

PLANNING OPTIONS FOR THE PHILANTHROPIC CLIENT

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Whether a donor-advised fund or a private foundation would be the preferable vehicle for philanthropically minded individuals depends on their social goals and financial circumstances.

Charitable contribution options for the high net worth individual (HNWI) range from making informal, *ad hoc* cash gifts to public charities to the testamentary formation and funding of private foundations and charitable trusts. Some HNWIs eagerly anticipate the thrill of having a building named in their honor on the campus of their alma mater while others give because they are pressured to do so by family or friends. However, it is the rare HNWI for whom charitable giving is not part of his or her overall income and transfer tax planning strategy. Advisors who understand the options available will be able to counsel their clients wisely, producing either enhanced tax savings for the clients or more significant after-tax gifts to the charitable institutions, or sometimes both.

When does altruistic giving cross the line from being mere “charity” to “philanthropy”? In reality, this is a semantic question—the words “charity” and “philanthropy” are synonyms and can be used virtually interchangeably. However, the terms suggest somewhat different results. Charitable individuals are thought of as being altruistic, yet basically informal about their giving. When a need arises, they make a

contribution. The universe of their “causes” is limited to organizations they know directly or to whom they are introduced through family or friends. On the other hand, philanthropic individuals take a more formal approach to their giving and are apt to use specialized charitable vehicles to meet several planning objectives at one time. It is not a matter of “good” or “bad,” or “appropriate” or “inappropriate,” it is a matter of degree of the HNWIs engagement in the process.

When HNWIs begin to make large charitable commitments (typically but not always later in life), the need to address the use of charitable vehicles becomes self evident. The use of a planning vehicle generally presupposes a multiyear commitment to philanthropy and provides the structure needed to meet the goals of the HNWI and to put the brakes on runaway giving.

The following are some common vehicles to assist with planned giving. One or more of these may be appropriate given the circumstances of the HNWI:

- Donor-Advised Fund (DAF):¹ This is a public charity that is sponsored by either a charitable or commercial organization. It enables an individual to time a contribution to the fund (generally accelerating the contribution), as well as

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the distribution to the ultimate charity (generally made at a more leisurely pace).

- Pooled Income Fund (PIF):² This is a partially deductible gift to a common fund established by a charity that pays the donor an annuity for life.
- Private Gift Annuity (PGA):³ This is also a partially deductible gift to a public charity, but one that gives rise to an individualized annuity between the donor and the charity. A portion of each annuity payment represents ordinary income and a portion represents capital gain.
- Charitable Remainder Trust (CLT):⁴ Contributions to these split interest trusts are partially tax deductible based on the actuarial present value of the remainder interest in the trust. The donor (or other non-charitable beneficiary) retains the income interest from the trust, either in the form of a fixed dollar amount (annuity) or a fixed percentage of the trust's value determined annually (unitrust), for a period of years or his or her lifetime while the remainder interest is ultimately paid to a charitable remainderman.
- Charitable Lead Trust (CLT):⁵ This is another type of split interest trust that is essentially the mirror image of a CRT; the charity receives the income from the trust for a period of years in either the form of an annuity or unitrust payment, while the remainder is paid to a non-charitable beneficiary. Unlike the CRT, contributions to the CLT may or may not be partially tax deductible, depending on the legal structure of the trust.
- Private Foundation (PF):⁶ This is essentially a "private charity" that the donor or his or her designees control, subject to a nominal 1% or 2% excise tax on investment income. PFs are best suited for those with substantial wealth and are often used to underwrite generations of family philanthropy.

By mixing and matching these various vehicles, the individual can devise a lifetime or testamentary philanthropic plan that will meet his or her personal planning objectives, satisfy his or her need for cash flow, and affect one or more charities in a way that is meaningful to him or her.

