Transcript

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Episode 68 – Charitable giving: Wealth management strategies for the ultra high net worth

Susanna Poon - Client bought a painting a long time ago for $10,000. The painting is now worth $200,000. It's hanging in his living room. No longer wants to use it. So what are his options with giving away his piece of artwork? If the client donated it to a museum or a university where the art will be displayed or studied by students, then it's related to the purpose of the charity. Then there's a related use issue and then they'll get the full fair market value of it. The opposite of that will be if the client donated the painting to the Salvation Army, for example, which would then sell the painting and generate the cash for it, so the Salvation Army would get the $200,000 value but because the not for related use the client would only get the deduction for the cost basis so he would only get a $10,000 deduction versus the full $200,000 deduction.

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Emily Larsen - And I'm Emily Larsen. In each episode, we'll explore topics relevant to today's trusted financial advisors, interviewing experts and investigating the world of wealth advising from every angle. We'll also provide you with actionable ideas designed to improve outcomes for advisors and their clients.

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Emily Larsen - Before we get started, one quick request. If you have enjoyed the show and found them of value, please take a moment to leave us a rating or review on iTunes. It would really mean a lot to us.

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Ben Jones - Charitable giving is something that touches many of our clients from large to small. But for those of you who serve or aspire to serve the ultra high net worth segment, charitable giving is a very important aspect of their wealth management strategy. In this episode we're exploring how financial advisors can be the bridge between individuals with excessive capital and organizations or causes in need of capital. And how by assisting your clients with this part of their wealth strategy you can build stronger relationships and create better potential outcomes for the clients and the impacts that they're trying to make in the world.

Emily Larsen - Today we're going to dive into what clients need to consider when they're starting to think about charitable giving. Our guest is an expert on this topic, Susanna Poon. She's the director of philanthropy services at CTC my CFO, a part of BMO Financial Group.

Ben Jones - You're likely familiar with the most common form of giving, where an individual chooses an entity and gives money directly to that charitable organization. But for many high net worth clients they benefit from creating an entity for charitable giving. Susanna will lead us through the three main types of entities that these clients might consider creating, and the pros and cons of each.

Emily Larsen - The three entities we'll discuss are donor advised funds or DAFs, private foundations and LLCs. But first we'll talk about how advisors can broach this topic with their clients.

Susanna Poon – The advisor should be having regular conversations with their clients as they meet with them. The best way to figure out whether this is applicable to the client is to ask them questions about their life and if you find that your client has a charitable interest they're serving as a volunteer or a board member at a nonprofit, they recently attended or donated at a fundraiser, or their alma mater is having a capital campaign and they discuss that they went to reunion and participated in it, that means that they care about something and they care about giving. And so that opens the door. They have the charitable interest. And beyond that I think it's the advisor's responsibility to dive deeper and ask the client and the donor if they want to involve their family in the process of charitable giving. Are they married? Do they have kids? Do they have grandchildren? Do they want the family to be involved in the giving journey? Do they want this experience to be an education for all of them to work together and do they want to create a legacy for their family's history. Another signal which the advisor should pick up when reviewing the financial statements or the income of the client is is the client expecting an increase in wealth this year or in the future so is the client expecting more salary, a larger bonus, or is the client getting a vested stock distribution that year. This all creates additional income which triggers the opportunity to take itemized deductions against their adjusted gross income. Finally, when you're talking to the client, are they facing a liquidity event? Are they selling a family business that they've held for many years? Are they selling a vacation home or their current home? Do they have artwork that they are planning to get rid of? Is their company going public? All those situations triggers excessive capital creation and then how do you want to deal with all that extra money? How much do you need to preserve it for your family and how much can you afford to give away? And then there's personal life changes affecting the clients. Are their parents passing away unexpectedly or expectedly? Do they expect an inheritance as part of that? And what do they want to do with that money? Are they going to give it away? Are they going to save some of it for their family? And also is there a divorce that's pending? Oftentimes a married couple have been together for many years and one of them is the wealth creator. And then the divorce happens and suddenly the non-wealth creator gets a very large divorce settlement and they may not necessarily need all that funding and may not necessarily want to keep all of it because of the personal attachment to the former spouse and so that often triggers the divorcee to engage in a large amount of charitable giving. And then finally it's the age. You see your client starting to get close to 70 and a half years old and they have a minimum required distribution that is coming out of their IRA. They can donate up to $100,000 of that distribution directly to a public charity and that will be excluded from their income so they don't even need to itemize for it. And for a married couple they can exclude up to $200,000 of their minimum required distribution from both their IRAs and they do not need to itemize that on their tax return. I think the first thing the advisor should ask the client is what are your passions and what is a social impact that you want to make with your donation? Understanding what do they care about and why do they want to do this? Do they care about education and providing scholarship to underrepresented groups to attend college for the first time? How do they want to use that interest and use their dollars to make changes in society? Understanding both their passions and the social impact goal, then we'll help drive a selection of the best option for them. There's a variety of ways to implement their passions and goals, and the options vary from donating cash or an appreciated asset directly to the public charity or private foundation, and whether it's for general use or restricted use, for specific purpose and then there's also creating split interest gifts -- donor advised funds, private foundations and LLCs.

