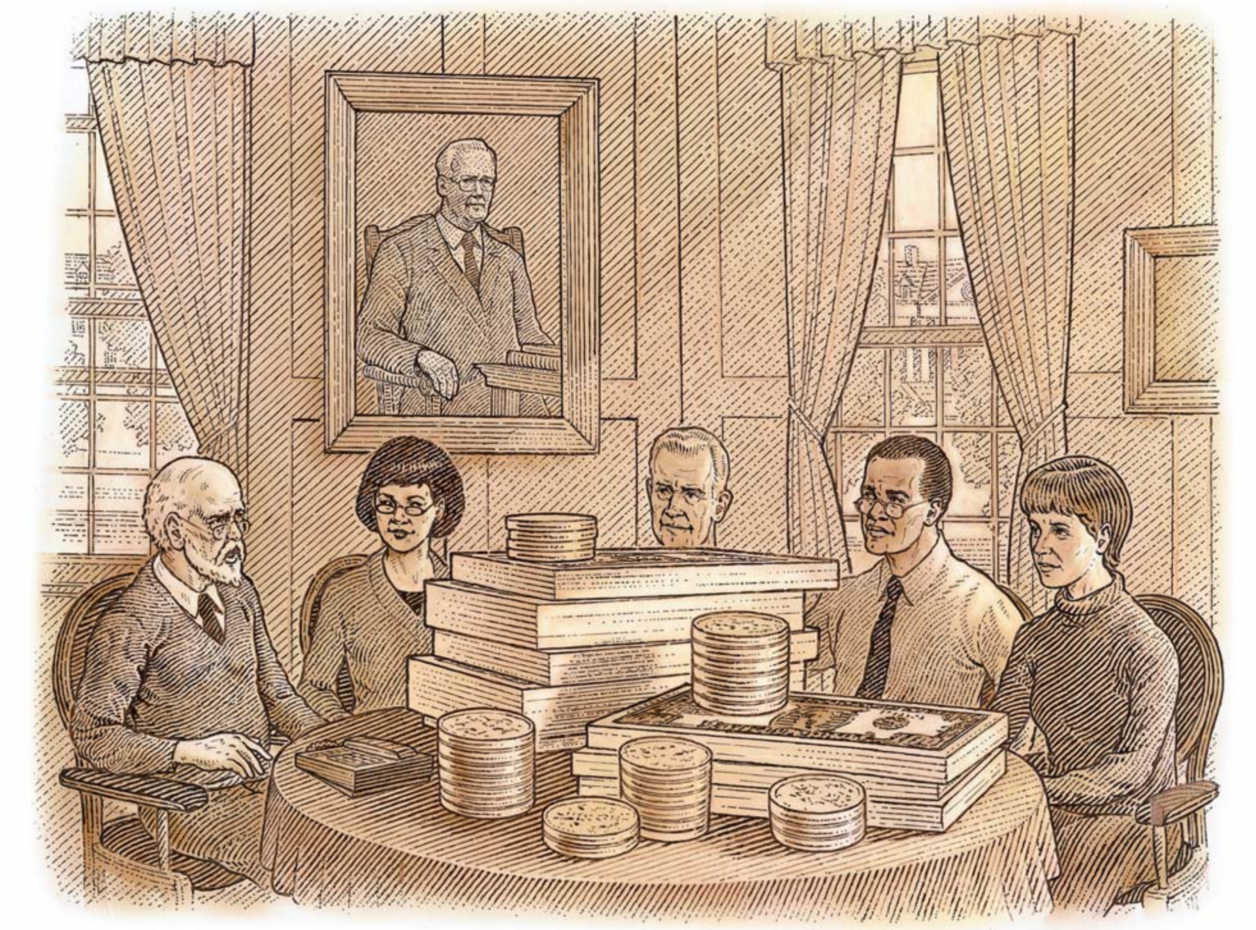


KEVIN SPAULDING

An Efficient Alternative

Establishing a family foundation may not be in your best financial interest.

