

Charitable Giving

Tax And Nontax Advantages Of Community Foundations

Treated as public charities under the IRC, community foundations often provide tax advantages that other means of charitable giving do not

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Most tax and estate advisors — attorneys, accountants, bank officers — for excellent reasons, have a conservative approach to money. Indeed, much of the work of those professionals is to assist individuals in conserving their wealth. For example, for decades these professionals have helped clients reduce current income taxes and protect heirs against excessive estate taxes, typically through judicious and careful planning. Many planning arrangements which had been used to effect income, estate and gift tax reduction have been eliminated or restricted by changes in the tax law. However, planning opportunities through charitable arrangements continue to be effective for many philanthropically inclined individuals and businesses. Occasionally, individuals and companies use a private foundation as the center piece of their charitable giving program. The determination of whether a charity is a private foundation or a public charity, generally, turns on where the entity derives its support. Usually, if more than two-thirds of its support comes from investments and from donations from a small group of individuals and businesses, the organization is a private foundation.

For many would-be donors, however, private foundations may not be as effective as other charitable arrangements. For example, private foundations are subject to a 1 or 2 percent excise tax on net investment income thereby eroding what is available to achieve the donor's charitable goals or programs. They are also subject to rules requiring that they distribute a minimum percentage of their net worth each year,¹ to restrictions on the percentage of a business which they may own, the types of investments they may make and the type of activities they may support and face an assortment of

other complex and detailed rules, including rules on reporting their activities. Moreover, private foundations are prohibited, in effect, from engaging in any economic activities with their donors or administrators, members of their families or entities in which they have significant interest. For example, a foundation may not sell or buy assets from one of those persons even on bargain terms for the charity. Furthermore, a foundation usually cannot even own interest in property (such as an undivided interest in real estate) with one of those persons. These restrictions and prohibitions do not apply to public charities.

In addition, adherence to these and other rules can significantly increase the costs of administering private foundations. These costs further erode what is available to accomplish the charitable goals of the donors. Even small charitable trust funds may be private foundations under the tax law. For many of them, much of their annual income disappears in taxes and administrative fees.

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passing a tax advantage. One such means — the community foundation — is less well known than it deserves. Community foundations are treated as public charities under the Internal Revenue Code. They often offer both tax and nontax advantages over many other forms of charitable giving.

Tax Advantages

Community foundations offer their donors the maximum tax deduction allowable under the law for charitable contributions. Up to 50 percent of adjusted gross income (as specially computed) for gifts of cash and non-appreciated property, and up to 30 percent of adjusted gross income for gifts of long-term capital gain property, generally can be deducted in the year of the gift; amounts that cannot be deducted right away can be carried forward and used as deductions over the succeeding five years.² The limits for most private foundations are 30 percent for cash and non-appreciated property and 20 percent for long-term capital gain property. Donors to community foundations thus are able to take a greater deduction sooner than donors to most private foundations, and to take advantage of the time value of money in ways that gifts to the latter cannot.

Gifts of appreciated long-term capital gain securities, real estate or other assets can be especially advantageous. Cash produces only one tax deduction; long-term appreciated property can produce, in effect, two — deduction of the property's fair market value, and avoidance of the capital gains tax that would have been due had the property been sold. This disparity holds even if the donor is fulfilling a legally binding pledge.³ Gifts of long-term capital gain (appreciated) marketable securities to a private foundation also can carry the same tax benefits, up to 1995.

However, gifts to a private foundation of other types of long-term capital gain property (such as real estate) do not produce this double benefit. Moreover, the Internal Revenue Service recently ruled that the double benefit also is denied for a contribution of marketable securities which are prohibited from sale under Sec. Rule 144.⁴ Even where the same income tax benefit may be available to a donor for a gift to a private foundation as it would be for

one to a public charity, it may be preferable to use a community foundation for ease of making the gift and its administration.

For example, creating a private foundation may require certain approvals from state officials or registering with them in some states. In virtually all cases, it will require filing applications and tax returns with the IRS. In contrast, a component fund in the name of an individual, family or business can be established in about half an hour at a community foundation. Speed and simplicity can be important to a client whose need for a tax deduction becomes clear late in the tax year or who wants to donate publicly traded stock in the relatively near future.

