



Oklahoma City

Community
Foundation

the adviser

a newsletter for financial planning professionals

May 1997

MAY 31 TAX BREAK SUNSET DOESN'T MEAN END OF OPPORTUNITY



May 31 marks the end of a temporary tax incentive for gifts of publicly traded stock to private foundations.

However, donors can take advantage of the same deduction, without an expiration date, at the Oklahoma City Community Foundation.

The reinstatement of full deductibility for gifts of publicly traded stock to private foundations (Section 170(e)(5) of the

Internal Revenue Code) was included in last summer's Small Business Act. However, the extension was temporary — lasting only eleven months, from July 1, 1996, to May 31, 1997.

This lesser-known tax break has caused a rush of "millionaire donors" to create private foundations and unload their reserves of appreciated stock, according to a Jan. 27 *Wall Street Journal* article. The extension has been a boon to family foundations, who have lost significant funding opportunities since the incentive last expired in 1994. For this reason, the Council on Foundations, an association of American foundations and corporations, is supporting legislation in both the U.S. House and Senate that will make this private foundation tax break a permanent part of the IRS Code. If the law is not permanently extended, such contributions to private foundations can only be

deducted at the stock's cost, rather than its full market value, after the May 31 deadline.

However, the same opportunity for full deductibility of this type of gift exists — without danger of expiration — for donors establishing a Donor-Advised Fund or an Affiliated Fund at the Oklahoma City Community Foundation. The Community Foundation is a *publicly supported* non-profit organization. Certain tax laws treat donations to public charities more favorably than the same types of donations to private foundations.

Tax incentives may or may not be a donor's primary reason for making a charitable contribution, but one thing is certain: Charitable deductions and other incentives stretch the charitable dollar by reducing the "costs" associated with grantmaking and asset management, and allow donors to do far more with their gift than they might imagine.

The Community Foundation offers the broadest deductibility of gifts. Cash gifts are deductible up to 50 percent of adjusted gross income as compared with a ceiling of only 30 percent of AGI for gifts to private foundations. Gifts of long-term

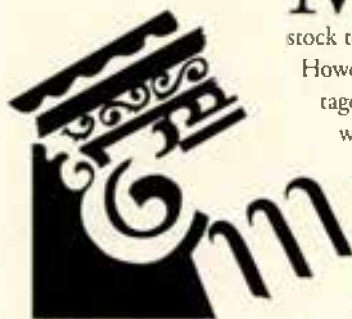
capital gain property (publicly traded securities, closely held stock, real estate) are deductible at fair market value, subject to a 30 percent of AGI ceiling. This is compared to deductions of cost basis only, up to 20 percent of AGI, for gifts of this type of asset to private foundations.

A fund at the Community Foundation can offer donors many of the other benefits associated with private foundations as well: family involvement, continuity of charitable purpose and donor recognition.

A private foundation is often an attractive vehicle for family philanthropy because it can offer complete control over distributions and allow for multigenerational involvement in family philanthropy. The private or family foundation can set its own board of trustees to direct grantmaking and provide recognition for a single donor's or a family's charitable endeavors.

On the other hand, private or family foundations can be costly to set up, staff and maintain. Community foundations are not subject to

"THE SAME OPPORTUNITY FOR FULL DEDUCTIBILITY OF GIFTS OF PUBLICLY TRADED STOCK EXISTS — WITHOUT DANGER OF EXPIRATION — FOR DONORS ESTABLISHING A FUND AT THE COMMUNITY FOUNDATION."



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OKLAHOMA CITY COMMUNITY FOUNDATION, INC.
Statement of Activities and Changes in Net Assets Arising from Cash Transactions

	Nine Months Ended March 31, 1997	Year Ended June 30, 1996
REVENUE AND SUPPORT		
Contributions received	\$ 16,574,454	\$ 8,836,977
Investment income	4,149,732	5,435,161
Net investment gains	5,963,288	15,011,103
Other income	<u>6,898</u>	<u>27,137</u>
TOTAL REVENUE AND SUPPORT	26,694,372	29,310,378
EXPENSES AND DISTRIBUTIONS		
Grants and program services	3,937,605	5,993,401
Investment management fees	261,172	308,201
General and administrative	<u>567,019</u>	<u>615,377</u>
TOTAL EXPENSES AND DISTRIBUTIONS	<u>4,765,796</u>	<u>6,916,979</u>
INCREASE IN NET ASSETS	21,928,576	22,393,399
NET ASSETS AT BEGINNING OF PERIOD	<u>152,800,673</u>	<u>130,407,274</u>
NET ASSETS AT END OF PERIOD	<u>\$174,729,249</u>	<u>\$152,800,673</u>

OKLAHOMA CITY COMMUNITY FOUNDATION, INC.
Investment Performance
Pooled Investments