A quick survey of these vehicles shows that one either makes a complete and total gift and relinquishes legal ownership of the asset at the time of the gift (DAFs and PFs) or one makes a partial or future gift and retains some control (all the rest). In this article, the use of DAFs and PFs for philanthropic purposes will be ex-

plored. It is assumed that, should an HNWI decide to fund one of these vehicles, that neither the HNWI nor his or her heirs need the assets to fund their lifestyles or, if they do, that alternative means are employed to replace the assets removed from the estate to fund the DAF or PF.

Donor-advised funds

For the taxpayer who is looking to control the timing of contributions, deductions, and subsequent grants to public charities, donor-advised funds may be just the ticket. From the donor's point of view, DAFs are simple, cost-effective, easy to understand and administer, and serve as a personal charitable "pocketbook." If the donor's goal is efficient tax planning with the ultimate goal of benefiting a favorite charity or charities, he or she should strongly consider using a DAF.

Interestingly, until the enactment of the Pension Protection Act of 2006, DAFs were not defined in the Code. The 2006 Act instituted a three-prong test to determine if an entity is, indeed, a DAF:⁷

- It must be separately identified by reference to contributions from donors. In other words, the donations do not go into a black hole of non-accountability. Many DAFs allow donors to name their fund within a fund.
- The DAF must be owned by a "sponsoring organization," which is basically an organization that is defined in Section 170(c), is not a private foundation, and maintains one or more DAFs. Therefore, a sponsoring organization may be another charity that sponsors DAFs (e.g., the Jewish Communal Fund or the American Endowment Foundation, or any of a myriad of community foundations) or it may be a Section 501(c)(3) charity sponsored by a financial institution (e.g., Schwab Charitable Fund or Bank of America Charitable Gift Fund).⁸
- The donor(s) or his or her designee(s) has or reasonably expects to have advisory privileges with respect to both the distribution of fund as-

¹ Section 4966(d)(2).

² Section 642(c)(5); Reg. 1.170A-6(b)(1).

³ Reg. 1.1011-2(a)(4)(i).

⁴ Section 664(d); Reg. 1.170A-6(b)(1).

⁵ Reg. 1.170A-6(c).

⁶ Section 509(a).

⁷ Section 4966(d)(2).

⁸ To qualify for an income tax deduction, the contribution cannot be made to an organization described in Section 170(c)(3), (4), or (5) (i.e., a war veterans organization, lodge, or cemetery corporation) or a Section 4943(f)(5) Type III supporting organization that is not a functionally integrated Type III supporting organization.

EXHIBIT 1. A sampling of donor-advised funds

	COMMERCIAL PROVIDERS		
	Fidelity Charitable Gift Fund	Vanguard Charitable Endowment Program	Schwab Charitable Fund
Sponsor	Fidelity Investments	Vanguard	Charles Schwab & Company
Website	www.charitablegift.org	www.vanguardcharitable.org	www.schwabcharitable.org
Size of fund	\$3.6 billion	\$1.94 billion	\$1.7 billion
Minimum initial Contribution	\$5,000	\$25,000	\$5,000
Minimum subsequent contribution	\$1,000	\$5,000	N/A
Fees	6% on the first \$500K or \$100, greater; .3% on- whichever is the next \$500K; lower thereafter.	Minimum \$100 maintenance fee on accounts below \$15K; .6% annual admin fee + .25% avg annual investment fee = .85% on accounts below \$1MM. Lower thereafter.	Administrative Fee: Minimum fee is the greater of \$100 or .60%. Otherwise, the fee is as follows: .60% on the first \$500K; .30% on the next \$500K; .20% on the next \$1.5MM; .15% on the next \$12.5MM and .10% on \$15MM and above. The investment fee varies anywhere from .09% to 1.16% on accounts with less than \$250K depending on your investment choice. Accounts greater than \$250K will vary depending on the advisor and assets under management, not to exceed .1% of assets under management.
Annual cost of \$100,000 Account	\$600	\$850	\$100k invested in the balanced pool fund would cost the following: Administrative fee of \$600 and an investment fee of \$790, totalling \$1,390.
Minimum grant size	\$50	\$500	\$100
Investment options	Mutual funds for lower level investments; customization available for larger accounts.	Several investment pools including, a multi-mutual-fund approach as well as single mutual funds.	
Perpetuity			No limit on the number of successor advisors to the fund.
Source of data	Wall Street Journal	"Quick Facts" through 9/30/2009 - Vanguard website	Wall Street Journal

EXHIBIT 1. A sampling of donor-advised funds, cont'd.

