# THE FIRST (AND OFTEN FORGOTTEN) RULE OF IMPACTFUL GIVING: GIVE THE RIGHT ASSET

RYAN BOLAND

**One of the most basic tenets of "impactful giving"—using available tax efficiencies to maximize the contribution itself—is far too often overlooked.**

Americans give approximately $300 billion to charity each year and donors are increasingly focused on knowing exactly what their charitable dollars are accomplishing. While givers in the past were often content to contribute to charities without knowing precisely how those charitable dollars were subsequently spent, many of today's donors are more interested in highly directed giving. They regard a significant level of due diligence concerning use of funds as a standard part of the giving process.

One operating principle of this "impact" movement is to explore new and creative ways that charitable funds can be used to effect long-term change. The movement is centered on measuring outcomes, using charitable dollars more efficiently, and leveraging complex financial structures to make socially beneficial investments. This increased focus on impact is expected to be a major driver of positive change within the philanthropic landscape in the years to come.

However, one of the most basic tenets of "impactful" giving – using available tax efficiencies to maximize the contribution itself – is far too often overlooked. As more donors are concentrating on maximizing the impact of charitable dollars, many continue to inefficiently fund their charitable pursuits, sometimes to a shocking extent. Donors can often realize a sizable increase in the amount that they can give by simply donating the best asset, at the right time.

In the vast majority of cases, the best asset is either a publicly traded security (such as stocks, bonds, or mutual funds) or, often even better, a nonpublicly traded asset (such as private stock, restricted stock, or real estate). The asset is donated outright, as opposed to liquidating it and then making the after tax donation.

## Avoiding the most common mistake

Following is an illustration of the most common charitable giving mistake.

*Example:* Larry had a long-term charitable mission that was as organized and well prepared as anyone I have assisted with the charitable contribution of nonpublicly traded assets. He had meticulously worked out a long-term philanthropic plan with a strong focus on how his wealth could be used to help improve treatments for leukemia – a condition with which his youngest grandson had been recently diagnosed. He had a list of several nonprofit organ-

*RYAN BOLAND, Esq,. is a Vice President of the Complex Asset Group at Fidelity Charitable.*

izations that he wanted to support (both financially and with his time), and had performed significant due diligence on each one to ensure that the charitable dollars would be used efficiently and with the greatest impact.

Last but not least, Larry was the founder of a mid-size firm in the energy industry, and he had planned on selling his interest in the company, which was highly appreciated, to fund his charitable efforts. His plan was to sell a significant stake in the company to a private equity firm and donate the proceeds. Larry's planning was well considered in every respect except one – how to most efficiently fund his charitable goals .

Selling a privately held asset, like private company stock, limited partnership or LLC interests, or real estate, and *then* donating the proceeds to charity is very rarely the best or most efficient way to give. If Larry sells the private stock, he must pay capital gains tax (and, often for high income taxpayers, the 3.8% Medicare surtax) on the appreciation accrued in that asset. He would be left with only the after tax proceeds to donate. For this reason, posttransaction cash is generally the *least* efficient, and consequently least impactful, way to give to charity.

On the other hand, if Larry donated his privately held asset *directly* to charity, the result changes considerably: by properly leveraging available tax efficiencies, a donor may be able to increase the amount of his donation by between 20% and 30%. Using this preferred approach would allow the full value of Larry's private company shares earmarked to be sold– worth about $7.5 million – to go to his favored charities. If he sold the shares himself and paid the required capital gains tax, only approximately $6 million would be available to donate to charities. That is a highly impactful, additional $1.5 million that could go to aid Larry's favored charities. Incredibly, both of these strategies have the exact same net "cost" to Larry.

Presently, roughly 75%[1] of charitable giving by individuals in the United States is accomplished using after-tax cash. The end result of this inefficiency is that hundreds of millions of dollars that could be going to charity each year are not. For advisors, whether accountants, trust and estate attorneys, or investment/wealth advisors, there is a significant opportunity to provide added value and cultivate stronger relationships with clients by making them aware of these opportunities.