Ben Jones - I love the concept of starting with why first. It is so powerful to get to the intrinsic motivations for a client at the beginning of a dialogue. What do they care about and why do they want to do this? So let's dive deep into the types of vehicles and we'll compare and contrast donor advised funds, private foundations, and LLCs.

Susanna Poon - The differences are that with a donor advised fund and a private foundation the client is contributing assets in a given year where they will receive an immediate income tax deduction for it. And then they can subsequently make the grants in future years. With an LLC the clients can transfer money into the LLC and do a variety of things. The LLC affords the most flexibility, control and privacy options for the donor, but the donor does not get an income tax deduction until the LLC grants money out directly to a public charity or a private foundation for charitable purposes.

Emily Larsen - And so in the instances where reducing income tax today is critically important to the donor advised funds, and the private foundations end up kind of rising to the top of the options for those types of clients.

Susanna Poon - Absolutely, that is why the conversations between advisor and the client around is there a lot of wealth creation suddenly for this year. Is there a liquidity event? That's why those conversations are important because if you see a surge of wealth in the future and you do not have an immediate plan for how the contributions will be used for charitable purposes, you can donate them into a donor advised fund or a private foundation, get the income tax deduction in that year and then execute on your charitable plans in the future.

Emily Larsen - So then we talk about kind of donor advised fund and private foundations in one category in terms of that they help you with current income tax deductions. What are the differences between those two products and maybe pros and cons of each?

Susanna Poon – Sure – so just a quick look at where donor advised funds and private foundations stand in the country right now is that there are about 280,000 donor advised funds, versus 83,000 private foundations, so there are three times as many donor advised funds as there are private foundations, but there are only $85B collectively across all the donor advised funds versus $750B in the private foundations. The assets in private foundations are about nine times greater than the amount of assets in donor advised funds and that is because private foundations have been in existence for much longer as part of the US history and then donor advised funds didn't really come into popularity until the early '90s. That's a historical background on them and sort of where they stand. However, donor advised funds have been rising in popularity -- both the number of accounts being opened and dollar amounts of assets being contributed. Part of that is the ease and the quickness of creating a donor advised fund. You can go online and fill out an application. If you're old-fashioned, you can paper fill out an application, and submit it in, transfer whether it's your cash or appreciated securities and within a few days open up, if not the same day, open up a donor advised fund account. With a private foundation, you need the assistance of an attorney to help you create that. You need bylaws and articles of incorporation drafted. You need to register in the state that you plan to operate your private foundation in; you need to apply to the IRS for tax exempt status. All of that can take several months-- and several thousand dollars in attorney's fees to set up. You can see the ease and quickness of opening a DAF account versus the harder and more complex and lengthier time of creating a private foundation.

