

Philanthropy 101: Donor-Advised Funds

by **Elfrena Foord, CFP®**

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Charitable giving is an easy subject to avoid when advising clients, especially given the complexities that can be involved. Before pushing the subject to the sidelines, consider a simple, affordable charitable-giving tool: donor-advised funds. With minimums starting at \$10,000, these funds are within the reach of many charitable-minded Americans.

Donor-advised funds have gained in popularity because they offer an organized, inexpensive and flexible way to give to charities. As evidence of their increasing popularity, donor-advised fund assets jumped from \$2.4 billion in 1995 to \$12.3 billion in 2001, according to the *Chronicle of Philanthropy*.¹ (See Table 1 on the next page.)

What Is a Donor-Advised Fund?

A donor-advised fund is just what the name implies: the donor contributes cash or assets to a public charity that sponsors and sets up a donor-advised fund. This public charity is called a sponsoring organization. Minimum contributions can be as small as \$10,000.

The donor receives up to three tax benefits from making the donation: an immediate income tax deduction, avoiding capital gains taxes if the gift is appreciated property, and a reduction of the gross estate by

Donor-advised funds are a simple, affordable and flexible charitable-giving tool that are within the reach of many Americans. Yet financial planners often avoid discussing this topic with clients because of the complexities that can be associated with a charitable-giving program. This article takes the mystery out of donor-advised funds by describing the ways in which these funds can be set up, where to find sponsoring organizations for a fund, questions to ask a sponsoring organization, and the advantages and disadvantages that clients should consider before deciding if a donor-advised fund meets their philanthropic objectives. Costs, tax implications and family considerations surrounding donor-advised funds are discussed and a comparison between donor-advised funds and private foundations is provided.

the amount of the excluded asset. The sponsoring organization does all the legal, philanthropic and accounting work. This allows the donor to focus his or her energy on grant-making functions, although even this activity can be delegated if the donor so desires.

Typically, the donor recommends which charitable organization will receive grants, when such grants will be distributed, and the amounts. However, the sponsoring organization has the final approval on the grants because certain guidelines must be followed, such as making sure that the contributions go to qualified nonprofit organizations.

Investment choices vary greatly among sponsoring organizations. Some may allow the donor's investment advisor to manage

the money, while others require the donor to select from the investments offered through the sponsoring organization's program. At the opposite extreme, a sponsoring organization may give donors no choice, as they must use the sponsoring organization's program.

Endowment Versus Non-endowment Funds

Two approaches can be used when granting money to donor-advised funds: endowment or non-endowment. In most cases, it is up to the donors to decide how they will grant the money, although some community foundations require donors to choose one or the other.

- 1. Endowment.** The distinguishing characteristic of an endowment is planned longevity of the fund. The donor contributes the asset (such as cash, securities or property) to a donor-advised fund and awards a yearly amount to charities from the earnings, usually five percent, with any additional earnings accumulating in the fund. The goal is for the fund to continue in perpetuity, distributing income each year. This appeals to many donors because it creates a family legacy for charitable giving or allows giving to a cause the family holds dear for years into the future.
- 2. Non-endowment.** The donor contributes the assets to a donor-advised fund and grants to the charities as much or as little (assuming the minimum distribution amount is met) as the donor wants each year. The fund can last for a short or a long time, and the donor can sprinkle grants to many causes or focus on one cause.

Where Are Donor-Advised Funds Found?

Donors can search four arenas for these types of funds:

Local community foundations. Community foundations are established in over 600 major cities in the United States for the express purpose of providing local residents with a structure that makes it easy to give to community causes. Certain grant-making support services may be provided to the donor by the foundation, such as providing information about current work in an area that the donor is interested in affecting. Therefore, local community foundations can be an excellent place to start investigating whether there is a good match between the client and a donor-advised fund.

The popularity of donor-advised funds sponsored by community foundations can be seen by looking at Table 2, which sum-

marizes information provided by 200 U.S. community foundations that were surveyed in 2000.²

Nonprofit organizations. Because donor-advised funds are becoming so popular, many nonprofit organizations have set them up to capture more charitable dollars. The organization may have a narrow focus, such as a donor-advised fund that allows the donor to name a scholarship recipient, or a broad focus, such as world peace or Christian-based philanthropy. (An example is the Christian Community Foundation.) Obviously, the organization will restrict the giving options to its own purposes.

A client's strong leaning toward a specific charity would be the starting point to explore a donor-advised fund in that organization. But an outright gift may be a more appropriate choice in this situation. A donor-advised fund would make sense only if the donor wanted to establish an endowment-type fund to continue in perpetuity. For example, a Rotarian who wants to leave a legacy could establish a donor-advised scholarship fund in his or her name through the Rotary Club.

