Charitable Grant-Making Alternatives:

Private Foundation v. Donor-Advised Fund

PLEASE NOTE: These materials are intended to provide general information to assist in determining whether a client or potential client should inquire further about the subject matter with legal and tax counsel. These materials are not intended to constitute, and may not be relied upon as, legal advice.

One of the most gratifying aspects of our firm's practice is facilitating the generosity of our clients—and the creativity they exhibit in exercising that generosity—toward the charities they care about. And an essential part of that process involves deferred grant-making.

The first step in this process involves selecting the right receptacle for charitable donations that allows a person to take advantage of income tax, gift tax, and estate deductions, while still maintaining some control over the investments of the endowment and the flow of benefits to charity. Under the current tax laws, any so-called "501(c)(3)" organization, which is both exempt from income tax and eligible to receive tax-deductible contributions, is classified by the taxing authorities as either a "private foundation" or what is referred to colloquially as a "public charity." For these purposes, public charities consist of churches; schools; university endowment funds; hospitals; medical or agricultural research organizations, governmental units; organizations that support—and are operated, supervised, or controlled by, or in connection with—other public charities; and other organizations that receive a substantial amount of their support from a relatively large number of donors or patrons. As a legal and practical matter, all 501(c)(3) organizations that seek tax-deductible donations must file an application with the IRS to approve of tax-exempt status (Form 1023) and file annual tax returns.

Private foundations, as the name suggests, are funded primarily by one—or a very small number—of related donors. Thus, most organizations established by clients for the purpose of making future grants are treated as private foundations, which are, for the most part, treated with a certain degree to disfavor in the eyes of the tax law.

As an alternative to a private foundation, a donor-advised fund is a segregated asset (or collection of assets) contributed by a donor to a sponsoring organization pursuant to an agreement whereby the donor designates "advisors" to make recommendations on grants and investments. Community foundations were the first to offer donor-advised funds, but over the last few decades, financial services firms began offering donor-advised funds through their nonprofit arms. (The latter tend to charge higher administrative and investment fees.) The donor-advised fund can be a relatively attractive alternative to a private foundation in terms of saving time and administrative costs, as well as income tax-deductibility for donors. It can also serve as part of an exit strategy for trustees, officers, or directors of existing private foundation who would prefer to simplify. That said, the donor and the donor's family sacrifice a certain degree of hands-on control vis-à-vis a private foundation.

For those considering an endowed gift, the following is a comparison of the various aspects of a private grant-making foundation (which is not an "operating" foundation or "conduit" for donations) and a donor-advised fund.

	Private Foundation	Donor-Advised Fund (DAF)
How is the organization established and maintained as a legal entity?	The donor establishes a trust (which may have one or more trustees) by executing a trust agreement with a trustee or a nonprofit corporation (which, in Texas, must have at least three directors) by filing articles or a certificate of incorporation with the secretary of state and adopting bylaws.	The donor enters into a written agreement, usually prepared by the sponsoring organization with input from the donor's estate planning attorney, appointing "advisors" and setting forth the terms under which the DAF will be administered.

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How does the organization establish tax-exempt status and eligibility for tax-deductible contributions?	Within 27 months after the foundation is established, it must file an application for exemption (Form 1023) with the IRS to obtain 501(c)(3) status for its entire existence. In addition, the foundation may be required to file for exemption from any state income or franchise tax, which is usually tied to the grant of a federal exemption.	The DAF's exemption from income tax comes under the sponsoring organization's exemption from income tax. As such, no filings are required.
What steps are necessary to maintain legal and tax-exempt status?	The foundation must file an annual return with the IRS (Form 990-PF), reporting its activities and financial information, which may also have to be filed with the state attorney general (with much of the content becoming a matter of public record). If the foundation is a nonprofit corporation, the board will need to execute documentation to elect directors, appoint officers, and handle other administrative matters, and the foundation may be required to make periodic filings with the secretary of state and state taxing authorities.	None.
To what extent is the value of non-cash property to an organization deductible for federal income tax purposes?	With respect to "qualified appreciated stock" (relatively small interests in publicly-traded companies held for over 1 year), the donor may claim the value on the date of the contribution; otherwise, with respect to most other capital assets, the donor must reduce the amount claimed by any unrealized long-term capital gain.	With respect to most capital assets, the donor may claim the fair market value on the date of the contribution; or in the alternative, the donor may elect to reduce the amount claimed by any unrealized long-term capital gain (allowing for a higher AGI threshold limitation on total deductibility, as discussed below).

