

Our goal in preparing this guide is to provide an unbiased comparison of private foundations and donor-advised funds that will help you choose the vehicle that can best serve your specific charitable objectives.

BERNSTEIN NONPROFIT ADVISORY SERVICES

Private Foundations and Donor-Advised Funds: Making the Best Use of Your Philanthropic Vehicle(s)

The private foundation and donor-advised fund offer specific advantages in such areas as control, flexibility, operating costs, tax benefits, and perpetuity, but the two vehicles can also be combined. In a low-return investment environment, donors can integrate the vehicles to help keep the level of their philanthropic giving in step with their investment results.

If you now have more to give or more time to devote to philanthropy, you may feel that simply writing personal checks to your favorite charities is no longer sufficient. You may want to set longer-term priorities for your giving, involve other members of your family in your decisions, or establish a philanthropic program that will outlive you. For these and other reasons, you may now prefer to channel your giving through a philanthropic vehicle of some kind. The private foundation and the donor-advised fund are among the structures you will likely want to consider.

There are important similarities between the two: With both, you donate assets that are irrevocably committed to charity, and you receive a charitable income tax deduction in the year of your contribution, even though the money may not pass to charity until some future date. Both provide

tax-advantaged growth for the assets they contain, and both are regulated under Section 501(c)(3) of the Internal Revenue Code, which defines charitable organizations.

Both private foundations and donor-advised funds enable you to decouple decisions about asset donation from decisions about grantmaking. You can, for example, donate highly appreciated assets at a time that you and your advisors consider appropriate. The private foundation or donor-advised fund can then sell these assets in a tax-advantaged environment and reinvest the proceeds. Over the subsequent months or years, you can use these funds and the associated investment earnings to make grants, including relatively small ones, to charities. This decoupling is a powerful advantage of both charitable vehicles.

Private Foundations and Donor-Advised Funds at a Glance

	Private Foundations	Donor-Advised Funds
Operating costs	Typically high, but can be modest	Low
Tax deductions for contributions	Deductions limited to:	Deductions limited to:
Cash	30% of AGI	50% of AGI
Securities	20% of AGI	30% of AGI
Privately owned assets	Cost basis	Fair market value
Excise tax	1% or 2% of income	None
Control	Absolute	Contingent on sponsor
Funding	Excess business holdings can be a challenge	Excess business holdings can be a challenge
Access to alternative investments	Limited for smaller foundations	Extensive
Annual grantmaking	Required 5% distribution	Flexible (no minimum or maximum)
Anonymity	No	Achievable if desired
Perpetuity	Yes	Contingent on sponsor
Compensation of board members	Yes	No
Legislative risks	Yes	Yes
Beneficiary of IRA	Yes	Yes
Lead beneficiary of CLAT	No	Yes
Bernstein advisory and management services	Yes	Yes

But there are important differences, too. A private foundation¹ is a freestanding legal entity, a corporation or trust that you establish and control. You are responsible for writing checks, corresponding with grantees, keeping records, and all other administrative duties, and you may decide to hire staff to handle some or all of them. A donor-advised fund, by contrast, is an account or fund you create at a sponsoring organization that is itself a public charity—perhaps a community foundation or a religious group. You fund your account by donating cash or assets, and, as the name implies, you play an advisory role with respect to investments

and grantmaking. The sponsoring entity handles check writing, record keeping, and other administrative tasks.

Online, you can find numerous documents comparing private foundations with donor-advised funds, many of them published by organizations that have a vested interest in one or the other structure. Our goal in preparing this guide is to highlight the most relevant features of both structures and to provide an unbiased comparison that will help you choose the vehicle that can best serve your specific charitable objectives.

¹Here and throughout this paper, we are referring to private nonoperating foundations. We do not specifically consider other vehicles, such as operating foundations and supporting organizations.

