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Bringing fluidity to illiquid assets

By Phil Tobin & Eric Kinaitis,
American Endowment Foundations

Donor advised funds (DAFs) are charitable giving vehicles that are established by a sponsoring public charity, which make grants to other charitable organizations based upon the donors' recommendations. DAFs have become recognized as a simple, smart and meaningful way to engage in philanthropy for individuals and their families due to the tax savings that they offer and the ease of implementation and oversight that they provide to both donors and their financial advisors.

Established in 1993, American Endowment Foundation is a national independent sponsor of donor advised funds. AEF offers a neutral platform for investment flexibility and grant making, as well as administrative expertise geared to personalized charitable management.

Community foundations pioneered the development of donor advised funds prior to the 1980s. In the decades since, the field has greatly expanded as commercial and independent charitable sponsors, educational institutions and other operating charities started offering the service. DAFs are now the fastest growing charitable giving vehicle in America, outnumbering private foundations by nearly three to one, and vastly outpacing charitable trusts and other similar charitable giving entities combined.

According to the 2013 Donor Advised Fund Report from the National Philanthropic Trust, DAFs grew by nearly $7bn from 2011 to 2012, reaching over $45bn in managed assets. This represents the largest yearly percentage gain in the history of the report.

According to a recent report from Giving USA, Americans gave more than $335bn to charity in 2013, showing four consecutive years of growth in charitable giving. An analysis of IRS data for the most recent completed tax year estimated that nearly $121bn in cash donations were made to charities by individuals. Although this 'checkbook charity' is of great value to the organizations receiving the funds, many donors may not be aware of the greater tax and control benefits that donor advised funds could have offered to them.

Not all donor advised fund programs are alike; some sponsors are more flexible than others. In addition to the traditional cash and marketable securities, varied sponsoring organizations will accept illiquid assets including shares of closely held companies (S-corp, C-corp), interest in LLCs, LPs, real estate, life insurance policies, as well as varied retirement assets. Some will allow the donor's financial advisor to manage investments in the donor's fund once the illiquid assets are sold.

One of the most interesting donor situations we face at American Endowment Foundation is the gifting of illiquid assets. Nearly half of US corporations are classified as S-corporations, representing assets of over $3trn. This presents an enormous opportunity for financial advisors to provide creative and tax-smart solutions in the gifting of illiquid assets.

An illustration of how a donor could gift S-corp shares is illustrated below:

Step 1: A donor gifts $1m of S-corp shares with no cost basis to a charity. The donor receives a $1 million tax deduction. The charity assumes the donor's cost basis of zero.

Step 2: The charity sells the S-corp shares for $1m.

Step 3: On gifts of S-corp shares, most charities must pay a tax (Unrelated Business Income Tax – UBIT) at the corporate income tax rate of 35% on the appreciated shares ($1m x 35% = $350,000)

Step 4: The charity keeps $650,000 after taxes ($1m - $350,000 = $650,000)

However, there are some creative strategies using donor advised funds that can reduce the effective UBIT rate from 35% to 10%, a reduction of approximately 70%. By reducing the UBIT tax on this gift of S-corp shares, the donor will have $250,000 more assets in the DAF to support his or her favorite charities ($1m less 35% vs. $ 1m less 10%).

From the example above, the clear advantage of donor advised funds is evident. By implementing a DAF, the donor received an immediate tax benefit from an illiquid asset, and was able to retain a larger share of the gift to support his or her charitable interests.

Although the strategies to handle illiquid assets can be as varied and numerous as the assets themselves, providing insight to a DAF administrator concerning the scope and type of assets the client is looking to give and the clients' charitable intent are starting points. For the donor, they will be guided down the best path in doing charitable good while remaining tax-smart.

The financial advisor benefits by managing client assets that were not otherwise available while in their illiquid form. ■