Tax efficient charitable giving

Q: What does it take to set up a foundation? We're going to have record income this year and want to donate it to our favorite charities. What is most tax efficient?

Private and Public Foundations are both classified as tax-exempt, 501(c)(3) organizations by the IRS and donors can get a current-year tax deduction. The major difference is where they derive their financial support. While a public charity gets its funding from the public, a private foundation is usually funded by a single source. There are no restrictions on how often donations are made.

A private foundation is funded by a single individual, family or business and is organized for charitable, educational, religious, scientific or literary purposes.

Most of the over 91,000 private foundations have assets under $1 million, but the minimum for starting a new foundation is $250,000. Contributions are tax deductible, with limits, and may be carried forward up to five years.

Each year foundations are required to pay out 5% of their previous year's net average assets in qualifying distributions which include charitable donations and specific expenses. If the net average is $255,000, the required pay-out is $12,750. These foundations will last a long time when only minimums are paid out.

Because a private foundation is under the donor's control, donors define the mission, choose the board members, decide how the funds are invested, and when and where the funds are given. It's even okay to hire family members. Giving back is a great way to share community and family values.

Foundations can exist into perpetuity and charitable giving can continue as long as the foundation exists. The family legacy can be passed from one generation to the next and there are companies that can set up your new private foundation in less than a week.

If you want to close down a private foundation, your irrevocable donations can be transferred into a donor-advised fund (DAF). Maintained and operated by a section 501(c)(3) sponsored organization, DAF accounts are funded by individuals and tax deductibility is limited by AGI.

The DAF has legal control over the contribution and the donor can make grants to support favorite charities and advise on investments. A DAF functions as a conduit and assets grow tax-free. A successor can be named to take over upon the death of the donor.

The most common strategy for using DAFs is to "front load" charitable contributions in high income years. Distributions may be made at any time. Cash, stock, mutual funds, real estate, private business interest or private company stock are eligible contributions. This is arguably the easiest and most tax-advantageous way to give to charities.

Over time, your donation can potentially grow based on your investment preferences, making even more money available for your charities.

Another way to donate is by making a qualified charitable distribution (QCD) directly from your IRA. For a QCD to count toward your current year's required distribution, you must be 70 ½ years old and the IRA custodian must transfer funds directly to a qualified charity by the 12/31 deadline.

Rather than giving at death, consider a private foundation, a donor-advised fund or a qualified charitable distribution and get a tax benefit while you are still breathing.

Define your charities, decide on contribution amounts and dates, review tax implications and work with qualified advisors to donate efficiently.

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