By Philip T. Tobin

A Symbiotic Relationship

Balancing the use of private foundations with donor-advised funds can help meet donors' needs

Much of the wealth being transferred in the United States today is in the form of highly appreciated illiquid assets: family businesses, closely held stock, interests in limited liability companies (LLCs) and limited partnerships (LPs) and real estate. For many financial advisors, illiquid assets are likely to represent 80 percent or more of a typical client-family's net worth. The repositioning of these special assets creates potential challenges for (1) the clients who are transferring them, and (2) their heirs and favorite charities that stand to benefit from this movement.

The owner of a highly appreciated illiquid asset who is philanthropically inclined has many gifting alternatives from which to choose. The two primary family foundation alternatives are the private foundation (PF) and the donor-advised fund (DAF).

Triggered by the enormous wealth accumulated in the early 20th century and continuing into the 21st century, the PF has long been considered the gold standard of family philanthropy for families of significant wealth. The hallmark of the PF is the control it offers donors in the selection of board members and the charitable organizations that benefit from its support, as well as the ability to continue family involvement over successive generations.

Despite the popularity of PFs, in the past 20 years, DAFs have become the fastest growing vehicle for family philanthropy, currently outnumbering PFs by two to one. Too often, donors view PFs and DAFs as alternatives, when in fact, they can use them both as complementary vehicles to accomplish different purposes. To facilitate charitable gifts of highly appreciated illiquid assets, advisors are increasingly using DAFs as a complement to PFs, because there are advantages to a PF and a DAF working together. Donors who want to maintain an existing PF, or contemplate establishing a PF can consider incorporating a DAF as part of the overall philanthropic structure.

Potential Complications

High-net-worth families often make substantial charitable gifts each year in the form of checkbook charity or by gifting appreciated stock. However, if illiquid assets make up the bulk of their net worth, these complex assets can create a number of issues.

Donors may be concerned that their favorite small charity can't accommodate the gift or sale of these assets efficiently. Sometimes illiquid assets have a limited market or require liquidation sophistication involving special tax, legal and financial considerations. Beyond that, families may not be satisfied with simply turning their money over to one charity to use as the charity sees fit. They're concerned about the possibility that their grants may be used for other charitable projects than they intended or that the residual assets will be managed poorly.

Donors often want to support more than just one charity—and sometimes more than one community. Also, they may not want to contribute the entire asset to any one charity, but rather just a portion.

In addition, families may want continuing involvement that will permit future generations of the family to participate in an ongoing philanthropic plan. They want to help prepare the next generation—through the lessons and values associated with these meaningful assets—before they transfer the bulk of their wealth.

To resolve these issues, families are seeking a

Philip T. Tobin is chairman and CEO of the Hudson, Ohio-based American Endowment Foundation (AEF), a public charity and leading independent sponsor of donor-advised funds

family foundation solution that permits their ongoing involvement in how the assets are managed, liquidated and reinvested. They want flexibility with accountability. They want flexibility in their grantmaking, a way to support multiple charities—now and into the future. And of course, they want to maximize the tax advantages of their philanthropic program. Both the PF and the DAF can help the family deal with these important considerations.

Establishing a DAF

Advisors can help clients who have an existing PF establish a companion DAF. The process for setting up the companion DAF is simple and quick. DAFs can typically be established in one day and then funded later, depending on the complexity of the asset. (Speed and ease of set-up become important when your client has year-end time constraints.)

DAFs need a sponsor, but not all DAF sponsors operate alike. Some are more restrictive and less "donor friendly" than others. Sponsors include community foundations, many financial institutions, certain national charitable and religious organizations and national independent sponsors that aren't affiliated with for-profit financial institutions or other charities.

The board of the PF can become the advisor to the companion DAF, and the DAF can carry the original name of the PF. Another name can be used for anonymity. For donors who want full recognition of their family grantmaking, some DAF sponsors will create a letterhead—closely resembling the look and feel of a PF.

Tax Benefits

DAFs are considered public charities for tax purposes. Because the donor's illiquid asset is often highly appreciated, this designation carries with it significant tax advantages over PFs. The DAF can work alongside the PF, with the net result of leaving more assets available for their combined charitable grantmaking.

If the client is contributing appreciated illiquid assets (such as closely held C corporation and S corporation shares, LLC and LP interests, real estate, etc.) to the companion DAF, the tax deduction is valued at fair market value (FMV). If those illiquid assets are contributed to the PF, the deduction is limited to the donor's basis. Because a donor's cost basis in the illiquid asset is often negligible, the ability to deduct for the full FMV of the stock during the donor's lifetime can be the difference between a large deduction and no deduction at all.

> With a companion DAF, your client can choose to support his favorite charities with full recognition or with anonymity on a grant-by-grant basis.

Advisors can help clients set up a companion DAF to the PF and contribute all or a portion of the illiquid asset. For example, the donor may contribute a portion of his closely held shares or an undivided partial interest in real estate. Donors may prefer the DAF for its higher annual adjusted income deduction (50 percent of adjusted gross income (AGI) for gifts of cash—30 percent for gifts of other asset types) relative to PF limits of 30 percent and 20 percent. (Both vehicles allow a five-year carryover of unused deductions.)[1]

Gifts of real estate or closely held stock to a DAF—as a complement to a PF—offer other advantages as well. Assets in a DAF aren't subject to the excise tax on net investment income, and DAFs aren't required to make a minimum annual distribution. (Note that donors, through their DAFs, often give more than 5 percent voluntarily.)

