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Informed Philanthropist

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Message from the Executive Suite

Tax Cuts, Charitable Giving, and You


Roger Silk, CEO


James Lintott, Chairman

As we write, congress is debating the new budget and trying to decide which taxes to cut and by how much. With over a trillion dollars at stake, virtually everyone in America will be affected.

A question of special interest to us is what will the effect be on charity. Because we've heard so many differing opinions, we decided that it was important to get facts. You may be surprised that the facts quite strongly suggest that any tax cuts will be good for charity (see page 3).

Our view has been and remains, that whatever Congress does or does not do, you have primary control. By far the biggest determiner how much tax you pay or how effectively you use your assets to achieve your goals is not the tax rate. It is how you plan given those rates, whatever they are and however they change.

Sterling CEO Begins Column for MorningstarAdvisor.com

MorningstarAdvisor.com, the division of mutual fund information giant Morningstar targeted specifically at investment professionals, has recruited Sterling CEO Roger Silk to write a column on philanthropy.

Silk's column, which debuted on April 10, will appear monthly and will cover topics in philanthropy and philanthropic planning of importance to investment professionals in properly serving their clients. Silk's columns can be found by going to MorningstarAdvisor.com.

In addition, Sterling Foundation Management has recently received some important recognition in the press. *Forbes* magazine ran an item on our programs working with foundation creators to help them train their children to be philanthropists, with a possible side benefit of enhancing the children's chances for admission to top universities. *Bloomberg Wealth Manager*, a magazine aimed at investment professionals, ran a feature story on private foundations which relied heavily on information provided by Sterling.

IRS News

IRS Rules Contribution of Stock Options to Private Foundation OK

The IRS has recently ruled that a contribution of stock options by a corporation to a private foundation does not violate any of the relevant rules, and is therefore permitted. The IRS considered a number of issues, including the relationship between the issuing corporation and the foundation, the fact that the option was subsequently sold to an unrelated third party, the potential for self-dealing between the foundation and the corporation, and the potential for unrelated business income tax.

The IRS ruled that there was no self-dealing because the option represented a pledge rather than an extension of credit, and because the exercise of the option would be by an unrelated third party. They further ruled that any gain from the sale will not be unrelated business income, and that such gain would also not be subject to a two percent excise tax on net investment income.

IRS Permits Deduction for Partial Gift

In a recent private letter ruling (PLR 200108012), the IRS has determined that a taxpayer may take an income tax deduction for stock given to charity, even though the taxpayer is not giving the voting rights that go

See IRS News, page 4

Important Recent Gifts

While the general press covers huge gifts of tens or hundreds of millions of dollars by famous donors such as Bill Gates or Ted Turner, the smaller but vital gifts are too often overlooked. The following is a brief listing of some recent smaller gifts of importance as reported by the *Chronicle of Philanthropy*.

■ **Greater Baltimore Medical Center Foundation (Baltimore):** $3-million bequest for unrestricted use from R. Manfred Kwasnik, a lawyer in Towson, Md., who died in 1999 at age 85, in honor of his late wife, Rita C. Kwasnik.

■ **King's College (Wilkes-Barre, Pa.):** $2-million from an alumnus who wishes to remain anonymous, to help finance reconstruction of the college's student center.

■ **La Jolla Playhouse (Calif.):** $1-million from Audrey Geisel, of San Diego, whose late husband was Theodor Geisel, author of the Dr. Seuss books, to build two rehearsal rooms.

■ **Maryland Institute College of Art (Baltimore):** $5-million pledge from Eddie Brown, founder of Brown Capital Management, an investment-management company in Baltimore, and his wife, Sylvia, to help construct the Brown Center, which will house an auditorium and the college's computer-design programs. In addition, the Browns will match up to $1-million raised from other sources to create an endowment fund for the building's operating expenses.

■ **Pennsylvania State U. (University Park):** $1-million pledge from Cathleen McFarlane-Ross, of West Palm Beach, Fla., whose late husband, Norris (Mac) McFarlane, owned the Macalloy Corporation, in Charleston, S.C., for a professorship and a scholarship fund in materials science and engineering.

■ **Samford U. (Birmingham, Ala.):** $11-million bequest from Lucille Stewart Beeson, of Birmingham, who died in January at age 95, to endow scholarships at the university's nursing school and to establish the Dwight and Lucille Beeson Exceptional Scholars Program, named for Mrs. Beeson and her late husband, a retired insurance executive. The scholars program will provide scholarships for 30 to 50 graduates of Alabama high schools each year.

■ **Scripps Foundation for Medicine and Science (La Jolla, Calif.):** $3-million in a charitable remainder trust from Leonard Polster, of San Diego, a retired executive at UBS PaineWebber, an investment company, and his wife, Edith, to support the breast-care center at the Scripps Memorial Hospital La Jolla.

