Sorting Out the Differences between Private Foundations and Donor-Advised Funds

By Page Snow

There’s a lot of discussion these days about the difference among charitable giving vehicles. Are donor-advised funds (DAFs) the way to go? When does it make sense to establish a private foundation (PF)? In comparing private foundations to donor-advised funds, it is easy to reduce the analysis to a dry recitation of tax advantages, regulatory concerns, and giving strategies and limitations. But unlike any other financial product, a charitable giving vehicle is, above all, an embodiment of the donor’s values and a symbol of altruistic priorities.

A would-be philanthropist might ask, “Which is better for me, a private foundation or a donor-advised fund?” A financial planner probably would rattle off a list of fees associated with each, or explain that donor-advised funds offered through brokerages such as Schwab, Fidelity, and Vanguard are gaining popularity. The planner might mention that while DAFs are growing in number, private foundations remain hugely popular, and in the United States more than 88,000 private foundations control nearly $561 billion in charitable assets, according to The Urban Institute—National Center for Charitable Statistics (2010).

Ask an experienced philanthropist which charitable vehicle is best and the answer likely will be: “Each has its own strategic advantages. Which one addresses your specific philanthropic goals?”

Indeed, the idea that foundations and DAFs attract the same target market is a fallacy. Veteran philanthropists understand the advantages of each—and often employ both.

When to Form a Private Foundation; When to Use a Donor-Advised Fund

At the most basic level, a foundation is an organization controlled by its founder and directors, whereas a DAF is a giving account—like a bank account—that’s housed in a public charity such as a community foundation. By contrast, a private foundation is a distinct legal entity—a private charitable organization with its own character, mission, and bylaws. Many start with a single individual founder, who runs the foundation as sole director and president.

In practice, this distinction creates a fundamental difference between DAF philanthropy and that of private foundations. Most DAFs are used as simple pass-throughs for funding. On average, donors tend to make grants of more than 20 percent or more of their DAF assets every year (though that’s not a requirement) (Spector 2009). Foundation assets, on the other hand, tend to flourish over time through additional contributions and tax-free growth.

DAFs have a limited lifespan; they allow donors to appoint successors for one or sometimes two generations. Foundations usually are set up in perpetuity, and often that’s their greatest appeal. The endowment grows for years and the foundation’s core values are passed to each new generation. It’s a time capsule that preserves the memory and interests of the founders while engaging children, grandchildren, and generations beyond.

Modern Philanthropy

An old wealth-advisor chestnut is that you need assets of $5 million or more to justify a private foundation. Whether that ever was the case, it is no longer. The model private foundation of the 21st century usually is started with assets of between $250,000 and $1 million. A new generation of online management tools and outsourced services has made the process fast and easy. It can take as little as 2–3 days to get a private foundation up and running. What is more, outsourcing a foundation’s administrative tasks can mean having a virtual staff of experts that is easy to manage and generally much less costly than hiring permanent staff members. Hiring staff is, of course, a personal decision. But due to the advent of online and outsourced services, it is no longer a requirement and most modern foundations do without staff completely.

Private foundations typically focus on a specific mission and involve family members or intimate friends and associates who share a set of common values. Generally, their goal is to address a particular social issue in for example education, the environment, health, poverty, or religion. All told, private foundations have a tremendous collective impact on our society, and they give generously. In fact, in the teeth of the recession in 2009, family foundations and individual donors with private foundations among our clients increased their giving by 15 percent, and the majority exceeded the Internal Revenue Service’s (IRS) 5-percent minimum distribution requirement (MDR) (Foundation Source 2010).

Innovation and Flexibility

DAFs typically are limited to straightforward granting to U.S.-based nonprofits, which makes private foundations more appealing for those who want to move beyond the basics. For donors who want to engage in strategic philanthropy,
PFs provide many more options for charitable giving beyond conventional grants, such as the following:

Program-related investments. These are loans, loan guarantees, and equity investments that private foundations can make for charitable purposes. They may include loans to houses of worship and schools, public service organizations such as medical clinics and soup kitchens, and counseling centers. Equity investments can be made to for-profit enterprises that have a clear charitable purpose, e.g., venture financing to start a local business designed to lift people out of poverty, or underwriting medical research that falls outside of mainstream funding. This gives the entrepreneurially inclined an additional way to involve themselves in their foundations—leveraging their business acumen to help shepherd charitably minded enterprises to success.

Direct charitable activities (DCAs). A private foundation can run its own program instead of funding someone else’s. For donors who are hands-on, this is the make-or-break feature of their philanthropy. For entrepreneurially minded donors, it’s not about finding charities to which they want to donate; it’s about solving a problem of personal concern using their capital, networks, and skills. Examples of DCAs include a program to remove tattoos from inmates when they leave prison and return to society, building a mathematics museum to demonstrate the importance of math in everyday life, and building a skateboard park as an after-school venue to keep young people out of trouble.

Grants to individuals. Private foundations are permitted to make grants to individuals for emergency relief or hardship assistance for such circumstances as loss of employment, illness, and temporary displacement, provided IRS guidelines for these grants are followed. A prime example would be a philanthropist who gave 200 grants to people in her community whose homes were devastated by a hurricane. Another would be the donor who gave funds to families burdened with huge medical bills for a child’s cancer treatment.

International giving. Private foundations have the ability to make grants to overseas charities and nongovernmental organizations that serve a clear charitable purpose. This has particular appeal for donors who travel the globe and want to make donations to people they meet overseas.

