

7 PITFALLS TO AVOID AT YEAR-END



As the nation's leading provider of outsourced support services for private foundations, Foundation Source offers some practical advice on how to avoid common funding pitfalls that might lead to problems with the IRS.

Donors should take care to avoid common pitfalls when contributing to their foundation:

- Appreciated property
- Indebted property
- Privately held stock
- Timing and valuation of stock transfers
- Prearranged sales

Likewise, advisors to private foundations should consider strategies to:

- Cut the foundation's tax liability in half
- Eliminate the potential tax liability inherent in appreciated property

Pitfall 1: Donating highly appreciated property may give rise to only a fraction of the expected tax benefits.

A donor's charitable deduction for the gift of non-cash property to a private foundation is generally limited to the donor's cost basis in that property, often a fraction of its fair market value. An important exception allowing for a full fair market value deduction is available for the donation of appreciated property, but only if it is considered "qualified appreciated stock." Qualified appreciated stock is stock and mutual fund shares that satisfy two conditions:

(continued)

1. The stock is publicly traded on an established securities market for which market quotations are “readily available;”¹

and

2. The stock is capital gain property that, if sold at fair market value at the time of the donation, would generate long-term capital gain.

The qualified appreciated stock exception is available only if the donor and certain relatives have, at the time of the gift, contributed cumulatively 10% or less of the corporation’s outstanding stock to the private foundation. This exception does not apply to contributions of:

- Real property
- Intellectual property
- Tangible personal property, such as artwork
- Bonds
- Notes
- Warrants
- Options
- Partnership interests
- Publicly traded stock subject to transfer restrictions under SEC rules

¹ Market quotations are considered “readily available” if the securities are listed on the New York Stock Exchange, the American Stock Exchange, or any city or regional exchange in which quotations are published on a daily basis, including foreign securities listed on a recognized foreign, national, or regional exchange in which quotations are published on a daily basis.

Pitfall 2: Donating indebted property may require the donor to pay a self-dealing tax.

A donation of indebted real or personal property by an insider or “disqualified person” (which includes a foundation’s officers, directors, trustees, substantial contributors and their respective family members), may be treated as a sale or exchange between the donor and the foundation. A foundation is forbidden from entering into a sale or exchange with a disqualified person even if the sale is for less than full fair market value (e.g., a bargain sale). If a disqualified person is considered to have entered into a sale or exchange with a foundation, he or she must pay a tax penalty equal to 10% of the donated property’s fair market value, not merely the amount of indebtedness on the property.

For example, the donation by a disqualified person of a vacation home worth \$1 million subject to a \$50,000 mortgage could result in a \$100,000 tax penalty, not a \$5,000 tax penalty as might be expected (e.g., 10% of \$1 million, not 10% of \$50,000).

Surprisingly, there is no “de minimis” exception to this rule, even if the amount of indebtedness is inconsequential relative to the property’s value. Moreover, the IRS cannot abate a self-dealing tax penalty, **which must be paid by the self-dealer personally, not by the foundation.** Specifically, the donation of indebted property by a disqualified person will be considered a sale or exchange if the foundation assumes a mortgage that was placed on

the property prior to the donation, or takes the property subject to a mortgage placed on the property by a disqualified person within a ten year period ending on the date of transfer.

Similarly, if an interest in a partnership with indebtedness is donated to a foundation, the donor may be required to pay a tax penalty for self-dealing. This is because each partner is generally considered to be responsible for bearing a proportionate share of a partnership's indebtedness. If a donor contributes a partnership interest to a foundation, the foundation becomes responsible for the donor's share of the partnership's indebtedness. Under the self-dealing rules, a foundation's assumption of a disqualified person's indebtedness constitutes a self-dealing violation.

Pitfall 3: Donating privately held stock may be fraught with unexpected complications.

A donation of privately-held stock to a private foundation should be made only after consultation with your tax advisor to avoid unexpected and unwanted complications. Here are a number of factors that should be considered beforehand:

1. Denial of Expected Tax Benefits. Unless the donated stock is "qualified appreciated stock" (see Pitfall 1), the donor's deduction likely will be denied a fair market value charitable deduction for the donated stock. As discussed above, the donor of non-cash property to a private foundation usually is limited to cost basis unless the property is qualified appreciated stock.
2. Liquidity Dilemma. Each year, a foundation must satisfy a five percent minimum payout requirement. The amount of the payout requirement is determined, roughly, by multiplying the foundation's average assets during the prior year by five percent. Usually, a foundation's investment assets produce sufficient income to satisfy its annual payout requirement.

