DONOR-ADVISED FUNDS & PRIVATE FOUNDATIONS: MAKING THE RIGHT CHOICE

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Donor Advised Fund (DAF) - Overview

- DAF has been around for decades; Not statutorily defined until Pension Protection Act of 2006
- Each DAF established and maintained by a "sponsoring organization"
- Sponsoring organization has legal control over the DAF and its assets; Donor has "advisory privileges"
- DAF's exempt status derives from sponsoring organization; DAF need not separately seek recognition of exemption

Donor Advised Fund – Definition

- I.R.C. § **4966(d)(2)**:
  - (1) Separately identified by reference to contributions of a donor or donors;
  - (2) Owned and controlled by a sponsoring organization;
  - (3) Donor reasonably expects to have advisory privileges with respect to distribution/investment;
  - (4) Does not make distributions only to a single identified organization or gov entity; and
  - (5) in certain circumstances, donor does not advise which individuals receive grants for travel, study, or other similar purposes.

Private Foundation (PF) - Overview

- PF is separate legal entity; Not associated with another charity
- PF must obtain its own exemption under I.R.C. § **501(c)(3)**
- PF offers greater potential for donor control
- PF is subject to additional administrative and compliance requirements (excise taxes under Chapter 42 of I.R.C., including self-dealing, excess business holdings, taxable expenditures, net investment income, jeopardizing investments, and failure to distribute income)
- **Note**: DAFs are now also subject to excess business holdings rules.

Private Foundation - Definition

- I.R.C. § **509(a)**: "Private Foundation" is a domestic or foreign organization described in 501(c)(3) ***other*** than those described in 509(a)(1)–(4)
- I.R.C. § **501(c)(3)**: Includes "[c]orporations, and any community chest, fund, or foundation, organized and operated exclusively for . . . [exempt purposes]"
- I.R.C. § **509(a)(1)–(4)**: Essentially refers to many traditional charitable institutions (e.g., churches, schools, hospitals, medical research organizations, governmental units, etc.), certain exempt function organizations, supporting organizations, and organizations testing for public safety.

Formation

- **Donor-Advised Funds:**
  - Enter into agreement with sponsoring public charity (i.e., "sponsoring organization")
  - No need to apply for tax exemption
  - Can be established relatively fast
- **Private Foundations:**
  - Form an entity under state law (nonprofit corporation or charitable trust)
  - Submit Form 1023 or 1023-EZ with IRS (recognition of exemption)
  - Usually wait 90 to 180 days to receive exemption

Relative Cost

- **Donor-Advised Funds:**
  - Modest or no start-up fees
  - Annual maintenance and investment fees
- **Private Foundations:**
  - More substantial start-up fees (including legal fees and filing fees to obtain exemption)
  - No set annual maintenance and investment fees (unless PF engages 3rd party to provide such services), but have annual minimum distribution requirement and annual compliance cost associated with Form 990-PF

Charitable Deduction

- **Donor-Advised Funds:**
  - Contributions of ordinary income property deductible up to 50% of donor’s adjusted gross income (AGI) (cash contributions deductible up to 60% of AGI)
  - Contributions in excess of limitation can generally be carried forward for 5 years
- **Private Foundations:**
  - Contributions of ordinary income property deductible up to 30% of donor’s AGI
  - Contributions in excess of limitation can generally be carried forward for 5 years

Charitable Deduction (cont.)

- **Donor-Advised Funds:**
  - Capital Gain Property: contributions deductible up to 30% of donor’s AGI; Deduction based on fair market value of gifted asset
  - High Risk, Private Equity, or Illiquid Assets: Some DAFs may not be willing to accept
- **Private Foundations:**
  - Capital Gain Property: contributions deductible up to 20% of donor’s AGI; Deduction based on donor’s basis (except for qualified appreciated stock)
  - High Risk, Private Equity, or Illiquid Assets: Greater freedom to accept, but subject to limited deduction and Chapter 42 excise taxes

Administration

- **Donor-Advised Funds:**
  - Sponsoring organization handles all administrative tasks (including grant-making and annual tax compliance)
  - Charge fee based on value of assets
- **Private Foundations:**
  - PF responsible for grant making, administration and compliance (either directly, through staff or by third parties)
  - Must remain cognizant of IRS restrictions (excise taxes), prudent investment rules, and state-law fiduciary duties