Emily Larsen - Certainly.

Susanna Poon - And also the lower startup cost. There are no costs with opening a donor advised fund, and whereas you have to pay all the attorney fees, state registration fees, and the application to the IRS. With donor advised funds, the minimum contribution can be as little as 5,000. With a private foundation, while there's no minimum required contribution amount it doesn't make sense to create a private foundation with less than $2M because of the up-front costs associated with the creation. Also with administrative fees going forward, with donor advised funds the administrative fees are fixed at about 60 basis points for the first $0.5M. It's a sliding scale of administrative fees. With a private foundation, you're paying out of pocket for most of those administrative costs, whether it's hiring someone to do the bookkeeping, to cut the grant checks, to meet with the grantees, to file the tax returns, etc. So there's a lot of annual upkeep costs with private foundations. I do want to point out that there are currently several providers out there who will manage your private foundation for you.

Emily Larsen - What role does the financial advisor play for the customer, once these things are up and running? Does it vary?

Susanna Poon - It varies greatly. We see advisors who work at financial institutions who will help the clients cut the checks, who will even talk to the nonprofits on behalf of the clients. And then we see advisors who will send the client out to a third party back office service providers and then have nothing to do with the process as well.

Emily Larsen - I see. What other types of things can be utilized in order to make a gift?

Susanna Poon - You can donate real estate, artwork, planes -- that is actually one of the most common questions I get asked is I have an asset, *I don't need it, how can I use it for a donation*? And I think that's where the differences in rules between a donor advised fund and a private foundation come into play more because with a private foundation the limitations on deduction is only up to 30% for cash and 20% for appreciated securities and it's only for publicly traded securities and that's valued at fair market value. I think when the client comes to the advisor to talk about their passions and intents, we ask them also what type of asset they want to contribute and that actually drives the conversation around what type of entity is appropriate for the client to achieve their goals. For example just use a house. The client might have a second home that they don't need and they would like to contribute it to a charitable entity, so they can use the cash generated from the sale of the home to make donations. When you donate the real estate to a donor advised fund it is considered a noncash asset so it's subject to the 30% ceiling but it gets the full fair market value for purposes of income tax deduction. Whereas if you donate the real estate to a private foundation it's subject to the 20% ceiling because it's a non-cash asset but because its real estate is not a publicly traded security it is valued at cost basis only. We would recommend that in order to maximize the income tax deduction they should put it into the donor advised fund instead of the private foundation.

Ben Jones - Emily asked Susanna about the downside of using private foundations for donor advised funds.

Susanna Poon - Once you donated the asset and created funds available for distribution, another difference between donor advised funds and private foundation is that with a DAF there's no required payout. With a private foundation, you have a 5% annual minimum required distribution so if your donor advised fund has $1M you're not required to pay out any of it, whereas, if you have a private foundation and it has $1M in it you are required to spend at least $50,000 of it for charitable purposes. It's a 5% of the assets that the private foundation has and then the other issue to consider is privacy. With a donor advised fund when you make a grant you can remain anonymous, because the grant can be made in the name of the sponsoring charity who has legal custody of the assets and make no reference to the advisor or the name of the donor advised fund. Whereas with the private foundation there can never be complete anonymity because people can look at the 990PF which is the tax return for the private foundation and see exactly to which organizations you made grants and the amount of those grants so there can never be complete privacy with a private foundation.

Emily Larsen - And then is that something that clients are very comfortable self-identifying if they want privacy or not want privacy? Are they comfortable releasing their names, or is that a dialogue between the advisor and the client, usually?