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To what extent are annual charitable contributions to such an organization deductible by an individual donor for federal income tax purposes?	The aggregate amount that may be claimed as a deduction in a taxable year is limited to a percentage of the donor's adjusted gross income (AGI), with any otherwise deductible amount in excess of these thresholds eligible to be carried forward for five years and claimed as a deduction (subject to the same limitations). The percentage limitation depends on the asset contributed: cash is currently subject to a 30% AGI limitation, while most capital assets are subject to a 20% AGI limitation.	The aggregate amount that may be claimed as a deduction in a taxable year is also limited to a percentage of the donor's AGI, but the thresholds are more generous: cash is currently subject to a 60% AGI limitation, while most capital assets are subject to a 30% AGI limitation (or if the donor elects to reduce the deduction claimed with respect to a capital asset by any unrealized long-term gain, a 50% AGI limitation).
Is the "exempt" organization subject to any other taxes?	The foundation is exempt from income tax with respect to contributions received and any income earned in the performance of its charitable activities (e.g., admission fees to an art exhibition); but this exemption does not apply to any taxable income generated from an investment in an unrelated business (e.g., a partnership with ordinary business income that flows through to the owners). In addition, the net investment income of a private foundation is currently subject to an excise tax of 1.38%.	Income earned by the sponsoring organization is generally exempt from income and excise tax, as it would be unusual (if not prohibited) for it to invest in an unrelated business.
What charities are eligible to receive grants from the organization?	Grants may be made to 501(c)(3) organizations that also qualify as public charities (generally speaking, not other private foundations or organizations that test for public safety).	Grants may be made to the sponsoring organization itself or to other public charities (other than certain disqualified supporting organizations). Traditionally, sponsoring organizations often limited the scope of their charitable objects to a geographic area, and some still do.

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To what extent may grants be made to organizations that do not qualify as public charities or to individuals?	The foundation must exercise “expenditure responsibility” – i.e., exert all reasonable efforts and establish adequate procedures to see that any such grant is spent solely for the purpose for which it was made; obtain reports from the grantee on how the funds were spent; and make reports to the IRS regarding the same. Specifically, scholarship programs to individuals for travel or study must be preapproved by the IRS. Beyond that, as a practical matter, grants may not be made to individuals.	Generally speaking, the DAF must also exercise “expenditure responsibility” (see left). Practically speaking, in our experience, most sponsoring organizations will not be willing to do so.
How much <u>must</u> be distributed for charitable purposes each year?	Generally speaking, at least 5% of the net fair market value of the foundation’s investment assets must be distributed or expended each year for charitable purposes or the foundation and its managers may be subject to a prohibitive excise tax.	Although there are no formal distribution requirements under the tax law, some sponsoring organizations impose a minimum annual distribution amount or percentage of the value of the net fund.
Who determines how much is distributed in grants and how those grants are expended?	The trustee (or trustees) or board of directors selected by the donor (which may include the donor) hold the legal authority to select grantees and make grants.	Although the sponsoring organization must have the ultimate legal authority to expend funds, the advisors designated by the donor (which may include the donor) may make recommendations, which in our experience, the sponsoring organizations usually follow. The rules differ from organization to organization, but many accommodate a broad line of succession with respect to advisors.
Can the donor and other persons who participate be paid compensation?	Yes, but as a general rule, the compensation must be reasonable for the services being provided (for example, based on comparable data for similar services in the market).	No, unless the person is also legitimately employed by the sponsoring organization in another capacity.
Can the donor or other related parties borrow money from the organization?	No.	No.

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Can funds of the organization be used to pay a charitable pledge on behalf of a donor or other participating party who made the pledge?	No.	Yes (pursuant to recent guidance from the IRS), but only if the party who made the pledge is then serving as an advisor; the DAF makes no reference to the pledge in the grant to the charity (i.e., it is up to the charity to accept the grant as fulfillment of the pledge); and the advisor claims no income tax deduction for—and receives no other benefit as a result of—the grant.
Can funds of the organization be used to pay a membership fee on behalf of—or purchase tickets to charitable events to be attended by—the donor or another participating person?	No.	No.
To what extent may a donor, another participating person, or parties related to them engage in other transactions with the organization?	If the foundation engages in any of a broad range of direct or indirect financial transactions with such persons, both the participating persons and the managers may be subject to a confiscatory excise tax on "self-dealing." (For example, a donor or other "disqualified person" may not sell property to the foundation, even for an established fair market value.)	As a general rule, the DAF can provide, directly or indirectly, no "more than incidental benefit" to any such persons.
To what extent can the donor or other participating parties manage the investments?	Subject to the specific limitations on the types of investments (described below) and a general legal duty to exercise reasonable prudence, the trustees or officers of the foundation are free to manage the investments of the foundation as they see fit.	Some sponsoring organizations allow the donor to designate advisors to recommend investments; but as with grant making, the sponsoring organization must have the ultimate legal authority to make those decisions.

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Are there any limitations on the types of investments that may be made?	Under the effective prohibition on "excess business holdings," generally speaking, the foundation may not own more than a 2% interest an active business enterprise if the aggregate holdings of the foundation and its significant donors, managers, and related parties exceed 20% of the ownership of the entity (or 35%, if unrelated third parties effectively controls the entity). Furthermore, although the foundation may always own investments that directly contribute to its charitable activities, it may not own unrelated investments that are deemed to be so risky as to "jeopardize" its ability to carry out it charitable functions (e.g., options, commodities).	A DAF is also subject to the prohibition on "excess business holdings" (see left). In addition, sponsoring organizations tend to impose limitations on the types of investments that may be held, which can vary significantly from DAF to DAF.