11 Facts about Donor Advised Funds and Private Foundations

When evaluating options for best structuring charitable giving, donors often wish to assess the differences and benefits offered by creating a private foundation or opening a donor advised fund (DAF).

While private foundations and DAFs enable strategic and tax-effective charitable giving, they differ enough that they can appeal to different types of donors, be more effective in specific situations, and can even complement each other. This article will go into eleven characteristics of DAFs and private foundations, comparing and evaluating each vehicle. A summary paragraph will provide concluding thoughts and discuss the trend of pairing a DAF with a private foundation.

This article provides details concerning the characteristics of each vehicle and compares them in regards to: (1) initial setup costs, (2) time required to establish, (3) tax deductibility, (4) organizational structure, (5) donor control, (6) administration and associated costs, (7) distribution requirements, (8) flexibility in grantmaking, (9) capacity for international giving, (10) privacy and anonymity, and lastly, (11) legacy and family giving.

Definitions

A private foundation is a section 501(c)(3) organization established by an individual, family, or corporation, often with a large initial donation. Private foundations are often defined into two categories: operating and non-operating. Operating private foundations must carry out their own charitable activities by "spend[ing] at least 85 percent of its adjusted net income or its minimum investment return, whichever is less, directly for the active conduct of its exempt activities". Most private foundations are non-operating, these foundations make grants out of their assets to other charitable organizations instead of carrying out their own programs.

A donor advised fund, or DAF, is a separately identified fund or account that is maintained and operated by a section 501(c)(3) public charity, which is called a sponsoring organization. Sponsoring organizations may be independent, community-based, religiously affiliated, or connected with financial institutions.

Both vehicles could provide mechanisms for domestic and international philanthropy but differ in their structures and management. Understanding this is key to choosing the option that will best fulfill a donor's charitable goals.

(1) Initial Setup Costs

Initial contributions used to create a private foundation vary and may be as low as $15,000, but historical guidance has suggested that "a minimum investment of $1-2 million is prudent." As a stand-alone legal entity, setting up a private foundation is a lengthy process with costs including legal fees, filing fees, potentially the need to hire staff, and to lease office space.

In comparison, some large sponsoring organizations often require between $5,000 to $25,000 to open a new donor advised fund, though community foundations may ask for as little as $1,000 for a setup contribution. Sponsoring organizations are section 501(c)(3) organizations that administer DAFs and can be community foundations, independent public charities, religiously affiliated, or associated with large financial institutions. With the pre-existing structure of the sponsoring organization, setting up a new fund requires little time or effort on the part of a donor.

At CAF America, there is no set-up fee for establishing a DAF. Donors may choose whether their DAF is invested or not and is easily set-up by speaking with one of our staff and signing a fund agreement.

(2) Time Required to Establish

Establishing a private foundation can be costly both in time and money. Since a private foundation is a distinct legal entity, it must comply with all legal requirements governing charitable entities both at the state and federal level. Ensuring that your private foundation is established within the correct legal parameters often requires outside counsel and may be a lengthy process.

Setting up a DAF can typically occur within a day due to the pre-existing structure of the sponsoring organization.

At CAF America, a DAF can be established within a few hours.

(3) Tax-Deductibility

Donations to private foundations are generally tax deductible up to 30% of Adjusted Gross Income (AGI) for cash gifts and up to 20% for illiquid assets.

Donations to DAFs are treated as contributions to a public charity. Such contributions are generally tax deductible up to 60% of AGI for cash gifts and 30% for illiquid assets. The donor may take an immediate tax deduction during the year in which a contribution is made, regardless of whether funds are disbursed that same year.

(4) Organizational Structure

As it is a standalone organization, a private foundation must meet certain legal requirements as established by the IRS. The Council on Foundations lists three main steps: pre-formation planning, formation, and IRS recognition. These steps involve defining the scope and mission of your foundation, deciding on its legal structure,

registering it within the appropriate state, and finally applying for 501(c)(3) status. Foundations have a board of directors or trustees who manage the activities and funds of the organization and some can have other staff members who do programmatic or grant-related work.

A donor advised fund is not an organization but a fund held at an already registered 501(c)(3) public charity called a sponsoring organization. The sponsoring organization will have its own organizational structure and may conduct its own charitable activities outside of fund management. This means that donors do not need to be concerned with daily administration of their fund or its investments and have the flexibility of advising grants whenever they choose.

(5) Donor Control

Private foundations allow the donor total control over investments and distributions, with direct involvement of the individual or family members. The donor is able to structure the foundation, selects a board of directors, and oversees the operations of the foundation including the awarding of grants and investments.

With a donor advised fund, a contribution is made into an account with a sponsoring organization. The sponsoring organization owns and legally controls all funds but donors have an advisory role in how funds are invested and distributed. Once the DAF is created the donor has no administrative responsibilities, as the sponsoring organization conducts the due diligence, communicates with the charity, sends grants, and collects grantee reports.

