ROUND TABLE
WEALTH MANAGEMENT

CHARITABLE GIVING CONSIDERATIONS: DONOR ADVISED FUND OR PRIVATE FOUNDATION?

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For many wealthy families charitable giving and philanthropy are among their top financial goals. Aside from the simplest form of writing a check to a favorite charity, there are many other options and strategies to help high net worth families achieve their charitable goals. Two popular options are the donor advised fund (DAF) and the private foundation. But how does a family choose one of these over the other? Usually, the choice of vehicle depends on the specific circumstances of each family. The motivation for charitable giving may be personal, may be tied to creating a family legacy or may be related to the tax incentives available. This article discusses the basic characteristics of each structure, which must be considered in conjunction with your charitable goals and family situation to determine the appropriate charitable vehicle for your family.

CONSIDER THE FAMILY

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DONOR ADVISED FUNDS

A DAF is an account which is maintained and operated by a tax exempt organization, such as a community foundation, financial services company or an independent gift fund (also known as the sponsoring organization). An individual establishes their own account and has the ability to make grant recommendations to the sponsoring organization. Typically there is a relatively low minimum required to open a DAF account (about $5,000), and the fees can vary from national sponsors (lower fees) to Community Foundations (higher costs).

GRANT MAKING

A donor makes recommendations to the sponsoring organization to make grants to various public charities. There are usually minimum amounts per gift and sometimes a maximum number of gifts allowed per year, which will vary by sponsor. DAFs are best for straight-forward, routine donations to public charities that you would normally handle by writing checks directly to the organization. The advantage of a donor advised fund, as opposed to an outright gift to the charity, is that the donor can take an income tax deduction for the full amount of the gift (subject to income limitations discussed

below) and the one-time donation to the DAF can be spread out over multiple years and to multiple charities since there are no payout requirements in a DAF.

INVESTMENTS

The sponsoring organization usually offers a selection of investment options from a pre-selected list of mutual funds or pooled investment options specific to the provider. When a donor funds a DAF with assets other than cash, the donated assets are usually sold with no tax consequences to the donor. Although there may be brokerage fees associated with the liquidation, this a good way to give away low basis stock and avoid paying capital gains taxes on the sale. Some DAFs allow for separately managed investment accounts for asset values over a certain size. A separately managed account would be permitted to hold investments outside of the standard options offered by the provider.

TAX TREATMENT

Donations to DAFs are given similar tax treatment to donations made directly to other public charities. Donations are deductible in the year of the gift, subject to certain income limitations. Cash donations are deductible up to 50% of adjusted gross income or AGI[1], while long term appreciated securities and other long term appreciated assets are deductible up to 30% of AGI (usually at the fair market value of the contributed assets). Donations which would have otherwise been made over multiple years can be made in a single year in order to maximize the income tax deduction in a particular year.

ONGOING CONSIDERATIONS

After the DAF has been funded the ongoing requirements are minimal. The main considerations would be limited to additional contributions, direction as to grant recipients and investment considerations. There are no annual filings, tax filings, reporting requirements or ongoing administrative requirements associated with contributions to a DAF. This makes them more suitable to individuals or families who do not want to deal with the complexities of a private foundation.

PRIVATE FOUNDATIONS

A private foundation is a distinct legal entity set up by a family, an individual, or group of individuals, which may be organized as a trust or a corporation. In order to qualify as a tax exempt entity it is necessary for the entity to go through an approval process to receive 501(c)(3) status from the IRS. Unlike a DAF, there are administrative requirements to consider when establishing a private foundation. Annual tax filings are required and the foundation may be subject to an excise tax of up to 2% on its net investment income.

[1] Total income minus certain deductions

An additional requirement of private foundations is an annual payout of 5% of the value of the foundation's net investment assets.[2] The payout may include grants as well as administrative costs such as professional fees (excluding investment management), employee compensation, travel expenses, office supplies, and other costs incurred in carrying out the charitable purpose. The payout must be made by the end of the year following the year on which the 5% calculation is based. If excess amounts are distributed they may be carried forward for up to five years to satisfy future distribution requirements.

