Planning for Large Charitable Contributions

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This presentation should be viewed only as a summary of the law and not as a substitute for tax or legal consultation in a particular case. This is especially true in this topic, which is very, very complex. This is a very simplified overview of the rules, for the purpose of comparing several alternatives, each of which is complex. Your comments and questions are always welcome.

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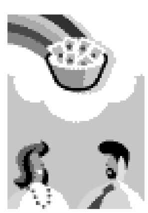
Large Charitable Contributions



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Large Charitable Contributions

- When do people make large charitable contributions?
  - ⇨ When a business is sold, especially a business that the sellers founded many years ago
  - ⇨ When an executive retires and cashes in the stock options
  - ⇨ When a couple faces the estate tax and does not want to enrich the federal government
  - ⇨ When a large inheritance is received

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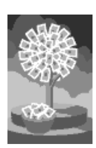
Charitable Contributions -The Tax Basics -



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Charitable Contributions -The Tax Basics -

- Can I deduct this donation? It depends on:
  - ⇨ What is donated?
  - ⇨ What kind of organization is the donee?
  - ⇨ How do we measure the contribution for tax purposes?
  - ⇨ What is the maximum contribution amount that we can deduct this year?

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Charitable Contributions -The Tax Basics -

- Basic Types of Donations
  - ⇨ Cash
  - ⇨ Property that, if sold, would produce long-term capital gain ("LTCG property")
  - ⇨ Neither cash nor LTCG property

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Charitable Contributions
-The Tax Basics -

- Basic Types of Donee Organizations
  - ⇨ Publicly-supported charity
    - Typically supported by the general public or government funds
  - ⇨ Private foundation
    - Typically supported by one family or company

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Charitable Contributions
-The Tax Basics -

Type of Contribution	**Type of Donee**	**Amount of contribution**	**Deduction limit per year***
Cash	Public Charity	Face amount	50% of income
	Private Foundation	Face amount	30% of income
Not cash, not LTCG property	Public Charity	Tax basis in property	50%/ ord. inc. prop.
			30%/ STCG prop.
	Private Foundation	Tax basis in property	30%/ ord. inc. prop.
			20%/ STCG prop.
LTCG property	Public Charity	Fair market value*	30% of income
	Private Foundation	Tax basis*	20% of income

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Charitable Contributions -The Tax Basics -

- Special Rules
  - ⇨ Contributions of LTCG property to public charities –
    - ▪ *If* the property is tangible personal property (like art) that is not used by the donee, the amount of the deduction is limited to the donor's basis
    - ▪ Other special rules apply to property that is depreciable or subject to debt.

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Charitable Contributions -The Tax Basics -

- Special Rules
  - ⇨ Contributions of LTCG property to private foundations –
    - ▪ The amount of the deduction is fair market value for *publicly-traded stock*.
      - ❖ But only if the donor and the donor's family do not contribute to the foundation more than 10% of the outstanding shares.

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Charitable Contributions
-The Tax Basics -

- Special Rules
  - ⇨ Donations that exceed the annual limitation –
    - Are carried *forward* for up to five years, but…
    - Do not survive the death of the donor.

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Charitable Contributions
-The Tax Basics -

- Bottom Line
  - ⇨ Donations to publicly-supported charities are subject to *more generous* tax deduction rules.
  - ⇨ Donations to private foundations are subject to *less generous* tax deduction rules.

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Regulation of Private Foundations

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Regulation of Private Foundations

- **California**
  - ⇨ Nonprofit Public Benefit Corporation Law
  - ⇨ Uniform Supervision of Charitable Trusts Act
  - ⇨ Nonprofit Integrity Act of 2004
  - ⇨ Revenue and Taxation Code

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Regulation of Private Foundations

- **Federal**
  - ⇨ Internal Revenue Code
  - ⇨ Volunteer Protection Act of 1997

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Private Foundations vs. Publicly Supported Organizations

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Private Foundations vs. Publicly Supported Organizations

- A private foundation is organized as:
  - ⇨ A nonprofit corporation
    - ▪ A nonprofit "public benefit" corporation in California
  - ⇨ A trust, or
  - ⇨ An association (rarely)

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Private Foundations vs. Publicly Supported Organizations

- A nonprofit organization is *not necessarily* exempt from income tax.
- It must *apply for* and *obtain* "determination letters" from the IRS and FTB saying it is tax-exempt.
- The tax exemption for charitable organizations is under *Section 501(c)(3)* of the Internal Revenue Code.

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Private Foundations vs. Publicly Supported Organizations

- "Charitable" purposes under Section 501(c)(3):
  - ⇨ Religious
  - ⇨ Charitable
  - ⇨ Scientific
  - ⇨ Testing for public safety
  - ⇨ Literary or educational purposes
  - ⇨ To foster national or international amateur sports competition
  - ⇨ To prevent cruelty to children or animals

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Private Foundations vs. Publicly Supported Organizations

- All Section 501(c)(3) organizations (that is, all tax-exempt charities) default to *private foundation* status.
- To avoid private foundation status, an organization must prove that it satisfies an *exemption* from private foundation status.
  - ⇨ Note the *two kinds* of exemption:
    - Exemption from *income tax*
    - Exemption from *private foundation status*

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Private Foundations vs. Publicly Supported Organizations

- Common exemptions from *private foundation* status:
  - ⇨ Public support (more than 1/3 of support from the general public, governments, or other publicly-supported organizations)
  - ⇨ Self-support (from dues, fees or sales)
  - ⇨ Supports another public charity
  - ⇨ Hospitals, schools, colleges, medical research organizations, churches
- ⇨ *Note:* For many "public charity" is a misnomer.