Percentage Returns

	Nine Months Ended March 31, 1997	Year Ended June 30, 1996	Three Years Ended June 30, 1996	Five Years Ended June 30, 1996
EQUITIES				
Community Foundation	9.60	26.35	17.60	13.35
Standard & Poor's 500	14.68	26.06	17.21	15.72
Indata Median	13.34	24.54	15.89	15.12
FIXED INCOME				
Community Foundation	4.13	4.60	4.77	7.61
Lehman Int. Gov. Corp.	4.23	5.02	4.99	7.70
Indata Median	4.23	5.12	5.15	8.26
TOTAL FUND				
Community Foundation	6.93	16.62	11.27	10.55
50% S&P/50% Lehman	9.38	15.54	11.17	11.78
Indata Median	8.68	15.40	11.72	12.30

Results given are for all Community Foundation Funds excluding those in separately invested supporting organizations. Special assets are also excluded. Equity performance is compared to the Standard and Poor's 500 Stock Index; fixed income performance is compared to the Lehman Intermediate Government Corporate Index; total return is compared to an equal weighting of these two. Indata is a universe of investment managers used widely to judge performance.

Charitable Contributions and Closely Held Corporations

by Bill Schlittler, CPA, and Mark Dyer, CPA



BILL SCHLITTLER
IS A SHAREHOLDER AT
COLE & REED, PC.
HE HAS TAUGHT
GRADUATE-LEVEL CLASSES
IN TAX AT OKLAHOMA
STATE UNIVERSITY.
MARK DYER IS A TAX
MANAGER WITH
COLE & REED, PC.
BOTH ARE MEMBERS OF
THE OKLAHOMA SOCIETY
OF CPAs, THE AMERICAN
INSTITUTE OF CPAs AND
THE ESTATE PLANNING
COUNCIL, AND HAVE
CO-AUTHORED VARIOUS
ARTICLES ON
TAX-RELATED ISSUES.

Many of the tax considerations involving gifts of publicly traded stock are equally applicable with respect to charitable contributions of interests in closely held businesses.

For example, donations of either type of property are generally subject to the same limitations with regard to deductibility. The donor's analysis of whether to give cash or property is essentially the same.

The tax benefits of donating highly appreciated stock, which were discussed in the August 1996 edition of *The Adviser*, generally apply to both publicly traded and closely held stock. However, there are some key differences between the charitable gifts of the two types of property that can affect both the donor and the charity receiving the gift, revolving primarily around the exempt character of the charity as either a public charity or a private foundation.

The following discussion focuses on the main tax implications resulting from this distinction.

Maintaining control of a business entity is a crucial issue for the owner of a closely held business who may be considering a gift of a portion of the business interest to a charity. Because of this control issue, owners of closely held businesses frequently contemplate establishing a private foundation as the charitable recipient and gifting some or all of their

closely held business interest to this newly formed foundation.

By controlling the private foundation, an owner can maintain control of the business even after the gift of the business interest. In some cases this can be an effective strategy and it can produce good results. However, donors and their advisers need to consider the notable differences between private foundations and public charities, such as the Oklahoma City Community Foundation, with regard to gifts of closely held business interests.

Deduct Fair Market Value or Cost?

In many cases, gifts of closely held business interests to private foundations may not achieve the results desired by the donor.

For instance, donors of appreciated publicly traded stock to private foundations can deduct the **fair market value** of the stock rather than its cost if the gift is made before June 1, 1997. Donors of closely held stock to private foundations can only deduct the **cost** of the stock regardless of whether the stock is donated before or after June 1, 1997.

In the case of C corporations that have operated successfully for many years, the difference in fair market value and cost can be substantial. In the case of partnerships, limited liability companies and S corporations, the difference may not be as large since the tax basis in these entities is

increased each year by the amount of undistributed profits; but the difference between fair market value and cost can still be significant.

In contrast, donors to public charities of closely held stock can deduct the **fair market value** of the stock rather than its cost. Thus, to the extent a public charity can achieve the philanthropic goals of a donor who wishes to make a charitable gift of an interest in a closely held business, the value of which includes a significant appreciation component, the public charity may be a more attractive charitable vehicle than a private foundation because of the greater income tax deduction.

Mandatory Distributions Can Cause Problems

Another difference between public charities and private foundations that donors and their advisers should consider before making a gift of a closely held business interest to a private foundation is the mandatory distribution requirement that private foundations must satisfy.

Except for "private operating foundations," which are distinguished from other private foundations because they perform exempt activities directly rather than making grants and distributions, all private foundations must make a minimum amount of charitable distributions every year.

