

PODCAST
PRESENTATION

DIVERSITY OF PHILANTHROPIC SOLUTIONS

HOST: Hello and welcome. Northern Trust is proud to sponsor this podcast, the Diversity of Philanthropic Solutions, the second in a three-part series on the diversity of giving. Today's podcast will be of particular interest to individuals who have determined they want to contribute to charity, but are unsure of the solution that will best meet their needs.

I'm Bill Whitt, director of research at Northern Trust and our guest today is Grace Allison, tax strategist for Northern Trust. Previously, Grace was engaged in the private practice of law as a partner with the Chicago office of Katten Muchin & Zavis. She is a graduate of The University of Chicago Law School and Wellesley College and is on the Board of the Chicago Council on Planned Giving.

Please understand that the strategies discussed during this podcast are not intended to be legal advice. As always, you should contact your attorney or tax advisor to review any strategy in light of your own specific situation.

Grace, thank you for being here today. When you first consider making contributions to charity, what are some of the questions you need to consider?

GRACE: Bill, that's a terrific way to begin our discussion. I'd suggest asking a whole list of questions:

- What do I hope to accomplish through philanthropy?
- What charity or types of charities would I like to benefit?
- How will family members be involved in making gifts?
- How involved do I want to be in the causes that I support?
- How should I structure my gift?

HOST: Does it surprise donors to learn that charitable gifts can be structured in many different ways – and that the size of the gift may or may not influence the choice of charitable vehicle?

GRACE: I think it does, Bill. In practice, outright contributions to charity may range from a modest check at one extreme to very substantial asset donations at the other. Similarly, one donor may choose to make a substantial donation to a donor advised fund, while another chooses to establish a substantial charitable remainder



trust or private foundation. From the donor's viewpoint, it's important to recognize that many factors are involved – motivation, cash flow needs, tolerance for complexity – and, of course, taxes.

HOST: You mentioned taxes. I'm sure our listeners would be very interested in learning a bit more about the tax treatment of the various gifting options.

GRACE: While each situation is unique, there are nonetheless some general truths. For starters, the federal tax law provides incentives for charitable giving in the form of generous deductions under the income, gift and estate tax. In general, the same charitable techniques that qualify for deductions under the income tax also qualify for gift and estate tax charitable deductions. That being said, donors should remember that the gift and estate tax charitable deductions are unlimited; in contrast, the income tax charitable deduction is limited by a number of factors, including the donor's adjusted gross income.

HOST: Let's begin our discussion of the various charitable solutions, starting with the most straightforward.

GRACE: Generally speaking, the simplest gifts are the ones with which we are all most familiar – direct donations, or outright gifts, to charity. For some donors, making an outright gift is as simple as writing a check or arranging for the transfer of selected securities, real estate or collectibles. Other donors desire a greater degree of control. Their gifts may be documented by written agreements that:

- Restrict the use of the gift;
- Specify how gift proceeds are to be invested; or
- Direct the recipient to produce annual reports detailing how gifted monies are used.

Whether their gifts are restricted or unrestricted, donors are best served when they engage both their financial advisors and the planned giving office of the recipient charity before making firm plans. For example, the charity may have a particular funding opportunity that will uniquely match the donor's interests. Planned giving officers can also advise which types of gift restrictions are acceptable – or not acceptable – to the institution.

HOST: And is the tax code kind to the donor who makes direct donations to public charities?

GRACE: Indeed it is, Bill. The income tax charitable deduction for outright transfers to public charities during life is very generous – up to 50% of adjusted gross income for cash contributions. In addition, these transfers also qualify for the unlimited gift and estate tax charitable deductions.

HOST: I seem to hear a lot these days about donor advised funds. Can you explain all the interest in this particular charitable solution?

GRACE: Donor advised funds have become increasingly popular in recent years because of their versatility and ease of operation, particularly in contrast to private foundations. The nation's largest donor advised funds have assets in excess of \$15.5 billion.

In simple terms, a donor advised fund is a separate account over which the donor and his designees have the power to recommend grants and investments. The account is owned and held by a sponsoring charity, often a community foundation and less frequently, a large public charity, such as a hospital or educational institution. Major financial institutions also offer associated donor advised funds.

HOST: Now, who would be interested in a donor advised fund?

GRACE: A donor advised fund will appeal to individuals who want to establish a tradition of giving by involving their family members in the grant-making process. Compared to private foundations, donor advised funds are less complex for the donor.

HOST: How does a donor advised fund work?

