Wealth Planning **Update**

Exploring charitable giving

An update on donor-advised funds vs. private foundations.

Several months ago, we compared donor-advised funds to private foundations in an issue of *Wealth Planning Update* that has become quite popular. Changes in the tax code since then warrant an update.

Whether the goal is to improve a local community or support a more far-reaching cause, charitable giving is an important goal for many investors. With donations of cash or other assets, you can support a specific nonprofit organization's mission, while also teaching future generations about empathy and generosity. According to the National Philanthropic Trust (NPT), in 2016, individuals donated more than $280 billion, about 72% of overall giving.[1] There are a variety of ways to support the causes you believe in, including the following:

Donate directly
Donate cash or other assets to a charity's general fund for unrestricted use, or to a restricted fund for a specific project.

Donate through your will or trust. Make testamentary gifts to charities in your will or trust by giving a set dollar amount or a portion of your estate or trust.

Designate a charity as the beneficiary of your Individual Retirement Account (IRA) or 401(k)
Charities do not pay income tax on donations they receive from these accounts. However, you may need spousal consent in the case of a 401(k); check your state's laws.

Establish a donor-advised fund (DAF) or your own private foundation (PF)
Both offer an immediate income tax deduction in the year of the gift and allow you to distribute the funds over an extended period of time.

The growing popularity of donor-advised funds

NPT reports that, as of 2016 (the latest available data), assets held in DAFs amounted to $85 billion, up 9.7% from 2015, due to increased contributions and investment gains. Contributions equaled more than $23 billion that year, reaching an all-time high. The total number of DAF accounts stood at 284,965, compared with 83,276 private foundations.

While there are nearly triple the number of DAFs than PFs, private foundations hold almost nine times the amount of assets than DAFs. Private foundations generally have larger balances (such as the Bill and Melinda Gates Foundation) and have been in existence much longer, giving them the benefit of compounded growth over the years (such as the Rockefeller Foundation). The first DAFs were created in the mid-1930s and only became popular with the growth of national DAF programs starting in the early 1990s.

Despite having lower overall assets, DAFs have historically had much higher grant payout rates (grant payments divided by total assets multiplied by 100) than private foundations. DAFs are not subject to the 5% minimum required distribution (MRD) that PFs are. Nevertheless, the overall grant payout rate for DAFs in 2016 was just over 20%, and has been near or above 20% each year since the NPT started collecting the data in 2007. In contrast, private foundations paid out slightly over 6% in 2016.

Continued

Today, charitable sponsors of DAFs exist in every state, with nearly half of DAF accounts in the three states with the largest charitable sponsors: Massachusetts, California and Pennsylvania. The charitable sponsors fall into three categories:

- **National charities,** including organizations such as National Philanthropic Trust[2] and those affiliated with financial institutions
- **Community foundations,** ranging from major metropolitan areas, such as the Chicago Community Trust, to smaller rural organizations
- **Single-issue charities,** including faith-based and education-focused organizations

Choosing between a DAF and a PF

Below are some high-level guidelines to help you compare a DAF and a PF. Note that our discussion of PFs is limited to grant-making foundations operated by individuals and families, and excludes private operating foundations and corporate foundations, such as Google.org. Your financial professional can help you determine if a DAF or PF is right for you.

A DAF may make sense if you are:

- Making a minimum contribution of approximately $5,000–$50,000 (account minimums differ by sponsoring charity and/or DAF program)
- Seeking a simple, fast and inexpensive way to form a charitable giving vehicle
- Looking to maximize your charitable giving income tax deductions
- Contributing closely held stock, publicly traded stock, real estate or cryptocurrency that has appreciated in value, especially if you want a larger tax deduction
- Seeking greater flexibility in the annual amount of your grant making, including (under current law) the ability to forego making any grants in some years
- Looking for greater privacy in your grant making, including keeping the balance of your charitable giving vehicle private

Although a DAF offers lower administrative and management fees, more favorable deduction limitations and asset valuations, and no excise tax on investment income, a PF provides greater control in the areas of grant making and investing. This is because a donor to a DAF must surrender discretion and control over contributed assets, retaining solely advisory privileges. The sponsoring charity makes all final decisions with respect to DAF grants and investments.

A charitable sponsor of a DAF typically offers several investment pools into which you can allocate funds for investment (although most charitable sponsors will permit independent and active management of a DAF account if it has a minimum balance determined by the charity — typically $250,000 to $1 million). On the other hand, a you may retain complete control of the investment of funds in your PF within the PF rules; PF investments are not limited to a selection of investment pools.

In addition, as a donor to a PF, you can exercise full control over grant making. With a DAF, the charitable sponsor has the legal right to approve or deny a grant and makes all the final decisions. However, it's important to note that you can make recommendations and, in practical application, the charitable sponsor generally approves recommendations for grants to 501(c)(3) public charities.

Finally, as a donor to a PF, you may appoint its board members, including family members, providing the opportunity for your family's future generations to participate in its legacy through philanthropy. A PF may operate in perpetuity, and successive generations may serve on the board. A PF exists until its board votes to dissolve and unwind its operations.