Susanna Poon - Yes, it's usually a conversation between the advisor and the donor and it's a case by case basis. Sometimes the donors are happy to have their name out for purposes that having their name associated with a nonprofit helps them attract other donors. Sometimes the donor is the founder or CEO of a publicly traded company and when they make a donation to an organization that may be involved in some services that may be unappealing to some other folks in the public, they may be more careful about not making the donation public because they do not want to have any backlash that would affect their publicly traded company. If a donor has a DAF, or private foundation -- if they want the grant to be anonymous, they can only make it from the donor advised fund. But one way for donors who have private foundations to make an anonymous grant is to distribute the fund amount into a new donor advised fund and have the donor advised fund then make the grant, so that it can break the chain and be anonymous that way.

Emily Larsen - How interesting! I feel like one of the things we haven't talked about is perpetuity, and so how long can donor advised funds live on, how long can private foundations live on?

Susanna Poon - One of the appeals of having a private foundation is that a private foundation can exist in perpetuity and continue to exist until its board votes to dissolve the private foundation. So you actually have to take proactive steps to close down a private foundation. With a donor advised fund, depending on who the sponsoring charity is, so it's really important to read the documents when you open an account. The rules vary greatly. Oftentimes a donor will create a DAF, and be the initial advisor for the DAF. If the donor does not name a successor upon the death of the donor, the balance of his or her donor advised fund will be added to the general pool of the sponsoring charities' fund. It's really important for the donor to name a successor and then after the death of the initial donor and the initial successor to empower the successor so that the successor can name subsequent successors.

Emily Larsen - Sure.

Susanna Poon - And depending on the sponsoring charity, the rules vary on how long the donor advised fund can stay in existing. Some sponsoring charities put a limit on two generations of a family. Some sponsoring charities will also put a limit on naming only two successors. All these restrictions can also be negotiated up front. When a donor creates a new DAF account with a sponsoring charity, it's important to read through the forms, name a successor, and empower the successor to name subsequent successors and also come up with a contingent plan, which is upon the death of all successors how would you like the balance to be distributed. If none of those things are taken care of, the balance will be distributed to the general fund of the sponsoring charity. And all of these things can be negotiated ahead of time before you actually open the account so while sponsoring charities have some default rules like it can only be for two generations or you can only name two advisors, you can negotiate around these rules at the creation of a donor advised fund.

Emily Larsen - As you've heard, private foundations have historically been the way ultra wealthy individuals set up charitable giving for themselves, their families, and estates. And donor advised funds are now very popular as a way to easily and quickly set up an entity for donating money but one final approach is becoming an appealing option for some donors and that's an LLC, or a limited liability company.

Susanna Poon - With an LLC, it's really a pass through entity. So the client when they transfer any funds into it, the client is effectively the owner and controls the asset, and that's one of the benefits of having an LLC. The con is that at the time of the transfer of the assets the client does not get any type of income tax deduction because the LLC itself is not a tax exempt organization. Only at the time that the client ultimately makes a grant to either a public charity or a private foundation, does the client receive a income tax deduction. Why would a client choose something like an LLC? It's for three main reasons: it's control, flexibility, and privacy. In terms of control, the client controls the timing of the donations. The LLC is not subject to the minimum required distribution rules of a private foundation to give out 5%. It's also not subject to some sponsoring charities do impose a minimum of one grant every three years or five years. Even though there's no dollar amount that needs to be given out from the sponsoring charity. The second part is investments. Compared to a donor advised funds LLCs are not restricted to investing in the pool funds that the sponsoring charity offers. They are also not subject to the approvals of sponsoring charities, if they are able to have an independently managed fund. Compared to a private foundation, a LLC is not subject to all the rules that private foundations have for an investment such as excessive business holding, jeopardizing investment, prudent investor rules, so the LLC has the best control for investments in that it can freely invest in high risk for profit companies that have a focus on social impact with unknown returns. The LLC is not subject to all the IRS rules for private foundations. Most important of which is self-dealing so the LLC can pay rent for office space that is owned by the client or a related family member, which a private foundation cannot do. That's a self-dealing violation. The LLC can also attract the best staff by paying the highest undisclosed salaries to those employees whereas a private foundation must list the name of its top five paid employees so their names and their salaries are made public. Private foundations tend to follow market rate compensation for nonprofit private foundations.