The amount that must be distributed is equal to 5 percent

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of the fair market value of the private foundation's assets. For example, a private foundation with assets having a fair market value of \$500,000 must distribute approximately \$25,000 each year. Failure to make minimum mandatory distributions will subject the private foundation to excise taxes that range from 15 percent to 100 percent of the undistributed portion of the mandatory distribution amount.

This mandatory distribution requirement presents two problems for private foundations that hold closely held business interests.

First, it is usually more difficult and expensive to determine the fair market value of a closely held business interest than that of a publicly held company. The fair market value of the closely held business interest must be determined each year, possibly requiring the private foundation to annually obtain an independent appraisal.

Second, the closely held business might not make distributions equal to 5 percent of its fair market value. Closely held businesses typically retain most of their earnings for growth, or pay out earnings as compensation to their owners.

Most closely held C corporations have dividend payout rates of less than 5 percent of their fair market value. Similarly, many closely held partnerships, S corporations and limited liability

companies have distribution payout rates below 5 percent.

If the private foundation does not achieve a cash return of at least 5 percent on its interest in the closely held business, the foundation may be forced to sell part of its interest in such business. This may prove difficult, since

there is usually a very limited market for the closely held business interest. Furthermore, the owners of closely held businesses typically want to confine ownership of the business to family members or a small group of select business associates.

Public charities like the Community Foundation are not subject to the mandatory distribution rules. Income can accumulate over the years without incurring any penalty. The typical low dividend or distribution rate of closely held businesses will not force the public charity to sell its interest in a closely held business or deplete its otherwise available

cash reserves just to satisfy a statutory requirement.

Excess Business Holding Rules a Major Concern

Another very important difference between private foundations and public charities that donors and their advisers must consider is the "excess business holdings" rule.

This rule generally limits the combined ownership interests in any business enterprise held by a private foundation and all "disqualified persons" to 20 percent of the total ownership of the business, and imposes a tax on the value of any interest held in such business that exceeds this limit.

A "disqualified person" is generally defined as anyone who donates more than 2 percent of the private foundation's total contributions, including the donor's family members and businesses in which the donor or family members own greater than a 20 percent interest.

While this rule seldom poses a problem with respect to publicly traded stock in business enterprises, it is frequently a compelling concern for a private foundation that receives (or is considering accepting) an interest in a closely held business. The minimum tax imposed for exceeding the limit is 5 percent of the value of any excess holding that occurs during a tax year, but increases to 200 percent of the value of any excess business holding retained

by the foundation at the end of the year!

There are limited exceptions to this rule, but it effectively makes private foundations inappropriate and unattractive vehicles for donating interests of any significance in a closely held business.

Public charities, on the other hand, are not subject to this limitation and can, therefore, be a very effective vehicle for contributing interests of any size in closely held businesses.

When assisting owners of closely held businesses, we are frequently asked to evaluate a plan that includes transferring a portion or all of a closely held business interest to an existing or newly formed private foundation.

After considering the factors discussed in this article, the closely held business owner's dispositive plan is frequently altered to exclude the private foundation and include a public charity, such as the Community Foundation, as the recipient of the interest in the closely held business.

There are many situations in which private foundations can very effectively achieve a donor's charitable goals. But in many cases involving closely held businesses, a public charity is a more viable charitable entity.

Contact Nancy Anthony, executive director, for more information on the Oklahoma City Community Foundation (405/235-5603). ■

"DONORS AND THEIR ADVISERS NEED TO CONSIDER THE NOTABLE DIFFERENCES BETWEEN PRIVATE FOUNDATIONS AND PUBLIC CHARITIES, SUCH AS THE COMMUNITY FOUNDATION, WITH REGARD TO GIFTS OF CLOSELY HELD BUSINESS INTERESTS."

Spending policy provides protection for permanent funds, maximizes support for charitable organizations



A SPENDING POLICY PROTECTS AN ENDOWMENT FROM THE LONG-TERM EFFECTS OF INFLATION, SMOOTHS OUT FLUCTUATIONS IN ANNUAL INCOME DUE TO MARKET SHIFTS, AND FREES FUND MANAGERS TO FOCUS ON MAXIMIZING TOTAL RETURN.

A major thrust of the Oklahoma City Community Foundation's mission is to build and effectively manage a permanent and growing endowment for the benefit of non-profit organizations and charitable causes in Oklahoma City. Therefore, it is essential that we focus on protecting these funds for future generations, while maximizing the dollars available for current grantmaking.

To address these goals, the Trustees of the Community Foundation approved a formal spending policy at the end of Fiscal Year 1996 for many of the funds of the permanent endowment.

Spending rules are commonly used to provide a structured method of making distributions from an endowment fund which 1) protects the future income stream from the effects of inflation, 2) provides a predictable annual income, and 3) allows the investment managers to focus on maximizing total investment return to the fund.