Reporting & Disclosure

- **Donor-Advised Funds:**
  - Sponsoring organization must file Form 990; DAF not responsible for any additional annual report
  - Sponsoring organization responsible for providing receipt of contributions
  - DAF donors can generally be kept confidential
- **Private Foundations:**
  - PF must file Form 990-PF each year
  - PF responsible for providing receipt of contributions
  - PF donors generally must be publicly disclosed in 990-PF

Donor Control/Participation

- **Donor-Advised Funds**
  - Donor makes grant recommendations ("Advisory Privileges")
  - No opportunity for family employment at DAF
- **Private Foundation**
  - PF retains control over and responsibility of grant-making
  - PF can employ one or more family members of founder so long as compensation is reasonable and non-excessive (need to be very careful to avoid self-dealing)

Investments

- **Donor-Advised Funds**
  - Investments made by sponsoring organization
  - Donor may have input ("advisory privileges"), but no control
  - Charge annual investment fee
- **Private Foundation**
  - Responsible for own investment program, may outsource to outside professionals
  - Board of PF has fiduciary duties and subject to TUPMIFA

Prudent Investor Rules

- **Donor-Advised Funds**
  - Requirements met by sponsoring organization
- **Private Foundation**
  - Requirements met by PF:
    - Texas Uniform Prudent Management of Institutional Funds Act (“TUPMIFA”)
    - Texas Uniform Prudent Investor Act (“TUPIA”)

DAF: Additional IRS Rules

- **Pension Protection Act:**
  - **Incidental Benefits Prohibited** [I.R.C. § **4967**]
  - **Automatic Excess Benefit Transactions** [I.R.C. § **4958(c)(2)**]
  - **Excess Business Holdings** [I.R.C. § **4943**]
  - **Taxable Distributions** [I.R.C. § **4966**]
  - **Proposed Regulations** [Notice **2017-73**]

PF: Additional IRS Rules

- **Private Foundation Excise Taxes:**
  - **Net Investment Tax** [I.R.C. § **4940**]
  - **Self-Dealing** [I.R.C. § **4941**]
  - **Mandatory Minimum Distributions** [I.R.C. § **4942**]
  - **Excess Business Holdings** [I.R.C. § **4943**]
  - **Jeopardizing Investments** [I.R.C. § **4944**]
  - **Taxable Expenditures** [I.R.C. § **4945**]

Fiduciary Responsibility

- **Donor-Advised Funds**
  - Requirements must be met by sponsoring organization
- **Private Foundation**
  - Fiduciary duties held by PF's Board:
    - Duty of Loyalty, Duty of Care, and Duty of Obedience
    - TBOC § 22.230(a) (Interested director, officer, and other related person transactions limited)
    - TBOC § 22.225 (loans to directors prohibited)
  - Must be cognizant of Texas AG oversight

Why Choose DAF?

- **Potential Reasons:**
  - Desired gift is of a lesser amount (lower start-up costs)
  - Greater charitable deduction potential (i.e., up to 60% of AGI for cash; up to 30% of AGI for appreciated property and FMV deduction)
  - Grant-making can generally begin sooner (due to faster set-up time and tax status already in place)

Why Choose DAF? (cont.)

- **More Potential Reasons:**
  - No legally-imposed annual payout requirement
  - Avoid compliance and administration responsibilities (control and responsibility vested in sponsoring organization)
  - Greater donor privacy (ability to maintain confidentiality)

Why Choose PF?

- **Potential Reasons:**
  - Greater control over grant-making and administration (legal right and power to choose grantees, grant amounts, etc.; not just advisory)
  - Greater control over investment (legal right and power to establish investment portfolio, subject to prudent investment and other applicable rules)
  - Want to include family (may include family members in positions of authority, subject to self-dealing rules) and create lasting, on-going legacy

Why Choose PF? (cont.)

- **More Potential Reasons:**
  - Want more control over multi-generational succession (ability to establish own succession policy; not subject to sponsoring org's)
  - Desired gift consists of certain assets (e.g., higher risk assets)
  - Donor can negotiate/enforce individual grant agreements; Useful for major grants for specific purposes (e.g., to ensure grant is actually used to build new wing of hospital)

Questions?