Comparing Financial and Charitable Techniques for Disposing of Low Basis Stock

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Despite the market turmoil over the past 12 months, and corresponding dramatic fall in the price of most stocks, concentrated, low basis stock positions continue to constitute a significant percentage of the net worth of many investors and families. It may be true that the "dot-com" millionaires are no longer millionaires (or, for that matter, employed), but many other investors—those in traditional "blue chip" companies or in those technology firms that survived—remain far too concentrated in single stock positions.

For some of these investors, the decision to remain so concentrated is emotional—some combination of attachment, greed, unrealistic expectations, and inertia that keeps them wedded to one stock, despite the increased risk of doing so. For other investors, it is a desire to avoid or defer the payment of taxes associated with selling the stock outright.

An emotional expectation aside, the evidence is fairly clear that holding a concentrated stock position is a risky proposition. James Picerno cites a study by Princeton University professor Burton Malkiel and notes, "A new study finds that individual stock volatility has been rising, suggesting that investors must own more equities to maintain their grip on diversification…it takes two to three times as many stocks to build a portfolio today with the same level of risk as a set portfolio three decades ago" (see Picerno [2000]). This increased volatility can have a significant impact on the long-term net worth of the investor, as noted by Alan Feld: "…the fact is…that volatility erodes any stock's compounding rate—the true measure of wealth accumulation" (see Feld [1999]). David Stein and his colleagues performed extensive analysis on the diversification versus concentration issue, and concluded, "When the initial asset has substantially more risk than the (appropriate) benchmark, [we] recommend near-complete diversification, despite a high initial tax cost…Sensitivity analysis reveals that greater diversification is needed a) with greater initial asset volatility, b) with a longer investment horizon, c) with a lower expected return of the initial asset, d) with a higher cost basis, and e) with a lower risk-free rate" (see Stein et al. [2000]).

Once the decision has been made to reduce the concentration in a single stock, the next decision is the most appropriate strategy to do so. The correct strategy is rarely an "all or nothing" approach, but rather a combination of the various techniques available. These different techniques can be broadly categorized into "financial" or "charitable" strategies, and the remainder of this article summarizes several of the more popular ones, and develops a template for determining the appropriate strategy for a given investor situation.

DETERMINING THE INVESTOR'S GOALS

Recognizing that "prescription without diagnosis is malpractice," the first step is to gather as much information as possible about the nature of the investor's holdings, his/her view on the future performance of the stock, and the underlying goals of the diversification. Exhibit 1 illustrates sample questions that can help focus the discussion in the proper

EXHIBIT 1
Determining the Investor's Goals and Objectives

1. What is the nature of the shares:
    a. Tax basis (approx.)?
    b. Are shares short-term or long-term for tax purposes?
    c. Free and clear or restricted (i.e., do the shares have a legend on them)?
    d. If restricted, please describe (i.e., Rule 144, Rule 144(k), or Rule 145).
    e. If Rule 144, have the shares been held for more than one year? More than two years?
2. Is the investor considered an affiliate or insider under Section 16 of the Securities and Exchange Act of 1934?
3. In general, is the investor "bullish" or "bearish" on the future performance of the stock?
4. If the investor had cash in hand equal to the current market value of the concentrated stock position, how many shares would he/she buy? How does this compare to how many shares are currently being held (less than 25%, less than 50%, less than 75%, etc.)?
5. Does the investor have a "target price" for executing the disposal (e.g., the current market price, some price higher or lower than the current price, at "best market" levels, etc.)?
6. What is the time frame for completing the disposal of the low basis asset (as quickly as possible, over time, only if the stock reaches a target price level, during the next trading window, etc.)?
7. What is the relative importance of each of the following:
    a. Control of and retention of growth on the underlying stock,
    b. Maximum liquidity for diversification,
    c. Income and/or growth from the subsequent reinvestment portfolio,
    d. Current income tax deduction,
    e. Immediate or eventual charitable contribution.

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direction. The answers to these questions will tend to lead the investor toward either a financial or charitable disposal strategy, or perhaps to segment the shares proportionally into both categories. Armed with the necessary information, the investor can now begin to compare the various disposal alternatives.

