TAX PLANNING FOR LARGE CHARITABLE CONTRIBUTIONS – PRIVATE FOUNDATIONS, DONOR-ADVISED FUNDS AND COMMUNITY FOUNDATIONS

Individuals who provide substantial support to charitable organizations enjoy several benefits:

- o They see their funds put to good use;
- o They have some degree of influence over how the organizations use their funds;
- o They often are recognized by the community for their good works; and
- o They receive tax deductions for their contributions.

By using private foundations or donor-advised funds, these individuals can accelerate their tax deductions while continuing to enjoy the other benefits of regularly supporting worthy organizations.

Examples

Consider these two examples:

Example 1: *Sale of the Family Business*

John and Donna plan to sell their family business in 2020 for $10 million and to receive more than half of the purchase price in cash. The sale will generate a tax gain of $8 million. They have over $2 million of income in 2020 from other investments. Over the years they have contributed to many charities and have taken leadership roles in a number of them. Charitable contributions may satisfy three of their goals:

1. To use $5 million of the sales proceeds to make periodic contributions to charities over several years;

2. To involve their adult children in their charitable projects (hoping to make charitable giving a part of their children's lives); and

3. To shelter as much of their 2020 tax gain from income tax as possible.

John and Donna could contribute directly to operating charities the entire $5 million in 2020. This would reduce their taxable income from $10 to $5 million. However, donating the entire $5 million in 2020 would deprive John and Donna of the opportunity to involve their children in their charitable giving plans over several years. In addition, the charities might expect further large contributions after 2020; and, if John and Donna do not pledge future contributions, their influence over how their funds are used by the charities might diminish.

A private foundation might be the answer. John and Donna could establish their own private foundation and contribute the entire $5 million to the foundation in 2020. They might make the donation before the sale in the form of stock of their family corporation valued at $5 million. (The contribution would be valued at their tax basis in the shares, but they would not recognize gain on the sale of the shares. The foundation, as a tax exempt entity, would pay tax on only a nominal amount of the gain it recognized). Or they could contribute to the foundation $5 million from the cash proceeds of the sale. After the sale of the business, the foundation would hold the $5 million as an endowment, using the *income* to pay expenses and to make annual contributions to operating charities. (The foundation also could contribute to operating charities all or portions of the $5 million *principal* amount.)

John and Donna would receive a large tax deduction in 2020 for their contribution to their new foundation. This deduction would shelter from income tax a portion of their gain on the sale of their business. The $5 million (and all income from it and appreciation in its value) would be excluded from the taxable estate of both John and Donna at their deaths.

The foundation could bear their name and they could control it during their lives. Their children could be involved in the foundation during John and Donna's lives and could then carry on the foundation, if the children wished to do so. John and Donna could provide in their estate plan for additional gifts to the foundation, if they wished.

Example 2: *Charitable Contributions in the Estate Plan*

Jane is a wealthy widow and is involved in several charities. She wants to dedicate over $10 million of her estate to charitable purposes.

Her estate plan provides for a substantial contribution to her foundation, all of which will be deductible for estate tax purposes. The foundation bears her name and will continue to support her charities after her death.

To implement this plan, Jane organizes a private foundation in 2020 to which she contributes $2 million.

She enjoys an income tax deduction in 2020 for her contribution. In 2020 she selects individuals whom she trusts to operate the foundation after her death. To involve them in her foundation's decision-making during her life, they begin serving as directors now. This gives her the opportunity to show them how she wants to make contributions to operating charities -- and also to see if they are considerate of her wishes. She retains a veto right to be sure that the board respects her wishes while she is a director.

Private Foundations

A "private foundation" is a nonprofit corporation or trust with two principal characteristics: it is dedicated to religious, charitable, scientific, literary or educational purposes (all of which are referred to as "charitable" purposes in this bulletin) and it receives its support from one person or a small group of people rather than from the public. A private foundation typically is funded and operated by an individual, a husband and wife, the individual members of a single family or a company.

