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TAX REPORT

Invasion of the Charity Snatchers!

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As the tax-code debate heats up this election season, one cherished break for taxpayers in upper brackets—the deduction for charitable contributions—is under fire.

Not only are tax overhaulers on both sides of the congressional aisle taking aim, but so are both presidential candidates.

That means well-heeled donors should consider whether to accelerate donations planned for future years into 2012, while the tax treatment is still favorable. "We're raising this question with all our clients," says Beth Kaufman, an attorney at Caplin & Drysdale in Washington.

The threat is shining a new spotlight on "donor-advised funds," which allow donors to donate now and deduct at current tax rates, while making the charitable gifts later. In effect, they are miniature versions of private foundations—but without the considerable expenses or hassles. They also are a rare example of a tax-favored vehicle that can work equally well for the wealthy and the merely affluent.

"It amazes me that my clients with tens or hundreds of millions of dollars are using the same techniques and investments I would" for charitable giving, Ms. Kaufman says.

The mechanics are straightforward. A donor-advised fund is an individual account held under the umbrella of one large tax-exempt organization. Donors contribute and deduct immediately and then invest the money in the account, which gains tax-free. Later, even years later, donors ask the umbrella group to make grants from their fund to one or more tax-exempt charities of their choice.

The minimum to open an account can be $5,000 or even lower, with minimum grants as low as $50 a pop. There usually aren't any limits on maximum grants.

Donor-advised funds aren't right for everyone. Accounts have administrative and investment fees that can eat up 0.7% of assets a year and sometimes much more. And the funds require giving up ownership of the contributed assets—a tough sell for some donors.

Nonetheless, with an estimated $40 billion of assets spread among 2,300 sponsoring groups, according to Benjamin Pierce, head of Vanguard Group's charitable arm, donor-advised funds are rising rapidly. At three large providers—Fidelity Investments, Charles Schwab and Vanguard—assets have more than quadrupled over the last decade, to $13 billion, despite lackluster stock-market growth.

James Bennett

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Marc Schindler, a financial planner in Houston who, with his wife, has had a donor-advised fund with the Houston Jewish Community Foundation for more than a decade, says he plans to raise his contribution by 50% this year. "I think a lot of tax deductions will be going away in the future, given the tremendous budget deficit," he says.

Tax Appeal

At the heart of these funds' appeal is one of the tax code's best breaks, for people who want to donate: Givers get a full deduction for contributions of assets held for more than a year that have increased in value, while skipping capital-gains tax. The current capital-gains rate is 15% for the highest earners.

"You can give more if you do it the right way," says Zach Gerger, a retired anesthesiologist in Charlotte, N.C., who has had a donor-advised fund for more than a decade.

Here is why: Say an investor has shares he acquired more than 20 years ago for $5,000. Now their value is $40,000, and he would like to give that amount to a dozen favorite causes. If he sells the stock and donates the proceeds, he will owe capital-gains tax of $5,250, leaving him with $34,750 to give and deduct.

But if he gives the stock instead, he can deduct the entire $40,000 (assuming other tax limits don't kick in). If he still likes the stock, he can use $40,000 of cash to replace it and come out ahead (assuming he intended to give in the first place).

He could, of course, get the same tax benefit—minus account fees—by giving shares directly to tax-exempt groups. But some of them (say, a small church or a walk-a-thon) can't handle noncash contributions. In addition, he might want to spread out the gifts over many years, or donate an amount smaller than a single share of his stock.

Some advisers have integrated donor-advised funds into their clients' overall strategies. Bert Whitehead, a planner in Franklin, Mich., says he has several clients who regularly contribute shares of their most highly appreciated stocks to these funds and never write donation checks for cash.

Laura Peebles, a nonprofit specialist at Deloitte Tax in Washington, suggests donor-advised funds for clients who tend to lose their letters confirming donations. "That gives them only one document a year to track," she says.

These funds can offer other benefits as well. Dr. Gerger used his fund to help teach his children his philosophy of giving when they were young. Every year they got the chance to choose a charity to receive a grant, after doing research and making a case. "My daughter always picked animal charities," he says.