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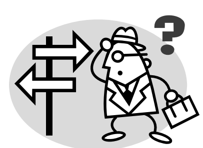
Grant-Making Foundations vs. Operating Foundations



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Grant-Making Foundations vs. Operating Foundations

- Private foundations generally are supported by a family or a company.
- A typical private foundations invests its funds and contributes the income to other hands-on public charities.
  - ⇨ This would be a "*grant-making foundation*"

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Grant-Making Foundations vs. Operating Foundations

- A private foundation that engages in "hands on" charitable activity or holds assets (such as art or an historic property) for use in a charitable activity probably qualifies as a "*private operating foundation.*"
  - ⇨ Donations to a private operating foundation get the *more generous tax deduction rules* that apply to donations to public charities.
  - ⇨ But most of the same internal *restrictions* apply as for grant-making foundations.

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Managing a Private Foundation

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A Small Tax on the Investment Income of Private Foundations

- A 2% tax applies to the net investment income of private foundations.
- If the foundation makes all of its required distributions, the tax rate decreases to 1%.
- This offsets the cost of IRS enforcement activities for tax-exempt organizations.

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Minimum Annual Distributions by Private Foundations

- Private grant-making foundations must value their assets each year.
- By the end of the following year, the foundation must "distribute" at least 5% of that year-end value.
  - ⇨ It's *value*, *not income*.
- The "distributions" are grants to hands-on charities.

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Paid Foundation Managers

- No more than 49% of the directors of a private foundation (organized a a California nonprofit public benefit corporation) can be compensated – or related to anyone compensated – by the foundation.
  - ⇨ So a child of the directors should not be a paid executive director.
  - ⇨ It is possible to sidestep this rule, but usually best to respect it.
- All permitted compensation must be "reasonable" in amount.

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Prohibited Transactions

- What family members *can't* do with their foundation:
  - ⇨ Sell, exchange, lease property at any price
  - ⇨ Furnish good, services or facilities
    - ▪ Unless the family furnishes it to the foundation for free
  - ⇨ Paying expenses of the family
    - ▪ Unless the payments are for reasonable and necessary *personal services* and are not excessive

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Prohibited Transactions

- What else family members can't do with their foundation:
  - ⇨ Make any loan or extension of credit
    - ▪ Except for interest-free loans *to* the foundation
  - ⇨ Transfer the foundation's *income* or *assets* to the family
  - ⇨ Use the foundations assets
  - ⇨ An agreement by the foundation, other than certain employment agreements, to give money or property to a *government official*.

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"Taxable Expenditures"

- A foundation can't make:
  - ⇨ Improper grants
    - For example, a grant to an *individual* without a prior IRS ruling approving the grant program
    - For some grantees, the foundation must exercise "*expenditure responsibility*"
  - ⇨ Payments for non-charitable purposes
  - ⇨ Political expenditures

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Public Tax Return

- A foundation must file a comprehensive tax return (Form 990-PF) that shows its compliance with these rules.
  - ⇨ The return must be made public.
  - ⇨ Check www.guidestar.org
  - ⇨ On the return, the foundation states whether it accepts *grant applications* from the public.
    - It's ok to say "No, thanks."

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Charitable Lead Trusts

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Charitable Lead Trust

- An alternative to a private foundation
- Basic structure:
  - ⇨ Income to charity for a period of time
  - ⇨ *Remainder to the family of the donor*
- Some of the private foundation restrictions apply to some types of Charitable Lead Trusts.

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Charitable Lead Trust

- When to use one:
  - ⇨ Donor wants an *upfront* income tax deduction, is *not* concerned about the percentage-of-income limitations or *estate taxes*
    - *Use a "grantor"* charitable lead trust.
    - Make annuity or "unitrust" payments to charity.
    - Set up during life and *survive* the term of the trust.

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Charitable Lead Trust

- When to use one:
  - ⇨ Donor wants to reduce estate tax on assets expected to appreciate and wants a gift tax deduction, *and*
  - ⇨ Donor wants to make a gift that would *not* be limited by the percentage-of-income limitations in the year of formation.**
    - *Use a "qualified non-grantor"* charitable lead trust.
    - Make annuity or "unitrust" payments to charity.
    - Set up during life or at death.

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Charitable Lead Trust

- When to use one:
  - ⇨ Donor is *not* concerned about gift or estate taxes, and
  - ⇨ Donor wants to make a gift that would *not* be limited by the percentage-of-income limitations in the year of formation,** or
  - ⇨ Donor wants to avoid the private foundation rules, at least until 2010.
    - *Use a "non-qualified non-grantor"* charitable lead trust.
    - Pay all income to charity.
    - Set up during life.

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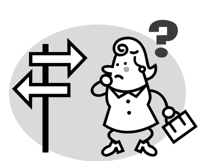
Charitable Lead Trust vs. Private Foundation



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Charitable Lead Trust vs. Private Foundation

- PF provides a larger income tax deduction.
  - ⇨ But the percentage-of-income limitations apply.
  - ⇨ Some CLTs sidestep these limits, but also defer the income tax deduction.
- PF leaves nothing for the family.
    - ▪ For growth assets, a CLT can leave a lot for the family.
- ▪ Both are subject to complex tax rules.

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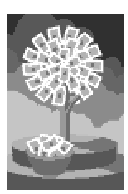
Community Foundation vs. Private Foundation



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Community Foundation vs. Private Foundation

- A community foundation provides:
  - ⇨ Best tax deduction rules,
  - ⇨ Professional management, and
  - ⇨ No set-up hassles
- But …
  - ⇨ Limited control over investments

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Thank you

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