	NOT-FOR-PROFIT PROVIDERS		
	Jewish Communal Fund	American Endowment Foundation	New York Community Trust
Website	www.jewishcommunalfund.org	www.aefonline.org	www.nycommunitytrust.org
Size of fund	\$1 billion	\$150 million	\$1.8 billion
Minimum initial Contribution	\$5,000	\$10,000	\$5,000
Minimum subsequent contribution	No minimum	\$250	No minimum
Fees	.75% on the first \$5MM or \$150, whichever is greater; .5% on the next \$15MM; .1% on balances above \$20MM.	95 basis pts (.95%) on 1st 500k (\$4,750); 75 basis pts on next 500k, 50 basis pts on next 1.5MM and 25 basis pts on the balance.	No matter the size it is the greater of 2.5% of grants made during the year or 40 basis pts of the market value of the fund.
Annual cost of \$100,000 Account	\$750	\$950	If the \$100K fund made no grants, then the fee would be \$400. If the \$100K fund made \$20K worth of grants, then the fee would be \$500. If the \$100K Fund made \$10K worth of grants, then the fee would be \$400 —since the admin fee is the greater of the two calculations. In addition to the admin fee, there is, of course, the 'hidden' fee of the investment manager.
Minimum grant size	\$36 or \$100 of (depends on type of grant and type of DAF)	\$250	\$250
Investment options	First \$5,000 in money market funds; various mutual funds; private money management for larger accounts.	Flexible and open architecture.	For donors who anticipate making grants with a substantial portion of the funds they establish, there is the Vanguard Prime Money Market Fund. For those donors with a longer-term orientation, there is an investment pool of managed accounts in several asset classes overseen by NYCT's investment committee. For donors who would like a relatively high level of current income, there is an income-oriented fund of funds managed by Vanguard.
Perpetuity		No limit on the number of successor advisors to the fund.	No limit on the number of successor advisors to the fund.
Source of data	JCF Website	Tom Tobin @ AEF	Robert V. Edgar @ NY Community Trust

EXHIBIT 2. Comparison of the main points of difference between donor-advised funds and private foundations

Point of Comparison	Donor Advised Fund	Private Foundation
Donor's startup and administrative costs	Negligible – but administrative costs are paid from fund assets	Substantial – legal fees to draft instrument and file with State Attorney General
Size of Initial Contribution	As stated by the DAF – can be as low as \$5,000	No stated minimum, however cost to set up and administer make modest initial contributions not feasible.
Ultimate Control over Grants to Charitable Beneficiaries belongs to...	Donor Advised Fund	Foundation Board of Directors or Trustees
Excise Tax on income	None	1% or 2% of annual net investment income
Income Tax Deduction – percent of adjusted gross income (AGI) allowable in a given year	<ul style="list-style-type: none"> • Up to 50% for cash contributions • Up to 30% for long term appreciated property 	<ul style="list-style-type: none"> • Up to 30% for cash contributions • Up to 20% for long term appreciated publicly traded stock
Income Tax Deduction equal to fair market value of gift?	Yes, for most assets	Only for cash or publicly traded stock; deduction for other gifts is generally cost basis
Annual Payout Requirements	None	At least 5% of a PF's assets must be paid out annually
Privacy	DAF donors can remain anonymous	PF tax returns and donors' names are public record.
Perpetuity	Not all DAF's allow for the advisor role to be handed down more than one or two generations – depends on the DAF.	PF's can provide a perpetual philanthropic legacy for the family
Grants to Individuals	Not allowed under Pension Protection Act of 2006	Allowable pursuant to a scholarship or other program.
Grants to Charities outside the United States	Requires enhanced due diligence before making; some DAF's prohibit them to keep costs down, or charge an additional fee.	Requires enhanced due diligence before making
Grants with Conditions Attached	Limited ability, if any, to negotiate or enforce grant agreements with grant recipients	Commonplace for PF's and grantees to enter into agreements setting forth the purpose, terms and conditions of a grant as well as monitoring procedures and expectations.

