Donor Advised Fund or Private Foundation?

The United States is a country with significant wealth. A recent study revealed that about 10 million American families have a net worth of $1 million or more. That same study showed that over 100,000 of those families have a net worth of $25 million or greater.

With this increase in wealth, more Americans are now looking for ways to get involved in philanthropy. Traditionally, it was common for wealthy families to establish private foundations as a means to achieve a philanthropic legacy. Today there are over 90,000 private foundations holding more than $600 billion in assets. While private foundations have proven popular with wealthy donors who desire control over their philanthropy, they come with disadvantages.

For many donors, a donor advised fund is a simpler and easier way to be philanthropic while still maintaining some level of control. Today, the donor advised fund has become one of the most popular charitable giving vehicles. In 2012 there were more than 200,000 donor advised funds holding $45 billion in assets. Since then, the number of DAFs and assets under management have experienced substantial growth.

What are the advantages and disadvantages of donor advised funds as compared to private foundations? An analysis of these differences enables professional advisors and donors to choose the charitable giving vehicle that best allows them to achieve their personal, financial and philanthropic goals.

Donor Advised Funds

A Donor Advised Fund (DAF) is a fund created by a donor who transfers complete control of the fund assets to the charity. However, while a donor transfers complete control of the assets to charity, he or she also retains the ability to recommend distributions from the fund. These recommendations are usually followed, especially because the donor will typically make additional gifts to the fund in subsequent years. Thus, the donor is able to have a family fund that is controlled by a charity and entitled to all of the public charity income, gift and estate tax benefits.

DAF donors and their family maintain a significant level of involvement in the fund and also influence the distributions from the fund. Most DAF's also provide children with an opportunity to make recommendations after the demise of the parents.

For the first time, the Pension Protection Act of 2006 provided a definition of DAFs and implemented rules governing their operation. A DAF has three specific requirements. First, it must be separately identified. Second, it must be owned and controlled by the sponsoring charity. Third, the donor must have a reasonable expectation of advisory rights. If all three apply, the DAF is subject to various requirements and a number of prohibitions. Sec. 4966(d)(2)(A).

The concerns of those who are considering a DAF relate to visibility and control. While the DAF can indeed have a family name attached to it, this does not provide the same level of recognition and visibility as a named private foundation. In addition, while public charities are typically very responsive to donor desires, DAF distributions are ultimately in the control of the public charity.

Private Foundations

Unlike a DAF, a private foundation (PF) is an independent entity organized under Sec. 501(c)(3) that does not qualify as a public charity. This is because a PF receives its funds from a small number of sources, typically a single individual, family,

or corporation, as opposed to the general public. Due to this distinction, PFs are subject to greater oversight and stricter operational constraints. In part, this is due to a presumption that it is easier to circumvent the rules that apply to charitable activity when a charity is controlled by a family or small group of people as opposed to those charities that are in the public eye or funded by a broad group of public donors who may keep the charity accountable for its activity and use of money.

PFs fall into one of two categories: private non-operating foundations and private operating foundations. Non-operating foundations are considered traditional PFs because they do not engage in charitable activities directly, but instead make grants to organizations directly involved in charitable activities. In contrast, an operating foundation directly engages in charitable activities.

Tax Benefits of DAFs and Private Foundations

One of the most significant differences between DAFs and non-operating PFs relates to the tax benefits for charitable contributions. Donors who make contributions to public charities are able to take a deduction subject to the deduction limits of 30% of their contribution base (typically AGI) for appreciated property and 50% for cash. The donor is allowed the same deduction limits for gifts to DAFs. In contrast, donors who make gifts to PFs are able to take a deduction subject to less favorable limits of 20% for appreciated property and 30% for cash. The limits for DAF and non-operating PF gifts are listed in the table below, along with valuation limits for gifts to PFs.

Deductibility of Gift	**Private Foundation**	**Public Charity/DAF**
Cash and Ordinary Income Property	Up to 30% of AGI	Up to 50% of AGI
Capital Gain Property	Up to 20% of AGI	Up to 30% of AGI
Value for Deduction Purposes	Fair market value deduction for gifts of cash and most publicly held stock. Otherwise, deduction limited to basis.	Fair market value deduction for donated asset.

Because of the more favorable deduction limits for gifts to DAFs, donors with substantial AGI may prefer to make contributions to DAFs. For example, consider a donor who has AGI of $2 million and who makes a $1 million cash gift to a PF. Because of the 30% AGI limit for cash gifts to PFs, the donor is only able to take advantage of $600,000 of the $1 million deduction in the current year. However, if the donor were to make his gift to a DAF, the donor can deduct $1 million in the year of the gift. However, a donor may carry forward any unused deduction for up to five additional years.