FINANCIAL DISPOSAL TECHNIQUES

Three of the most popular "financial" strategies for disposing of low basis assets are 1) "completion" strategies, 2) exchange funds, and 3) options-based hedging strategies (collars and variable prepaid forwards). Each of these strategies has benefits and considerations, and will be appropriate in different situations. In general, however, these strategies will be popular with investors who wish to maintain some degree of ownership in the underlying asset, perhaps because of a generally bullish view of the future performance of that asset. These strategies will also be appropriate for investors with little or no charitable inclination, at least with respect to their holding in the underlying stock.

Completion Strategies

This disposal technique has the primary benefits of being simple to understand and relatively easy to implement. In essence, it is simply a disciplined outright sales strategy executed over time. The underlying stock is classified with respect to asset class, sector, volatility, and so forth, and a "completion portfolio" is developed *around* this asset. This portfolio should be as uncorrelated as possible to the underlying asset, so as to minimize sector and security-specific risk, and will be funded by periodic outright sales of the initial asset. As David Stein describes it, "…[the investor can] invest the liquidated asset in a portfolio that will 'complete' the remaining undiversified holdings. That is, seek a portfolio that will have low (or ideally negative) correlation with the initial holdings" (see Stein et al. [2000]).

For example, the investor might sell 10% of the initial asset on a quarterly basis over 10 quarters, using the after-tax proceeds of the sales to fund the corresponding, uncorrelated, reinvestment portfolio. How quickly the asset is liquidated will be a function of the overall investment horizon of the investor. As Alan Feld notes, "After five years of an average [market] environment, we wouldn't expect the diversified portfolio to have fully recouped the tax cost of selling the single stock, but we'd probably still recommend selling about half the position because the downside could erase millions of dollars. After 10 years, the investor would likely be better off diversified in all but the most favorable environments" (see Feld [1999]).

Completion strategies have several benefits:

- They are easy to explain and understand.
- The investor will retain control of the asset and much of any growth in that asset.
- They do not involve any leverage.
- Ongoing tax loss harvesting may allow for a minimization of the tax consequences of selling.
- They have a high degree of flexibility, and can be re-examined and revised on a periodic basis.

These strategies, however, do have certain considerations with which the investor should be comfortable:

- They can take time to implement.
- If the shares in question are restricted securities (i.e., Rule 144), there may be regulatory limitations as to how much can be sold within a given time period.
- The investor has no downside protection on the stock, and in the early stages of implementation the investor is widely exposed to adverse price movements.
- If the investor does not have substantial other assets with which to fund the surrounding portfolio, then all liquidity for that portfolio must come from liquidation of the underlying asset, which can lengthen the implementation even further.
- The investor may not have much diversification (and, therefore, reduction of risk) in the early stages of implementation.
- It may not be possible to manage the sale of the assets in a tax-effective manner.

In summary, then, completion strategies may be appropriate for younger investors with longer time horizons, especially if they want to retain a position in the underlying stock, are not especially charitably inclined with respect to their holdings, and have other assets (or investable income) that can be used to create the completion portfolio.

Exchange Funds*

Exchange funds, also known as "swap funds," involve the formation of a limited partnership among several investors, each of which holds a different concentrated stock position. Each investor contributes his/her shares to the partnership, and in exchange receives a *pro rata* ownership position in the entire portfolio of stocks making up the partnership.

This exchange of stock is tax-free to the investor, with certain caveats, and the investor achieves some level of diversification in a tax-efficient manner. But the caveats are not insignificant, and include:

- The tax basis on the contributed shares stays with the investor, and the investor must keep the shares in the exchange fund for at least seven years to achieve the full tax benefit. After seven years, the investor may pull out of the fund, and will receive a *pro rata* position in the then-market value of the full portfolio of stocks, while maintaining the original tax basis of the contributed shares. So the investor has, essentially, traded a concentrated position for a more diversified position, tax-free.
- If the investor pulls out of the fund before the seven-year mark, however, he/she typically will receive back his/her originally contributed shares in a *pro rata* amount equal to lesser of the partnership's then-net asset value or the market value of the stock originally contributed, thereby negating the entire purpose of entering into the fund in the first place.
- By law, at least 20% of the fund's portfolio must consist of "illiquid" investments. For most funds, this means investing in real estate partnerships, or REITs, which may or may not constitute an appropriate asset class for the investor. In addition, it is typical for the fund to take on leverage (by borrowing against the remaining 80% of the portfolio) in order to fund the REIT investments. The interest expense on this debt creates a drag on the income and overall performance of the fund.

