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Siller & Cohen
Family Wealth Advisors

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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, as well as limited partnerships and real estate. For many of our clients, illiquid assets are likely to represent as much as 75% or more of their family net worth. The use of these special assets to meet charitable goals creates potential challenges for (1) the clients who are transferring them and (2) the charities that stand to benefit from the gifts.

If you now have more time and assets to give to philanthropy, you may feel, as we discussed in our previous article, "Enhancing Your Legacy Through Philanthropy", that simply writing personal checks to your favorite organizations is no longer sufficiently gratifying. You may want to set longer-term priorities for your giving, involve other members of your family in the decision-making process, and/or establish a philanthropic program that will carry on your legacy and outlive you. For these and other reasons, a philanthropic vehicle of some kind, typically either a private foundation or Donor-advised fund, or both, are among the structures you will likely consider. This article will provide an overview of both the Private Foundation (PF) and Donor-Advised Fund (DAF) vehicles, and discusses the advantages of using both types of vehicles together, rather than the more typical strategy of choosing one or the other.

There are, of course, similarities between the two. With both the PF and DAF, an individual (the "Donor") donates assets that are irrevocably committed to charity, and receives a charitable income tax deduction in the year of the contribution, even though the money may not pass to specific charities until some future date. Both can provide tax-advantaged growth of capital for the assets they hold, and both are regulated under Section 501(c)(3) of the Internal Revenue Code.

A key feature of both a PF and a DAF is the decoupling of the initial decision to *make* charitable gifts in the future, from the decision about when, and how much, to gift to *specific* charities. For example, in a year that you expect to have high earnings, you could donate highly appreciated assets to a PF or DAF to obtain a tax deduction. The PF or DAF can then sell the donated assets, pay no tax on the gain, and then reinvest the proceeds. Subsequently, over the next months or years, you can use these funds, and the investment earnings they generate, to make grants, small and large, to your favorite charities. This decoupling is a powerful advantage of both charitable vehicles.

There are important differences between these vehicles, too. For the purposes of this overview we will focus on the most important differences: operating costs, tax deductibility, control, grant making, and, finally, for how long each of these vehicles can remain in existence.

Differences in Operating Cost

A PF is a legal entity, in either a corporate or trust form, that a Donor establishes and controls. The Donor is responsible for reviewing grant requests, keeping records of grant making, filing the annual Form 990PF with the IRS, and all other administrative duties. Many Donors hire third party providers to handle some or all of these duties. The operating costs of a PF are typically significantly more expensive than a DAF. When factoring in accounting services, legal services, investment management services, and administrative services, the cost of operating a private foundation can be 1.5% to 2% of the net asset value of the foundation per year.

By contrast, a DAF is an account or fund that a Donor creates at a sponsoring organization that is itself a public charity. The sponsoring organization can be a financial institution, a community foundation, or a religious organization. Administrative and investment fees at DAF sponsoring organizations typically come in under 1% per year, with minimum starting balances of just $10,000 to $25,000 to open an account, depending on the sponsor. Clearly, ease of set up and ongoing administration are directly correlated to cost. In this way, a DAF is not only a turn-key set up, it is also less expensive to operate.

Tax Deductibility Differences

The tax deductibility of donations is typically more generous for DAFs than for PFs. Gifts of cash to a PF can be deducted in any year up to 30% of the Donor's adjusted gross income (AGI); the same cash gift to a DAF will allow for a maximum deduction of 50% of AGI. Donations to PFs funded by appreciated public securities allow a deduction of fair market value up to 20% of AGI, versus 30% of AGI for a similar donation to a DAF. By contrast, a DAF is an account or fund that a Donor creates at a sponsoring organization that is itself a public charity. The sponsoring organization can be a financial institution, a

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When a Donor contributes closely held business interests, real estate, or other illiquid assets to a PF, the Donor's tax deduction is limited to his or her cost basis in the gifted assets. If those same assets are contributed to a DAF, the Donor is permitted to deduct the full fair market value of the gifted assets. For those Donors whose cost basis in gifted assets is very low, choosing to make the gift to a DAF, rather than a PF, can be the difference between a large income tax deduction, and possibly little or no deduction.