BY DAVID LIPSCHULTZ AND DEEDRA ALLISON

WHEN A.C. LINNERUD retired from North Carolina State University in 1993, he wanted to continue his lifelong involvement in education. On the suggestion of his financial adviser, he established a private family foundation to distribute funds to college-bound students.

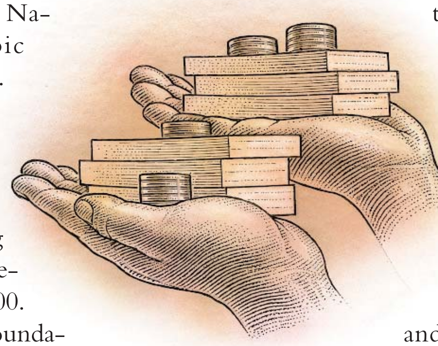
The foundation sounded good in theory, but administering it became burdensome, and Linnerud discovered that he needed an accountant and an attorney to handle the extensive paperwork. "Every year I'd have to [solicit requests for grants] in the newspaper, and I'd get calls and letters every day from people wanting donations," says the former statistics professor. "I had to do everything on my own. It was taking up a lot of my time making sure everything was running right. You would think giving money away would be easier."

He was right. On the advice of another financial adviser, Linnerud put his money in the American Endowment Foundation (AEF), one of several public charities that handle managerial duties while allowing donors to make grants without creating a private foundation. The choice was a simple one for Linnerud and his wife. "The private foundation was probably not in my best interest," he says. "I miss nothing about it. Now, instead of filling out paperwork, we do all of it over the telephone. The original concept for us was that we were going to donate so many dollars eventually; [with the donor-advised fund] we can do the majority while we're alive."

Under this little-known charity tool, donors transfer irrevocable and unrestricted gifts of cash, securities, or other property to the public host charity, where assets grow tax-free. Then, donors "advise" the host on what types of causes and organizations to support, as well as the amount and frequency of distribution. However, unlike with a private foundation, the host charity is under no obligation to honor an individual's philanthropic wishes, emphasizes AEF President Philip T. Tobin.

The charity's board of directors typically accepts grant suggestions to qualified 501(c)(3) tax-exempt public entities and governmental groups, "but they will not grant money to individuals, to overseas organizations, to private foundations, or that satisfies an unrelated pledge fulfillment—such as a pledge to a church or alma mater," says Tobin. Qualified organizations include religious, educational, charitable, amateur athletic, scientific, or literary groups, and organizations that test for public safety or are involved with preventing cruelty to children or animals.

Originally, donor-advised funds (DAFs) were created at the community level so that people could disperse money and enjoy the rewards while living rather than bequeath the money. Then, 10 years ago, Fidelity Investments established the Charitable Gift Fund, a donor-advised fund now managing assets worth $2.7 billion. Vanguard and Schwab, among other financial institutions, and independent organizations such as the AEF and the National Philanthropic Trust now offer DAFs. According to *The Chronicle of Philanthropy*, the value of assets and the number of donors setting up DAFs rose by one-third from 1999 to 2000.



Family-managed foundations, though, are still more prevalent and well-known. Of the estimated 44,000 private foundations in the United States, two-thirds are family managed, according to the Council on Foundations. The money comes from a single family, and at least one family member serves as an officer or a board member. Though a family foundation is a private foundation, all of its transactions are matters of public record.

Private foundations, unlike DAFs, immediately connote prestige, and they allow total control in dispersing the assets. However, the IRS charges a premium for those rights and freedoms. First, an attorney must draft and file paperwork, so private foundations are costly and time-consuming to set up, sometimes taking as long as six months to establish.

From then on, foundations are beset with endless regulations, from taxes that actually penalize you for giving, to tax return roadblocks for smaller philanthropic foundations, to mandatory paper filing (sorry, no electronic shortcuts). But just as important if not more so, tax laws do not favor private foundations as much as they do donor-advised funds (see the table on this page).