■ **Yellowstone Park Foundation (Bozeman, Mont.):** $3-million pledge from Chin-Cheng Wu, founder of ArrowPoint Communications, in Acton, Mass., which was bought by Cisco Systems in 2000, and his wife, Shalin, to help build a visitor-education center

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Sterling Foundation Management is the nation's leading manager of private charitable foundations. Our mission is to ensure that our clients achieve the maximum possible results from their charitable giving. We do this by providing turn-key foundation management, along with advice to make sure clients enjoy the greatest available tax benefits, optimal control, desired family involvement, and long term continuity of purpose.

Sterling Foundation Management does not practice law, and nothing in this text is to be construed as legal or tax advice. The information in this newsletter, while believed to be accurate, is not guaranteed.

Donor Advisory

Beware of Fund-raising Efficiency Statistics

According to a study by the *Chronicle of Philanthropy*, fund-raising drives by certain commercial organizations on behalf of their non-profit clients can be very inefficient. However, such studies must be viewed with serious skepticism by informed readers.

The *Chronicle* reports that "Americans donate at least $1-billion annually to charitable fund-raising campaigns run by commercial solicitors, but only about a third of that money ends up in the charities' hands." The report goes on to say that they "analyzed computerized financial reports filed by commercial fund raisers and nonprofit groups in nine states: California, Connecticut, Minnesota, New Hampshire, New York, North Carolina, Ohio, Pennsylvania, and Virginia.…On average, nonprofit groups that hire solicitation companies receive only about 35 percent of the donations collected in their

See Donor Advisory, page 4

Research Shows That Tax Cuts Boost Charitable Giving

In the current debate over tax cuts, too much attention has been focused on the amount of money which would be "given back" to "the rich," and not enough on what they are likely to do with the additional money.

As F. Scott Fitzgerald famously observed, the rich are different. This is particularly true of their philanthropy. Unlike everybody else, the rich are prone to create private foundations. So what? Well, private foundations form the backbone of support for most of the charities in this country that do not themselves enjoy large endowments. When a person creates a foundation, they commit to give to charity not just this year, but every year. And as anyone who's ever been involved in running a charity knows, there is no substitute for steady, reliable funding. You just can't build long term programs without it.

The conventional wisdom is that reductions in tax rates would hurt charitable giving because there would be less tax benefit to giving. However, I believe the opposite is true with respect to private foundation creation. In fact, our studies show that a significant tax cut, especially in the estate tax, could have a tremendously favorable impact on charitable giving by "the rich."

There is no question that philanthropic activity, as virtually all economic activity, is affected by tax considerations. Currently under consideration are cuts in both the top marginal income tax rates, and cuts in or elimination of the estate tax. A careful examination of the evidence is quite revealing.

Cutting Income Taxes Increases Giving

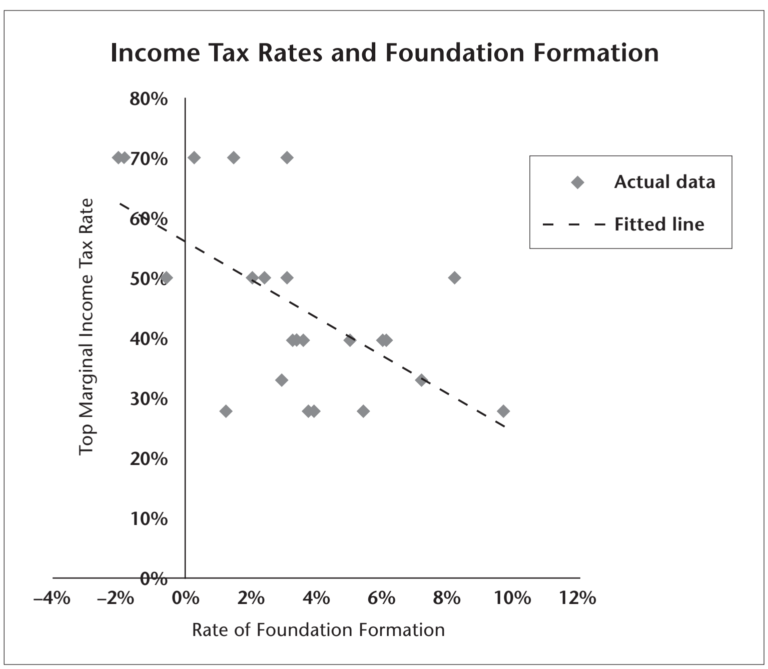
Although many in the non-profit world believe that reductions in income taxes will lead to reductions in charitable giving, the history of the past quarter century does not support this conclusion. If anything, the data support the exact opposite conclusion—i.e., that reductions in top marginal income tax rates encourage charitable giving. For example, economist Alan Reynolds, writing in 1997, examined the effects of the 1986 tax cut, which reduced the top marginal rate from 50% to 28%. At the time, some charity groups had been concerned that the rate cut would hurt charitable giving. However, Reynolds found that instead of falling, giving grew dramatically. He believes this was due to the strong economy which, in his view, was strongly stimulated by the tax cuts.