Flexibility

From a tax perspective, gifting illiquid assets to a DAF offers no advantage over a direct gift to any public charity. However, the DAF and the PF allow the donor to retain much greater flexibility than a direct gift: for example, ongoing family involvement and investment flexibility. It also gives the family an opportunity to support many charities or easily change the recipient charity should the goals of the donor cease to coincide with the mission of a particular charity.

The PF donor has a great deal of flexibility in where the assets are held in custody and how they're managed. Not all DAF programs are alike in this regard. Many offer only a limited menu of proprietary pooled investment options or mutual funds. Others offer the flexibility of separately managed investment accounts. A few will allow the donor to select the custody platform.

Anonymity or Recognition

There's no privacy with a PF. Everything about a PF is a public record. Anyone can use the Internet to access a PF's 990PF tax return and determine asset holdings, names of directors and key employees (and their compensation), administrative fees paid, grantee organizations and grant payments and much more. This information opens the door to solicitations from prospecting consultants and grant seekers. Many donors are concerned about being inundated with grant requests. This availability of information can be an issue for many donors or family members who treasure their privacy.

> The companion DAF doesn't require a separate tax return or state filings: The sponsoring organization files a consolidated return on behalf of all of its DAFs.

Privacy is a distinguishing feature of the companion DAF. Your client can choose to support his favorite charities with full recognition or with anonymity on a grant-by-grant basis. The client can even use the DAF to support causes not favored by other family members or charitable causes outside the scope of the PF. Through the life cycle of the PF, donors may establish separate DAFs for family members with other philanthropic or geographic interests apart from those of PF. PFs typically make grant disbursements quarterly or semi-annually. Most DAFs are more flexible; some process grants daily.

Tax-Filing and Annual Distributions

In addition to requiring PFs to file the annual 990PF tax return, some states require PFs to file an audited financial statement, which adds complexity and cost. In contrast, the companion DAF doesn't require a separate tax return or state filings. The sponsoring organization files a consolidated return on behalf of all of its DAFs. This is key to the DAFs feature of maintaining the privacy of the donor.

PFs, by law, are required to make an annual 5 percent minimum distribution. DAFs don't have this Internal Revenue Service restriction—there's no minimum distribution requirement (although sponsors typically report distributions between 15 percent and 20 percent).

The 5 percent minimum distribution can become a burden when the corpus of a PF sustains portfolio losses in a down market environment. Grants made from the PF to the companion DAF can be used to satisfy the minimum requirement. (Note that transfer of assets from a PF to the companion DAF is a one-way street. The DAF can't make distributions to a PF.)

Because of the complexity of the compliance and reporting rules that a PF must meet, the administrative costs and taxes that are incurred establishing and maintaining the PF almost always exceed those of the companion DAF. As a result, the DAF has more dollars are available for grantmaking.

Lower Threshold

While some experts in PFs will disagree, traditional wisdom says that the client should be willing to contribute at least $5 million (with at least a $1 million initial contribution) to establish and operate a PF. It's interesting to note that IRS records show that nearly two-thirds of the private non-operating PFs in the country fall below the $1 million threshold.[2]

Clients who want to see which strategy best accomplishes their philanthropic objectives can get practical experience with a DAF at a much lower threshold of $5,000 to $10,000. If at a later time they still want a PF, then the DAF can work alongside it, so as to draw on the symbiotic strengths each has to offer.

Note that in recent years, many DAF sponsors are reporting increases in PFs terminating into DAFs.

Terminating a PF

In recent years, more families are choosing to terminate some portion, or all, of their PFs in favor of a DAF. Even with the equity market recovery of 2010, the continued market volatility and uncertainty may give your clients pause for thought. The market downturn of 2008-2009 reduced assets at many PFs to such a level that maintaining a PF was no longer efficient or prudent.

Other reasons for terminating a PF include:

- The PF's original purpose no longer has the urgency it once did.
- Financial and administrative factors make it difficult for the PF to operate effectively.
- The original founder may be slowing down, and the children or grandchildren may not share his passion.
- Busy schedules and geographic dispersion make it increasingly difficult to provide the required administrative attention.
- The founders desire that children and grandchildren focus on the family's philanthropy, not on the burden of PF administration.

It may be time for your client to consider the transfer of all or a portion of the assets of the PF to a companion DAF. The process at the federal level for a complete transfer is easy. All it takes is a board resolution in accord with its governance documents, a grant from the PF to the companion DAF, and a statement on the PF's last 990PF tax return that assets have been transferred to the qualified companion DAF.[3] (Professional expert legal advice is recommended to comply with state requirements, which vary by state.) For a partial transfer, all it takes is a grant to the established companion DAF.

Bottom Line

Too often, advisors see the PF and DAF as family foundation alternatives and recommend one over the other. In fact, the best solution may be a PF and a DAF working alongside each other so as to draw on the symbiotic strengths each has to offer.

Endnotes

1. *www.aefonline.org/comparisonPF.htm.*
2. Internal Revenue Service SOI Tax Stats— Domestic Private Foundations Statistical Tables.
3. Internal Revenue Code Section 507.