(6) Administration and Associated Costs

Some of the more significant annual costs of running a foundation include employee wages (when relevant), office space, legal counsel fees, and submitting the annual 990-PF form to the IRS.

Administration costs for a donor advised fund are usually a small percentage of the contributions made to the fund and covers grants management, transaction fees, and standard investment fees. The percentage may drop with larger donations.

(7) Distribution Requirements

Private foundations are required to disburse 5% of the fair market value of the foundation's assets. Called "qualifying distributions", these are charitable expenditures, typically in the form of grants made to public charities or as program related investments (PRI).

There is no required annual disbursement level for donor advised fund assets, however, the average industry payout rate is around 20%.

CAF America has a payout rate of about 80%, one of the highest in the industry.

(8) Flexibility in Grantmaking

Private foundations may make grants to any public charity, charitable project, or foreign charitable organization, as long as the foundation conducts expenditure responsibility (ER) or equivalency determination (ED is only for foreign organizations), two protocols established by the IRS to ensure that grants are charitable in nature. However, these protocols can be complicated and burdensome, so smaller foundations may choose to restrict their giving to already registered US public charities.

For donor advised funds, donors may make contributions to their funds before making grant decisions. DAFs engage predominantly in making grants to a variety of charities but may allow their donors to give to charitable projects or foreign charitable organizations. Donors recommend grant recipients to the sponsoring organization, which conducts any necessary due diligence and handles the administration required. Sponsoring organizations of donor advised funds that are committed to regulatory-compliant and risk-free grantmaking also use expenditure responsibility and equivalency determination when making grants to charitable projects or foreign charities.

At CAF America, donors may give both domestically and internationally through a single fund and recommend expedited grants to more than 1.7 million charities across the globe.

(9) Capacity for International Giving

Both private foundations and donor advised funds may make grants internationally, however, this is an extremely complex process. The IRS's rules for making grants internationally are the aforementioned expenditure responsibility and equivalency determination (you can read more about both here). Small foundations may find that their resources are too limited to conduct their own international grantmaking. Given the level of effort involved, many sponsoring organizations also opt to not engage in international grantmaking and use specific intermediary organizations for international giving, therefore additional fees may be required to give abroad. Both private foundations and donor advised funds should ensure that they are compliant with relevant anti-money laundering, anti-bribery, and counter-terrorist financing legislation such as the FCPA and the PATRIOT Act.

At CAF America, donors benefit from more than 25 years of regulatory compliance and expert due diligence. Beyond conducting equivalency determination or expenditure responsibility, CAF America (1) mitigates the risk of money laundering and financing of terrorism, per the requirements of the PATRIOT Act, certain Executive Orders and other federal anti-money laundering rules and regulations; (2) prevents bribery, per the requirements of the Foreign Corrupt Practices Act (FCPA); (3) monitors sanctions programs and licensing requirements set by the Department of Treasury's Office of Foreign Assets Control (OFAC) and ensuring compliance; (4) maintains knowledge and consideration of in-country laws regarding a local grantee's ability to accept foreign funding or other applicable local laws.

(10) Privacy and Anonymity

There is no option to donate anonymously to a private foundation due to the requirement to submit the 990-PF to the IRS, which includes the names of all donors to the foundation who gave above $5,000 in a given tax year.

In contrast, donor names can be kept confidential through donor advised funds and anonymous grants are also allowed.

(11) Legacy and Family Giving

Private foundations are often named for the donor (or donors), while family members are commonly named to the board of directors. Foundations can remain under family control indefinitely allowing for a legacy to be established.

Donor advised funds may also be named for the donor and/or the donor's family. Family members can participate in decisions on grant distribution as advisors. A successor may be also named. If the donor wishes to create a legacy of giving, both DAFs and private foundations can meet this requirement.

In summary

Private foundations attract donors who can make a substantial initial endowment and who wish to maintain complete control over the administration and disbursement of funds. DAFs offer donors the ability to start with a smaller initial contribution, modest administration fees, and more advantageous tax benefits, in exchange for releasing the full control over the funds, while maintaining an advisory role in directing grants to their chosen charities.

With recent changes in tax law, DAFs are becoming more popular as advisors recommend their clients bunch their giving into a DAF. For most donors, a DAF presents an easier and cheaper solution than establishing a private foundation. Given how well DAFs fair in the comparison above, it's not entirely surprising that even donors with private foundations are opting to use DAFs alongside their foundation to, for example, give anonymously or give internationally without doing the complex and costly due diligence work themselves.

Every donor is different and some may prefer the control of having their own private foundation, while others may prefer the benefits that a DAF offers. Advisors should keep these 11 facts in mind as they discuss philanthropy with their clients.

To learn more about transitioning a private foundation to a donor advised fund, please click here.