EXHIBIT 2
Exchange Funds

Benefits	Considerations
• Tax deferral	• High costs and fees
• Some diversification	• Seven-year lock-up
	• Little control over portfolio
	• Inflexible
	• Passively managed portfolio
	• 20% illiquid investments, usually funded through leverage
	• A risk of "buying other people's dogs"

- In a typical partnership, the investor will have a limited amount of time (usually five business days) to review the other shares that have been contributed and decide if he/she is comfortable staying in that partnership. After this short review period, the investor is locked into the partnership, as described above. Since one reason many investors may be seeking to diversify out of their respective stocks is that they believe they are fully (or over-) valued, there is some risk that any given investor is, in essence, exchanging his/her shares for a portfolio of shares that each contributing partner expects to underperform in the future (i.e., the investor is investing in the other partners' "dogs").
- The portfolio manager is usually attempting to create a partnership portfolio that will track a specified benchmark index, such as the S&P 500 or the Nasdaq 100. As a result, there is no guarantee for any given investor that his/her particular position will be accepted into the partnership, if the manager believes those shares do not "fit" with the rest of the portfolio. In particular, it may very difficult to find a partnership that will accept small cap stocks or highly volatile Internet or technology stocks—the very stocks many investors are seeking to diversify away from. Further, while the fund achieves some level of diversification for the investor, it is typically diversification *within* a specified asset class (e.g., large cap, mid cap) rather than a true diversification across asset classes, as defined by modern portfolio theory.
- Since any sales of stock within the partnership may result in a taxable event for the partners, most portfolio managers attempt to construct a portfolio that remains fairly constant throughout the seven-year lock-up period. That is, once the initial portfolio is constructed, it is, more or less, passively managed for the life of the partnership. Despite this, many funds will charge an up-front entry fee of 1%–3% *and* an annual management fee of up to 1%. This fee structure makes exchange funds a somewhat expensive alternative for most investors, especially given the relative inflexibility and lack of true diversification achieved.

Exhibit 2 summarizes the benefits and considerations associated with exchange funds. As a general comment, these funds may be a viable alternative for investors with long time horizons and who hold other assets with which to create more truly diversified portfolio, but they tend to be better deals for the firms that offer them than for the investors who participate in them. Investors should probably not dedicate a significant percentage of their underlying concentrated stock to these strategies. There are other alternatives available that offer more flexibility, more control, and lower fees.

Collars and Variable Prepaid Forwards (VPFs)

The structure and mechanics of collars and VPFs have been described extensively elsewhere (see Welch [2000], Welch [2001], and Kiefer [2000]), and both strategies represent slight variations on a common theme. Using (typically) OTC options, the investor purchases a put option from a financial institution (which provides downside protection on the stock) and partially or completely finances this protection by selling a call option at a higher strike price back to same financial institution (thereby limiting the amount of upside growth retained). The result is a locked-in "range" of value for the shares over the life of the trade (typically two-seven years), defined by the respective put and call strike prices.

Once the shares have been protected, they become very secure as collateral, and the same bank that executed the "hedge" is willing to offer a loan or cash advance against that protected position at a comparatively attractive rate. The result is that the investor can protect the value of the underlying position and generate immediate liquidity without selling the shares for tax purposes. These strategies do not eliminate the tax consequences of selling, but they do allow for a deferral of these taxes until the maturity of the trade (and possibly longer).

The nature and amount of that cash advance depends on the structure of the trade. With a collar, the advance represents an actual loan against securities (albeit protected securities), and as such is subject to regulatory restrictions. If the loan is taken for reinvestment back into marketable securities (a "purpose" loan), then the bank is limited to lending a maximum of 50% of the market value of the stock.

With a VPF, the cash advance is not a loan, but rather a discounted cash advance against the forward sale of securities. As a result, the advance rates tend to be much higher (usually somewhere between 75%-90% of the market value of the stock, depending on the structure and maturity of the trade), and there are no restrictions as to how the money can be reinvested. VPFs usually make more sense, then, for investors seeking the maximum amount of up-front liquidity for reinvestment into a diversified portfolio. Since there are only two cash flows in a VPF (the initial advance to the client and repayment at maturity), they may also make more sense for investors seeking to generate a lifestyle income off of the reinvestment portfolio (because there is no drag on the portfolio from ongoing interest expense).