Operating Costs

Private foundations are generally far more expensive to establish and run than donor-advised funds. Applying for 501(c)(3) status for a private foundation is likely to entail legal fees, and you will probably need accounting and bookkeeping services to prepare the foundation's annual tax returns. You will face none of these costs if you set up an account with an existing donor-advised fund program. Administrative and investment fees at donor-advised fund programs are often less than 1%, but they can run as high as 2%–3%. The minimum starting balance is typically just \$10,000–\$25,000.

Because of the cost differential, you will probably be better off creating a donor-advised fund if your charitable program is smaller than \$5 million. Above this level, a private foundation can be cost-effective, but a donor-advised fund may still make sense for a variety of reasons.

However, there are exceptions to this pattern. We have worked with some private foundations that spend as little as \$2,250 per year on legal and accounting fees. At some donor-advised funds, the minimum administrative fee is 0.60%. Based on these assumptions, operating costs would be identical for a donor-advised fund and a private foundation with \$375,000 in assets. According to recent research,² private foundations without paid staff frequently have operating and administrative expenses well below 0.60%, but those with staff almost always have expenses greater than 0.60%.

Tax Issues

Rules regarding the tax deductibility of donations are typically more generous for donor-advised funds than for private foundations. If you give cash to a private foundation, the maximum deduction you can use in any year is equal to 30% of your adjusted gross income (AGI); the same cash gift to a donor-advised fund will allow for a maximum deduction of 50% of your AGI. If you donate securities to a private foundation, the maximum deduction is 20% of AGI, but it

is 30% of AGI for the same donation to a donor-advised fund. If you give a private foundation business interests, real estate, or other privately owned assets, the deduction may be limited to the cost basis of the assets, which in some cases could be zero; the deduction for the same donation to a donor-advised fund will be based on the fair market value of the assets.

Keep in mind that with both vehicles, charitable income tax deductions that are above the stated limits can be carried forward for as many as five additional tax years.

There's another tax issue that also works to the detriment of private foundations: They are subject to an excise tax on the income and realized capital gains they generate each year. If the foundation is managed effectively, the excise tax will be 1% of income, but if certain tests are not met, it will be 2%. To avoid the 2% excise tax, a foundation typically needs to make annual qualifying distributions greater than 5% of its portfolio value.³ While a 1% excise tax is relatively small—certainly when compared to the tax rates applied to most taxable accounts—it is not so small as to be irrelevant. By contrast, earnings and income at a donor-advised fund are generally not subject to taxation.

We used our Wealth Forecasting SystemSM to analyze the impact of this excise tax over a 30-year period. In the median case, a private foundation that invests assets of \$10 million in a moderate portfolio, spends 5% a year, and pays the 1% annual excise tax will have \$12.6 million in assets remaining after 20 years, and \$16.4 million remaining after 30 years. A donor-advised fund with the same parameters but no excise tax will have \$12.8 million after 20 years and \$16.8 million after 30—an increase in assets of \$200,000 and \$400,000, respectively. Keep in mind, as well, that these differences result from the excise tax alone and do not reflect the other incremental expenses of a private foundation.

Both vehicles can become subject to taxation at the corporate rate (35%) for any unrelated business taxable income (UBTI) that they receive. This kind of income can arise

²2011 Foundation Operations and Management Report, Association of Small Foundations

³See page 5, Grantmaking. To be taxed at 1%, a foundation must make distributions equal to or greater than the average distribution ratio for the past five years multiplied by the current portfolio value and increased by 1% of the year's net investment income.

through some types of investments in private equity funds, real estate investment trusts (REITs), and other partnership or limited liability company (LLC) structures that use debt to acquire property.

Private foundations also face a burdensome tax filing requirement. The annual return, Form 990-PF, can be a long document, and its details are in the public record, where they're available for anyone to review. The donor to a donor-advised fund has no tax filing requirement for the fund. The administrator has to file annually, but that is for its entire portfolio of funds and has no impact on the individual donor.