DAFs, alternatively, are quick, easy, and inexpensive to establish. Donors relinquish some control over the ultimate choice of beneficiaries, but they also hand off the complicated record keeping and time-consuming vetting of charities. Once you decide what types of organizations you want to support, the host charity may help you find legitimate entities.

Linnerud, for example, supports scholarships at three universities, plus the Senior Games, churches, and USA Track & Field. "We were thinking of how best to give some money to the people in New York [affected by the September 11 tragedies]," says Linnerud, who felt uncomfortable giving blindly to relief agencies such as the Red Cross because of their high overhead costs. "We decided on a foundation set up for the education of orphans or those who lost a parent. That would be the best thing for us to do because we're sure of what

Two Options for Philanthropy

	DAFs	Private Foundations
Tax deductions		
—Securities	Up to 30% AGI	Up to 20% AGI
—Cash	Up to 50% AGI	Up to 30% AGI
—Appreciated property	Up to 30%	Up to 20%
—Public securities	Fair market value	Fair market value
—Private holdings	Fair market value	Cost basis
Tax reporting	None	State and federal annually
Start-up fee	None	$15,000–$25,000*
Minimum amount of assets	$10,000	$3 million–$5 million**
Administrative costs	Up to 1% of assets	3%–5% of assets
Excise taxes	None	Up to 2% on investment income
Minimum payout	None	5% of assets a year
Giving options	Anonymous or public	Public
Typical giving limitations	501(c)(3) charities	None
Decision making	"Adviser"	Complete control

AGI—Adjusted gross income

**Estimate includes fees for accounting, legal, and investment services.*

***No legal minimum; however, most brokerages advise against creating a foundation if your assets are less than this amount.*

Sources: American Endowment Foundation and GivingCapital Inc.

the money is being used for. [Tobin] dug that foundation up for me."

Having someone else research and determine acceptable charities may seem inconsequential, but it ensures that you, personally, will not be inundated with requests for grants and appeals for support. Technically, you donate funds to a host charity that disperses the money, so you have the right to give anonymously or in someone else's name. Also, if family members or anyone else contributes to your fund, they receive the instant tax breaks, too.

Two more issues to consider are mandatory payouts and tax on investment income. Private foundations must disperse at least 5 percent of assets yearly and pay an excise tax of up to 2 percent on investment income, which means that if your foundation earned $1 million last year in interest from investments, the foundation had to pay roughly $20,000 in excise tax. DAFs have no minimum payouts and pay no excise tax.

However, one of the most important things to keep in mind, especially if you are part of a family-owned company or are an early-stage investor, is that DAFs—unlike private foundations—allow a fair market value deduction of a nonpublic security. If you have a foundation and want to donate stock in a pre-IPO company whose value has tripled, you can deduct only the actual cost of the shares—a third of their current value.

The government has complicated matters concerning public stock donations to private foundations by continually imposing and repealing tax laws indicating whether the cost of the stock or the fair market value could be deducted. In the early 1990s, the rules allowed a deduction of only the cost of the stock.

That's when Frank Zenie opened a DAF to complement the Zenie Foundation. As a longtime investor, entrepreneur, and director of early-stage companies, he had accumulated a significant amount of appreciated stock. "The private foundation was looking a lot less attractive because of the write-off," he says. A DAF, he discovered, allowed him to deduct the current value of the stock.

Even though the government changed the laws in 1997 to again allow people who donate to private foundations to write off the fair market value of appreciated public securities, Zenie maintains his fund. Those investors who endured the on-again, off-again deduction rules during the past 20 years understand it is unclear how long this will be the prevailing wind on Capitol Hill.

"If you want to give away money to *charities* [rather than to individuals], you can't touch what you get with a donor-advised fund," says Zenie, who continues to operate his foundation. "If I were only giving to charities, there's no way I would maintain the private foundation." ℝ

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