VPFs are also the hedging strategy of choice in two specific investor situations:

1. When the concentrated stock investor is an affiliate or insider of the underlying company. In December 1999, the SEC issued a "no action" letter that the market has widely interpreted as laying out a "roadmap" for how to hedge affiliate shares using a VPF. The resulting structure makes it easier to manage any Section 16 (insider trading) risks while maintaining the tax deferral benefits.
2. Many investors took out straight margin debt against their stock positions, which was a cost-effective way of generating liquidity from the stock without selling—as long as the stock price held up. With the collapse of the market over the past year, many of these investors found themselves facing margin calls—and frequently were forced to sell the stock at unattractive prices in order to meet those calls. As an alternative to selling, VPFs allow these investors to a) put a hard floor under their stock price, b) generate enough proceeds to refinance the outstanding debt (at an attractive rate of interest), and c) continue to participate in some degree of any recovery in the stock price.

Collars and VPFs tend to be attractive for investors who remain bullish on the future performance of the underlying stock, but who recognize that they are too concentrated in one position. These strategies offer many of the benefits of both selling and holding onto the stock—the removal of downside risk and immediate liquidity of selling, and the upside growth retention of holding. These strategies are also popular with investors who wish to retain full control of both the stock and the corresponding reinvestment portfolio. Finally, because of flexibility with respect to how the trades are settled at maturity, investors are not locked into selling the shares—they have the ability to roll into a new trade or simply cash settle and retake possession of the shares.

Collars and VPFs may not be the disposal strategy of choice for everyone, however. They do involve the use of leverage (albeit "protected" leverage); the investor needs to believe that the combination of the performance of the underlying stock and the performance of the reinvestment portfolio will exceed the implicit cost of financing. If the price goes down after the stock is hedged, they can prove to be fairly expensive alternatives to selling.

Because these strategies involve over-the-counter options, they are highly regulated, and only sophisticated and "accredited" investors should be allowed to enter into them. Further, they are fairly complex from a tax perspective, and investors should retain independent tax counsel (and SEC counsel as well if they are affiliates) to review and advise on the transactions before they are entered into.

Exhibit 3 summarizes the benefits and considerations associated with hedging and liquidity strategies. In general, they are appropriate for sophisticated investors seeking maximum control over their assets, maximum flexibility, and retention of growth on their stock. They are probably not appropriate for less sophisticated investors who are less optimistic about the future of the stock,

EXHIBIT 3
Collars and VPFs

Benefits	Considerations
• Downside protection	• Involves the use of leverage
• Immediate liquidity for diversification	• Counterparty risk
• Retention of growth in the stock	• Tax complexity
• Tax deferral	• Straddle rules
• Flexibility	• No charitable result
• Control	
• Retention of ownership	

who have very long investment horizons, or who have immediate charitable intentions for their stock position.

CHARITABLE DISPOSAL TECHNIQUES

The three strategies discussed so far are useful in helping investors achieve *financial* goals, but none of them has any direct philanthropic implications, and this is an important consideration for many investors. For charitably inclined investors, other alternatives must be explored, and three of the more popular ones are 1) charitable remainder trusts (CRTs), 2) private foundations, and 3) donor advised funds. As with financial strategies, each of these alternatives may be appropriate for certain investor goals and situations.

Charitable Remainder Trusts (CRTs)

CRTs fall into a broader category of "split interest trusts" in that there are two or more beneficiaries to that trust. As applied to the disposal of low basis stock, a CRT is usually implemented as follows. The holder of the low basis stock creates the CRT and irrevocably gifts the stock into the trust. The trustee of the CRT will then liquidate the shares. Because the CRT is a charitable entity, this sale is exempt from immediate tax consequences. The proceeds of the sale are then invested into a more diversified portfolio. Because there are no taxes involved, 100% of the market value of the stock can be put back to work in the reinvestment portfolio.