Control

Within the limits of the law, the directors of a private foundation (the trustees if it is a trust) exercise total control over investment practices, grantee selection, grant amounts, grant timing, and decisions regarding single-year or multi-year commitments to grantees. This level of control is one of the primary advantages of the private foundation.

In a donor-advised fund, all of these decisions are under the ultimate control of the administrator/charitable sponsor. In recent years, many administrators have provided donors with the look and feel of control—a feature that has helped

them attract new donors and expand their programs, often to substantial size. Nonetheless, it's important to recognize that sponsors/administrators have the right to introduce restrictions on investments or grantees at any time. When you donate assets to a donor-advised fund, you relinquish legal control.

Funding

Both vehicles can be funded not only with cash, but also with stocks, bonds, privately held business shares, real estate, and other assets. Donor-advised funds have fewer legal restrictions on the types of noncash gifts they can receive, but many administrators impose restrictions of their own on gifts other than cash and readily marketable securities.

Donors on the verge of selling a small family business or other asset may want to give a fractional interest in the business to their favorite charity. But if they donate more than a minimal share to their private foundation or donor-advised fund, the IRS will consider it an "excess business holding" that will need to be removed from the foundation's or fund's balance sheet within five years. If the prospective sale of the business falls through and the holding is not removed, a stiff penalty becomes due. One possible solution

Choosing the Right Sponsor for Your Donor-Advised Fund

As a first step, you might ask your advisors or use the web to develop a list of potential sponsors. After learning the basic facts, you could call the administrators with questions, such as:

- How flexible are you about the grantees I choose and the size of the grants I make? Are there any limitations? Can I make grants to organizations outside the United States?
- Would I be able to donate nonpublic assets such as shares in my small business?
- How would my investment portfolio be managed, and who would manage it?
- For how many years (or generations) could my fund exist? If there's a time limit, what would happen afterward?
- What fees do you charge?
- As a donor, how would I interact with your fund? For example, would I be able to manage my investments and grantmaking online?
- What documentation can you show me to confirm the long-term stability of your organization?

Getting What You Want from Your Private Foundation

The most effective private foundations, in our experience, have three key elements in common: a well-conceived mission, strong leadership, and a sound investment policy.

- **Mission:** This may be broad or narrow, depending on your interests, but if you want your foundation to exist in perpetuity, you probably don't want to make it too narrow. Future generations of your family may have their own philanthropic priorities, and allowing them some flexibility may help inspire a deeper commitment from them to the work of the foundation.
- **Leadership:** Whether it's provided by a single director or a board of trustees, leadership calls for vision and drive. Strong leaders have a passion for accomplishing the foundation's mission. But here, too, perpetuity is a concern. If you intend to pass your private foundation to your children and grandchildren, it's critically important to engage them in your giving program as early as possible. Good leaders nurture future leaders.
- **Investment policy:** A long-term investment policy is also critical to success. To keep pace with inflation after 5% spending, you'll need to invest at least 70%–75% of the foundation's portfolio in risk assets, such as equities and high-yield bonds. This will be especially important if you want your foundation to be able to step up its grantmaking in periods when the economy is weakest. A sound investment policy statement will give succeeding generations a road map for managing your foundation's assets and relieve them of pressure to repeatedly reinvent the wheel.

is to reset the five-year clock by granting the excess business holding to a donor-advised fund that's willing to accept it. If the holding was initially given to a donor-advised fund, a second one will now need to be found.

Alternative Investments

Certain hedge funds and private equity funds are open only to qualified investors with a minimum of \$25 million in investable assets. Smaller private foundations may be unable to qualify for these alternative investments. In contrast, in the case of a donor-advised fund, the "investor" is the sponsoring organization, which may manage hundreds of millions of dollars in assets. Hence, even a donor-advised fund of just a few thousand dollars could be deemed eligible for services requiring investor qualification.