Cash distributions from many of the endowment funds of the Community Foundation are based on a spending policy that calls for distributing 5 percent of the average market value. The remaining investment return is left with the fund to add to the fund's value,

which protects the future income stream from the effects of inflation.

The annual distribution from the fund is more predictable because the amount is not tied to current income, which fluctuates due to shifts in market conditions, but is based on a rolling quarter average of the fund's market value, adjusted for additional contributions. Depending on the type of fund, the number of quarters used in the average ranges from eight to 20.

"Large educational and institutional endowment managers across the country seem to agree that an amount close to 5 percent of market value is a safe amount to spend and still provide protection for the principal against inflation," said Carla Pickrell, the Community Foundation's director of administration.

The 5 percent figure is based on an estimate of two factors over time: market return and inflation. A conservative prediction of average market return over time is 8 percent. It is widely expected that inflation would average 3 percent over time. This leaves 5 percent to spend while still protecting the

fund's value for the future.

Allowing managers to focus on the long-term growth of the funds enables them to place more emphasis on equities in their asset allocation.

Without a spending policy based on market value, managers might focus their investment strategy on producing a current income target. This would dictate a higher percentage of fixed incomes in the portfolio since they typically produce more current income than



CARLA PICKRELL

equities do.

However, equities historically outperform fixed income investments in the long run. By placing emphasis on a total return concept, the managers are able to concentrate on a goal of building significant capital appreciation.

"The total return concept is especially important because of our active encouragement of *growing* endowment funds," Pickrell said. "The agencies receive an annual distribution from their endowment that is 5 percent of an *ever-increasing amount*, even if there are no additional contributions to the fund." ■

MISSION STATEMENT

The mission of the Oklahoma City Community Foundation, a non-profit public charity, is to serve the charitable needs of the Oklahoma City area through the development and administration of endowment funds with the goal of preserving capital and enhancing its value for the benefit of the Oklahoma City area.

The mission will be fulfilled by pursuit of these goals:

- Provide convenient, efficient, and effective ways through which donors can contribute assets to charitable purposes.
- Encourage donors to create funds which will benefit the community both now and in the future.
- Advocate for the development of endowment funds and provide appropriate means by which permanent endowment funds can be built and wisely managed to provide long-term support.
- Develop the Funds for Oklahoma City, restricted and unrestricted community endowments, which can be used by the Trustees and the community to develop, coordinate, and enhance services and programs which meet the changing needs of the community.

For more information, contact Nancy Anthony at 405/235-5603.

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 Carla S. Pickrell, *Dir. of Administration and Assistant Treasurer*

private foundation regulations, including various excise taxes, distribution requirements and restrictions on certain types of investments. Additionally, because the Community Foundation pools most permanent funds for administrative and investment purposes, even the smallest fund enjoys the professional fund management and investment returns available to a \$100 million investment pool. These economies of scale add significant value to a charitable gift.

A fund at the Community Foundation does not offer the donor family complete autonomy over the distributions from the fund, but the fund's structure does allow for the donor family to remain involved in focusing the grantmaking. A fund at the Community Foundation can also offer donor recognition – the fund can be named for the individual or family, and all distributions will be identified to the recipient as from the donor's fund. The donor may also choose to remain anonymous, which is not an option with a private foundation.

Through a Donor-Advised Fund, the Community Foundation can continue the same grantmaking purposes established by the original donor even if there are no longer active family members to be involved. The "variance power" held by all community foundations ensures that if the charitable purpose or organization supported by a fund becomes irrelevant or no longer exists, the Trustees can redirect distributions to the closest use without having to go to court to do so. Donors can also choose an advisory committee to direct distributions from the fund and to ensure continuity of purpose.

In the case of Affiliated Funds, a separate board is appointed, with the majority appointed by the Community Foundation and the remainder appointed by the donor. An Affiliated Fund is a large endowment fund of \$500,000 or more, whose assets are invested separately from the Community Foundation's general endowment funds. (An in-depth discussion of Affiliated Funds was published in the February 1997 edition of *The Adviser*.)

The Community Foundation supports charitable giving in any form. The appropriateness of establishing a fund at the Community Foundation or of establishing a private or family foundation depends on your client's individual situation. The staff of the Community Foundation would be happy to discuss with you or your client the differences between the types of foundations and help you decide which best fits your client's situation. ☒

For more information contact Nancy Anthony at 405/235-5603.



Oklahoma City

Community
Foundation

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"TAX INCENTIVES MAY OR MAY NOT BE A DONOR'S PRIMARY REASON FOR MAKING A CHARITABLE CONTRIBUTION, BUT ONE THING IS CERTAIN: CHARITABLE DEDUCTIONS STRETCH THE CHARITABLE DOLLAR AND ALLOW A DONOR TO DO FAR MORE WITH THEIR GIFT."

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