PODCAST PRESENTATION

DIVERSITY OF PHILANTHROPIC FUNDING ALTERNATIVES

HOST: Hello and welcome. Northern Trust is proud to sponsor this podcast, The Diversity of Philanthropic Funding Alternatives, the third and final 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, and need to determine what assets should be used to fund their chosen solution.

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, as we've discussed in prior podcasts, there are many reasons for making philanthropy an integral part of your personal wealth transfer plan. Having made the decision to contribute to charity and identified the solution that best meets your needs, what decisions are left to make?

GRACE ALLISON:

There still remains the question of what to donate. That choice depends not only on your net worth, but also on the nature of the assets you may have worked a lifetime to accumulate. The decisions you make here will directly impact the effectiveness of your philanthropy. Whether you have a concentration of highly appreciated stock, a family business, or an art collection, it's important to understand the implications of each potential funding source.

HOST: This sounds pretty complex — where should a donor turn for help?

GRACE: There are a number of individuals who can help.

➤ Your *estate planning attorney* will have suggestions about the types of assets best suited for a particular charitable vehicle.

➤ Your *investment managers*, with their knowledge of your portfolio, will be able to identify highly-appreciated assets, concentrations and assets with unusual characteristics.

➤ Your *trust professional* can help assess cash flow needs — for both you and your family members.

➤ And your *accountants* will be familiar with your personal tax profile: adjusted gross income, income tax bracket, accumulated capital gains or losses, and alternative minimum tax liability.

In addition, to the extent that your assets are complex or unusual, you will want to involve the recipient charities — good communication helps ensure that your expectations will be fulfilled and that your funding choices will not create unanticipated problems.

HOST: In the Diversity of Motivations podcast, Marguerite Griffin noted that although tax savings are rarely the primary motivation for significant philanthropy, donors generally expect their charitable transfers to result in charitable deductions — do you agree, Grace?

GRACE: Yes. And protecting that charitable deduction typically requires specialized expertise. For example, many donors are surprised to learn that the size of their income tax charitable deduction depends not only on the size of their gifts, but on the type of assets used to fund them and the type of charity involved. Furthermore, some distinctions that are very important for lifetime transfers become unimportant at death. For example, during life, the income tax charitable deduction is limited to a percentage of adjusted gross income. In contrast, at death, the estate tax allows an unlimited charitable deduction for all properly structured transfers, whether in cash or in kind. The basis and holding period rules that apply at death are another great leveler, giving all assets a step-up in basis to fair market value and a long-term holding period. A skilled estate planning attorney will know how to make all these technical rules work for you in the funding context.

HOST: When we talk about funding, what types of assets are we talking about?

GRACE: For many donors, potential funding sources are limited to cash, publicly traded stock or a combination of both. For others, the funding alternatives are more diverse and may also include:

- closely-held stock, including S corporation stock
- real estate
- collections of tangible personal property, such as art, books and coins
- patents, trademarks and other intellectual property
- retirement assets
- employee stock options or
- alternative investments

HOST: Let’s begin with the most common funding sources: cash and publicly-traded stock. How should a donor choose between them?

GRACE: From a tax standpoint, it generally makes sense to:

- sell a depreciated stock,
- take the tax loss, and
- donate the cash proceeds.

In contrast, donating a long-term appreciated publicly traded stock generally means avoiding or deferring capital gains tax on sale — while at the same time garnering an income tax charitable deduction based on fair market value.

It's also important to take investment concerns into account — for example, do you have a concentration of a particular stock sitting in your portfolio that you'd like to reduce without triggering capital gains tax?

For income tax purposes, donations of long-term publicly traded stock are treated very differently from donations of cash. If the recipient is a public charity, cash is deductible up to 50% of adjusted gross income. In contrast, a gift of long-term appreciated publicly traded stock is only deductible up to 30% of adjusted gross income if transferred to a public charity — and up to 20% of adjusted gross income if transferred to a private foundation.

So again, my advice would be to structure your gift so that it meets your investment needs and maximizes your charitable deduction, and work closely with your professional advisers.

HOST: What about donating cash or appreciated publicly traded stock to a donor advised fund or a trust?