## Giving more efficiently 101: publicly traded securities

Many high-income individuals and families hold appreciated publicly traded securities in their portfolios. Contributing these long-term appreciated securities to charity has gained traction in recent years. There are two key advantages:

- *Fair market value tax deduction:* Any long-term (held for more than one year) appreciated publicly traded securities may be donated to a public charity (generally speaking, Section 501(c)(3) nonprofit organizations) and a charitable income tax deduction taken for the full fair market value of the securities. The donor can use this deduction for that tax year for up to 30% of the donor's adjusted gross income.
- *Charities do not pay capital gains tax:* The public charity that receives the securities can sell them and, as a tax-exempt organization, generally will not have to pay capital gains tax, thus increasing the size of the charitable gift substantially. The more appreciated the securities, the greater the tax efficiency.

**The increased focus on impact is expected to be a major driver of positive change within the philanthropic landscape in the years to come.**

*Example:* A high-income couple purchased stock ten years ago for $60,000, and it is now valued at $200,000. If they sell the stock and donate the cash proceeds to charity, they will pay a combined federal tax and surtax of $33,320[2] on the $140,000 of capital gain. After paying the tax and surtax, they will have $166,680 left to give to charity. This would also be the amount of their income tax charitable deduction.

If, however, the couple donates the stock directly to charity, the charity will not incur any capital gains tax when it sells the shares. The couple would have a charitable income tax deduction for the full $200,000 value of the shares. The charity also receives the full $200,000 in value, so an additional $33,320

[1] "SOI Tax Stats - Individual Income Tax Returns Publication 1304 (Complete Report)," excerpt from Table 2.1, "Returns With Itemized Deductions: Sources of Income, Adjustments, Itemized Deductions by Type, Exemptions, and Tax Items."

[2] This calculation assumes that the couple's taxable income places them in the maximum 20% capital gains rate category and that they are also subject to the 3.8% Medicare surtax.

**EXHIBIT 1**
**Donating appreciated publicly traded securities**

| | Sell securities and donate proceeds to charity | Contribute securities to charity |
|---|---|---|
| Current fair market value of securities | $200,000 | $200,000 |
| Federal long-term capital gains * (23.8%); Assumes a cost basis of $60,000, and long-term capital gains of $140,000 | $33,320 | $0 |
| Charitable Contribution/Charitable Deduction** | $166,680 | $200,000 |

* Assumes all realized gains are subject to the maximum federal long-term capital gain tax rate of 20%. Also includes 3.8% Medicare surtax on net investment income. This does not take into account state or local taxes, if any.

** Availability of certain federal income tax deductions may depend on whether deductions are itemized. Charitable contributions of capital gain property held for more than one year are usually deductible at fair market value. Deductions for capital gain property held for one year or less are usually limited to cost basis. Does not consider effect of any limitation on itemized deductions (e.g., the Pease limitation see fn.3 in the text).

goes towards the charitable cause.[3] Accordingly, the charity receives a larger donation from a gift of appreciated securities than it would from cash, the donor gets a larger deduction, and the net cost/financial effect to the donor is identical.

One additional consideration is that if investors have long-term appreciated publicly traded securities with an unknown original-value or cost basis, donating the assets directly to charity can save them the time and trouble of finding out the original basis and paying the applicable capital gains tax (see Exhibit 1).

With a direct donation of long-term appreciated securities to a charity, the donor's federal income taxes are reduced by an additional $33,320, and the charity receives that full amount – or 23.8% -more.

Identifying the right securities to give to charity has been made easier with online tools that help donors and advisors recognize the most appreciated securities in their portfolio and select the most tax-efficient stock to give. If the most-appreciated stock is stock that the donor or advisor wants to continue to own, it can be given to a charity and repurchased for the portfolio, thus establishing a higher basis. This process would not trigger the wash sale rules[4] because the shares would be given to charity and not sold by the donor.

## Giving more efficiently 201: nonpublicly traded assets

Giving publicly traded securities is a terrific way to boost the power of one's charitable giving significantly. To give in the most tax efficient manner, however, many donors and their advisors must search beyond publicly traded stock and determine the most appreciated assets that they own. Those assets are often nonpublicly traded assets ("complex assets"). Given the entrepreneurial success of the baby boomers, the proliferation of alternative investments available to individual investors in recent years, and the sometimes staggering wealth created by young business visionaries, the most appreciated asset in a portfolio will often be a nonpublicly traded asset.