Reductions in top marginal income tax rates encourage charitable giving.

However, this economic analysis misses a simpler, and undoubtedly true explanation: For most wealthy people, income taxes are their largest single expense. For many, charitable giving is their next biggest expense. So, lower tax rates mean that there's more left over to give, and they give more.

Our own research confirms this simple logic. As the graph below shows, more foundations are created when the top tax brackets are lower than when they are higher. As an economist would say, there is a strong, statistically significant correlation between lower rates and higher foundation creation rates.

Applying these results to the current debate, a reduction in the top income tax bracket from the current 39.6% rate to the proposed 33% rate would be expected to result in the creation of approximately one thousand additional foundations each year. At an average size of over $6 million, that's an additional $6 billion a year.



Eliminating the Estate Tax Could Add Hundreds of Billions to Charitable Coffers

As impressive as the above numbers on the

See Tax Cuts, page 4

IRS News, *from page 1*

along with the stock. This is noteworthy, because the general rule is that a "partial gift" such as a gift of some of the rights as in this case, is not eligible for a deduction unless it is made as part of a qualifying trust.

However, the IRS decided in this case that the gift would be deductible because the stock was held under a voting agreement called a "pooling agreement" that was entered into eight years before the donation and that the arrangement was not made for the purpose of facilitating a later gift. The purpose of the pooling arrangement was apparently to ensure that a group of stock holders all vote as a block. Such agreements are common in closely held businesses.

Donor Advisory, *from page 2*

names....The remainder goes to the solicitors for expenses and profit."

What the study does not say is that, if the commercial fund raisers were bringing new donors for their clients, the results are actually extremely good. In general, it is very expensive to discover new donors for charities. It is very easy and quite common for an individual fund-raising drive to make little or no money. But that does not necessarily mean the drive is a poor use of resources. In fact, in sophisticated operations, the fund-raising executives will look not just at what a donor gives the first time, but at what that donor can be expected to give over time.

The bottom line is that there is much more to evaluating the efficiency of a fund-raising operation than a simple statistic can capture. When it matters, it is essential to make sure that you are looking at the right spread of statistics, and that you understand the context in which the charity is operating and in which the statistics are being presented.

Tax Cuts, *from page 3*

impact of an income tax cut are, they pale when compared to the dramatic benefits which could result from elimination of the estate tax.

The discussion about the effect of the estate tax on charitable giving is less susceptible to historical analysis because there has been very little meaningful change in the level of estate tax rates for decades. However, our work with clients and prospective clients suggests that the effect of reductions in the estate tax is likely to be positive, and big.

Dozens of real-life discussions with clients and prospective clients who are actively considering a foundation suggest to us that there are four basic ways people think about how much of their estates they will allocate to charity. These are: 1) a fixed dollar amount to charity with the remainder to their heirs, 2) a fixed dollar amount to heirs with the remainder to charity, 3) a fixed percentage of their wealth to charity with the remainder to the heirs, and 4) a fixed percentage of their wealth to heirs with the remainder to charity. It is in our experience quite rare for a prospective foundation creator to give to his foundation because of the existence of the estate tax.

The following table shows, for each of these strategies, the logical effect of a reduction in the estate tax rate on the amount being contributed to charity.

Strategy	Effect on Contributions to Charity
Fixed $ to charity; remainder to heirs	No effect
Fixed $ to heirs; remainder to charity	Increase
Fixed % to charity; remainder to heirs	No effect
Fixed % to heirs; remainder to charity	Increase

Although these results might at first appear surprising, they are not if you think about the founder's estate as a pie to be split among heirs, charity, and the government. Whenever the government's share is less, more is left to be split between the remaining two groups.

Paul Schervish, director of the Social Welfare Research Institute at Boston College used to oppose reductions in the estate tax on the grounds that it would hurt charity. However, after conducting a study of wealthy people (those with net worth of $5 million or greater), he changed his mind. He concluded that if the estate tax were eliminated, the portion of these wealthy people's estates that would go to charity would increase from 16% to 26%, an increase of about 60%. If these percentages are applied against the $41 trillion expected to pass from the baby boom generation, it implies a potential *increase* in charitable giving on the order of $4 *trillion* over the next fifty years or so. If it were spread out evenly over the next thirty years, such a $4 trillion increase would mean an annual increase of about $80 billion, which would be a very significant increase measured against the current total annual contributions to charity of approximately $200 billion.

The available economic and survey data, anecdotal evidence of real people, and logical analysis, all support the conclusion that reductions in either the income tax or the estate tax, or both, would result in more private foundations being created and more dollars contributed.