For gifts of real estate and closely held securities that generate significant ongoing income, a DAF provides another important tax advantage: income earned by assets donated to a PF are subject to an annual excise tax on net investment income of either 1% or 2% per year. By comparison, income earned by assets held in a DAF are not subject to the excise tax.

Additionally, PFs face the burden of a tax filing requirement. The 990PF, the annual filing for PFs, can be an onerous document. Its details, including a list of grant recipients and amounts, are a matter of public record viewable by anyone. The DAF, on the other hand, has no such tax filing requirement (because the DAF sponsoring organization files annually for all of its DAF accounts). This helps control ongoing administrative costs and, as we will see below, allows the Donor, if he or she wishes, to make gifts anonymously.

Grant-making and Donor Recognition Differences

By law, each year PFs are required to distribute to charities a minimum of 5% of the PF's prior year-end asset value. While certain PF administrative expenses in the prior year can be counted towards the 5% requirement, failure to meet the calculated minimum distribution can result in a penalty of 30% of the undistributed amount. If more than the 5% minimum disbursement is made, the excess can be carried forward to reduce the required amount for up to the next five years. By comparison, a DAF has no minimum amount that it must distribute each year.

Another consideration when making grants from a PF is the issue of Donor recognition. While publicity for the Donor' s generosity may be a goal in itself, to increase the Donor's standing in the community, or to encourage others to also make charitable gifts, there are times when Donors wish to make gifts anonymously. PFs provide no anonymity, as the Form 990PF is a public document that lists the charities the PF makes grants to each year, and the amount of each grant. On the other hand, most DAFs allow a Donor to make a grant without disclosing the Donor's identity. As we will later see, the ability to control how much is gifted from a DAF in a particular year, as well as the ability to make anonymous gifts, makes pairing the two vehicles within a Donor's philanthropic plan attractive.

Differences in Control

Grants from PFs are permitted to any 501(c)(3) charitable organization in the United States, so long as the grant is consistent with the PF's mission and purpose. Directors/Trustees of PFs can also create scholarships, and make loans to other charitable organizations. Grant-making to non-US based charitable organizations is also permitted, but the due diligence process the PF employs to select offshore grantees is likely to be reviewed by the IRS.

DAFs, on the other hand, may be subject to refusal of a grant request, depending on the sponsoring organization's policies. For instance, some DAF sponsors will not permit grants to non-US charities. Additionally, the IRS explicitly forbids DAFs from making grants to individuals, or conducting their own scholarship programs. However, DAFs can fund scholarship programs that are run and maintained by qualified higher education 501(c)(3) organizations. PFs are attractive for larger gifts, especially for gifts over $2million, due to the issue of control. Directors/Trustees of a PF exercise total control over investment practices, grantee selection, grant amounts, grant timing, and decisions regarding single or multi-year grant commitments. This level of control is a primary advantage of the private foundation.

In a DAF, ultimate control over the DAF assets rests with the DAF sponsor. In recent years, to attract new Donors and expand their programs, many DAF sponsors have provided Donors with the look and feel of control. Despite the reduced level of control, Donors to a DAF can treat their philanthropy with the same rigor, thoroughness, and professionalism that they would apply to a PF, creating a board of directors, conducting official meetings, and performing grant due diligence and selections sessions. These decisions can then be communicated to the DAF sponsor, who will then make the disbursements.

Perpetuity – Differences in How Long Can a PF or DAF Exist

PFs are often described as perpetual philanthropic vehicles, that is, they can technically live forever, based on the availability of assets. PFs often provide procedures for appointing successor trustees or directors when the initial board retires or passes away. This feature allows a PF to continue on for generations, always in the Donor's family control, making it possible for the philanthropic legacy of the Donor to carry on indefinitely.