sets (grant recommendations) and to the investment of fund assets while held in the fund (the so-called donor-advisory role). While this role is specifically designated under Section 4966(d)(2)(A)(iii), it is important to note that the DAF still maintains legal ownership of the assets and is the final arbiter of all grant and investment decisions. In fact, to permit deductibility of contributions made to a DAF, Section 170(f)(18)(B) requires that the taxpayer

obtain "contemporaneous written acknowledgement....that the organization has exclusive legal control over the assets contributed."

DAFs are often thought of as the "poor person's foundation." This somewhat demeaning definition is not entirely incorrect—many of the DAFs on the market are available for a modest initial contribution of \$5,000, hardly a king's ransom and certainly within reach of modestly affluent families. However, that ap-

pellation seems to downplay the enormous advantages of DAFs. For example, because they are by definition "public charities" contributions to DAFs are subject to the same limitations for individual taxpayers as contributions to all other public charities, namely 50% of adjusted gross income (AGI) overall with an integrated 30% limitation for certain capital gain property. PFs do not enjoy these limits—contributions to PFs are limited to 30% of AGI with an integrated 20% limitation for capital gain property.⁹ The administrative burden and, generally but not always, the cost of maintaining a DAF is lower than a PF. There are no annual tax filings with a DAF, nor is there an annual requirement to pay out any minimum amount of assets as there are with a PF.¹⁰

There are, however, limitations to the usefulness of DAFs. This article stated previously that the fuzzy line between "charity" and "philanthropy" is crossed as the donor's approach to giving becomes more formalized and long-term. The line between the need for a DAF and a PF is also crossed when the donor's need to control the process becomes more important than the need to contribute. In other words, if one of the donor's stated goals is a desire to participate in the *business of philanthropy*, a DAF may not prove up to the task.

For a sample of DAFs, see Exhibit 1.

Private foundations

Private foundations are basically described in the regulations as a catch-all—any Section 501(c)(3) entity that does not fit the model of a public charity is, by default, a PF.¹¹ PFs can be further split into two categories, either private operating foundations or private non-operating (a.k.a. "grant-making") foundations.

Private operating foundations are more of a hybrid charity classification and are technically excluded from the definition of PFs, being separately defined in Section 4942(j)(3). Although for most purposes, private operating foundations are treated as PFs, they are granted some of the advantages of public charity status. They are exempt from the minimum distribution requirements of Section 4942. In addition, contributions to private operating foundations are deductible as if made to a public charity, i.e., they are "50%" charities.¹² Private operating foundations can be thought of as engaging directly in charitable activities with their investment income and assets. They must spend at

least 85% of the smaller of adjusted net income or minimum investment return and, in addition, meet certain asset, endowment, and support tests. An example of a private operating foundation is the Willem de Kooning Foundation. According to its most recently filed form 990-PF (available for all tax exempt organizations at www.guidestar.org) the \$55 million de Kooning Foundation is involved in "cataloging and maintaining the Willem de Kooning Foundation art collection and archive and facilitating museum exhibitions and scholarly research regarding Willem de Kooning."

A private operating foundation is generally concerned with generating income and maintaining assets that relate to its mission, whatever that may be, rather than merely disbursing funds to other charities. Private non-operating foundations, on the other hand, are basically in the fund disbursement business. The governing boards of PFs are charged with determining the appropriateness of the grants made and in some cases may take a very active role in working with grantees. However, at the end of the day, they are disbursing funds rather than directly running charitable activities. In the author's experience, most HNWI's who fund PFs fund private non-operating foundations.

A private non-operating foundation can function in many different ways. It can serve as a charitable pocketbook, which defines most PFs, or it can be a philanthropic activist or cheerleader with respect to its grantees. Generally speaking, it is the author's belief that PFs that serve merely as charitable pocketbooks are wasting their potential. At the very least, they are an expensive way to achieve results similar to the more efficient DAF.