Assets often used for this kind of charitable giving include private C corporation stock, S corporation stock, limited partnership (LP) interests, LLC interests, real

[3] In 2013, in addition to the maximum long-term capital gains tax increasing from 15% to 20% for top-income-rate individuals and families, the Pease limitation was reinstated for taxpayers with an adjusted gross income above $250,000 (individuals) and $300,000 (couples filing jointly). For those affected, the Pease limitation is an overall limitation on itemized deductions that reduces all itemized deductions, including those taken for state and local taxes, real estate taxes and mortgage interest, by 3% of the amount by which a taxpayer's AGI exceeds the applicable threshold, but not to exceed 80% of the amount of the deduction. (The current charitable deduction still allows donors to deduct up to 50% of their AGI for cash contributions to charity, and up to 30% for contributions of long-term appreciated securities, if the contributions are made to a qualified public charity.) For example, if a couple exceeds the AGI limit by $50,000, they take a small "haircut" in allowable deductions on that $50,000. Of course, the size of the "haircut" increases greatly for high-income earners.

[4] See Toolson, "Higher Tax Rates Increase Importance of Choosing Tax Efficient Investments," 92 PTS 108 (March 2014).

**EXHIBIT 2**
**Donating appreciated privately held stock**

With a direct donation to charity, the charity receives the full $2 million ($476,000 more that if the donor gave after paying tax) and the donor's federal income tax charitable deduction is $276,000 higher.

| | Sell private stock and donate stock proceeds to charity | Contribute private stock to charity |
|---|---|---|
| Current fair market value of private company stock | $2,000,000 | $2,000,000 |
| Federal long-term gains and Medicare surtax* (23.8%); Assumes a cost basis of $0 and long-term capital gain of $2 million | $476,000 | $0 |
| Charitable Deduction** | $1,524,000 | $1,800,000*** |

** Assumes all realized gains are subject to the maximum federal long-term capital gain tax rate of 20%. Also includes 3.8% Medicare surtax on net investment income.This does not take into account state or local taxes, if any.

** Availability of certain federal income tax deductions may depend on whether deductions are itemized. Charitable contributions of capital gain property held for more than one year are usually deductible at fair market value. Deductions for capital gain property held for one year or less are usually limited to cost basis. This does not consider effect of any limitation on itemized deductions (e.g., the Pease limitation see fn.3 in the text).

***As discussed in greater detail below, a donor of complex assets to a public charity must generally substantiate the value of the income tax charitable deduction claimed by obtaining a licensed appraisal of the asset. A valuation expert should be expected to discount the value of the asset for lack of marketability and for minority interest purposes. In this instance, a 10% discount is assumed. The extent of discounting is highly dependent on the facts and circumstances regarding the asset at the time of contribution.

estate, oil and gas interests, and other alternative investments. Within the private equity or venture capital realm, LP interests, LLC interests, portfolio company stock and, in some circumstances, carried interest can be contributed to a public charity. (See sidebar, "The Intersection of Private Equity and Charity.")

The gifting of complex assets requires more diligence and analysis than the gifting of cash or publicly traded securities, but has distinct advantages. These assets often have a relatively low cost basis (i.e., original cost) for the donor, and a significant current market value, which would result in large capital gains taxes if sold. For entrepreneurs who have founded companies, the cost basis may effectively be zero. When such an asset is donated correctly to a public charity, the donor not only eliminates capital gains exposure (*a la* public securities donation), but is also generally entitled to a tax deduction for the full current market value, based on a qualified appraisal pursuant to Regs. 1.170A-13(c)(3)(i)(A), (B), (ii)(G), (I), and (iv)(B) and Form 8283 (Noncash Charitable Contributions) (see Exhibit 2).

## Options for donating nonpublicly traded assets

Although not all charities have the administrative resources to accept and liquidate nonpublicly traded assets, some larger charities are able to accept them, and can work with advisors that provide guidance throughout the process. Giving these complex assets to a charity with a donor-advised fund (DAF) program is one of the simplest, most cost-effective, and flexible ways to donate them. By working with a DAF program that has the appropriate expertise and resources:

- The donor is able to take advantage of all available tax efficiencies of making the complex asset donation; diversify grants from one charitable donation to as many different public charities as he wants; and create a thoughtful, long-term plan for giving.
- The advisor serves as the broker of a high impact, emotional event in the client's life.
- The charities receive grants from the DAF, avoiding all of the complications and costly overhead involved in the complex asset dona-

tion, allowing them to stay focused on their charitable mission.