GRANT MAKING

A private foundation offers the grantor complete control over the grant making process. In addition to donations to public charities, the private foundation allows for scholarships, grants to individuals and families for emergencies or hardship, international grants and direct charitable activities. Private foundations may also allow for something called program related investments (PRI). PRIs are made to support charitable activities with the potential for return of capital to the private foundation within a specified time frame. PRIs often are accomplished in the form of loans or loan guarantees for charitable projects. A PRI can even involve an investment in a commercial venture for charitable purposes. Although the use of PRIs is not very common it is an example of the grant making flexibility allowed within a private foundation.

INVESTMENTS

The investment options in a private foundation are much broader than in a DAF. A private foundation can hold almost any type of investment including, cash, mutual funds, publicly traded stocks and bonds, private equity, hedge funds, real estate, private companies (closely held stock) and more. The foundation is required to follow the prudent investor laws in the state in which the foundation is organized (i.e., don't take extreme risks with the funds, diversify and invest the assets prudently). The foundation can choose investment advisor(s), custodians and investment strategies to meet its needs. Foundations should avoid investing with borrowed funds (a margin account) or investing in any structures which would cause the foundation to recognize unrelated business taxable income (UBTI)[3]. Both would cause a foundation to be taxed at for-profit income tax rates.

TAX TREATMENT

Donations to private foundations are subject to lower AGI limitations than donations to a DAF. Cash donations are deductible up to a limit of 30% of AGI, while long term appreciated assets are subject to a limit of 20%. The 20% limit is applied to the fair market value of long-term appreciated securities, but cost basis is usually used to determine deductibility for other long-term appreciated assets. For

[2] Net investment assets include investment assets (cash, stocks, bonds etc.) but not program-related investments or other charitable use assets which are used to carry out the foundation's mission.

[3] Unrelated business taxable income is the gross income derived from any unrelated trade or business regularly conducted by the foundation.

example, if a married couple with an AGI of $200,000 wanted to donate appreciated securities with a market value of $50,000 to their private foundation, their deduction in the year of the donation would be limited to 20% of AGI, or $40,000. They would be able to carryover the excess deduction of $10,000 to use over the next five years. In contrast, if the same couple donated the same appreciated securities to a DAF they would be able to deduct the full market value of $50,000 in the year of the donation since the limitation would be 30% of AGI or $60,000.

ONGOING CONSIDERATIONS

Besides the initial setup, which involves the drafting of legal documents and filing for tax exemption with the IRS, there are ongoing considerations related to administration, taxes and compliance for a private foundation. Annual tax filings (Form 990PF) as well as quarterly filings and estimated payments are required. If the foundation has paid employees there will be additional tax requirements.

Grant recipients must be reviewed in order to determine the status of each recipient organization. Procedures will need to be established for grant letters and notification of recipients. There are public disclosure requirements which must be met; specifically copies of certain tax documents must be made available to the public. Fortunately, there are services available that will handle most of these "back-office" tasks for an annual fee.

UNIQUE FEATURES

There are some features that are unique to private foundations that distinguish them from DAFs. Specifically, the private foundation allows for compensation of family members, selection of board members, donations to individuals, reimbursement of expenses, as well as broader investment options such as tangible assets and private equity. Many of these features are associated with control or flexibility and may be appealing to certain families based upon their goals and objectives.

DONOR ADVISED FUNDS		PRIVATE FOUNDATIONS
Account at a sponsoring organization	**STRUCTURE**	Independent legal entity
Requires sponsor approval No annual payout required Only to qualified charities	**GRANT MAKING**	At Board's discretion Annual 5% payout required Not limited to qualified charities
Limited to sponsor's offering	**INVESTMENTS**	Unlimited
Limited	**ONGOING CONSIDERATIONS**	Various(administrative, tax , legal)

A COMBINED APPROACH

In some cases there may be reason to use both a private foundation and a DAF. Gifts made by a private foundation are made public via tax filings and database services such as Guidestar.org and may lead to unwanted disclosure of information. If a private foundation were to make a grant to a DAF and then recommend a gift to a charity from the DAF the disclosure would be avoided.

