* T.C. Summary Opinion 2002-138.

Sympathy Only Goes So Far. California Gov. Gray Davis vetoed a bill that would have permitted diabetics to purchase lancets and blood glucose test strips from non-pharmacists without paying sales tax. Those items already can be obtained tax-free from registered pharmacists. In his veto message, Davis wrote, "I am sympathetic to those who have a legitimate medical need for lancets and glucose test strips, " but he said he vetoed the bill because it would "continue to erode the tax base," costing the state more than $1 million a year. Davis estimated California's looming budget deficit last month at nearly $30 billion. *2002 State Tax Today 213-8.*

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