Gifts of stock in a closely-held corporation, followed by redemption of the stock by the corporation, can reduce a company's accumulated cash, which may be a particularly useful idea if the company's sale is being considered.⁵ Such a gift must be structured carefully to ensure that it meets all requirements⁶ and does not fall foul of Internal Revenue Service rules on incomplete transfer. There may be other pitfalls. For example, the closely-held corporation whose shares are donated to a private foundation is likely to be one of the entities with whom the foundation cannot have an economic dealing. In such a case, the company may not be able to redeem the shares from the foundation or can do so only under very restricted conditions.

Deductions relating to contributions of appreciated property are governed by complex rules. For example, advisors and donors should be especially wary of the alternative minimum tax rules which in some cases can work to deny the benefit of any deduction attributable to appreciation in the asset given to charity. Still, a gift of appreciated closely-held stock made by a majority shareholder can offer real tax advantages to the donor (who is also able to retain the majority interest), and result in valuable contribution to charity — a high return for a few simple transactions. Yet other rules may foil this plan if the recipient is a private foundation. For instance, as a general matter, a foundation may own no more than 20 percent of the stock in any company reduced by the percentage held by the donor, the donor's family and certain others

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(subject, usually, to a 2 percent floor). That rule may work to prevent the gift from being made.

Professional advisors, but few others, are well aware of the virtues of charitable giving in reducing estate taxes. (One community foundation derives more than half of its new funds from donors referred by trust and estate attorneys at fewer than 5 percent of the law firms in its city). For an estate of any significant size, the benefits of charitable giving are worth considering, as the after-tax cost of a bequest of property can be less than 40 percent of full value and, in some cases, can cost less than 5 percent. Generally, the estate tax charitable deduction does not vary with the type of gift — cash paintings, property — or with the recipient, and the allowable deduction is unlimited.⁷ However, when a bequest to charity is made of a right to “income in respect of a decedent,”⁸ an asset which does not obtain a tax-free step-up in basis at its owner’s death, the legacy deprives the family of very little because the effective rate of combined estate and income taxes can exceed 95 percent. In fact,

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directing for the income in respect of a decedent to pass to a charitable remainder trust (described in more detail later), surviving family members can actually obtain enhanced benefits. In many cases, whether or not combined with marital deduction,⁹ the estate tax charitable deduction can offer attractive tax savings.

Unlike the rules for income tax de-

ductions, the rules for estate tax deductions generally are the same for giving to a community foundation and to a private foundation. However, the community foundation still may offer advantages: its administrative costs are low, and it is free from the excise taxes and operating restrictions that burden private foundations. As mentioned earlier, limits on the percentage of stock which private foundations may hold, for example, can frustrate the estate planning goals of shareholders or partners in a family business.¹⁰

For the professional advisor, understanding the tax benefits of charitable giving through community foundations is only the start.

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Key Decisions

The would-be donor first should decide what he or she most wants the contribution to accomplish, and

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whether it is better to make the gift now or later (or, of course both). Most community foundations are as accommodating to a donor's wishes as possible to make the best arrangement for all. The information the community foundation needs usually is relatively simple: Should the fund be used for particular charities or causes, or may the community foundation itself choose the charitable purposes or institution to support? What funding mechanism (current gifts of cash or property, bequests, or any of several kinds of trust) is most effective? To what degree will the donor wish to be involved in the grant making decisions?

Community foundations occasionally administer both *non-component* and *component* funds. A non-component fund is one that carries a material restriction. These are conditions that restrict the community foundation's authority over how property will be used for charitable purposes.¹¹ Usually the non-component fund will be treated as a private foundation and a separate tax return will have to be filed for it.¹² Moreover, donations to non-component funds generally do not qualify for the income tax deduction allowed for gifts to public charities but only those allowed for gifts to a private foundation. One exception is the *pooled common fund*, a fund whose founder chooses the beneficiaries each year. Grants from these funds can be made only to public charities organized under Sec. 509(a)(1) of the Internal Revenue Code, such as schools and churches. As a consequence, unlike other non-component funds, donations to pooled common funds are as fully deductible as donations to public charities.¹³

Component funds are funds that are held by the community foundation without material restrictions. This means that the instrument creating a component fund must be consistent with the community foundation's declaration of trust or articles of incorporation, but this requirement almost always is easily met. Component funds may have a special purpose (a designated fund or field of interest fund), or the donor may retain the right to suggest (but not direct) each year charitable beneficiaries or causes. These are known as *donor-advised funds* and come relatively close, in many respects, to

private foundations but without the restrictions, reporting requirements and tax limitations which apply to those foundations.