Control is Key

When someone makes a grant from a DAF, technically they are making a recommendation to the DAF’s governing board. That governing board has the ultimate authority to either accept or reject the recommendation (that’s why it’s called a donor-advised fund).

In practice, the DAF’s governing body rarely rejects a donor’s grant recommendation. However, if a donor is concerned about “control,” particularly if he or she wants to put a personal stamp on the grant or direct the grantmaking in a specific way, a private foundation affords vastly more control than a DAF. There’s simply no substitute for the prestige and “driver’s seat appeal” of leading a private foundation.

When it comes to investment control, foundations and DAFs differ as well. DAFs usually offer a limited choice of investment options based on a selection of mutual funds or investment pools, similar to a 401(k). Some allow donors to manage a portfolio of stocks, bonds, and mutual funds. But donations of real property and other nonmarketable securities to a DAF (such as real estate, jewelry, and artwork) may have to be sold.

By contrast, the investment options for foundations are as broad as the methods of grantmaking allowed. Foundations can own nearly any type of asset including partnerships, real estate, jewelry, closely held stock, stock options, art, and other valuables. Through a private foundation, donors can follow any investment strategy they choose so long as they follow the prudent investor rules, don’t take extreme risks, or engage in risky or jeopardizing investments.

Family Involvement

One chief concern that philanthropic advisors often hear is from first-generation wealth-creators who worry that their children, raised in affluence, won’t grow up to be morally driven members of society. Often these first-generation earners didn’t come from significant wealth themselves and they associate the challenges they faced with character building. They’re worried that their children, free of hardship and privation, won’t learn what it means to work hard for something that matters.

Private foundations serve as particularly excellent forums for inculcating ethics and imparting important life lessons. Foundations provide a common purpose that rallies families. They offer a means of sharing ideals across generations. Managing foundation assets provides ready-made financial training for younger family members, not to mention leadership, teamwork, communication, and planning skills.

Founders can name family members to the board and create a foundation in any image they wish. The directors can establish their own missions, bylaws, and grant-making guidelines. Board meetings become intimate gatherings and important family events that help maintain and deepen relationships.

By contrast, DAFs are used primarily for individual giving. As attorney and philanthropy expert Sally Venverloh (2009) has pointed out, “The cohesive board structure of a private foundation does not translate well to a DAF, which permits any of the named advisors to make grant recommendations independent of the others.”

Comparing Tax Advantages

Grants made by private foundations are listed on their annual tax returns, which are publicly available. Grantmaking through
DAFs, on the other hand, can be completely anonymous. Also, because DAFs are public charities they are subject to less regulation than private foundations. The 5-percent minimum distribution requirements of assets for private foundations is one example of the difference. However, because Congress previously threatened to regulate DAFs’ pay-out requirements, many DAFs have voluntarily adopted the 5-percent MDR rule.

Private foundations are subject to a tax of up to 2 percent on investment income; DAFs are not. However, growing assets is not typically the aim of a DAF. Moreover, excise taxes on foundation assets are minimal. Consider a foundation earning 5 percent in income on $1 million in assets, or $50,000. The excise tax on that income would be $1,000, a relatively small sum.

The tax benefits of investing in a DAF versus a private foundation are limited to one’s adjusted gross income (AGI). For a cash gift to a DAF, the personal deduction is limited to up to 50 percent of the donor’s AGI, versus 30 percent for a private foundation. Few people donate at a level where this makes a difference because contributions that exceed these limits can be carried forward for up to five years. For donors who contemplate contributions that bump up against the AGI limits, it is especially important to speak with a personal tax advisor. Tax law is complicated, and every circumstance is different.

How DAFs and Private Foundations Can be Complementary

DAFs and private foundations can be used wisely in tandem in several ways.

When a private foundation has not fulfilled its 5-percent minimum distribution requirement due to unforeseen circumstances at year-end, such as a grantee being unable to meet its challenge requirement, a private foundation can make a grant to a DAF to satisfy the MDR.

A DAF also can be used when a private foundation wishes to make an anonymous grant apart from its regular giving, which is reported to the IRS in the foundation’s annual tax return and eventually made public. This is an option for donors who want to make an unusually large gift without attracting undue attention.

Some private foundations donate funds to DAFs so that their directors can exercise the privilege of making discretionary gifts. This has two primary advantages: It avoids confusing nonprofits and the public about the foundation’s core mission and priorities, and it enables directors to get personal credit for their gifts (provided the DAF fund is in their name).

To take full advantage of giving through a DAF and a private foundation working together, it may be best to establish a private foundation first. A private foundation can make a grant to a DAF; going in the opposite direction from a DAF to a private foundation, however, is all but impossible in nearly every instance.

Conclusion

Despite the attention that donor-advised funds have received lately, private foundations remain incredibly popular and important. The reason is that they provide so many options and benefits to donors and families who wish to take a direct interest in their philanthropies instead of just writing checks.

Private foundations come in all stripes and sizes. Many are begun with as little as $250,000. The foundation structure affords direct control of those assets and the grants made from them, allowing philanthropists to direct their giving where, when, and to whom they wish, according to the vision and the values they set out. Private foundations also allow strategic and innovative options alongside traditional grantmaking, including program-related investments, direct charitable activities, and grants to individuals.

By choosing the charitable vehicle that best embodies your philanthropic aims, whether in the form of a foundation, a donor-advised fund, or both, you can do the kind of good work you want to be doing through charitable giving.

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References