Generally, the amounts contributed to a private foundation are held as an endowment, the income from which is used to pay the foundation's expenses and to make contributions to publicly supported operating charities. Some private foundations award scholarships or research grants directly to selected individuals (who are not related to the donors or foundation managers), rather than to operating charities. (However, this is often best handled by the educational institution, with the foundation officers participating in the award ceremony, but not making the selections.)

In contrast to most private grant-making foundations, an *operating charity* is directly engaged in "hands on" charitable activity and generally does not fund other organizations. An operating charity may be privately or publicly supported. A privately supported operating charity is called a "*private operating foundation*."

Private foundations must file annual tax returns and file annually with the California Attorney General's office. Private grant-making foundations must distribute annually 5% of the value of the foundation's assets.

The individuals who manage a private foundation operating in California are subject to five sets of rules. These are contained in the California Nonprofit Public Benefit Corporation Law, the federal Internal Revenue Code, the California Revenue and Taxation Code, the California Uniform Supervision of Trustees for Charitable Purposes Act and the California Nonprofit Integrity Act of 2004. Foundations holding funds that are required by the donor to be held has an endowment are also subject to the Uniform Prudent Management of Institutional Funds Act ("UPMIFA"). Foundations operating outside California are subject to the federal tax rules and other laws. (Complex tax laws also apply to donations to charitable organizations, with different rules for operating charities and private grant-making foundations.)

Although the rules that govern private foundations are somewhat complex, the organization and operation of a private foundation is not difficult for someone with an attorney and an accountant who are experienced in these matters – and with good communications among the foundation managers, accountant and attorney. The major challenges for foundation managers are choosing among the many projects that deserve support and wisely investing the foundation's funds. These are challenges which foundation managers share with everyone who makes charitable contributions. But foundation managers have more oversight and more downside risk if they ignore the rules.

Organizing a Private Foundation. Establishing a private foundation involves two major steps. The first step is a preliminary analysis of the income and estate tax consequences of the contemplated contributions to the foundation. The second step involves choosing a name and organizing a nonprofit corporation or trust, preparing its applications for tax exemptions and making the initial contribution to the foundation.

The tax analysis can be completed in a matter of hours or days. The initial documentation generally takes a week or two. The federal and California tax authorities generally respond to a tax exemption application for a private foundation within two to four months. When favorable "determination letters" are received from the tax authorities, the foundation is up and running.

Associations of Grant Makers. A tremendous resource for those who contemplate establishing a private foundation or who have an existing foundation is the **Council on Foundations** in Washington, D.C. (202-466-

6512 www.cof.org) The Council is an effective trade association for private foundation managers. Its membership includes over 1,100 foundations and corporate giving programs, each of which subscribe to a set of principles for effective grantmaking. The Council provides helpful publications and seminars on grantmaking, government relations, legislative developments and other topics of interest to foundation managers.

A local resource is **The Southern California Association for Philanthropy**, a nonprofit association of private-sector grantmakers. (213-680-8866 www.socalgrantmakers.org)

A Donor-Advised Fund as an Alternative to a Private Foundation

In the case of John and Donna, the principal tax benefit offered by the private foundation is the large immediate income tax deduction. However, if in 2020 their tax income is $10 million and they make a $5 million cash contribution to their private foundation, limitations on charitable contributions to private foundations will allow them to deduct only $3 million of the contribution in 2020. They would carry forward the other $2 million for up to five years.

Note that if John and Donna contributed the $5 million to a publicly supported charity in 2020, they could deduct the full amount in 2020, because a more generous limitation would apply. So John and Donna would derive greater immediate tax benefits from a contribution to a donor-advised fund than to their private foundation.

A "**donor-advised fund**" is a nonprofit organization that accepts substantial contributions from several donors. Although the fund in not engaged in "hands on" charitable activities, it is treated for tax purposes as a publicly supported operating charity, so more generous deduction limitations apply.

A "**community foundation**" is a donor-advised fund which generally operates in a particular geographic area. They can help donors identify worthy charities to support.

The donor-advised fund allocates to each of its donors a percentage interest in the fund's annual income, based on the value of their contributions to the fund. Each donor is entitled annually to designate the charity or charities to receive his or her portion of the fund's income. Some funds permit the donor to name successors who will make these annual designations after the initial donors die. The donors may also designate the charities to receive all or a portion of their initial contribution at their death or in years in which they do not designate the recipient of their share of the fund's income.