A *designated fund* is one whose income is destined for other public charities named by the donor.¹⁴ Designated funds are especially useful to donors who wish to support a particular organization or organizations, but who do not wish to make an outright gift of endowment. *Field-of-interest funds* are more general. The donor specifies a charitable purpose, such as relieving illiteracy or promoting the arts, and the community foundation selects the beneficiaries.¹⁵ Donors who want to establish scholarship funds, for example, may find it best to do so through a community foundation. Administering scholarship funds requires a surprising amount of specialized knowledge and attention to detail; and, if the entity is a private foundation, special IRS approval is required (and, as a result, can result in additional IRS scrutiny). Many community foundations are both skilled and eager to use their knowledge, and experience in the more complex administrative and philanthropic areas to help the donor achieve the desired charitable goals.

Donor-advised funds allow donors to suggest uses of the donated funds without incurring any administrative responsibility. A donor-advised fund can be a most effective buffer for a wealthy donor who cannot take on such tasks as reading applications and investigating agencies, but who retains an interest in the effect of his or her gift. (Advisors may want to emphasize that those who establish donor-advised funds can only recommend; that is, the community foundation must be free to accept or reject the recommendation in order to maintain the fund's charitable status and the maximum deduction.)

Establishing a component fund is now routine at most community foundations. It can be done quickly and at any time. Non-component funds generally are more complex, and the paperwork may take a little longer. The simplest kind of fund to establish is an unrestricted component fund — funds contributed to the community foundation for use in the best interest of the community.

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or add to one, with gifts of cash, publicly traded securities, closely-held stock, real estate, personal property or life insurance. A gift is made entirely at the donor's convenience. One may, for example, make a tax-deductible gift this year and distribute grants later but the gift to the fund must be irrevocable. A donor also can arrange a deferred gift — one that is planned now but completed later — to start or enlarge a fund. Because

there generally is no tax deduction for a charitable gift of a partial interest in property,¹⁶ some care is needed in setting up a deferred gift. Bequests, life insurance policies, and trusts of several sorts have all been used successfully.

Donors can bequeath to a fund a fixed amount of cash or particular property (a specific bequest); direct that some or all of the remainder of the estate go to the fund (a residuary

bequest); or direct that the remainder be sent to the fund only after all the primary beneficiaries are deceased (a remainder interest). Transferring a life insurance policy to build a fund is generally a straightforward and simple gift to arrange. The donor can deduct the value of the policy; if premiums are still due, and the donor continues to pay them, those amounts also are tax deductible.

Charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds are the most commonly used deferred-giving trust arrangements. They are sometimes attractive to donors who have appreciated property because they can offer several benefits: a current income tax deduction for the present actuarial value of the charitable remainder even though the charity must await the receipt of its gift; the trust may sell the donated appreciated asset without income tax because the trust is tax exempt. As with any charitable gift of appreciated property donors need to consider the potential impact of the alternative minimum tax when making contributions of appreciated assets to a charitable remainder trust or pooled income fund.

A charitable remainder *annuity* trust pays out a fixed amount each year to a beneficiary, either for life or for a set number of years (not greater than 20 years); then the proceeds of the trust go to the chosen charitable fund or cause.¹⁷ A charitable remainder *unitrust* pays out a fixed percentage of the yearly value of the trust's assets to a beneficiary, rather than a fixed sum, for life or for a term of years (again, not greater than 20 years).¹⁸ Because the payments change with the assets' value, a unitrust may be more useful in offsetting inflation than an annuity trust. The charitable tax deduction attributable to a contribution to a charitable remainder unitrust is calculated in a somewhat different manner than that for the deduction for a contribution to an annuity trust; it may be lower or greater depending upon its terms.