GRACE: Most charitable lead trusts are taxable — which means that funding them with modestly appreciated publicly-traded stock is a better strategy than funding with highly appreciated securities. On the other hand, highly appreciated long-term publicly traded stock is a good choice for funding a donor advised fund, a charitable remainder trust or a private foundation — and, in all three cases, the income tax charitable deduction will be based on fair market value.

HOST: Our discussion so far has centered on publicly traded stock — do your comments hold also for closely held stock?

GRACE: In general, different considerations and different tax rules apply to donations of closely held stock. Business owners typically donate closely held stock in the context of a pending liquidity event — prior to the sale of a business. With forethought, it is possible to maximize both financial and personal satisfaction by integrating charitable strategies into the liquidation plan.

But there are special concerns and some important income tax traps, such as the unrelated business income tax generated by S corporation stock, for example, or the special limit on the income tax charitable deduction for lifetime contributions of closely-held stock to private foundations or to trusts that benefit private foundations.

Moving to outright gifts, it's not always easy for a donor to find a charity willing to hold closely held stock. For some charities, the issue is liquidity: the charity's investment guidelines may not permit it to hold an illiquid asset. For others, the issue is potential liability as a corporate shareholder. For this reason, transferring closely held stock to a charitable remainder trust has become, in the right circumstances, a very popular technique for donors.

HOST: Let's turn to real estate. What do donors interested in contributing real estate need to know?

GRACE: In theory, almost any type of appreciated real estate can be used to fund a charitable transfer. Many donors choose to contribute highly appreciated long-term real estate to charitable remainder trusts during their lifetime, receiving cash flow and deferring capital gains. So long as the remainder beneficiary of the charitable remainder trust is a public charity, the charitable deduction will be based on fair market value. In contrast, the income tax charitable deduction for a transfer of appreciated real estate to a private foundation — or to a charitable remainder trust with a private foundation as a remainderman — is based on tax cost.

If real estate has declined in value, a better tax result can be achieved by selling to generate a tax loss and then donating the cash proceeds to charity.

HOST: Are there special concerns unique to real estate?

GRACE: Yes. In addition to tax concerns, there are environmental issues. Neither a charity nor the trustee of a charitable trust will welcome a contaminated landfill or an older building insulated with asbestos that may subject them to unascertainable liability under federal or state environmental laws.

Another concern is matching the liquidity needs of the charity or charitable trust with the marketability of the real estate. Private foundations, charitable remainder trusts, and charitable lead trusts all have payout requirements. In addition, there will be expenses associated with the real estate itself — real estate taxes, routine maintenance, and, in some cases, rehabilitation. If the real estate is not immediately marketable, some arrangement will generally have to be made for meeting cash flow demands. Sometimes, the solution is as simple as funding with both real estate and sufficient cash to meet anticipated cash flow needs until the property is sold.

HOST: Grace, didn't the Pension Protection Act create a special opportunity for qualified conservation easements?

GRACE: Effective only through December 31 of 2007, qualified conservation contributions are deductible up to a generous 50% of adjusted gross income and are allowed a special 15-year carryover period. Contributions of real estate interests to governmental agencies or charities may qualify under this provision, subject to a host of highly technical requirements. Donors who are considering qualified conservation contributions should talk to their tax advisors about making the donation while these tax incentives are still in place.

HOST: Grace, some wealthy individuals have collections of art or other personal property — can these assets be donated?

GRACE: Many collectors find it difficult to even think about parting with a beloved collection of art, coins or other valuable, tangible personal property. But unless disposition is carefully planned, individual pieces may not be properly preserved and maintained after the owner's death — or the collection as a whole may be dispersed. In the right situation, a well-planned transfer to charity — either during life or at death — may be the answer. In general, early communication with the recipient charity is critical. It is important to verify, for example, that the intended recipient wants the collection and has the resources to assume responsibility for it. If the intended recipient is unable or unwilling to accept the gift, it's important to know sooner rather than later.

For income tax purposes, the key requirement is that the collection be used by the donee for a purpose related to the donee's charitable purpose. For this reason, it's generally most appropriate to contribute a collection outright to a museum, school or university. If the related use requirement is not met, your income tax charitable deduction will be limited to the tax cost of the property, which may be much less than fair market value.