However, when privately held stock represents a significant proportion of the foundation's overall investment portfolio, the donated stock may be responsible for creating a significant payout requirement for the foundation. Although the donated stock may be valuable, it may not necessarily produce a reliable or consistent income stream. Therefore, unless the foundation has other significant liquid assets that can be used to satisfy the annual payout requirement, the foundation may need to borrow funds to avoid an under-distribution penalty. This same problem can occur when land or other illiquid assets are given to a foundation.
3. Expensive Annual Valuation. The Internal Revenue Code and Treasury Regulations require privately held stock to be valued yearly so that the foundation's annual payout requirement can be calculated accurately. If an expert needs to be retained, the cost for an annual valuation may be expensive, further straining the foundation's resources.

4. Limited Options for the Disposition of Donated Stock. Often, a disqualified person's family members represent the only interested purchasers for the donated stock, especially if the stock represents an interest in a family business. As discussed in Pitfall 2, a foundation is absolutely forbidden from entering into a sale or exchange with a disqualified person even if the sale is for full fair market value. The Internal Revenue Code treats certain family members of disqualified persons as disqualified persons themselves. Therefore, a family member who purchases the donated stock from the foundation may personally be required to pay a self-dealing tax penalty.

5. Excess Business Holdings Violations. Generally, a foundation's ownership interest in a business, when combined with the ownership interests of its disqualified persons and their respective family members, may not exceed 20%, unless the foundation alone holds less than a 2% interest. When the combined ownership exceeds 20% of a business enterprise, the foundation may face an annual excess business holdings penalty of 10%. After the donation, the foundation may be required to dispose of enough stock to bring the combined ownership percentage below 20%. As noted above, though, this may be difficult or impossible if the only interested purchasers are family members, who may be forbidden from purchasing the stock by the self-dealing rules.

Pitfall 4: Donating stock to a foundation through a broker may not give rise to tax benefits in the expected tax year and may not be valued as expected.

Unfortunately, the IRS may question the valuation date of the contribution and find that the contribution did not happen until the following year. Here's why:

If a donor delivers or mails a properly endorsed stock certificate and stock powers to the foundation or its agent, **the gift is considered completed on the date of delivery or mailing.** However, if a donor delivers or mails the endorsed certificate and stock powers to his own broker, as his agent, the gift may not be considered completed until the stock has been transferred to the foundation's name on the issuing corporation's books. This may take several weeks. The rationale is that a donor could change his mind and instruct his broker to return the certificate, making the gift incomplete.

So, if: (1) a donor mailed his broker an endorsed certificate and stock powers in late November, (2) the broker mailed the documents to the issuing corporation or an independent transfer agent in late December and (3) ownership of the stock was transferred to the foundation on the issuing corporation's books in January, the IRS could maintain that the contribution had not occurred in the year the donor mailed the certificate to his broker.

If the securities are transferred from the donor's account to the foundation's account at the same firm, the gift is generally considered

completed when the brokerage firm has made the appropriate ledger entry on its books transferring the securities to the foundation's name.

By contrast, if a brokerage firm needs to transfer securities held in street name to another institution, it will do so by means of the Depository Trust Company (DTC) system. A gift of securities by DTC typically involves five parties: the donor, the donor's broker, DTC, the foundation's broker and the foundation.

There are a number of points in the delivery process where delays or apparent delays can occur. For example, the donor's broker may not execute the donor's transfer instructions immediately.

In the present DTC system, a transfer entered by a broker is processed instantly and delivered to the recipient broker with virtually no time lag. The exception to this rule occurs if the donor's broker requests an NDO transfer, a night delivery order. Typically, NDO transfers are entered on a given day and delivered to the recipient the next day.

A transfer must be valued on the day it is completed. In general, a DTC transfer, except for an NDO transfer, is completed on the same day the donor's broker enters the transfer order into the DTC system. In the case of an NDO, the transfer is not completed until the following day.

Therefore, if stock is held in electronic form and the donor wishes to ensure his gift is valued on a particular day, he should consider instructing his broker to make a non-NDO transfer to the foundation on the desired day.

If the donor holds a paper stock certificate, he should consider endorsing the stock power on the back of the certificate and physically delivering or mailing it to the foundation or its agent via the U.S. Postal Service via certified mail, return receipt requested, to prove the date of mailing and that the endorsed stock certificate was received.

Pitfall 5: Donating property to a foundation may result in unexpected taxation of the donor if that property is then sold by the foundation.

The tax benefits of many gifts have been overturned under the "prearranged sale" doctrine because the donor has proceeded too far down the path of negotiating the sale of property to a third party before donating it to the foundation. When the IRS applies this doctrine, the donor may be taxed on the gain recognized upon the foundation's sale of the donated property. In that case, instead of the foundation paying tax on the sale at a mere one or two percent tax rate, the donor would be taxed at his own much higher income tax rates.