See the accompanying table for a more detailed comparison of the two vehicles.

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Comparing Donor-Advised Funds and Private Foundations[3]

	Donor-Advised Funds	Private Foundations
Minimum contribution	Depends on the charitable sponsor. Typically $5,000-$50,000. The BMO Charitable Fund Program DAF has a minimum contribution of $25,000.	None. Some online platforms require a minimum of $250,000 to set up a PF. Ideal for donors who plan to fund with at least $2 million.
Start-up costs	Typically none (often covered by the charitable sponsor). Can usually be established immediately by filling out an application.	An attorney drafts articles of incorporation and bylaws (or a trust document as a PF can be a corporation or a trust), and registers the PF with the state. The PF must also apply to the IRS for recognition as a tax-exempt organization. Legal fees and other start-up costs can be several thousand dollars. Typically takes several weeks to create.
Ongoing administrative and management fees	Varies with the charitable sponsor and level of services, but ranges from 60 to 100 basis points for accounts under $500,000 and 30 to 75 basis points for the next $500,000.	Varies with choice of board and level of services required. Must file annual tax returns, conduct independent audits, and manage and administer all functions. Some online platforms bundle services for a flat start-up fee and annual fees of up to 1% of assets.
Excise taxes on investment income	None.	1% to 2% of net investment income annually.
Tax deduction limits for gifts of cash	60% of AGI if you make only cash contributions in a tax year. 50% of AGI if you make both cash and noncash donations in a tax year. Unused deductions can be carried forward for up to five additional years.	30% of adjusted gross income. Unused deductions can be carried forward for up to five additional years.
Tax deduction limits for gifts of stock or real property held for more than a year	30% of adjusted gross income. Unused deductions can be carried forward for up to five additional years.	20% of adjusted gross income. Unused deductions can be carried forward for up to five additional years.
Valuation of gifts	Fair market value for cash and for stock and real property held for more than one year.	Fair market value for cash and certain publicly traded stock held for more than one year. Cost basis for gifts of closely held stock or real property.
Control of grants and assets	Donor may recommend grants and investments, but the charitable sponsor makes all final decisions.	Donor family has complete control of all grant making and investment decisions, subject to PF rules.
Required payout	None. The DAF may or may not make grants in any given year.	Must expend 5% of net assets valued annually (regardless of how much the assets earn) or pay a penalty.
Privacy	Names of individual donors can generally be kept confidential, if desired. The donor does not file tax returns for the DAF; the charitable sponsor files a tax return.	Must file detailed and public tax returns on grants, investment fees, salaries, etc.
Governance and succession	Donor(s) may name advisors to recommend grants and investments, and may also name successors (sometimes limited to two advisors or two generations). If they do not, the balance of the DAF goes to designated successor charities or, if none, to the charitable sponsor's general fund.	Opportunities for board selection, training and bringing in the next generation are greater with a PF than a DAF. There are no restrictions regarding who serves on the board.
Terminations	Except in certain limited circumstances, the assets in a DAF may not be distributed to a PF.	The assets in a PF may generally be distributed to a DAF and the PF may terminate, but there are many rules that must be carefully adhered to. This should help reduce tax filings, administrative oversight and fees, and eliminate excise tax.
Perpetuity	Can exist in perpetuity. However, it is important to check the charitable sponsor's policy on succession of advisors and also complete and regularly update the form for naming successors.	Can exist in perpetuity.

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Benefits of donating appreciated publicly traded stock held for more than one year

When you donate appreciated publicly traded stock that you've held for more than one year, rather than donating cash, you pay no capital gains taxes, and neither does the charity that receives the donation when it sells the stock.

For example, suppose you want to donate $100,000 to a DAF and have the choice of donating cash or appreciated publicly traded stock held for more than a year worth $100,000 (with a cost basis of $20,000). Assume you are in the 37% and 20% federal income tax brackets for ordinary income and capital gains, respectively.

Scenario 1: Donate cash	
Total value of gift:	$100,000
Charitable deduction: *Subject to federal income tax rules, which limit charitable deductions to a certain percentage of your AGI (60% or 50%)*	$100,000
Federal income tax savings:	$37,000
Net cost of your gift:	**$63,000** ($100,000 – $37,000)

Scenario 2: Donate appreciated stock	
Total value of gift:	$100,000
Charitable deduction: *Subject to federal income tax limitations, typically 30% of your AGI*	$100,000
Capital gains tax savings:	$16,000
Net cost of your gift:	**$47,000** ($100,000 – $16,000 – $37,000)

While each investor's situation is unique, the example above illustrates that there may be times when donating appreciated stock is advantageous relative to donating cash. Some donors whose modified adjusted gross income exceeds certain thresholds may also save Net Investment Income Taxes of 3.8% which is not illustrated in this example.

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[1] National Philanthropic Trust 2017 Donor Advised Fund Report.

[2] National Philanthropic Trust operates the BMO Charitable Fund.

[3] Source for statistics: National Philanthropic Trust 2017 Donor Advised Fund Report