Finally, it is not uncommon for a potential donor of complex assets to have already formed a private foundation. That donor may initially think that the privately held asset would be a perfect contribution to the existing foundation. However, if such an asset is given to a private foundation, the donor's charitable tax deduction generally would be limited to the donor's basis in the asset, not the fair market value. As indicated above, for a business founder or early investor, the tax basis in such an entity can often be negligible. Here, donor-advised funds can offer an advantageous alternative, allowing the donor to fully leverage all available tax incentives.

So, who among your clients may be the best candidates for this type of impactful charitable giving? Here are a few hypothetical, but typical, examples.

## Case study 1: the patriarch

Preparing for the sale of their long owned family farm, which was held by an LLC, Doug recognized that he and his sons would soon each have many millions of dollars in sales proceeds and capital gains taxes. They had always been highly active in their community, giving generously to area charities, both in cash donations and volunteer hours. To establish a philanthropic legacy, they decided as a family to donate interests in the LLC that held the farm, in advance of the potential sale. Due to the very low tax basis in the farm, this multimillion dollar charitable contribution of LLC interests enabled them to give approximately 25% more to charity than if they had sold the LLC and contributed the cash proceeds.

After making the charitable contribution of the LLC interests, a sale in earnest was pursued, and an agreement was reached within a couple of months. The charity sold its LLC interests as part of the larger sale and the charity's portion of the proceeds flowed directly to it.

**Legal note.** Anticipatory assignment of income doctrine: At the time of the charitable contribution of LLC interests, the farm was not under any agreement to sell. Several potential buyers had expressed interest but no sale agreement was signed and no commitments had been made. If there had been a signed agreement at the time of the charitable contribution, the IRS likely would consider the contribution of the LLC interest an anticipatory assignment of income as the result of a "prearranged" sale. Though this doctrine requires a close review of the specific facts and circumstances, it is generally critical that a charitable transfer occur before all material terms of a transaction to sell the company or asset have been finalized.[5] If the IRS scrutinized the contribution and concluded there had been an anticipatory assignment of income, the donor would be required to pay the capital gains tax, along with interest and possible penalties, as if he had sold the LLC interests.

## Case study 2: the entrepreneur

Kevin is a 45-year-old technology entrepreneur. His second software company was considering selling a sizable percentage of shares to a prominent private equity firm. Kevin had not yet fully defined his charitable mission and goals but was committed to using his increasing wealth for charitable causes.

Kevin's CPA suggested that he give shares in the company to a charity with a donor-advised fund program. If the opportunity to sell to the private equity firm materialized, the charity would be able to sell the donated shares to the private equity firm at the time of the private equity firm's larger investment. The proceeds from that sale would flow into the donor's DAF. By making the largest charitable contribution of his life in the same year as the significant sale of shares in his business, Kevin will be able to receive and use the maximum charitable deduction in the same year that his income increases significantly.[6] As his philanthropic goals are established, Kevin can recommend grants from the DAF to support charities.

**Legal note.** Qualified appraisals: As with all contributions of nonpublicly traded assets valued over $5,000, an independent qualified appraisal would be needed to substantiate the entrepreneur's charitable deduction. This appraisal should consider all the facts and circumstances regarding the asset at the time of the contribution, but is not required at the time of the contribution. It can be completed after the contribution is made, up until the time that the donor claims the deduction on his next tax filing, including extensions. Generally, it should be expected that the valuation expert will include some discounting due to minority interest and a lack of marketability. Even though there was no agreement in place at the time of the charitable

[5] Palmer, 523 F.2d 1308 (CA-8, 1975); Ferguson, 174 F.3d 997 (CA-9, 1999); Rauenhorst, 119 TC 157(2002).

[6] Section 170(b)(1)(D).

