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Managing Tax-Efficient Philanthropy for High Net Worth Individuals

By Melissa Olszak, CFP®, CFA

Directing philanthropic efforts is a crucial piece of guiding high net worth individuals, and it must extend beyond a family's desire to simply give back. To make the most of charitable initiatives, advisors must ensure the most efficient assets are given, the right vehicles are used and donations are managed to minimize tax liability.

Knowing the full portfolio helps to identify which assets to use for philanthropy. While cash is an "easy" item to give, there may be other options that are more tax friendly, such as an appreciated long term public security. In some cases, the potential tax benefits from selecting the "right" asset to give can be significant. For example, clients with concentrated public stock that is undervalued but has low basis can donate their holdings to a donor-advised fund (DAF) and then replace the stock through a cash purchase. The donation is taken for tax purposes at fair market value, and when the client purchases the stock back, they have increased their basis in the position while avoiding capital gains.

Picking the right philanthropic vehicles

Selecting appropriate assets is a start, but ensuring the right vehicle is used is just as crucial to creating best-case charitable giving scenarios. The two most common vehicles are DAFs and private foundations. Both are popular choices, but distinct differences should be considered for each client on a number of fronts.

- Investment control – Control is a major concern for many families, and having the ability to manage investments directly may be a priority. Private foundations provide that control, while those invested in DAFs are limited to the DAF's offerings. There are occasionally opportunities to bring an external manager onto a DAF. This typically results in additional fees, and there may be limits on how many external managers can be used with a DAF.

  For families with investable assets that exceed $5 million, investment control often makes private foundations the preferred choice. The larger the donation, the less inclined families are to hand over control to a third party or limit their investment choices and flexibility.

- Administration – Partly due to the increased investment control, private foundations require significantly more administrative work. Tax returns must be filed, balance sheets maintained, and a two percent excise tax is levied on investment income. Additionally, with the five percent distribution rule in effect, clients also must track grants to be sure they are meeting that annual burden. Administration for DAFs, however, falls to the sponsor and thereby shields donors from fees and paperwork.

- Distributions – Some families may want to space out distributions or take a year off from issuing monies from their charitable funds. Private foundations won't allow this, requiring a distribution of five percent of the foundation's value per year. DAFs, on the other hand, do not require any annual distributions.

- Privacy – Wealthy families may also want to consider the degree of privacy each vehicle provides. Ironically, private foundations yield very little in the way of privacy. A publicly filed Form 990 shows precisely how much was given to which charity and who made contributions to the foundation. Alternatively, there is no such public record that tracks back to individual donors when a DAF is responsible for disbursement.

The New York Times chronicled the mishap of a family that made a grant of $100,000 to one child's school. Upon enrolling a second child at a different school, the family was immediately approached by the development office for a gift of the same amount. "The client was taken aback," the article notes, "because the size of the gift

was consistent with what he had given to schools his other children had attended. The client had not realized how easy it was to get the information online."[1]

If a client has a private foundation but still wants to give anonymously, they can do so by using both a foundation and a DAF. The foundation would give to a DAF, then the DAF would grant the funds to the charity. For purposes of the foundation's 990 filing, the grant would simply be recorded as having gone to the DAF.

- Grants – Families looking for the highest degree of flexibility will lean toward private foundations. Foundations can make grants worldwide, and in some cases, can distribute to individuals for educational scholarships or hardship distributions. DAFs are limited to U.S. charities.

- Tax – There is a significant difference between the vehicles when it comes to AGI deductions. Private foundations give a 30 percent write-off for cash and 20 percent for securities, while DAFs offer a 50 percent deduction for cash and 30 percent for securities.

There are other tax benefits that relate to specific circumstances. Those with private equity and venture capital investments can enjoy significant tax benefits by granting appreciated stock distributions to either DAFs or private foundations. This allows individuals to avoid recognizing gains for which they would otherwise be responsible.

Perhaps for this reason, as well as administrative reasons above, DAFs have become a common option in Silicon Valley. As *The Wall Street Journal* reports, "donor-advised funds [run by Silicon Valley Community Foundation] have experienced growth in assets and in the grants made from the funds. Total assets in the funds rose to $893 million at the end of last year, up 16 percent from 2009, according to the Community Foundation. Meanwhile, grant-making out of the funds increased to nearly $120 million in 2010, up 46 percent from around $82 million in 2009."[2]

Organized approach suits multi-generational giving

When it comes to charitable giving, well-organized data that tracks family activities year over year can paint a clear picture of how much has been donated to which charity and when. These administrative issues may seem trivial, but staying organized makes it easier to share philanthropic and overall financial priorities within the family.

Managing charitable funds also can serve as a valuable arena in which families can work together and introduce the younger generation to investing, taxes and budgeting. They can then apply those lessons to their own financial lives and be more prepared to manage the family wealth. Clear tracking and ready explanations of how giving is balanced with tax exposure are excellent first steps toward this goal.

Tax planning brings to mind any number of goals, from checking on long-term investments to rebalancing portfolios to ensuring that charitable donations are inline with expectations. There may be opportunities to improve the way philanthropy is approached, be it moving away from cash gifts to more tax efficient assets, or staying ahead of the curve for families with concentrated positions. In all scenarios, families must have the right vehicles, assets and guidance to support their philanthropic ventures.

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[1] Weighing the Best Vehicles For Philanthropic Giving, Paul Sullivan, New York Times, January 29, 2011

[2] Donor-Advised Funds Show Rise in Giving, Pui-Wing Tam, Wall Street Journal, September 22, 2011

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