Though the more restrictive AGI and valuation limits on gifts to PFs may pose a problem, some donors choose to combine gifts to a PF and DAF in order to maximize their philanthropic and deduction potential. For example, a donor could choose to give $600,000 to his PF and the remaining $400,000 to his DAF, which would allow him to reach his 50% AGI limitation for cash gifts.

Operational Considerations

Perhaps the biggest difference between DAFs and PFs relates to the extensive rules governing PFs in Sections 4941 through 4947 of the Internal Revenue Code. PFs are subject to self-dealing, minimum distribution requirements, excess

business holding requirements and expenditure responsibility. Compliance with these requirements can require a considerable amount of time, effort and expense. However, after the Pension Protection Act of 2006, DAFs are now also subject to a number of additional rules regarding their use. Several of the operational differences are discussed below.

Management

Each PF will have a governing board of directors and trustees who are responsible for ensuring the foundation operates properly. A helpful resource is the Council on Foundations, which has provided some best practices regarding foundation management on its website. Because DAFs are not separate legal entities, their management is governed by the organization maintaining the fund. Accordingly, the establishment of a DAF reduces the time and effort a donor must expend in managing and selecting a foundation's governing board and trustees. It is important to note that PFs are subject to the self-dealing and disqualified person rules. As such, this may prevent disqualified-person managers from being involved in some foundation decisions.

A PF must distribute at least 5% of its total assets each year for charitable purposes. Distributions that count toward the 5% minimum distribution requirement are known as "qualifying distributions." Reasonable and necessary administrative expenses are qualifying distributions. Generally, distributions to public charities, including donor advised funds at public charities, are proper qualifying distributions. Distributions to nonprofit organizations that are not public charities (including other private foundations) require that the private foundation exercise expenditure responsibility. Distributions to individuals and foreign charities may be qualifying distributions but only if specific conditions are satisfied.

If the foundation does not make the required minimum distribution, it could be subject to a 30% excise tax on undistributed amounts, which can rise to 100% if not corrected after two years.

DAFs are not subject to any distribution requirement, though it is recommended that a DAF make periodic grants. Most DAFs make grants significantly in excess of 5% of assets each year.

A final benefit of a PF is that upon termination the PF's remaining assets can be contributed to a DAF. The reverse of this option, where DAF assets are transferred to a PF, is generally not available.

Disqualified Persons and Self-Dealing

Both PFs and DAFs are subject to rules regarding disqualified persons. The definition of who is a disqualified person with respect to PFs and DAFs is found in Sections 4946 and 4967, respectively. Generally, the definition of a disqualified person for both PF and DAF purposes includes, but is not limited to, the donor and family members of the donor. While the definitions may be similar, the rules apply to PFs and DAFs differently.

First, nearly all direct or indirect transactions between a PF and a disqualified person are prohibited as acts of self-dealing. Sec. 4941. Acts of self-dealing are subject to an excise tax on the disqualified person. Sec. 4941. However, there are a number of exceptions to the self-dealing rules. Reasonable and necessary compensation to a disqualified person is not self-dealing and a PF's providing a disqualified person with an incidental benefit will not in and of itself disqualify the transaction as self-dealing. Reg. 53.4941(d)-3(c)(1). This permits a PF to employ the donor or family members of the donor, provided that the compensation is reasonable under a fair market value standard. DAFs do not have a similar exception and are prohibited from paying any salary to disqualified persons, even if it is reasonable and necessary. Sec. 4958(c)(3)(a).

While a DAF is prevented from paying compensation to a disqualified person, it is not prevented from selling DAF assets to a disqualified person so long as the sale is at fair market value. Sec. 4958(c)(2). Otherwise, the sale is an excess benefit transaction and the transfer is subject to an excise tax. Sec. 4958(c)(1). The self-dealing rules prevent a PF from engaging in a similar transaction even if the sale was reasonable and at fair market value because it would be unlikely for the incidental benefit exception to apply. Reg. 53.4941(d)-2 and 53.4941(d)-3.

As can be seen, the disqualified person rules for DAFs and PFs create some interesting situations for donors. Some acts that are allowed for DAFs are prohibited for PFs and vice versa. Therefore, it is incumbent on a donor and their advisor to be familiar with how the rules operate in order to avoid prohibited acts.

Investments

A DAF relieves a donor of the responsibility of managing and overseeing the investments of the fund, which is instead handled by the sponsoring charity. For investment-savvy donors, some sponsoring organizations allow them to recommend how fund assets are invested within a pool of investment options. It is important to note that after the Pension Protection Act of 2006, DAFs are now subject to the excess business holdings rules of Sec. 4943. This may impact some of the assets a donor gives to the DAF and how long the DAF may hold onto those assets.