GRACE: A donor advised fund can be established while you are living or at death – the charitable transfer occurs when the donor transfers assets to the donor advised account. Grant-making from the account then takes place over the succeeding months and years. A key element is the ability of the donor and/or his designees to name family members and friends as “account advisors.” In this way, a donor advised fund can be used to promote family philanthropy or to create a giving circle.

When considering a donor advised fund, there are important differences to consider. Clearly, you’ll want to understand the fund’s fee structure and available investment options.

HOST: So, are there any other considerations?

GRACE: Yes, depending on your situation and your charitable objectives, you should also consider:

- Whether the fund will accept nontraditional assets such as closely held stock or partnership interests;
- The number of individuals who may serve as advisors;
- The presence or absence of a requirement to make distributions to the sponsoring charity;
- The ability to designate multiple charities to receive distributions at your death;
- Whether expert advice on grant recommendations is available from the sponsoring charity (that’s a real important one); and
- Minimums for contributions and additions.

HOST: And from a tax perspective, how does a donor advised fund compare?

GRACE: A lifetime transfer to a donor advised fund is treated, for both property law and tax purposes, as a direct transfer to the sponsoring public charity. For this reason, the applicable income tax limitations are the same as those for direct transfers to public charities: a 50% limitation for gifts of cash and a 30% limitation for gifts of securities. An unlimited charitable deduction is available for gift and estate tax purposes.

Because the sponsoring organization owns the donor advised fund account, all earnings of the account appear on the tax return of the sponsoring organization – a contributor to a donor advised fund, in other words, does not need to file a separate tax return for the account. Another plus: donors are not typically required to file gift tax returns solely because they have transferred cash or property to a donor advised fund.

HOST: I’ve read articles about donors who establish charitable trusts. What are these and how are they different from donor advised funds?

GRACE: There are two types of trusts that qualify for the charitable deduction: “wholly charitable” trusts, in which all interests are held by charity and qualified “split-interest” charitable trusts, which benefit both individual beneficiaries and designated charities. A qualified split-interest charitable trust, like a charitable remainder trust or a charitable lead trust, can enable you to maximize after-tax transfers to both individuals and to

your favorite charity. This flexibility can be very useful when addressing a wide range of situations.

HOST: Can you explain that a little more, Grace?

GRACE: Let's start with the charitable remainder trust, in which the initial interest is held by one or more individuals and the remainder by charity.

Suppose, Bill, that you had a concentration of low-basis publicly traded stock and wanted to defer gain on its sale – and that you also wanted to do something philanthropic. You could set up a tax-exempt charitable remainder trust and transfer that concentration to the trust, naming yourself as the initial beneficiary – all without triggering any capital gains tax. The trust would make payments to you throughout your lifetime, and you would be taxed on capital gains from the sale of the stock only as payments were received. At your death, the balance or remainder of the trust would go to one or more charities designated by you in the trust agreement. Alternately, you could name a third party as initial beneficiary – your spouse, another family member, a close friend.

HOST: I see: the key is that the benefit of the trust is split between individuals and charity. What does the Internal Revenue Service think about all this, Grace?

GRACE: Charitable remainder trusts are a well-established strategy, Bill. In 1969, Congress enacted Internal Revenue Code Section 664, which lays out the requirements for a properly structured charitable remainder trust. As a result, donors can enjoy a comforting certainty: so long as their charitable remainder trust is drafted and operated in a way that complies with the tax rules, their charitable deduction is assured. The Internal Revenue Service even publishes charitable remainder trust forms to make life easier for donors and their drafters.

A second endearing quality of the charitable remainder trust is its flexibility. Charitable remainder trusts can be hand-tailored by a skilled drafter to fit a variety of situations. The beneficiary of a charitable remainder trust may be the donor, another individual (such as the donor's spouse or children), a trust for the benefit of individuals, a corporation or a partnership. Equally important, charitable remainder trusts are valuable estate planning tools for unmarried couples, with each partner providing in his documents for the creation of a charitable remainder trust at death for the benefit of the other.

HOST: The second type of split-interest charitable trust you mentioned was the charitable lead trust – how does it differ from the charitable remainder trust?

GRACE: In a charitable lead trust, the current interest is held by charity and the future interest is held by individuals, typically family members. Like charitable remainder trusts, charitable lead trusts were created by Congress in 1969 and are an estate planning staple. There are four different types of charitable lead trusts, with the charitable lead annuity trust working best for deferred transfers to children and the charitable lead unitrust working best for generation-skipping transfers.

HOST: Could you share with us the benefits of the charitable lead trust and explain how it differs from the charitable remainder trust?