Apparently, not everyone feels this way. According to the *Philanthropy News Digest*,¹³ the

⁹ Contributions of most capital gain property to PFs are not limited to only 20% of AGI, the value of the gift is limited to the cost basis of the property. The one exception to this is contributions of publicly traded stocks, which are valued at fair market value.

¹⁰ This lack of a payout provision may change in the future, however. The proposed (but not passed) Tax Relief Act of 2005 would have required annual distributions of 5% of the fair market value of DAFs. Such a change would have helped put DAFs on a similar footing with PFs.

¹¹ Reg. 1.509(a)-1: "...Organizations which fall into the categories excluded from the definition of private foundation are generally those which either have broad public support or actively function in a supporting relationship to such organizations...."

¹² Section 170(b)(1)(A)(vii).

¹³ "Tax Laws, Bull Market Spur Growth of Small Foundations," *Philanthropy News Digest*, a service of the Foundation Center (6/10/2008); foundationcenter.org/pnd/news/story.jhtml?id=21720020.



Because they are by definition 'public charities,' contributions to DAFs are subject to the same limitations for individual taxpayers as contributions to all other public charities.

number of PFs in the U.S. grew by 49% over the ten-year period from 1995 to 2005. This dramatic growth is attributable to a number of factors, including a tax law change in 1998, which allowed donors to deduct the fair market value of public stock transferred to a PF, the raging bull market over that period, and the cachet of having a PF to call one's own. This would not be a bad thing if the PF was the most efficient way to achieve the philanthropic goals of the donor.

The administrative burden and, generally but not always, the cost of maintaining a DAF is lower than a PF.

The fact is, though, most of these foundations are small—very small. Interestingly, at the end of 2005, approximately 67% of the country's 77,000 PFs reported assets of less than \$1 million, while another 27% had assets in the \$1 million to \$10 million range.

These statistics can be interpreted a number of ways. One vendor suggests that small foundations are becoming increasingly cost effective as technical solutions for administration and compliance become more sophisticated and affordable. In its view, PFs as small as \$100,000 can make sense.¹⁴ In terms of cost effectiveness this may be true, but what business advantage is there in a \$100,000 PF? It is really too small to enable the donor to engage in the "*business of philanthropy*" to any real degree, and the risk of noncompliance is increased vis-à-vis a DAF.

Some may interpret those statistics differently. The author believes that the PF may be oversold by advisors as a planning option and may be oversubscribed by donors as a status symbol. Perhaps this view is somewhat cynical, but the formation of a PF for less than \$1 million is probably overkill. In an absolute sense, PFs are expensive. If the donor (along with his or her family) wants to be in the *business of philanthropy*, such expense should be viewed as a cost of doing business. However, if they are not

in the *business of philanthropy*, the use of a PF strictly as a charitable pocketbook is a waste.

The thesis is simple: If one wishes to use a PF to engage in the *business of philanthropy*, by all means, set up a PF. Otherwise, use a DAF.

Case study—The Perrin Family Foundation

In the past, the present author briefly served as a professional tax advisor for the subject of this case study and has been aware of the Perrin Family Foundation¹⁵ since around 2005. In his view, this foundation is a classic example of what a family foundation can and should be. It is a large foundation based on asset size (approximately \$14 million) and, on this basis, ranks in the top 6% of all PFs. However, it is really not that large when compared with some of the behemoths out there such as the Bill and Melinda Gates Foundation. Regardless, it is a comfortable size to meet the goals and objectives of the Perrin family, and the family occasionally donates additional funds to it. More importantly, the Perrin Family Foundation is structured as a business and operated like one. It is actively managed, runs an office, and uses an accounting system and appropriate internal controls. It is far from being just the "charitable pocketbook" for the family.