Grantmaking

While donor-advised funds can give away as little as 0% or as much as 100% of their assets in any year, private foundations are required to make grants totaling at least 5% of their asset value each year, based on a formula published by the IRS. If they spend more in a particular year, the excess

distribution can be carried forward to reduce the required disbursements for the next five years. Donor-advised funds have no such requirement and, therefore, no such excess distribution carryforwards.

The directors of a private foundation are permitted to make grants to any 501(c)(3) charitable organization in the US they would like to support, as long as it is consistent with their mission/purpose. They can create scholarships, provide grants to individuals, and make loans (known as program-related investments, or PRIs) to charitable organizations. They can also make grants to charities outside the US, but to ensure that the non-US entity is truly a charitable grantee, the private foundation will need to conduct extensive due diligence that is likely to be reviewed by the IRS.

Donors to a donor-advised fund can also recommend grants to any 501(c)(3) charitable organization, as long as it is consistent with the mission/purpose of the sponsoring charitable organization; if the sponsor's mission is sufficiently broad, any 501(c)(3) will do. On the other hand, the administrator may, without offering any justification, refuse a particular grant request, perhaps because the philanthropic

cause, the geographic region, or the grantee lies outside the administrator's area of interest. Furthermore, some donor-advised funds will not make grants to non-US charities. Donor-advised funds are forbidden from making grants to individuals or conducting scholarship programs directly, but they can fund scholarships offered by any qualified 501(c)(3) organization.

Despite the reduced level of control, donors to a donor-advised fund can treat their giving program with the same rigor, thoroughness, and professionalism that they would apply to a private foundation—creating a board of directors, conducting official meetings, and deciding on directions for grants and investments. These decisions can then be conveyed to the administrator of the fund as the donor's advice.

A private foundation is free, within limits, to use its investment portfolio to help achieve its goals. Mission-related investments are typically structured as private equity investments in non-charitable, for-profit enterprises that are consistent with the foundation's mission. For example, a private foundation seeking to eradicate a particular disease might invest in an early-stage pharmaceutical company that is developing a drug to treat it. Since the mission-related investment is likely to be illiquid and difficult to value, it could complicate the process of determining the required 5% spending rate each year thereafter. Nevertheless, the decision to make such an investment is entirely within the power of the directors. A donor to a donor-advised fund could recommend a similar investment, but some administrators will not feel comfortable holding an asset of this type on their fund's balance sheet. Prospective donors who may want to make mission-related investments should carefully review the rules and procedures of any donor-advised fund program they are considering.

Neither private foundations nor donor-advised funds are permitted to make grants where the grantor receives any kind of tangible benefit, such as a fund-raising dinner, in return. Let's suppose that a donor wants to purchase a table at a charity event for \$500—\$150 for food, staff, and venue, according to the charity, and \$350 as a charitable donation. IRS rulings on this kind of bifurcated payment are sometimes

referred to as the "but for" argument. *But for* the so-called charitable grant, an individual would not be able to pay just the \$150 non-charitable portion and attend the event. Since both parts of this grant are deemed to provide a personal benefit, both are forbidden to private foundations and donor-advised funds alike.

Neither vehicle is allowed to fulfill legally enforceable personal pledges to charities. However, many charities will allow the commitment to be rewritten so it becomes payable by the donor-advised fund or private foundation instead.

Anonymity vs. Bully Pulpit

A private foundation cannot withhold its identity when making a grant, but a donor-advised fund has much more flexibility here. If a donor prefers to give anonymously, most, if not all, donor-advised fund programs will allow for a check to be drawn in a way that does not disclose the donor's identity. Furthermore, individuals who want complete anonymity can give their donor-advised fund a name unrelated to their own. On the other hand, donor-advised funds can also meet the needs of donors who want recognition from a grantee.

For donors with no interest in anonymity, a private foundation often provides the opposite: opportunities for publicity. Many donors use their foundations as a bully pulpit to attract attention to causes they favor.