The CRT then pays to one or more *beneficiaries* (usually the original donor of the asset or related family members) an annual amount that is a function of the nature of the trust. Most frequently, the CRT is established as a charitable remainder *unitrust*, in which the annual payment made to the beneficiary is a fixed *percentage* (e.g., 8%) of the market value of the assets in the trust, recalculated on an annual basis. The beneficiary is taxed on this income based on a four-tiered characterization of how that income is generated (ordinary income, capital gains, tax-exempt income, and return of original principal). In other words, the sale of the donated asset is taxed over time as the beneficiary pulls income out of the trust, so tax is deferred but not eliminated.

Since the market value of the trust portfolio fluctuates with market conditions, the annual payment to the beneficiary also fluctuates, but the general idea is that the donor has gifted his/her shares into the CRT in exchange for an annual cash flow that is used to support the beneficiary's lifestyle. There are regulatory restrictions as to how high of a percentage the investor may seek to pull out on an annual basis, in order to maintain the charitable intent of the original gifting of the shares.

Upon the death of the donor, or a defined time period (not to exceed 20 years), whatever assets are left in the CRT portfolio will flow directly to the *charitable remainder*—the charity identified when the CRT was established. Once established, the CRT is irrevocable, though the donor can switch charities if desired. The donor cannot, however, terminate the CRT itself and pull the assets out.

Because of this ultimate contribution to a charitable entity, the initial gifting of the low basis assets into the trust results in a charitable deduction for the donor. Because the beneficiary of the trust takes out some percentage of the overall value of the gift over the life of the trust, however, the deduction is not dollar-for-dollar equal to the value of the stock that is gifted. Rather, the two separate interests in the trust (the interests that flow to the beneficiary and the interests that flow to the charitable remainder) are each valued at the time the CRT is

EXHIBIT 4
Charitable Remainder Trusts

Benefits	Considerations
• Charitable outcome	• Irrevocable
• Immediate income tax deduction	• Somewhat inflexible
• No leverage	• Fairly high maintenance and oversight required
• Diversification	• Loss of control over the assets
• Provides a tax-efficient income stream for the beneficiary	• Charity may end up the primary winner

created, using IRS-provided actuarial tables. The amount the donor of the low basis stock may deduct for income tax purposes equals the market value of the donated assets minus the present value of the "beneficiary interest." This income tax deduction may be realized over as long as five years, if appropriate.

Because of the split interest nature of the CRT, it represents somewhat of a hybrid between an outright sale and an outright charitable gift, and captures many of the benefits of both strategies. The donor of the low basis stock disposes of the asset in a very tax efficient manner and indirectly invests in (and benefits from) a more diversified portfolio. At the same time, this donor realizes an immediate income tax charitable deduction and, ultimately, will be making a substantial gift to a favored charity.

As with all strategies, however, there are issues to consider. Once established, the CRT is irrevocable and the donor of the stock no longer controls that stock—it is, in fact, removed from the estate of the donor. So the donor will receive no further benefit from any future price increase in the donated stock.

In addition, despite the tax deductions resulting from the donation, the donor should be truly charitably inclined, and not just seeking to use the CRT as a tax management ploy. This is because, if the reinvestment portfolio performs very well, the primary recipient of that performance will not be the beneficiary but the charitable remainder. The annual payments made to the beneficiary will increase as the portfolio value increases (assuming the trust is structured as a unitrust), but most of the increased portfolio value will flow through to the charity upon termination of the trust or death of the donor.

The reverse, of course, is also true. An investor who wished to gift a certain amount of money to a favorite charity may be disappointed if the reinvestment portfolio does not perform well.

Those investors motivated primarily by the tax deferral and income tax deductions aspects of the CRT need to analyze when the CRT will add value in comparison to an outright sale of the stock. Roy Adams and Glenn Kurlander summarize this analysis very well: "As an economic matter, the grantor [to a CRT] will benefit only if the sum of (1) the present value of the income tax deduction, plus (2) the present value of the annuity or unitrust payments exceeds the after-tax proceeds the grantor would realize if he (she) simply sold the securities and paid the capital gains tax" (see Adams and Kurlander [2001]).

Exhibit 4 summarizes the benefits and considerations of CRTs. As a general comment, this disposal technique may be appropriate for charitably minded investors seeking a tax efficient sale of their low basis stock. CRTs are useful for creating a reasonably safe, tax-efficient income stream for the beneficiary, but because the primary "winner" in the strategy is usually the charity, CRTs should probably not constitute an overlarge percentage of the investor's overall portfolio (unless the donor planned to leave most of his/her net worth to charity anyway).