Emily Larsen - Sure and there's a little bit more flexibility when it comes to that LLC side of things.

Susanna Poon - Yes and then finally LLCs have a lot of privacy protections. They don't have to file a 990PF to disclose their balance, their grant making, the names of their employees.

Emily Larsen - And so it sounds like I mean you and I had a dialogue before we even spoke today about the fact that interest in LLCs is rising. It's because of this control, the flexibility and the privacy that are kind of making this option rise to the top of the cream of the crop, if you will. What are the downfalls of it? Or what are the shortcomings?

Susanna Poon - Well, the biggest downside is that an LLC is not a tax exempt organization so clients have to pay for all the operational costs of the LLC with pretax dollars, whereas a foundation can pay for administrative expenses with dollars that have received a charitable deduction and then going back to what we said earlier is that there's no income tax deduction available until the time that the LLC actually makes distributions out to tax exempt organizations. And I forgot, on the flexibility issue, LLCs can do three things that private foundations aren't allowed and that's lobbying, public advocacy, and political contributions. LLCs can do all those things but they are not tax deductible contributions.

Emily Larsen - When you say they can do them, do they mean they can financially support those activities?

Susanna Poon - Yes. So an LLC can engage in lobbying. They can engage in public advocacy, and they can make political contributions with their funds. None of these activities are tax deductible to the LLC meaning the donor doesn't receive a tax deduction for them but they're permitted activities. Whereas all three of these are prohibited activities by a private foundation, private foundations are not allowed to use their funds for them. If they do they're actually subject to an excise tax. So with an organization for example that's interested in doing work to improve immigration issues, they may be supporting local social service organization, legal aid with grants, but they may also be involved in lobbying, public advocacy type work and they can use the LLC to engage in those activities.

Emily Larsen - Sure and so that right there is one important screen in terms of asking up front what their interests are and if any of those come up the LLC really is the option.

Susanna Poon - Yes. The LLC is becoming more popular but it's really specific to a certain type of donor who wants to have the freedom to engage in a variety of activities that holistically support their philanthropic goals. While that's becoming more popular I would say donor advised funds and private foundations remain more popular than LLCs. But I see that LLCs are becoming a third option that donors are considering. It became really popular in 2016 with the Chan Zuckerberg Initiative that was created. Mark Zuckerberg popularized the LLC although he was definitely not the first one to incorporate that use. And I think he's a good example of why the LLC is becoming more mainstream but at the same time not the right vehicle for most people. Because the LLC allows this very holistic approach to doing lots of complex things including impact investing, grant making, lobbying, political contributions. The general donor is not using all those tools so they don't need to have all that flexibility, control and privacy that's generally associated with LLCs. So they are better off for the most part with just either a simple donor advised fund that can achieve all their philanthropic goals or a private foundation. So the LLC, I would say has the most tools available but not everyone needs such a large toolbox.

Emily Larsen - Got it, got it. So the other thing that's kind of just in the back of my mind, when does it make sense to not choose any of these options? In what circumstance should a client choose an existing entity or like how do you match their needs with something that already exists?

Susanna Poon - Sure, if the client knows exactly what he or she wants to do with a specific organization they can make a grant straight out to the organization for their general fund or specify the use of it with the organization and they can go directly to them and negotiate the gift terms or just give the money outright. And then they can bypass the DAF, the private foundation, the LLC, all of which have associated costs with it. Your gift is more effective if you go straight to the public charity or private foundation that you want to contribute to. That is if you know what you want to do.

Emily Larsen - And then you have more flexibility -- you go down the roads of using one of these other entities to as your interests change or the interests of your family changes to direct the investments as you wish.

Susanna Poon - Yeah, direct investments and the grants.

Ben Jones - To wrap things up, Susanna talked about action steps that advisors can take when a client's trying to decide which of these three entities they want to use. In addition, she shares what advisors can do to educate themselves further on this nuanced topic.