Whether a DAF can exist in perpetuity depends on the policies of the DAF sponsoring organization. Some DAF sponsors allow a DAF to exist in perpetuity, just like PFs. Other DAF sponsors restrict the number of successor advisors that can be appointed, or even the number of years and/or generations that the DAF account will be allowed to be maintained. For those DAF sponsors that limit the duration of a DAF, different DAF sponsors have different rules regarding what happens to the assets that are left in the DAF account when it terminates. Most sponsors allow the Donor to designate specific charities to receive the remaining funds, while some require that any remaining assets pass to the sponsoring organization's unrestricted charitable fund pool, which the sponsoring organization then distributes to charities it wishes to support. Donors who have a long term vision of their charitable goals need to factor this issue into their selection criteria when examining DAF sponsors, before creating and funding these accounts.

The Best Choice – A Combination of Both Vehicles

Donors, especially those intending to donate illiquid assets, or those with a low cost basis, may benefit from creating a PF *together* with a companion DAF. As noted above, a DAF allows a higher annual adjusted income deduction (again, 50% for gifts of cash – 30% for gifts of other assets) relative to PF limits of 30% and 20%. Gifts of real estate or closely held securities to DAF, as a complement to a PF, offer other advantages as well. Also as noted previously, a DAF is not subject to excise tax on net investment income.

The combination of a PF and a DAF can allow a family to make some or all of their charitable gifts anonymously if they wish. While a PF cannot conceal its identity (indeed, all grants from a PF are disclosed on the PF's annual 990PF filing with the IRS), a PF can make a grant to a companion DAF, which can then, in turn, make the grant anonymously.

Creating a PF with a companion DAF can provide a Donor with flexibility in the timing of charitable grants. For example, in a given year, a Donor of a PF may want to make grants of *less* than 5% to charities, either because the Donor can't identify enough worthy charities to meet the 5% minimum, or because a stock market correction has lowered the value of the foundation's portfolio, and the Donor wants to hold onto those assets until markets rise again. With a companion DAF, the PF can make a gift of the shortfall amount to the DAF. This gift to the DAF counts towards the PF's 5% requirement, and the DAF can then hold this money for distribution in later years, at the Donor's leisure, because a DAF is not subject to the 5% minimum required distribution. Thus, the Donor can view the combined balances of the PF and DAF as a united pool of philanthropic capital.

Moving Forward

Clients looking to establish a long-term philanthropic plan clearly have a number of important issues to consider when determining which of these two vehicles, a private foundation or Donor-advised fund, is most appropriate for accomplishing their goals. Donors gifting more than $2 million should seriously consider the use of a private foundation. Still, others interested in gifting illiquid assets may want to consider a combination of a private foundation and a Donor-advised fund. If your primary considerations are control and perpetuity for future generations, you may favor the private foundation option. If, however, reduction of ongoing costs, administrative convenience, and having an option for making anonymous gifts are important to you, you may consider a Donor-advised fund. Finally, the combination of the two vehicles, each used for a specific purpose, might be the preferred approach. Regardless of which vehicle, or combination of vehicles you choose, by funneling future donations through a philanthropic vehicle, you will be making your family's charitable activities more organized, more effective, and, ultimately, more satisfying.

ABOUT SILLER & COHEN

Siller & Cohen is a boutique family wealth advisory firm providing financial solutions for the past twenty-five years to institutions and high net worth individuals. We combine the detail and careful attention of a smaller firm with the deep resources of a national organization. Our team includes CPAs[1], Certified Investment Management Analysts, and attorneys.[1]

While we offer our clients the full range of planning services, our core areas of expertise include wealth transfer, investments, and business succession planning.

This is the 11th year in a row that Barron's Magazine has recognized a member of Siller & Cohen as being among the top advisors in the nation.[2]

[1] Licensed, not practicing
[2] The list was compiled by RJ Shook, Financial Industry Consultants.
This is an objective ranking based on assets under management.

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