By **Robert T. Napier**

Private Foundations and Donor Advised Funds

Can two planning vehicles park in the same garage?

Donor advised funds (DAFs)[1] and private foundations (PFs)[2] are often compared and contrasted. Those making the comparisons often quickly conclude that a DAF is the better choice. More and more it seems that DAFs are becoming the reflexive recommendation of many advisors. Almost before a client describes her charitable desires—or how large the charitable funding will be—the advisor enthusiastically decrees, "The DAF is the right choice for you!"

Because advisors frequently refer to both DAFs and PFs as planning vehicles, it's helpful to look a little more closely under the hood of both alternatives. This topic is timely because some of the latest proposals from Washington seek to limit the benefit of itemized deductions to the 28 percent tax bracket.[3] If the value of deductions in the future may diminish, more clients will be intrigued by creating DAFs or PFs now.

On the Road

PFs seem like the cars America produced in the 1960s and 1970s. Those vehicles rumbled, dripped a little oil and guzzled a little too much gas. They had room for a family and possessed a unique brawny beauty. Cars like a red Ford Mustang, a metallic blue Pontiac GTO or a burnt orange Oldsmobile Cutlass 442 come to mind. These vehicles were meant to be driven and enjoyed.

Eventually, smaller, fuel-efficient cars would become popular and tour the highways of America. They were well-engineered, maneuverable, lighter and inexpensive to acquire and operate. Although very different from their predecessors, their economy and engineering gave them a beauty all could admire. Cars like the Toyota Corona, BMW 2002 and Datsun 240Z typify this kind of automobile. These cars were much like the modern DAF.

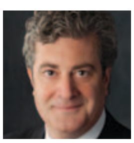
Today, DAFs and PFs are the charitable vehicles our clients use to travel and explore the tax and philanthropic highways. There are about 200,000 DAFs in the United States with an average account size of $225,000. There are about 80,000 PFs. Most PFs have under $1 million in assets, and about 6 percent of PFs have in excess of $10 million.[4] DAFs have approximately $45 billion in total assets, while PFs have over $500 billion.[5] These figures suggest that the DAF is, generally, the more popular choice for smaller contributions and that the PF is more intriguing for larger total contributions. So, which vehicle is right for which client?

A brochure from at least one prominent bank all but eliminates PFs from the realm of possibility and predetermines that the DAF is the only option. Is that the case? Are PFs an idea whose time has passed now that DAFs are being driven around the neighborhood? Certainly not. The PF has attributes that should make it a first choice for many. PFs offer unique advantages, and the disadvantages of PFs can be relatively minor.

PF Advantages

Most charitable clients are driven by more than just tax deductions and a desire to be charitable. They recognize that the legal entity of a PF requires some management and will incur some costs. Trustees or directors of the PF must confer, plan, strategize and review. It's their obligation. That dialogue is most valuable to matriarchs and patriarchs. All families prize harmony, and family dialogue can (but not always!) facilitate harmony.

While not all families will get along as the cheery Brady Bunch did road tripping in their Plymouth Satellite Wagon, having the PF as a vehicle to facilitate dialogue can go a long way in keeping the fam-



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ily engaged with each other. After all, the family is engaged over the positive, generous, even loving endeavor of making the world a better place. Let other families wrestle over perceived wrongs of Thanksgivings past.

From the advisor's perspective, it's heartwarming to see family interaction in these settings. From the family perspective, it's powerful to see children, perhaps in the environment of a boardroom, advocate for a meaningful charitable donation. The benefit of this type of experience for the next generation can be profound.

Perhaps you're thinking that a family can just as easily meet to discuss their DAF, and you would certainly be correct. But, is discussing the fiduciary obligations of managing a legal entity like a PF and its operations the same as discussing an account at an institution? For some it will seem the same, for others it won't be. Note also that there's a growing industry of consultants offering advice to public foundations and PFs. Undoubtedly, those consultants would be willing to aid donors of DAFs, but practically speaking, those donors are difficult for these consultants to identify.

Moreover, there's the economic and health reality of our modern world. Not every member of a wealthy family that wants a job has one. Many are under-employed. Not every member of that family is necessarily mentally or physically capable of retaining a job. A family member may be a stay-at-home parent or an individual struggling with the challenges of poor health.

In that situation, will the DAF hire the individual? No. The donor family isn't legally "driving" the DAF, it's only advising the custodian. The Pension Protection Act defines, in part, a DAF as a fund or account that is owned and controlled by a sponsoring organization, in which the donor expects to have advisory privileges with respect to the distribution and investments of the fund.[6] This is significant as many clients seek as much control as possible.

Conversely, might the PF hire the individual described? While employing a family member may be considered self-dealing, a PF may need staff.[7] Despite that prohibition, the PF may be staffed by family members if they're paid market compensation (below market may be fine and is preferable from the conservative practitioner's perspective). An independent compensation study is prudent in this regard but is certainly an added cost of the PF. We all know clients who have children well-suited to be on the legitimate payroll of the PF. With the increasing popularity of clients electing to leave a substantial portion of their wealth to charity, the PF can be a compelling charitable alternative.