Emily Larsen - How does the donor select an asset for contribution?

Susanna Poon - So the advisor can actually help a lot in this realm. So looking at the overall wealth of the donor, looking at what assets are available to the donors for contribution and what assets the donor does not need the most. And then it also depends on a couple questions to ask the donor. What type of organization are you donating to? Is it a public charity versus a private foundation, because the ceilings for deductions are different from both of those. And then what type of asset? Is it cash, or is it non-cash? Cash has the most favorable deduction limitations, but it's not often the best asset to use. Because using a non-cash asset that has appreciated over time, you can avoid the capital gains on it by donating it to charity. So the net cost of making that gift is less. But then you also have to ask questions about have you looked at whether the asset has been held long-term or short-term because if it's been held long-term you tend to get fair market value versus short-term which is cost basis and then in the more nuanced realm of donating artwork you need to ask questions like is there related use for that. So we can just go through that with an example of client bought a painting a long time ago for $10,000. The painting is now worth $200,000. It's hanging in his living room. No longer wants to use it. What are his options with giving away this piece of artwork and how does that affect the deduction? So if the client were to donate it to an art museum or a university that teaches art, then both of those are public charities. It would be subject to the 30% non-cash asset ceiling. And then if the client bought this painting five years ago it's now a long-term capital gain asset. The client would get the fair market value of that asset. And if the client donated it to a museum and university where the art will be displayed or studied by students, then it's related to the purpose of the charity. Then there's a related use issue and then they'll get the full fair market value of it. The opposite of that would be if the client donated the painting to the Salvation Army, for example, which would then sell the painting and generate the cash for it, so the Salvation Army would get the $200,000 value but because it's not for related use the client would only get the deduction for the cost basis, so he would only get a $10,000 deduction, versus the full $200,000 deduction.

Emily Larsen - Whoa!

Susanna Poon - And art is not something you want to donate to a private foundation that you have because it is an asset that will always be valued based on cost basis and subject to the

20% which is even lower limitation of your adjusted gross income.

Emily Larsen - Sure okay.

Susanna Poon - So all these factors.

Emily Larsen - This leads me to -- right, there's so many nuances with each entity and each asset for contributions. If I was an advisor who wants to move toward doing more in this space with the clients I have or I know my clients are more interested in me moving towards where do I learn more? How do I get more embedded in this world? What resources are available?

Susanna Poon - It's a great question. I think that participating in your local professional advisory community continuing education program whether it's for accountants, financial advisors or lawyers, to learn more about charitable giving. Joining your local planned giving council, reading up on all the tax law changes that are proposed, those are all great resources.

Emily Larsen - Great, thanks. So Susanna, what does it feel like when a financial advisor gets this right for the client?

Susanna Poon - It feels like a win for everyone. Like the clients are smarter about and more engaged with their giving, the grantees have funding for their projects, the constituents who are served by the nonprofit, whether they're students, families or Mother Earth, for environment protection, they get the services and help that they need. And the advisor is really the bridge between those who have excessive capital and those with plans and services that are in need of capital, and the relationship between the client and the advisor is just stronger.

Emily Larsen - Thanks so much to Susanna, for spending an afternoon in Chicago with me and for helping us explore the ultra high net worth planned giving corner of wealth management.

Ben Jones - Thanks for listening to *Better conversations. Better outcomes*. This podcast is presented by BMO Global Asset Management. To learn more about what BMO can do for you, visit us at www.bmogam.com/betterconversations.

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Ben Jones - And I'm Ben Jones. From all of us at BMO Global Asset Management, hoping you have a productive and wonderful week.

Emily Larsen - This show and resources are supported by a talented team of dedicated professionals at BMO, including Pat Bordak, Gayle Gipson, Matt Perry, and Derek Devereaux. This show is edited and produced by Jonah Geil-Neufeld and Annie Fassler of Puddle Creative.