Perpetuity

A private foundation is often described as a perpetual philanthropic vehicle—one that will last forever. As directors or trustees retire or pass away, successor trustees—often family members—will take their place. In this way, the foundation could go on for hundreds of years while affording the family ongoing control over the assets in its portfolio.

Whether or not succeeding generations can participate in a donor-advised fund program depends on the sponsoring organization's rules. Some will allow for perpetual successor advisors, which would enable the donor-advised fund to last just as long as the private foundation. Other administrators will restrict the number of successor advisors or the number of years or generations that the account will be allowed to

continue. Rules also differ regarding what happens to the remainder of the assets in the account when the donor-advised fund ends. In most cases, the donor can designate a charity or purpose for the remainder, but some programs require that any remainders flow into the sponsoring charity's unrestricted fund. Donors with long philanthropic time horizons need to decide whether this would be an acceptable use of their capital.

Compensation of Board Members

Some private foundations provide reasonable salaries and benefits to their board members. Within limits, they may also reimburse board members for expenses related to their work on behalf of the foundation. These practices have been abused in the past, but they are still allowed. Donor-advised funds cannot pay salaries or reimburse expenses; they can deploy their funds solely to provide direct support for charities.

Legislative Risks

Both vehicles could be vulnerable to changes in the legal code. In the case of private foundations, some lawmakers have attempted to reduce the value of the charitable income tax deduction, reduce the tax-advantaged growth in the foundation's portfolio, and increase the required minimum spending rate. But no significant legislation has passed since the rules for private foundations were revised in the Tax Reform Act of 1969. There have been parallel efforts to regulate donor-advised funds and boost their immediate charitable impact, but, here too, no significant legislation has passed since the regulations for donor-advised funds were enacted following the same 1969 act. Although nothing has come to pass, legislative action remains a risk for both private foundations and donor-advised funds.

IRAs and Charitable Lead Annuity Trusts

Neither private foundations nor donor-advised funds can be funded through a direct charitable rollover from an IRA during life. However, either one can be named as the beneficiary of an IRA upon the passing of the IRA's participant.

Charitable lead annuity trusts (or CLATs) are attractive vehicles for transferring wealth to charity and to living

heirs. (For further information, see "A Strategy for Capital Campaigns: Adopt the Donor's Point of View.") A CLAT can name a private foundation as its lead beneficiary, but, because of certain self-dealing rules, the donor to the CLAT cannot also be actively in control of the foundation. This may be an insuperable barrier. The situation is different for a donor-advised fund, which is under the legal control of the sponsoring organization, not the donor. For this reason, self-dealing rules would not apply here, and the donor-advised fund could be named as the lead beneficiary of a CLAT.

Compelling Combinations

Some donors create both a private foundation and a donor-advised fund and use them in an integrated fashion to achieve their objectives. In a period when investment returns are expected to be below normal, philanthropists with private foundations may be eager to bring their annual distributions below the 5% level—particularly if the asset balance has been depleted by high spending or a run of poor investment results. Creating a "sister" donor-advised fund can make this possible.

For example, a \$10 million private foundation with a minimum required distribution of \$500,000 might choose to grant \$400,000 to charitable beneficiaries and \$100,000 to its sister donor-advised fund. The donor can then take her time in deciding how to use the \$100,000 for grantmaking. While the private foundation and donor-advised fund are legally separate entities, a donor might view their combined balance sheets as a single pool of philanthropic capital, which can be protected through this kind of transfer. Keep in mind, though, that grants between private foundations and donor-advised funds are a one-way street running from foundations to funds, and not vice versa. (PRI loans, which are discussed on page 5, can also be used to keep spending in sync with investment returns.)

The combination of a private foundation and a donor-advised fund can serve other purposes, too. A donor with a private foundation might occasionally prefer to make an anonymous grant. While the foundation itself cannot conceal its identity, it can instead make a grant to a sister donor-advised fund, which can then make the anonymous

grant. And, as we have just seen, the grant from the private foundation to the donor-advised fund counts toward the required 5% annual distribution.