The foundation was started in 1994 based on the dreams of Sheila and Charlie Perrin. The founders did not want merely to form a charitable pocketbook; they wanted to make a difference. From the home page of their website: "The Perrin Family Foundation envisions mental and physical well-being for all children and young adults in Connecticut. Our mission is to provide equal opportunities for children and young adults to lead safe, productive, and creative lives."¹⁶

The Perrin's desire to start their foundation preceded the liquidity events that enabled them to make those dreams a reality. Sheila performed the preliminary research about the required structure and presented the information to their financial advisors. Unlike some of the planning we see today, the formation of the

¹⁴ "FAQ's About Private Foundations," page 7 of a brochure available at www.foundationsource.com (select "download brochure" option).

¹⁵ www.perrinfamilyfoundation.org.

¹⁶ www.perrinfamilyfoundation.org/index.html.

¹⁷ www.perrinfamilyfoundation.org/strategy.html; Perrin Family Foundation Form 990PF, 2008, Statement 15.

¹⁸ When calculating the ratio of operating and administrative expense made for charitable purposes, the value reported on Form 990PF, Part I, Column d as the numerator and the

ending fair market value (box I) was used as the denominator. A "fully loaded" ratio would include all of the expenses reported "per books" in Form 990PF, Part I, column a compared to the ending fair market value in box I. For the period 2006 to 2008, the "fully loaded" ratio averaged 1.3%.

¹⁹ Section 4945(g) allows for grants to be made to individuals if certain fairly stringent requirements are met. Notably, and among other things, any such grant must be awarded on an objective and nondiscriminatory basis. See Reg. 53.4945-4 for more details.

Perrin Family Foundation was an example of a dream being realized by the existence of financing, and was not a situation of a tax problem seeking a palatable solution.

Sheila serves as the president of the foundation and is the main family member dealing with the foundation on a day-to-day basis. She and Charlie, along with sons David and Jeff and daughter-in-law Anne, comprise the Board of Trustees. The foundation has given them a chance as a family to grapple seriously with questions of their philanthropic legacy.

Sheila, along with two part time employees, kicks the tires of prospective grantees hard. They place strict limits on grants through eligibility criteria centered on type of grantee (non-profit organizations that have tax exempt status), geography (Fairfield County and other locations in Connecticut), target audience (school-aged children) and types of programming (programming that occurs outside the traditional school day).¹⁷ Their presence in the community enables them not only to monitor the effectiveness of their grants first-hand but to provide assistance to the grantees in the form of networking events and skills workshops.

Interestingly, although the Perrins have established their own foundation, they do not shun DAFs. In fact, Sheila serves as the vice chair of the Fairfield County Community Foundation, and as such, has set up a DAF with that organization. Certainly, DAFs and PFs are not mutually exclusive.

Although not inconsequential in terms of dollars, the cost to operate the foundation as a percentage of fair market value is reasonable. A review of its Forms 990PF from 2006 to 2008 shows that operating and administration expenses made for charitable purposes averaged .58% of the fair market value of the foundation.¹⁸ It maintains a fairly steady stream of annual grants pegged to the 5% minimum investment return required to be distributed each year. For example, a total of 55 grants were paid in 2008 (\$801,400), averaging just under \$15,000 per grant. Assuming reasonable growth and prudent management, the foundation will be around to service the needs of children in Fairfield County for a very long time.

Contrast this substantial foundation with a tiny hypothetical foundation of \$250,000. While the dollar costs to operate the foundation may be able to be kept to around 1.5%, the risk of violating the myriad rules surrounding PFs

still exists. These include the prohibition on self dealing (Section 4941), taxes on undistributed income (Section 4942), taxable expenditures and expenditure responsibility (Section 4945), jeopardizing investments (Section 4944), and excess business holdings (Section 4943).