Also, if a private foundation needs to meet its annual 5% payout requirement and is undecided about the recipient, the grant may be made to a DAF and held there until a recipient is chosen. This allows the foundation time to decide who the recipient will be while still meeting the annual payout requirements.

Another interesting aspect of the interaction between DAFs and private foundations relates to conversion. In most cases, a private foundation has the ability to be converted into a DAF, but a DAF cannot be converted into a private foundation.

RECENT DEVELOPMENTS

PROPOSED MINIMUM DISTRIBUTION REQUIREMENTS FROM DAFS

As mentioned above, private foundations have an annual payout requirement while DAFs do not. Recently the increase in amounts being contributed to DAFs has drawn the attention of Congress. There is a concern that funds that are placed into DAFs are not being disbursed out to charitable beneficiaries and instead being held (and invested) at the sponsor even though the donor is benefitting from the income tax deduction in the year of the initial gift.

In 2014 tax reform legislation was proposed by Representative Dave Camp (R, MI). The legislation included a requirement that all contributions to a DAF be paid out within five years of transfer to the DAF. In the past there has been talk of requiring a percentage payout each year, but the idea of having the entire amount paid out within a set time frame is something new. Those in favor of reform hope that requiring a payout will get money to the charities faster rather than sitting in an account generating investment management fees for the sponsoring organization. Opponents believe that the current rules lead to increased giving over time and reform could lead to more money going to private foundations.

PROPOSED LEGISLATION

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PROPOSED LIMITATION ON CHARITABLE DEDUCTION FOR HIGH-INCOME EARNERS

President Obama's Fiscal Year 2016 Budget includes a proposal which would limit the value of all itemized deductions, including charitable deductions, for high-income earners (defined for this purpose as married couples with income over $250,000 or individuals with income over $200,000). Specifically the proposal would limit the deductible value to 28% of income while the highest tax rate is 39.6%. For example, a couple earning $500,000 per year would be in the highest income tax bracket of 39.6%. Under current law, a taxpayer is allowed an itemized deduction for gifts to charity which effectively allows them a deduction equal to $0.39 for every dollar they give to charity. The proposal would limit this to $0.28.

Opponents of this proposal fear that such a limitation would reduce charitable giving significantly. Given the Republican majority in Congress, it is unlikely that this provision will pass; however, reducing the value of itemized deductions for high income taxpayers has been a recurring proposal of the current administration.

While these recent developments may not change your charitable goals, it is important to be aware of potential changes to the treatment of your donations.

FAMILY CONSIDERATIONS

Before choosing a charitable strategy for your family there are many things to consider. The type of assets and amount you wish to contribute may help determine what type of vehicle you choose since DAFs have more limitations on the type of assets they will accept. Control over investments and grant making decisions may also influence your decision. As mentioned above there is often a limitation on investment options in a DAF and the final say on grant making is determined by the sponsor. For some families this is not an issue, and they may be willing to sacrifice a certain amount of control for the convenience of a DAF.

Family involvement and duration of your philanthropic legacy should also be considered. Some families choose to set up separate DAFs for different generations; others may allow younger generations to recommend a few grants per year. DAFs allow for successor advisors to be named to step in when the current advisor has passed away. Of course, a private foundation may also be used to bring a family together to fulfill their philanthropic mission or goals and may allow for more control by the family than a DAF.

Some families use philanthropy as a way to get the next generation involved in charitable giving as a full-time endeavor. A private foundation allows for a family member to receive compensation as a trustee or board member. In addition, a private foundation allows board members to be reimbursed for expenses such as travel related to the foundation's charitable purpose. Donor advised funds do not offer the compensation aspects, which some families may find desirable.

CONCLUSION

Choosing a vehicle to achieve your charitable goals will depend on many factors. Personal motivations, the desire to create a family legacy, administrative issues and the tax incentives involved must all be considered. Every family is different, and it is important to discuss your charitable goals with your family members as well as your legal, tax and financial advisors before choosing a charitable strategy to fulfill your objectives.

ABOUT THE AUTHOR:

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