The IRS is likely to apply the prearranged sale doctrine if the foundation is unable to abandon the sales transaction without legal recourse. This may be especially likely if, prior to the donation of the appreciated asset to the foundation, the donor signed a binding letter of intent, executed a written agreement or entered into a binding oral contract with a third party regarding the asset's sale.

The question of whether negotiations have progressed too far is one of facts and circumstances. Is the foundation able to renegotiate the sale transaction, change the terms or walk away from the transaction altogether? It is imperative that the facts are fully determined and expert legal and tax counsel obtained to protect all parties before the gift is completed.

Pitfall 6: Failing to consider strategies that could cut a foundation's tax liability in half during a year when highly appreciated stock is sold.

A foundation's normal rate of excise tax on its investment income is 2%. However, with a little foresight and planning, it may be possible to cut this tax liability in half.

A foundation's net investment income includes dividends, interest, royalties, rent and capital gains from the sale of assets that produce such income. The foundation's capital gains are calculated by reference to the donor's tax basis, which carries over to the foundation. In any year other than its formation year, though, the foundation may qualify for a reduced 1% tax rate if it crosses a special giving threshold.

When the foundation's current year qualifying distributions meet or exceed 1% of its net investment income for the year plus an amount determined by multiplying that year's average assets times an historical ratio, the tax rate is reduced to only 1%.

Qualifying distributions include grants to charities and payments made for administrative, legal and accounting services rendered to a foundation. The historical ratio is an average of the ratios determined for the five preceding tax years comparing qualifying distributions to assets.

This strongly suggests that a foundation, when it is economically reasonable to do so, should consider delaying the sale of highly appreciated assets until after its formation year.

Other steps that can be taken in a foundation's formation year to improve its chances to qualify for the reduced 1% tax rate in future years include:

1. Funding the foundation as soon as possible following formation; and
2. Limiting the foundation's charitable grants and other qualifying distributions to the greatest possible extent. A foundation has no annual minimum payout requirement in its formation year.

This planning tip has the effect of creating a very low (potentially zero) ratio of qualifying distributions to assets in its first tax year. The first tax year's atypically low ratio would have the effect of lowering the overall historical ratio, making it easier for the foundation to qualify for the reduced tax rate for the next five tax years.

Pitfall 7: Failing to consider a strategy to eliminate a foundation's potential tax liability in appreciated property.

In this case, a foundation sells highly appreciated stock. Thanks to careful planning, the foundation saves tens of thousands of dollars in excise taxes by qualifying for the reduced 1% tax rate. However, with a little more planning, the foundation might have reduced or eliminated its tax liability entirely.

If a foundation grants an appreciated asset, such as a publicly traded security, to a public charity instead of granting cash, the foundation will not pay any excise tax on the security's inherent capital gain. Moreover, the foundation will be deemed to have made a grant in an amount equal to the fair market value of the appreciated asset on the date of gift.

Of course, a successful outcome requires planning and cooperation with the charity.

About Foundation Source

Foundation Source is America's leading provider of outsourced services for private foundations. The company's back-office systems, online services and experts on-call provide clients with Professionally Administered Foundations that solve the traditional problems of complexity, compliance, community and cost. Foundation Source foundations are stronger and deliver greater social impact, allowing families to focus on their philanthropy rather than back-office administration and compliance tasks.

Foundation Source offers a full range of services to keep private foundations of all sizes operating smoothly and in accord with IRS regulations and federal law. Today, Foundation Source serves more than 1,000 private foundations nationwide.

- **Foundation Source Back-Office®**—Includes administration, compliance monitoring, transaction processing, tax preparation and filing, and financial and regulatory reporting.
- **Foundation Source Online®**—An online control center for managing the daily activities of the foundation. Facilitates communication, collaboration and the “practice” of philanthropy.
- **Foundation Source Client Services™**—Personalized support provided by senior executives with extensive knowledge and experience in foundation operations.

Our systems and procedures were created by top legal and accounting professionals in close consultation with the IRS. They have been adopted by many of the nation's leading law firms and top financial institutions. The company is headquartered in Fairfield, CT with regional offices in Atlanta, Boston, Chicago, Denver, Los Angeles, New York City, Philadelphia, Salt Lake City, San Francisco, and Seattle.

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Atlantic Trust has partnered with Foundation Source, the number one provider of management and advisory services for private foundations.

Foundation Source runs over 1,000 private foundations, of all sizes, nationwide. Running foundations is what separates us from consultants and software companies, and it's why our clients turn to us. We step in to operate, advise and strengthen all working aspects of the foundation, while Atlantic Trust manages the foundation's

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We work with both established foundations and individuals interested in starting a new foundation. For every foundation, we provide complete back-office administration, award-winning online systems and experienced philanthropic advisors. The result is a foundation that always runs smoothly, engages the family, and has the impact every client wants.

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