These are among a number of onerous limitations that are placed on PFs to ensure that they stay within the narrow confines of their charitable mission. Section 4941 enumerates a long list of "disqualified persons," such as substantial contributors, foundation managers and related parties, among others, with whom the PF cannot engage in certain direct or indirect transactions that are deemed to provide a personal benefit to the disqualified person. Section 4942 imposes a 30% tax on income that is not properly distributed during the year following the tax year. Section 4945 imposes a 20% tax on the foundation and another 5% tax on the foundation managers if taxable expenditures are made from the foundation. Such expenditures include, among other things, costs to carry on propaganda, costs to influence the outcome of public elections, and making certain grants to individuals or organizations. Section 4944 imposes a 10% tax on both the foundation and the management for any investments made that jeopardizes any of the charitable purposes of the PF. Such an investment is one for which the foundation manager did not exercise ordinary business care to provide for the short- and long-term needs of the PF in carrying out its charitable purpose.

This is a big responsibility to generate a required minimum annual distribution of only \$12,500. Realistically, how much more could the board distribute? Bigger distributions would deplete the foundation only that much quicker. Here is a rhetorical question: How much of the "*business of philanthropy*" can one be involved in at \$12,500 per year? Generally speaking, not much. However, this is not entirely true. A small foundation might be justified if a family is looking to meet a specific charitable need that cannot be met by a DAF. For example, they may choose to use a PF to establish a small scholarship fund in honor or memory of a loved one.¹⁹ Consider the hypothetical \$250,000 foundation. Assuming an average 3% annualized investment return, it should be able to provide annual scholarships to individuals in the minimum annual distribution amount of \$12,500 for 30+ years. Such a strategy would not be possible with a DAF be-

cause payments to individuals are not allowed from DAFs.²⁰ Arguably, even though the numbers are small, running a small scholarship fund does fall within the definition of the “*business of philanthropy*” and, in this case, justifies the small dollar investment.

Setting up a small foundation could also work in a situation in which a HNWI is looking to establish a philanthropic vehicle for the HNWI’s family during his or her lifetime to test the family members to see how well they handle such a commitment. If they meet the HNWI’s expectations, he or she may well contribute additional assets during life or at death or, if not, he or she will allow the PF to run its course and eventually disappear. Again, however, such an approach is recommended only when the HNWI is intending for the family to enter the “*business of philanthropy*” in some sort of meaningful way. To reiterate, if the purpose of a PF is to merely serve as a charitable pocketbook or a tax saving device, a DAF will generally work better. Tempered as described above, absolute size coupled with a reasonable level of engagement is important when choosing a PF.

Shifting gears

Is it possible to fund a DAF initially and later use those assets to fund a PF? What about setting up a PF that is later collapsed into a DAF? While flexibility is generally a desirable goal, one must bear in mind that contributions to either a DAF or a PF

are irrevocable and that the ability to internally change direction is limited. Generally speaking, a DAF cannot be used to fund a PF. DAFs are limited to making grants to public charities and PFs are, by definition, private and not public.²¹

PFs, however, can make contributions to DAFs. The reason that they can is the mirror image of the prohibition on DAFs making contributions to PFs. A DAF is by definition a public charity, so directing assets from a PF to a DAF is a perfectly acceptable transaction. This would be an option to consider if the foundation is winding down and the board is looking to get out of the *business of philanthropy* but is not yet ready to distribute all the remaining assets to the ultimate charities. Terminating the PF into a DAF relieves the trustees of the responsibility of administering the PF while delaying the ultimate distribution of assets to other public charities. The present author’s experience has been that DAF sponsors are more than happy to assist PFs that are looking to liquidate their assets into another tax exempt entity.

Conclusion

American society has determined that philanthropy is a worthy social goal and one that should be enhanced by the income and transfer tax law. Because of this, philanthropic taxpayers have a treasure trove of opportunities available to them to meet their planning goals in a tax efficient manner. Two of the most popular vehicles in common use today are the donor-advised fund and the private foundation. Either or both may have a place in your client’s arsenal. It is up to the financial advisor to guide his or her clients to the alternative that will achieve their social goals while making financial and tax sense. ■

²⁰ Section 4966(c)(1)(A) defines a “taxable distribution” as a distribution from a DAF to any natural person. If such a distribution is taxable, it is effectively not allowed to DAFs.

²¹ Section 4966(c)(2).