The Apples and Oranges of Charitable Giving

Private foundations and donor advised funds are both used to make gifts to public charities. They each provide contributors with current charitable income tax deductions even when final charitable gifts are made in future years. However, they differ greatly in terms of structure and operations. Some families decide to use one over the other; whereas, other families use both for specific purposes.

Historical Perspective

Private foundations have been popular for many years. In their current form, private foundations date back to 1969; however, they began to grow during the Gilded Age and grew even more popular after World War II. They remain popular, in part, because taxpayers can receive current charitable income tax deductions for future gifts to public charities.

Private foundations are often formed to receive gifts of highly appreciated stock. Years ago, Congress annually would extend the law that permitted taxpayers to receive charitable income tax deductions based on the fair market value of low basis stock given to a private foundation. The private foundation then could sell the stock without paying the high capital gains tax the taxpayer would have owed. Taxpayers benefitted from this combination of charitable deductions and capital gains tax avoidance.

Congress ultimately extended this benefit permanently and private foundations still are formed for these reasons. However, donor advised funds have become more popular in recent years due to their comparative ease of administration and operation.

This is not to say that donor advised funds are a brand new development either. The Cleveland [Community] Foundation celebrated its 100th anniversary in 2014, and the Chicago Community Foundation celebrated its 100th anniversary in 2015. Yet, the donor advised fund platform sponsored by investment firms has arisen more recently, within the past 20 years or so. So, why would someone choose to fund a private foundation versus a donor advised fund if both provide current tax deductions with future stewardship over charitable gifts?

Families can foster their charitable giving legacy in many ways, including the use of private foundations and donor advised funds. The choice of strategy is yours . . .

Comparing Apples and Oranges

A private foundation is established individually by the taxpayer as a separate entity which may be formed as a trust or as a nonprofit corporation. The taxpayer then remains responsible for the management and administration of this entity, including any filings which are not necessarily limited to tax returns. The taxpayer also remains responsible for the investment of all private foundation assets.

Private foundations often appeal to families who make larger gifts and who desire the greater level of control they can retain over their foundation and its operations. They also prefer to have complete and absolute control over all future charitable gifts made from their private foundation.

In return, private foundations are subject to more scrutiny by the IRS. That is, private foundations must follow specific rules that govern their operations or risk becoming subject to a variety of taxes. These rules include minimum annual distribution requirements (5% of net asset value) and an annual tax (1-2% of net investment income) that is used to defray the cost of this IRS oversight. Additional excise taxes are designed to prevent self-dealing and private benefit transactions between the foundation and its donor family.

Donor advised funds, on the other hand, are managed by a separate public charity such as a (1) Public Foundation (specific cause); (2) Community Foundation (Regional Causes); (3) Supporting Organization (Hospital or University) or (4) National Sponsor (Investment Firm). Because of this separate management, donor advised funds and their contributors are not subject to the higher level of scrutiny placed on private foundations. In return, however, contributors only can guide the choice of charitable gifts without technically having control over them. To their credit, though, donor advised fund managers solicit input on charitable gift preferences from their account contributors.

Donor advised funds often appeal to families who would rather avoid the startup (and continuing) costs of operating a private foundation. They also prefer the higher income tax deduction limits that apply to these funds as compared to foundations. Finally, they tend to appreciate the greater level of privacy and anonymity that is usually available to those who fund and operate a donor advised fund as compared to a private foundation. A chart comparing and contrasting some differences between a donor advised fund and a private foundation appears later within this discussion for your reference.

It's a Personal Choice

Many taxpayers decide whether to fund a donor advised fund or a private foundation simply by comparing the differences between them and choosing the structure that suits their own priorities.

Other taxpayers find a benefit to using both donor advised funds and private foundations as part of their long-term, family charitable giving legacy.

Here are a few examples we have seen that illustrate the use of both charitable giving vehicles:

Example 1. Clients wanted to obtain a tax deduction near the end of the year. Clients thought they ultimately would like to operate a private foundation to teach the importance of charitable giving to their children. With the current year almost over and their holiday travel plan pending, they decided to begin planning with a donor advised fund and then implemented a private foundation the following year. This secured their charitable deduction now and their legacy plan soon thereafter. Note that clients could not transfer the funds from the donor advised fund to the private foundation because their tax advisor explained this was not allowed under current law.

Example 2. Clients' parents created a family foundation to support their beloved New York community and other causes. Clients' parents later moved the family to southern California and all children (and grandchildren) now live there. They feel connected to their parents' other causes but never developed a connection to New York since they moved to California as children.

Clients used part of their private foundation assets to fund a donor advised fund that supports the New York community with the advice and management of local advisors who understand community needs and initiatives. They retained the balance of private foundation funds to support the other causes that remained dear to their parents and their family. Note that clients could transfer the funds from the private foundation to the donor advised fund because their tax advisor explained this was allowed under current law.

Example 3. Clients operated a private foundation but wanted to make certain gifts anonymously. The recipient organization would have honored their request, but clients did not want these gifts to be reported on the foundation's annual tax return which was subject to public filing and inspection. Clients created a donor advised fund through which they made their gifts to chosen organizations anonymously. Note that donor advised funds have more flexibility when reporting funds donated to them as well as gifts made from them anonymously to charities. Although they file similar tax returns, the public inspection and reporting rules govern donor advised funds and private foundations differently.

COMPARING DONOR ADVISED FUNDS AND PRIVATE FOUNDATIONS

	DONOR ADVISED FUND	PRIVATE FOUNDATION
Tax Deduction Limit Cash Gifts	50%	30%
Tax Deduction Limit Publicly-Traded Stock	30%	20%
Tax Deduction Limit Other Appreciated Property	30%	20%
Administrative Control	Donor recommends grants Fund manager controls	Donor controls grant making and all operations
Privacy/Public Disclosure	Confidentiality for donors anonymous gifts allowed	Public disclosure required
Required Annual Distributions	None	5% of net asset value
Annual Excise Taxes	None	1-2% of net investment income
Self-Dealing Rules	Not Applicable	Apply
Annual Reporting	Part of consolidated report for all donor advised funds	Separate report filed by foundation
Liability Risk Insurance	Provided by fund manager	Purchased separately by foundation

Example 4. Clients operated a private foundation but wanted to give their new board members (grandchildren) a chance to grow into their management role through limited, separate and independent grant making.

Clients created and funded a donor advised fund. The grandchildren provided advice and input with respect to these expanded charitable gifts. The administrator of the donor advised fund helped the grandchildren feel independent while ensuring the gifts reached qualified public charities.

Example 5. Clients had operated a private foundation for years but had given away a substantial portion of its assets. As they aged, clients felt that they had accomplished their mission but no longer wanted to operate the private foundation. In essence, the annual administrative costs to operate the private foundation outweighed its ongoing benefits to them.

Clients created a donor advised fund to which they transferred the remaining assets of the private foundation. The donor advised fund continued to support the original mission of the private foundation without subjecting clients to the ongoing responsibilities and costs associated with their former private foundation. In this case, clients actually became more energized over their charitable giving because their focus returned to the gift giving legacy that originally prompted them to create the private foundation.

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