Private Foundations and Donor-Advised Funds (DAFs)

Increasingly popular, private foundations and DAFs represent slight variations of a pure charitable gifting of the low basis asset. In both cases, the investor receives a charitable deduction for the gift, but otherwise receives no economic benefit.

As described by Paul Rhoads and Stephanie Denby, a private foundation (PF) is a "tax-exempt, not-for-profit entity established as either a corporation or trust for the purpose of supporting other qualified charitable organizations…it typically is established and funded by a single source, consisting of an individual or family, and is operated by a board of directors or trustees for stated purposes that are spelled out by the donor in the governing instrument" (see Rhoads and Denby [1999]).

Though established for philanthropic purposes, a PF offers the donor far more control over the gifting process than an outright donation of the asset. Typically, if a PF is initially funded with a low basis asset, that asset will be sold immediately (tax-free), and the proceeds will be reinvested in a diversified portfolio. The PF, acting through its Board or Trustees, will then make grants out of the PF to one or more charitable causes, as defined in the PF charter. Frequently, the original donor of the asset will reside on the Board of the PF, or act as a trustee, and he/she therefore can exert considerable control over how the money is spent.

Further, the donor can appoint or hire children and family members to the PF, thereby creating an environment for heirs to learn about philanthropy and the responsibilities of wealth (and possibly pay them a salary while doing so).

In terms of a charitable deduction, the tax laws actually favor direct gifts to public charities versus gifts to PFs. Cash contributions to PFs are deductible in an amount of up to 30% of the donor's adjusted gross income (AGI) in the year of the gift, while direct contributions to charities are deductible up to 50% of AGI. Contributions of low basis stock or property are deductible only up to 20% of AGI when donated to a PF, compared to 30% for public charities.

In practice, however, the charitable deduction is an important but not overriding reason for establishing a PF. What the donor is seeking, frequently, is a means of "putting his/her stamp" on a charitable endeavor, of including family members in that endeavor, and of perpetuating a legacy after they are gone.

DAFs are a similar concept, but the gifting of the low basis asset is not made to a family-specific organization established for that purpose. Rather, the donor gifts the assets to a "host organization" established to accept gifts from multiple donors. Historically, DAFs tended to be community-sponsored, and were an attempt to coordinate charitable giving within a given region. One of the fastest growing trends today, however, is national level DAFs sponsored (or supported, in the case of "private label" DAFs) by large mutual fund companies and investment management firms, such as Fidelity, Charles Schwab, Vanguard, T. Rowe Price, and Eaton Vance.

DAFs are, in essence, "commingled" pools of the charitable gifts of many investors. A donor might gift a low basis asset into the DAF, which would sell the securities (tax-free) and add the proceeds to the overall investment pool of the fund, which is typically managed to achieve a specified rate of return (e.g., conservative or aggressive). The donor can then *suggest* how the DAF make charitable gifts out of that pool (hence the name "donor advised"). The fund is not obligated to follow the suggestions of the donors, but as long as the charity named by the donor is an eligible and legally organized public charity, it would be rare for the trustees of the fund not to follow the donor's suggestion.

DAFs have several characteristics that may make them very attractive alternatives to PFs. DAFs have no start-up costs, and the establishment of a fund within the host organization takes a matter of minutes. Also, there is no obligation to immediately name the recipient of the charitable gift. In other words, donors can gift low basis shares into a DAF, generate an immediate charitable tax deduction, but then take their time in determining how that gift should be allocated.

Further, gifts into a DAF can be made anonymously, whereas PFs are required to file public records of all grants and gifts on an annual basis. PFs also are required by law to expend at least 5% of the foundation's net asset value on an annual basis—this requirement does not exist with DAFs. PFs also incur a 1% -2% excise tax on any investment income earned by the foundation—not so with a DAF.

Finally, the charitable deduction allowed for gifts to a DAF actually exceeds those for a PF. Cash contributions to DAFs are deductible up to 50% of AGI (compared to 30% for PFs), and contributions of low basis assets are deductible up to 30% of AGI (compared to 20% for PFs).