HOST: Anything else donors need to be aware of if they are considering contributing a collection?

GRACE: Whether the transfer is made during life or at death, a qualified appraisal of the collection will be required. The relevant tax rules have recently changed, so be sure that both your appraiser and your appraisal meet all the new requirements — if they don't, the entire charitable deduction will be in jeopardy. And for both personal and tax reasons, you should seriously consider a written agreement with the donee detailing how your collection will be displayed and maintained. Not only will this bring you peace of mind, it may save your income tax charitable deduction.

HOST: Many individuals have a substantial amount of their wealth put aside for retirement. Can retirement assets be donated?

GRACE: Distributions from retirement plans — such as pension plans, IRAs, and 401(k) plans —are taxed as ordinary income to noncharitable recipients such as individuals, making them ideal assets to contribute to charity. Unfortunately, donors are generally allowed to make direct distributions from IRAs and pension plans to charity only at death. As a result, funding a lifetime transfer to charity with retirement assets typically has meant taking a taxable distribution from a pension plan or IRA and then contributing the proceeds to charity.

Now, effective through the end of 2007 only, a special rule allows taxpayers over age 70-1/2 to distribute up to $100,000 per year directly to charity from their IRA accounts. No income is recognized on the transfer, and no charitable deduction is available. Distributions must be "qualified charitable distributions," a term of art that does not include distributions to supporting organizations, donor advised fund accounts, private foundations, charitable remainder trusts and charitable lead trusts. This limited opportunity applies only to IRAs: it does not apply to other types of retirement assets, such as pension or 401(k) plans.

HOST: It's common these days for individuals to own their employer's stock in their retirement account — can this be donated?

GRACE: If you hold appreciated publicly traded employer stock in one or more retirement plans, you are presented with an excellent philanthropic opportunity. Here's the strategy. First, on retirement, take a lump-sum distribution of the company stock from your retirement plan, paying ordinary income tax on the stock's basis. Then contribute the stock to a charitable remainder trust, thereby deferring significant gain on the net unrealized appreciation, facilitating diversification, generating cash flow—and, of course, benefiting the charitable remainderman.

HOST: Grace, we've covered a lot of territory. Are there other types of assets that represent charitable funding opportunities?

GRACE: Patents, trademarks and other intellectual property can also be donated, although, if the contribution is a lifetime transfer, the donor must contend with burdensome income tax rules. In contrast, a transfer of intellectual property at death is more straightforward from a tax perspective.

Employee stock options are yet another potential alternative for funding. Though incentive stock options cannot be transferred to charity during the employee's life, they may be transferred at death, with a charitable deduction available based on the value of the option at the date of death. In contrast, the terms of the particular employer's plan may allow nonqualified employee stock options to be transferred during life. This means the employee would recognize income (and an offsetting charitable deduction) when the charity exercises the option.

Lastly, many portfolios include not only stocks and bonds, but also alternative investments such as hedge funds or venture capital funds. If you're considering donating alternative investments, you need to consider whether the specific charity is a permitted holder of the investment under the securities laws, if the charity's investment guidelines allow it to hold the fund and whether the investment generates unrelated business taxable income that could cause an otherwise tax-exempt public charity or private foundation to pay tax.

HOST: Clearly, donors have a lot to think about. Do you have any final words, Grace, for our listeners?

GRACE: When considering how to fund philanthropic transfers, you may confront issues ranging from the relatively simple to the complex, with cash or publicly traded stock at one end of the continuum and more esoteric assets at the other. The more complex the asset, the more time you'll need to allow for adequate planning. As you identify and consider alternatives, you'll want to be sure to consider your overall financial and philanthropic goals, as well as the tax impact of each. In the end, you, your family and your charitable donee will reap the benefits of your careful research, thoughtful planning and detailed execution.

HOST: We hope that you have enjoyed this podcast and invite you to listen to parts 1 and 2 of this series which explore why people give and the various charitable solutions that are available. A copy of the companion white paper is available at NorthernTrust.com/giving. For a comprehensive listing of our podcasts, please visit NorthernTrust.com/podcasts. I'm Bill Whitt, and on behalf of Grace Allison and Northern Trust, thank you for listening.