A pooled income fund is a commingled fund of contributions from various donors, each of whom receives a proportionate amount of the pool's income for life.¹⁹ When a donor dies, a proportionate amount of the pool's assets is separated from the pool and given to the charitable or-

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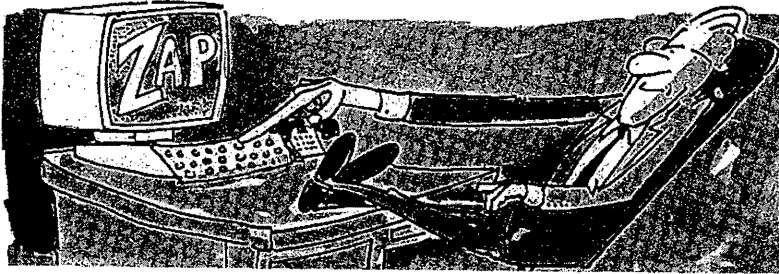
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ganization that holds the fund.²⁰ If the pooled fund is held by a community foundation, the released assets can be used in a designated fund that benefits a particular public charity.²¹

There are also trusts — the *charitable lead annuity trust* and the *charitable lead unitrust* — which make annual payments to charity with the remainder passing to designated individuals. Generally, the charitable lead trusts are used to reduce estate, gift and generation-skipping transfer taxes rather than income taxes, as well as to benefit charity. These trusts can be powerful estate planning tools especially for the well-to-do philanthropic individual who wishes to reduce wealth transfer taxes. They are also complex. The staff of an experienced community foundation can provide certain advice about lead trusts and how they can be used to start a fund at a community foundation.

Nontax Advantages

Another advantage that community foundations may offer donors is continuity. Where a single charitable agency might fail over time, the community foundation administers funds in perpetuity, and with the assurance of contemporaneousness. Community foundations possess a variance power; that is, the foundation's board has the ability to change a fund's specified purpose if the donor's original intent becomes unnecessary, impossible, or inconsistent with the charitable needs of the area.²² Although many well-drafted charitable trust instruments would include a similar provision, the trustee of a private foundation, in many cases, may not have the experience or special knowledge a community foundation may possess to develop the best alternative charitable plan.

This knowledge comes from experience in the community. In fact, it comes from experience in a special place in the community. Community foundations regularly create or start community projects, identify problems, and work with other organizations to find solutions to all types of charitable needs. They are well known and well respected in the communities they serve. Unlike private foundations, community foundations are not thought of as representing the attitudes of a single

founding family or corporation. Unlike individual charities, community foundations have interests that extend across the entire community. Donors who first notice the tax savings of giving through community foundations may find the fact that their gift will be used to its utmost to be the most satisfying reward of all.◊

FOOTNOTES

1. IRC Sec. 4942.
2. IRC Sec. 170(b) (1) (A), Sec. 170(b) (1) (C); Treas. Reg. Sec. 1.170A-9 (e) (11) (ii).
3. Rev. Rul. 55-410, 1955-1 C.B. 297; *Helvering v. Hammel*, 311 U.S. 504 (1941), *Electro-Chemical v. Comm'r.*, 311 U.S. 513 (1941).
4. PLR 9247018. Private Letter Rulings are not precedent. IRC Sec. 110 (i). However, they are often indications of IRS' position.
5. See Rev. Rul. 78-197, 1978 C.B. 83.
6. For example, some gifts must be appraised; see Treas. Reg. Sec. 1.170A-13 (a).
7. IRC Sec. 2055 (a) and Sec. 2055 (d).
8. IRC Sec. 691 (a).
9. IRC Sec. 12056 (a).
10. IRC Sec. 4943(c) (2) (A).
11. Treas. Reg. Sec. 1.170A-9(e) (11) (ii) (B) and Sec. 1.507-2 (a) (8).
12. Treas. Reg. Sec. 301.7701-4, 301.7701-2; IRC Sec. 7701(a) (3).
13. IRC Sec. 170 (b) (1) (E) (iii).
14. Treas. Reg. Sec. 1.170A-9(e) (11) (v) and 9(e) (13) (x); IRC Sec. 509(a) (1), 509(a) (2), or 509(a) (3).
15. Treas. Reg. Sec. 1.507-2(a) (8) (iii) (B).
16. IRC Sec. 170 (f).
17. IRC Sec. 664(d) (1).
18. IRC Sec. 664 (d) (2).
19. IRC Sec. 642(c) (5); Treas. Reg. Sec. 1.642(c)-5).
20. Treas. Reg. Sec. 1.642 (c) -5 (b) (5).
21. The IRS approved this use of proceeds from a pooled income fund in a private letter ruling, PLR 89-24-040 (March 20, 1989). However, more recent rulings have raised questions about the appropriate procedures, Rev. Rul. 92-108 and Rev. Rul. 93-8.
22. Treas. Reg. Sec. 170A-9 (e) (11) (v) (B) (1).

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