GRACE: Absolutely, charitable lead trusts are very useful in situations where family members are independently wealthy and have no immediate need for additional cash flow or where the donor wishes to defer a gift to avoid giving the younger generation too much, too soon. In a charitable lead trust, the initial interest is held by one or more charities – perhaps the donor's private foundation – and the remainder interest is held by

children or grandchildren or trusts for their benefit. Because the gift to individuals is deferred, the donor can leverage her estate, gift or generation-skipping tax exemptions to the fullest. The key here, Bill, is the time value of money: a gift of a future interest has less value than a gift of a present interest.

HOST: Grace, you mentioned private foundations as potential charitable beneficiaries for charitable lead trusts – what are they and when might they be appropriate?

GRACE: Private foundations are popular charitable solutions – at last count, there were almost 68,000 grant-making private foundations in the United States. Unlike public charities, private foundations are supported not by the general public but by a very limited number of donors – typically a corporation or a high-net-worth family.

Some foundations are organized as wholly charitable trusts; others are wholly charitable non-for-profit corporations. Most are *grant-making foundations* that make grants to public charities selected by their trustees, board or grant-making committees. A minority are *operating foundations* that directly fulfill a charitable function, typically by providing some type of service to the public, for example, operating a museum or a soup kitchen. Over half of all private foundations are family foundations, controlled by individual donors and their descendants, advisors and friends.

Many donors conclude that a private foundation is the ideal vehicle to promote family philanthropy. A typical expectation is that the foundation will unite the family as it works together toward common goals. This expectation, in my experience, is more likely to be fulfilled if the foundation is established during the original donors' lifetimes, so that family members can share first-hand the donors' passion and vision. On the other hand, it's not likely that a deeply divided family will find itself united through a private foundation, whether or not the donors are alive.

HOST: Developing a family tradition of giving sounds like a compelling benefit; what are some of the drawbacks of private foundations?

GRACE: Well, one downside of a private foundation is its administrative complexity. For example, the tax rules require annual distributions equal to at least 5% of average monthly asset value, with a 30% penalty tax on late payments. There are also rules on self-dealing, excess business holdings, jeopardizing investments and excess expenditures, all with associated penalty excise taxes. Finally, there is a 2% tax on net investment income – which must be paid in estimated quarterly installments. To keep their foundation on the straight and narrow, donors typically turn to their accountants or a financial services provider who will serve as agent or trustee.

HOST: Does it matter how a private foundation is funded?

GRACE: Yes it does. Gifts of cash are subject to a 30% limitation; gifts of publicly traded stock are subject to a 20% limitation. Importantly, the income tax charitable deduction for transfers to a private foundation of long-term appreciated assets other than publicly traded stock, such as real estate or closely held stock, is generally limited to tax cost, which typically is very low. For this reason, most lifetime transfers to private foundations are funded with cash or long-term publicly traded stock.

On the other hand, if a transfer to a private foundation is made at death, the unlimited estate tax charitable deduction is available, whether the asset being transferred is cash, publicly traded securities, real estate or closely held stock.

HOST: It sounds like donor advised funds and private foundations share many of the same benefits. When would a donor choose one over the other?

GRACE: You're correct, Bill, donor advised funds share two of the most appealing characteristics of private foundations: donor involvement and family participation. Of the two, donor advised funds are more tax efficient for lifetime gifts – with a 50% income limitation for gifts of cash and a 30% limitation for gifts of long-term publicly traded stock.

The trade-off is that private foundations offer the donor more control. With a donor advised fund, the donor makes recommendations about grants and investments with final approval coming from the sponsoring charity. With a private foundation, final approval comes from the donor and her board.

HOST: Grace, this has been an extremely educational discussion. Do you have any last words to share?

GRACE: Thank you, Bill. Philanthropy is ultimately a very creative exercise – whatever your age, income level or family situation, there is an appropriate philanthropic strategy. For some, outright gifts will remain the vehicle of choice. For others, searching for a higher level of personal involvement, the answer is a private foundation – or even a private operating foundation. For still others, the flexibility of a charitable remainder trust or a donor advised fund is most appealing. Whatever your final choice, we believe that you will be most satisfied if your choice is an informed one, reached by considering the full diversity of the available philanthropic solutions.

HOST: We hope that you have enjoyed this podcast and that you will join us for part three of this series when we discuss the “Diversity of Philanthropic Funding Alternatives.” Until then, be sure to download a copy of the companion white paper at www.northerntrust.com/giving. For a comprehensive listing of our podcasts, please visit www.northerntrust.com/podcasts.

I'm Bill Whitt, and on behalf of Grace Allison and Northern Trust, thank you for listening.

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