Donor-advised funds vary widely, however. If you are thinking of going this route, here is what to do.

Know the different types of sponsors. The sponsor is the tax-exempt umbrella group holding the donor-advised funds, and there are different types. The first ones on the scene, some before World War II, were "community" trusts or foundations. These sponsors are likely to have a local or regional focus and often vet and work closely with charities.

Then there are donor-advised funds sponsored by "single-issue" or specialty groups, such as the Jewish Federations or WaterStone. Two such groups, the King Baudouin Foundation United States and CAFAmerica, specialize in funds that make tax-deductible donations to groups abroad.

The fastest-growing segment are donor-advised funds sponsored by "national" charities. Many are offered by financial institutions such as Fidelity, Vanguard or Schwab, but others are stand-alones, such as the National Philanthropic Trust. These sponsors typically impose far fewer restrictions on donors but are less in touch with the charities they give to.

Determine the sponsor's grant-making policies. Once a giver contributes an asset to a donor-advised fund, he or she no longer controls the money. Technically, the donor requests that the sponsor make a gift of a certain amount, and then sponsor decides whether to make it.

Calls for comprehensive tax overhaul usually involve broadening the tax base and lowering rates, which would cut the value of charitable write-offs if they survive at all. Indeed, one of Mitt Romney's advisers recently said the candidate favors that approach. *Associated Press*

Sponsors vet grant requests to make sure the group is tax-exempt under Internal Revenue Service rules. But some—including many of the national charities such as Fidelity, Vanguard and Schwab—typically honor all donor requests to legitimate U.S. charities.

Community foundations and single-issue sponsors sometimes deny requests for grants outside their purview. They also might ask for a contribution to the umbrella organization's general fund in return for honoring other requests. If that happens, "make sure to negotiate such issues before setting up an account," says Joe McDonald, an attorney at McDonald & Kanyuk in Concord, N.H., who advises wealthy donors.

Also, ask about the sponsor's minimum grant amount. It is as low as $50 at some sponsors, but much higher at others.

Compare account minimums, fees, investment options and assets accepted. They vary widely, especially among community foundations and single-issue sponsors.

As a benchmark, Fidelity and Schwab accept minimums as low as $5,000 from one donor, while at Vanguard the minimum is $25,000. All three charge an annual administrative fee of 0.6% on accounts $500,000 and under, which drops as the amount in the fund increases.

At these three sponsors, donors with smaller accounts—under $250,000—choose among investment pools rather than a mix of individual funds or stocks. Fees vary, from less than 0.1% to 10 times that or more.

The most popular assets contributed to donor-advised funds are cash and securities, but some sponsors accept nontraded assets if there is a way to sell them. As with other financial accounts, the more a donor contributes, the greater the latitude and hand-holding he or she receives.

President Barack Obama has a recurring proposal to limit the value of itemized deductions (including for donations) to 28% for all upper bracket taxpayers, whether or not the tax cuts expire. *Getty Images*

Check out the sponsor. If the sponsor founders, so could your account. In 2009, an organization known as the National Heritage Foundation went bankrupt. A court ruled that $25 million in 9,000 donor-advised funds was available to pay creditors, wiping out the accounts.

All charities sponsoring donor-advised funds have to file a Form 990 with the IRS, a revealing if complex document. Large donors might want to ask for audited financial statements as well, Ms. Peebles says: "If a group doesn't have them, it's a red flag."

Find out about portability. If you are unhappy with your sponsor, can you move the account to another one? There isn't a uniform policy. Fidelity, Schwab and Vanguard all allow transfers, while some community foundations or trusts and single-issue sponsors don't. Ask before you give.

Understand the end game. Some sponsors don't allow accounts to survive the original donor and put remaining assets in their general charitable fund. Others allow the donor to name one or more successors to decide donations until the account is empty.

These funds aren't perfect—but when used properly they can help you maximize your tax breaks and minimize giving headaches.

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