Making a Decision

If your primary concerns are control and perpetuity, you may well favor a private foundation. On the other hand, if you are more focused on reducing costs and having the option to maintain anonymity, you will probably be more comfortable with a donor-advised fund. Or, as we've just discussed, you may find it beneficial to establish both vehicles and use each for specific purposes. Whichever path you choose, you will likely find that funneling your donations through a philanthropic vehicle will make your charitable activities more organized, more effective, and more satisfying.

Bernstein Can Help

Whether you create a private foundation, a donor-advised fund, or both, Bernstein can help you manage the financial side of your charitable activities so you can give with maximum impact. We've conducted extensive research on the closely interrelated issues of funding, investment policy, and spending policy, and we base our advice to clients on the conclusions we've drawn from this research. Frequently, we help clients select assets that can be given tax efficiently to their private foundations and donor-advised funds. Finally, we assist clients in setting an asset allocation for their charitable accounts, and we provide expert investment management services.

For further information, please e-mail us at philanthropy@bernstein.com.

Notes on Wealth Forecasting System

The Bernstein Wealth Forecasting SystemSM (WFS) is designed to assist investors in making a range of key decisions, including setting their long-term allocation of financial assets. The WFS consists of a four-step process: (1) Client Profile Input: the client's current assets, income, expenses, cash withdrawals, tax rate, risk-tolerance level, goals, and other factors; (2) Client Scenarios: in effect, questions the client would like our guidance on, which may touch on issues such as which vehicles are best for intergenerational and philanthropic giving, what his/her cash-flow stream is likely to be, whether his/her portfolio can beat inflation long term, when to retire, and how different asset allocations might impact his/her long-term security; (3) The Capital Markets Engine: our proprietary model that uses our research and historical data to create a vast range of market returns, taking into account the linkages within and among the capital markets (based on indexes, not Bernstein portfolios), as well as their unpredictability; and (4) A Probability Distribution of Outcomes: based on the assets invested pursuant to the stated asset allocation, 90% of the estimated returns and asset values the client could expect to experience, represented within a range established by the 5th and 95th percentiles of probability. However, outcomes outside this range are expected to occur 10% of the time; thus, the range does not establish the boundaries for all outcomes. Further, we often focus on the 10th, 50th, and 90th percentiles to represent the upside, median, and downside cases.

Asset-class projections used in this paper reflect initial market conditions as of December 31, 2012. They include the following median forecasts of 30-year compound rates of return: US diversified stocks (represented by the S&P 500 Index), 8.1%; US value stocks (represented by the S&P/Barra Value Index), 8.3%; US growth stocks (represented by the S&P/Barra Growth Index), 7.9%; developed international stocks (represented by the Morgan Stanley Capital International [MSCI] EAFE Index of major markets in Europe, Australasia, and the Far East, with countries weighted by market capitalization and currency positions unhedged), 8.6%; emerging markets stocks (represented by the MSCI Emerging Markets Index), 6.9%; US small-cap and mid-cap stocks (represented by the Russell 2500 Index), 8.3%; taxable bonds (represented by diversified securities with seven-year maturities), 3.8%; and inflation (represented by the Consumer Price Index), 3.0%. Expected total returns on bonds are derived taking into account yield and other criteria. Globally diversified equity portfolios comprise an annually rebalanced mix of 21% US diversified stocks, 21% US value stocks, 21% US growth stocks, 22.5% developed international stocks, 7.5% emerging markets stocks, and 7% US small-cap and mid-cap stocks.

An important assumption is that stocks will, over time, outperform long-term bonds by a reasonable amount, although this is by no means a certainty. Moreover, actual future results may not be consonant with Bernstein's estimates of the range of market returns, as these returns are subject to a variety of economic, market, and other variables. Accordingly, this analysis should not be construed as a promise of actual future results, the actual range of future results, or the actual probability that these results will be realized.

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