For many PFs, the biggest problem is the lack of expert investment, accounting and grant-making capabilities that can be found in large institutions maintaining DAFs. For more modestly-sized PFs, the earnings of the foundation typically will not permit employing full-time experts in these areas. Thus, many modestly-sized PFs are run by family members as volunteers with occasional assistance in the investment and accounting areas. These family foundations face operational challenges in effectively managing and distributing assets.

PFs are also subject to other rules that make them less attractive to donors. Under Sec. 4944, a 10% excise tax is imposed on each jeopardizing investment of a PF. A PF also must abide by the excess business holdings rules of Sec. 4943 and distribute at least 5% of its total assets each year. Finally, while pending bills may reduce the future excise tax to 1%, at publication date most PFs pay a 2% excise tax on net investment income, which can be reduced to 1% if certain requirements are met. Sec. 4940(e).

Compliance Requirements

A PF also has more extensive filings and tax return information than compared to the DAF. Examples of possible filings include: Form 990-PF, excise tax returns, gift receipts and Form 8283. A PF's tax returns are pubic record, so donors who are interested in privacy may prefer DAFs, which as part of a sponsoring organization do not have separate filings, although the sponsoring organization often imposes some fees on the DAF to cover compliance costs.

Control and Legacy Planning

Many donors want as much control and influence as possible over their philanthropic goals. PFs are good charitable vehicles to provide donors with direct involvement in their philanthropy. A donor may be directly involved in the management, grantmaking and activities of a PF as a trustee or member of the governing board. On the other hand, a DAF offers a donor the option to direct multiple-year giving without the need to stay as involved. Ultimately, though, while the DAF allows a donor to make recommendations as to the investment and distribution of assets, the sponsoring

organization retains the final authority on such matters.

PFs also provide donors an opportunity to create a legacy for themselves and their family. A donor's family may maintain influence and control over the PF even long after the donor has passed away. In contrast, many charities sponsoring DAFs have policies limiting the length of time successor family members can have advisory privileges with respect to distributions.

The potential for greater family involvement exists with PFs. Not only could a family member serve as a trustee or a board member of a PF, but family members could also be hired staff, so long as their compensation is reasonable so as to avoid acts of self-dealing. With a DAF the donor does not have direct control over whether family members could serve as trustees or board members of the sponsoring organization. In addition, the disqualified person rules for DAFs prohibit the payment of any compensation or reimbursement to family members of the donor.

One of the key considerations in selecting a PF or DAF is the charitable purpose of the donor. Both PFs and DAFs are long-term charitable entities. After two or three generations of family involvement, many PFs and DAFs are controlled by a nonfamily board with minimal connection to the original donor. If the donor prefers to fund a specific charitable field of interest, then a DAF with that type of public charity is most likely to be consistent with that purpose. One hundred years after funding, a DAF with a university will support education or a DAF with a medical research organization will support medical research. After one hundred years, a nonfamily PF board may support general public interest projects that could be very different from the donor's original charitable purposes.

Conclusion

Whether a donor should establish a PF or DAF ultimately depends on the personal, financial and philanthropic goals of the donor. Donors who plan to contribute significant sums, such as $20 million or more, may find that a PF is a good option. In this instance, the PF will have the resources to hire the staff and experts necessary to handle the investment, management and required filings of the PF. As an added benefit, the donor has access to the control, influence and legacy that comes with a PF.

However, for those donors looking to contribute perhaps $10,000 to $1 million or more, the DAF provides an easier and simpler way to achieve financial and philanthropic goals. Of course, each donor's situation is unique, and a professional advisor should be prepared to discuss the differences of DAFs and PFs so that their client can make an informed decision regarding their philanthropic legacy.

Endnotes

i. TIME Magazine, "U.S. Millionaires Club Grows to Almost 10 Million," available at *http://time.com/23764/u-s-millionaires-club-grows-to-almost-10-million/*.
ii. Id.
iii. Internal Revenue Service, "Domestic Private Foundations, Tax Year 2010," available at *http://www.irs.gov/pub/irs-soi/2010PrivateFoundationsOneSheet.pdf*.
iv. National Philanthropic Trust, "2013 Donor Advised Fund Report," p. 4, available at *http://www.nptrust.org/daf-report/pdfs/donor-advised-fund-report-2013.pdf*.
v. Council on Foundations, "Stewardship Principles," available at *http://www.cof.org/resources/stewardship-principles*.
vi. Sec. 4944 provides a definition and several examples of "jeopardizing investments."

Published October 1, 2014