## THE INTERSECTION OF PRIVATE EQUITY AND PHILANTHROPY

**While the wealth accumulated by those working in the private equity industry receives significant attention, less widely reported and recognized is their frequent, deep commitment to philanthropy. With their financial savvy and strong links to the philanthropic community, it is natural that many private equity executives and investors want to be sure they are giving in the most tax-efficient manner.**

**Private equity donors often own a veritable buffet of appreciated nonpublicly traded assets. Because the world of private equity is constantly seeking appreciation and exit, the variety of interests that make up private equity can be ideally suited for charitable giving.**

**LP interests: A private equity firm generally will have one or more LPs that serve as bundles of portfolio company investments. These are traditionally thought of as private equity funds. An outside investor typically provides funding at or near the time of formation of the fund. As the fund matures and portfolio companies are sold, the LP investors receive distributions. If the investments in the portfolio companies have performed well, the LP interests can be highly appreciated and so, are excellent charitable funding sources.**

**Portfolio company shares: Portfolio company shares are the shares that the private equity fund holds. They represent the cleanest private equity interest to transfer, value, and liquidate. In some circumstances, an investor or partner at a private equity firm will own shares individually (or through a co-invest vehicle) and have the ability to donate them. If shares are owned individually (or can be distributed to the individuals by the fund) and can be contributed to a charity, the charity can usually seek liquidity when that company sells or through an established secondary market.**

**Carried interest (LLC): The general partner of a private equity fund (the LP referenced above) will typically be formed as an LLC. The payments to the holders of these LLC interests generally represent what is commonly considered the "carried interest." Carried interest is generated as portfolio companies are sold. Since there is often zero tax basis in the carried interest, all wealth created through them is taxable as capital gains. While the carried interest can be a terrific asset to use for charitable giving, among the issues that the donor and charity should be aware of are exit or liquidity opportunities and the potential for claw-back under the LLC operating agreement. Moreover, the LLC general partner has an interest in whether to permit transfers of the carried interest and may need to create a policy to enable and administer the charitable goals of multiple partners.**

contribution in the example, because there were multiple private equity firms that were interested, the valuation expert was expected to apply only a small discount for lack of marketability to the value of the shares. With charitable contributions of these assets, a small valuation discount is desirable because a higher valuation results in a higher charitable deduction for the donor.

### Case study 3: the founder

After devoting almost 30 years to building her business, Mary's focus was shifting to her philanthropy, specifically toward funding the creation of educational programs for low-income children. Mary was sharing her philanthropic goals with her financial advisors, while at the same time sharing news about a possible liquidity opportunity within her business. Her financial advisors saw a way, in a single transaction, to help her transition out of her business life and devote more of her time and resources to her philanthropic mission.

At the time, Mary's company was about to embark on a significant stock buyback program. The company planned to purchase up to 20% of the stock from its shareholders. Participation in the buyback was voluntary.

Mary's financial advisors recommended she consider giving some of her shares to charity. The charity could decide whether to sell shares back to the company as part of the buyback program. Because the charity would not pay capital gains tax when it sold the shares, approximately 20% more money would go to charity than if Mary sold the shares herself, paid the taxes, and then made the donation.

**Legal note.** In this example, it was critical that the charity have the discretion to participate in the stock buyback program. If the shares that the charity received from the donor had already been committed to be sold back to the company, the IRS would have considered the contribution an anticipatory assignment of income. (See legal note above on anticipatory assignment of income.)

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## Conclusion

When considering philanthropy in the broader context of wealth planning, it is important to look carefully across an entire portfolio to determine the most appropriate assets to give to charity to ensure that both the charitable organization and the donor receive the maximum charitable impact from the assets. Taking advantage of the efficiencies of giving publicly traded securities to charities, such as long-term appreciated stock or mutual funds, is one relatively simple way for millions of donors to increase the size, scale, and impact of their charitable giving.

To gain maximum efficiency, however, many donors must consider donating the most highly appreciated asset in their portfolio, which is typically their complex, nonpublicly traded assets. Much of the wealth transferred in the United States is held in these assets but, until recently, they have been a largely untapped source of funding for philanthropic endeavors. These types of illiquid assets often have a low cost basis and a high current value; an outright sale by the donor triggers a significant capital gains tax event. Correctly donating the assets to charity results in an appraised fair market value tax deduction and the charity generally does not pay tax when it sells the asset.

These combined tax advantages allow donors to give significantly more than they otherwise could. In a philanthropic landscape where more donors are now focused on maximizing the effect of their charitable dollars, the giving of complex assets is one of the most impactful, but unfortunately most overlooked, ways to give.

There is a tremendous opportunity for tax and financial advisors to point out to their clients the advantages of giving assets other than cash to charity. Doing so successfully represents a big win for donors, advisors, and charities alike. ■