Donor Advised Funds
vs.
Private Foundations:

A
Comparison

Thomas D. Peebles, Jr.
Carnahan, Evans, Cantwell & Brown, P.C.

Presentation to Community Foundation of the Ozarks
Professional Advisors Council

November 6, 2012

[Note: The following outline is based primarily on an article written by Ruth Masterson and published by the Association of Small Foundations]

Donor Advised Funds and Private Foundations both offer tax deductions to individual donors for current donations, with the understanding that the donated funds will be used to make future grants for charitable purposes. Each is, in its own way, an excellent vehicle for philanthropic giving. But Donor Advised Funds and Private Foundations differ structurally and operationally.

Donor Advised Funds are funds held within and managed by another public charity (referred to as the "sponsoring organization" or "sponsoring charity"). Donor Advised Funds are particularly attractive for Community Foundations, but are also utilized by national investment firms (e.g., Fidelity Charitable Gift Fund), other public foundations or public charities that set up funds within their institutions to support their own charitable mission (e.g., universities and hospitals).

In contrast, Public Foundations are freestanding entities, usually corporations (occasionally Trusts), and must apply for and obtain their own tax exempt status. As a result, a Private Foundation comes with its own substantial responsibilities and requirements, as well as certain freedoms and the potential for greater control by the donor. Most Private Foundations are "non-operating" (i.e., their primary function is grantmaking). Private Operating Foundations are beyond the scope of the presentation. All Private Foundations are responsible for their own filings to government agencies, the most notable of which is IRS Form 990-PF. In addition, Private Foundations are subject to more stringent tax laws and regulations than public charities, including Donor Advised Funds.

The key differences between Donor Advised Funds and Private Foundations are as follows:

- Starting up: Sponsoring charities have the capacity to set up new Donor Advised Funds for donors quickly and generally at no cost. Although the creation of a new Private Foundation can be initiated promptly, the process of fully establishing it takes longer and, in most cases, requires the services of an attorney and accountant – with correspondingly higher costs. Because a Private Foundation is an independent entity, it must apply to the IRS for tax-exempt recognition, and the donor must make a number of structural decisions at the outset.

- Tax deductibility: Gifts to Donor Advised Funds or Private Foundations are both tax deductible, but there are different deduction limits against the donor's adjusted gross income (AGI). Gifts to Donor Advised Funds yield maximum tax deductibility to donors. For example, cash donations to Donor Advised Funds are deductible up to 50% of the donor's AGI, whereas cash donations to private non-operating foundations are only deductible up to 30% of the donor's AGI.

- Administration: Administrative tasks are a necessary part of grantmaking, from determining a grantee's tax status, to mailing checks, to filing annual information returns. Private Foundations must do the work themselves; sponsoring charities charge a fee (usually based on asset size) to handle all administrative tasks for Donor Advised Funds.

- In-house expertise: Sponsoring charities provide extensive expertise to Donor Advised Funds. To begin with, they have the capacity to assess whether a grantee is a public charity that is eligible to receive a grant. Community and public foundations know their community or issue area well and can provide excellent information to the donor about strategic or effective grantees. In contrast, Private Foundations typically need to hire consultants to provide expertise, unless the individuals involved (such as board members or staff) bring these skills with them.

- Staffing: Private Foundations may hire their own staff, including family members (provided the hiring is done carefully to avoid violating self-dealing rules). Sponsoring charities staff Donor Advised Funds themselves, however, and the donor has no authority to hire and pay staff from the Donor Advised Fund account to manage the fund.

- Giving levels: Although there is no minimum annual payout requirement from Donor Advised Funds (except in accordance with the sponsoring charity's policy), there is a required level of annual charitable distributions from Private Foundations: a minimum payout in grants and reasonable administrative fees of 5% of the average value of the previous year's investment assets.

- Control: It is important for donors to Donor Advised Funds to understand that once they make the donation into the Donor Advised Funds, final selection of grantees is controlled by the sponsoring organization. Donors retain the right to advise, but not to control, gifts and grants from Donor Advised Funds, although donor recommendations are respected and usually followed. In contrast, Private Foundation directors or trustees do have final say over grant recipients and grant levels. In addition, although Donor Advised Funds are limited to granting to certain types of 501 (c)(3) public charities, private foundations have greater flexibility in grantmaking and may give to individuals (under certain restrictions and procedures for determining recipients) and to for-profit entities for charitable purposes (again, so long as certain procedures are followed). Pledges made by Donor Advised Funds also must be approved and administered by the sponsoring organization, whereas Private Foundations are able to make and fulfill pledges directly.

- Investment management: Donor Advised Funds are invested and managed as part of the sponsoring charity, and they therefore derive the benefit of the sponsoring charity's investment expertise and large investment pool. Donor Advised Fund holders typically choose from a few types of investment plans but do not otherwise determine how the assets are invested. Such policies vary among sponsoring organizations, however, with some inviting donors at certain giving levels to choose an investment manager for their Donor Advised Funds. In contrast, Private Foundations maintain full control over the management of their own investment portfolios.

- <u>Transparency and anonymity</u>: Although sponsoring charities and Private Foundations both file annual publicly available tax forms (Form 990 and Form 990-PF, respectively), giving through a Donor Advised Fund creates a greater degree of anonymity for donors who wish to remain anonymous.

  When an individual makes a gift to Donor Advised Funds, the donor or grantor is only identified on the recipient sponsoring organization's Form 990 when the amount of the gift exceeds the greater of $5,000 or 2% of the sponsoring organization's contributions reported for that year.

  When an advised gift is made out of the Donor Advised Funds, the sponsoring organization typically gives the Donor Advised Fund advisor the option of being anonymous to the recipient public charity.

  In contrast, donors who give $5,000 or more to Private Foundations are indentified by name on Schedule B attached to the Form 990-PF, and all grants that are made from the Private Foundation are also identified on the 990-PF. Therefore, donors to Private Foundations do not have the option of remaining anonymous, and Private Foundation grant payments are a matter of public record.

In consultation with his or her client, a professional advisor should cover certain questions in order to identify how the client might best use the charitable vehicles available. The following list below is not comprehensive, but key questions include:

- Does the client wish to use the fund to hire staff (including family) in order to pursue a charitable mission?

- Does the client wish to make grants to individuals, such as for hardship?

- Does the client wish to make grants to charitable projects being carried out by for-profits?

- Does the client want absolute control over investment management?

- Does the client want absolute control over grantmaking decisions?

- Is the client willing to meet a 5% minimum annual charitable distribution requirement?

If the answer to one or more of the above questions is an unequivocal "yes," and if the amount the client is willing to donate exceeds $1 million, it is likely that a client will benefit from allocating at least a portion of his or her dollars to a private foundation.

However, Donor Advised Funds remain a great solution to consider instead of, or in addition to, a Private Foundation. Additional questions, including those that follow, will help the professional advisor in making recommendations to the client:

- Does the difference in tax deduction limits against AGI make a difference to this client?

- Is reduction of initial setup costs a high priority?

- Is the individual prepared to select a board, operate a grantmaking program, and manage an organization or hire someone to handle these responsibilities on behalf of an entity?

- Does the client wish to remain anonymous with some or all grants?

- Does the client wish to highlight issue areas or legacies with name attribution?

- Does the client want the responsibility of ensuring that grantees or their projects are legally approved?

A professional advisor will listen carefully to the answers to these and other questions and gather as much information as possible to effectively assist their client. The professional advisor should assist in indentifying and prioritizing relevant factors, including the tax implications, remembering that every situation is unique to that client. The comparison chart attached highlights the differences between Donor Advised Funds and Private Foundations.