Because the fund serves many donors, it can offer expertise, a professional staff and economies of scale. However, the fund is not tailored as precisely as a private foundation to the donor's specific needs. The donor-advised fund often provides greater tax benefits than a private foundation and is often more convenient for the donor to establish and operate. (An existing private foundation can take advantage of this convenience by transferring its assets to a donor-advised fund. Get legal and tax advice before such a transfer.) For these reasons, a donor-advised fund is particularly well-suited for donors whose total contributions (during life and at death) will be less than $1 million. But the donor-advised fund is a good alternative for anyone who considers establishing a new private foundation.

Most donor-advised funds can identify the donor's share of the funds with the donor's name, if desired. The recipient of a grant or scholarship from the donor-advised funds make little or no distinction between a grant from the Staley Foundation or from the Staley Fund at the California Community Foundation. (The eight-foot long check will say "Staley Fund" in big letters and "at the California Community Foundation" in tiny letters.)

A donor-advised fund can also offer a donor **anonymity** that would be difficult to achieve if the donor used his or her private foundation.

Donor-advised funds offer donors limited or no control over investment decisions.

Back to John, Donna and Jane

For John and Donna, the donor-advised fund provides greater tax benefits than a private foundation and satisfies most of their other objectives. They can consult their children each year when they select charities to receive their share of the fund income. Some donor-advised funds would allow John and Donna to specify that their children can make the annual selection after their death. In contrast to a private foundation, John and Donna's children will not have formal roles in this process as directors or officers. With the donor-advised fund, their children will not be subject to the supervision of the IRS, the Franchise Tax Board, and the California Attorney General, as they would be if they managed a private foundation.

A donor-advised fund could also serve Jane's objectives, particularly if she found it difficult to select directors to carry on her private foundation when she can't. If her tax income for 2020 exceeds $7 million, the donor-advised fund does not offer her any greater income tax benefit than a private foundation. But if her tax income for 2020 is between $3.3 and $7 million, the donor-advised fund will allow her to deduct more of her $2 million donation in 2020 that a comparable gift to a private foundation. Jane will receive the same estate tax deduction whether she contributes the property at death to a private foundation or a donor-advised fund.

More info about donor-advised funds

Community foundations operating locally include:

California Community Foundation
Los Angeles (213) 413-4130
www.calfund.org

Glendale Community Foundation
(818) 241-8040
www.glendalecommunityfoundation.org

Ventura County Community Foundation
Camarillo (805) 988-0196
www.vccf.org

Jewish Community Foundation
Los Angeles (323) 761-8700
www.jewishfoundationla.org

Orange County Community Foundation www.oc-cf.org
Irvine (949) 553-4202

San Diego Community Foundation
San Diego (619) 235-2300
(Also has a fund for Imperial County)
www.sdfoundation.org

Donor-advised funds operated by investment firms include:

Fidelity Charitable Gift Fund
Boston, MA (800) 682-4438
www.charitablegift.org
The T. Rowe Price Program for Charitable Giving
Baltimore, MD 800-564-1597
www.programforgiving.org

Vanguard Charitable Endowment Program
Malvern, PA (888) 383-4483
www.vanguardcharitable.org

Summary

An individual or company planning to make large charitable contributions should work closely with a tax advisor. A private foundation can provide a great deal of personal satisfaction as well as tax benefits. A donor-advised fund can provide similar or greater tax benefits, with less hassle.

Individuals who consider making large charitable contributions during their lifetime should also consider **charitable lead trusts** (which send their income to a charity for a period of time, and then return the principal to the family – at a substantially discounted value for estate and gift tax purposes), **supporting organizations**, **charitable remainder trusts** and combinations of such trusts with insurance-funded "**wealth replacement**" **trusts**. Charitable giving techniques are available for specific types of assets (such as personal residences) or specific objectives (such as maximizing the portion of a senior generation's estate that will pass to the grandchildren after two generations pay estate tax).

I would be pleased to discuss these matters with you.

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