PF Disadvantages

Now let's address some of the perceived disadvantages attributed to PFs. PFs must give away at least 5 percent of their assets each year. Individual DAF accounts currently don't have that requirement (cumulatively they do). Representative Dave Camp, chairman of the House Ways and Means Committee, has proposed the Tax Reform Act of 2014.[8] The bill proposes a requirement that all donations to a DAF be paid out within five years of their contribution. If this is just a bill, why bother mentioning it? To quote a 1970s' advertisement for the aerodynamic Triumph TR7, Rep. Camp's bill may reflect the "shape of things to come."

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If the client is so cold-hearted that she's reluctant to distribute a minimum 5 percent of her PFs assets annually, she was likely not very charitable in the first place. Given that investment returns over time have historically exceeded this modest threshold, distributing 5 percent seems like an insignificant negative. Moreover, eventually, DAF account assets must be distributed. This is monitored by the sponsoring DAF, and it has the authority to make the distribution decision for the donor, if necessary.

Note that PFs must also pay an excise tax of, typically, 1 percent of earnings (not 1 percent of assets) while DAFs have no such requirement.[9] Theoretically, a PF can eliminate this tax by making its charitable gifts in-kind rather than in cash. Regardless, focus on the excise tax for all but the very largest PFs is looking at the minutia and not the bigger picture. It's akin to fixating on the

few oil drops my bright orange 1972 Oldsmobile Cutlass left on the driveway. Do I wish the crankcase was tighter and there were no oil drips? Of course. On the whole, was that car a joy to own and operate? Without question.

But, the DAF disciples have more expenses to reference. There are no tax returns or other governmental filings required of DAFs while that paperwork is required of PFs. Those compliance costs can be annoying and are expenses that the DAF clearly outmaneuvers. However, the DAF sponsoring organization isn't working for free. DAFs rightfully impose fees to cover their compliance costs and pay their employees. For large DAFs, the fees can exceed the costs of operating a PF. For example, one national sponsoring organization charges $4,500 annually for a DAF with $1 million in assets. It's quite possible that a PF with $1 million in assets could be operated for less than the fees incurred by a DAF of the same size.

The DAF is a perfect vehicle for charitable gifts that a client wants undisclosed for sensitive reasons.

Smaller DAFs are clearly less expensive to operate as compared to PFs of the same size. However, as the assets grow in size, the cost advantage of a PF may well be superior to a DAF of the same size.

The Tax Code is more generous to DAFs than PFs when it comes to adjusted gross income (AGI) limits.[10] While the AGI limits aren't often an issue (there's a 5-year carry forward for charitable deductions unused in the year of donation), the limits must still be considered when studying DAFs and PFs.[11] If the client has a short life expectancy (so deductions carried forward become less valuable) or wants the biggest tax deduction now and her charitable gifts exceed the AGI limits for gifts to a PF, then how about parallel parking both a DAF and a PF side by side? The annual charitable tax deduction can then be maximized. Additionally, donations of appreciated non-marketable assets to a DAF can be deducted at full fair market value—a benefit unavailable to PF donors.[12]

Another possible negative of the PF is privacy. The tax returns for a PF are made public on the Internet, while the assets and activity of DAFs are entirely private. Some clients considering a PF have an unfounded fear that they'll be bombarded with unwelcome pleas for donations. While it's true that a snoopy neighbor like Gladys Kravitz may become bewitched studying clients' PFs, let her snoop; most clients' PFs have nothing to hide.

The DAF is a perfect vehicle for charitable gifts that a client wants undisclosed for sensitive reasons. Conversely, making gifts to a supporting organization from a DAF can be exceptionally challenging, but doing so from a PF is simple. Relatedly, the DAF can deny a donor's request if it doesn't recognize the intended donee charity. All donors value flexibility, so it's also significant that a PF can become a private operating foundation or can terminate by transferring all its assets to a DAF. However, a DAF can't distribute any of its assets to a PF or a private operating foundation.

Clients' Driving Styles

So, perhaps advisors might better serve their clients by helping their clients understand which charitable vehicle fits their driving style. When the rubber hits the road, clients making substantial charitable gifts may prefer the advantages of PFs. Many clients may even choose both. After all, these two vehicles can comfortably co-exist together in our clients' planning garages.

Endnotes

1. "Donor advised fund," as used herein, is a general reference to giving accounts created through various sponsoring organizations. See Internal Revenue Code Sections 4966(d)(2) and 170(c).
2. A private foundation is generally defined in IRC Section 509(a).
3. *www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2015.pdf*, at pp 154-155.
4. Donor-Advised Fund Report, National Philanthropic Trust (2013), *www.nptrust.org/daf-report/giving-vehicle-comparison.html.*
5. *Ibid.* at *www.nptrust.org/daf-report/recent-growth.html.*
6. Pension Protection Act of 2006, Pub. L. No. 109-280, Section 4966(d)(2) (2006).
7. IRC Section 4941(d)(2)(E); Treasury Regulations Sections 53.4941(d) – (2)(d)(2) (1984).
8. Tax Reform Act of 2014, H.R., 113th Cong. Section 5203 (2014). The Tax Reform Act of 2014 also proposes a 25 percent surtax on some compensation exceeding $1 million annually. A full draft of the Tax Reform Act of 2014 can be found at *http://waysandmeans.house.gov/uploadedfiles/ways_and_means_section_by_section_summary_final_022614.pdf.*
9. IRC Section 4940.
10. IRC Section 170(b)(1).
11. IRC Section 170(b)(1)(D).
12. IRC Section 170(e).