Exhibit 5, taken from a book published by the National Center for Family Philanthropy (see Foote [2000]), compares donor advised funds to private foundations. In general, DAFs are more flexible, less expensive to set up and maintain, offer a better income tax deduction, and will be a better alternative for investors who, while seeking to make charitable gifting a part of their lives, do not wish to devote all or a significant part of their daily lives to doing so. Private foundations offer the advantages of more control over the gifting process, a way of bringing family members together in a charitable endeavor, and establishing a public legacy organization for the donor, who typically plans to devote an increasing amount of time in the management and ongoing operations of the foundation (e.g., retirees).

EXHIBIT 5
Comparing Donor-Advised Funds and Private Foundations

Management and Other Issues	Donor-Advised Funds	Private Foundations
Control of grants and assets	Donor may recommend grants and investments, but the host organization makes all final decisions.	Donor controls all grant making and investments.
Excise taxes	None	Excise tax of 1% to 2% of net investment income annually.
Required payout	None	Required to expend 5% of net asset value annually, regardless of how much the assets earn.
Privacy	Names of individual donors can be kept confidential if the donors wish.	Required to file detailed tax returns on grants, investment fees, trustee fees, staff salaries, etc., which are public records.
Liability and insurance	Covered by the host organization.	Trustees are responsible for any coverage they deem necessary.
Investment, accounting, audit, and tax return	Host organization handles all investment, files annual tax return, obtains annual independent audit, and sends donors regular financial reports; host organization controls the endowment.	Trustees are responsible for ensuring that these functions are performed; donor controls endowments, sets policy, and chooses the investment managers.
General administration	Host organization handles all financial and administrative management.	Trustees are responsible for ensuring that these functions are performed.
Grant administration	Donor can recommend potential grantees or ask the host organization to suggest them.	Trustees are responsible for ensuring that these functions are performed.
Succession	Some host organizations encourage the continuance of donor-advised funds from one generation to the next. The IRS is still considering succession issues.	Opportunities for board training, succession, and bringing in the next generation are greater.
Perpetuity	Most donor-advised funds revert to the host organization after their original donors or the two succeeding generations die.	Foundations can exist in perpetuity.
Costs	Varies with organization and level of services.	Depends on how much the trustees wish to spend on administration and other activities.

SUMMARY AND CONCLUSIONS

No one disposal technique is the preferred alternative in every situation. The investors' tax situation, investment objectives, time horizon, and charitable inclinations all must be taken into consideration. Frequently, the best course of action is a combination of techniques—for example, a combination of completion fund, hedging, and CRT for investors with modest charitable inclinations who seek tax-advantaged diversification and a subsequent lifestyle income from the reinvestment portfolio. Or perhaps a combination of hedging and donor-advised fund for a charitably inclined investor who remains bullish on the future performance of the underlying stock, but recognizes the need for diversification.

EXHIBIT 6
Comparing the Techniques for Disposing of Low Basis Assets

Feature Product	Collars/ VPFs	DAFs and PFs	Exchange Funds	Completion Funds	CRTs
Maintain Control of Asset?	Yes	No	Partially	Yes	No
Protect Value of Stock?	Yes	No	No	No	No
Generate Liquidity for Reinvestment?	Yes	No	No	Yes, over time	Yes
Participate in Growth of Stock?	Yes	No	Yes, to a degree	Yes	No
Philanthropic Result?	No	Yes	No	No	Yes
Charitable Tax Deduction?	No	Yes	No	No	Yes
Financing Cost?	Yes	No	Yes, if leveraged	No	No
Management Fee?	Yes	Yes	Yes	Yes	Yes
Flexible?	Yes	Yes	No	Yes	No
Revocable?	Yes	No	No	Yes	No

Exhibit 6 summarizes many of the characteristics of the various disposal techniques for low basis assets. This matrix can be used in combination with a thorough knowledge of the investor to formulate the overall disposal strategy that will most closely meet that investor's goals and objectives, thereby adding value to and strengthening the relationship with that investor or family.

ENDNOTE

*This discussion focuses on public, multi-client exchange funds, which are the most common form of this strategy. The author is aware of several firms that offer private, single-client exchange funds that involve the use of different techniques to largely mimic many of the benefits of public funds, while avoiding several of the pitfalls.

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