Commercial sponsors. Many mutual fund companies and brokerage firms have donor-advised funds. *Bloomberg Personal Finance* magazine recently featured 27 such sponsors.³ Vanguard (\$25,000 minimum) and Fidelity (\$10,000 minimum) are examples of mutual fund families that will set up donor-advised funds, but they typically take only cash and marketable securities. Brokerage firms such as Schwab also have donor-advised funds.

TABLE 1
Donor-Advised Fund Assets

Year	Total Assets (in Billions)	Grants Paid (in Billions)	Number of Donors
1995	\$2.4	\$0.5	N/A
1999	\$7.5	\$1.2	27,902
2000	\$11.3	\$1.6	46,653
2001	\$12.3	\$2.0	53,275

TABLE 2
Community Foundation Donor-Advised Funds (DAFs)

2000 Fiscal Year	
Total Number of DAFs	17,213
Assets in DAFs	\$5.2 billion
Number of Gifts to DAFs	42,562
Value of Gifts to DAFs	\$1.4 billion
Number of Grants from DAFs	96,263
Value of Grants from DAFs	\$695 million
Number of New DAFs Created	2,601

With commercial sponsors, donors must use the institution's mutual funds for the investments. Grants are made on the commercial entity's letterhead and the donor's name is mentioned as the contributor. No advice is given regarding grants, so this approach works best for people who clearly know to whom they wish to give. Nevertheless, philanthropists are finding commercial sponsors a viable option, as illustrated in Table 3.⁴

Independent sponsors. A popular independent sponsor is the American Endowment Foundation. Started in 1992, it has 250 funds and has received over \$65 million in contributions. Because this

TABLE 3
The Five Largest Commercial Sponsors of Donor-Advised Funds

	Assets (in Millions)		Change
	2001	2000	
Fidelity Investments Charitable Gift Fund	\$2,600	\$2,400	10.4%
National Philanthropic Trust	\$346	\$225	53.3%
Vanguard Charitable Endowment Program	\$289	\$171	68.5%
Ayco Charitable Foundation	\$195	\$162	30.3%
Schwab Fund for Charitable Giving	\$140	\$62	125.5%

TABLE 4

Sponsors of Donor-Advised Funds

	Community Foundation	Nonprofit Organization	Commercial Sponsor	Independent Sponsor
Yearly Fees	.65 – 1.75% (Lower as Size Goes Up)	Usually None	.65 – 2.75%	.25 – 1% (Lower as Size Goes Up)
Minimum	\$10,000	\$25,000	\$10,000–\$500,000	\$10,000–\$100,000
Investments	Organization-Directed or Donor-Directed	Organization Manages	Flexibility Within Mutual Fund or Brokerage Structure	Financial Advisor Manages or Flexible Within a Structure
Services	Can Be Minimal or Extensive	Might or Might Not Allow Input on Grant	Distributes Checks to Charities; No Help to Donor	Distributes Checks to Charities; No Help to Donor
Acceptable Assets	Broad Choices	Cash, Marketable Securities	Cash, Marketable Securities	Anything

organization does not manage money, donors can recommend their own money manager or advisor to make the investments. The American Endowment Foundation accepts a wide range of assets and a fund can start with as little as \$10,000. Its fee is 1 percent a year or as low as .25 percent for funds over \$2.5 million. (The advisor who manages the investment would charge an additional money management fee.) All donors have their own letterhead. In this way, the donor has the appearance of a private foundation, but without all the work.

Another independent sponsor is an alliance between National Philanthropic Trust, started in 1996, and Giving Capital, its administrator organization. The alliance offers investment options through a variety of mutual fund companies and investment management firms. The minimum contribution is \$25,000, and there are three fees: a charitable administration fee of .75 percent for accounts under \$1 million; an investment fee of 1.00–1.75 percent, depending on the size and type of investments; and a \$25 annual account fee.

A new independent sponsor is Mycfo-Foundation, established in 1999 by retired Internet company executives for their own philanthropy. The minimum is \$100,000, and a donor chooses among seven investment options.

Investment Options

If donors expect to operate a donor-advised fund for years or over generations, they usually care about how the money will be invested. Following are the four options that sponsoring organizations offer.

Broad investment choices. A few sponsoring organizations allow donors and their advisor the ability to choose their own investment portfolio. Guidelines and oversight for the investments used are set up by the sponsoring organization.

Mutual fund choices. Some commercial sponsors and some community foundations offer donors five to ten mutual funds from a family of funds. A donor can choose from this group and can change the mix over time.

Pools of mutual funds. Sponsoring organizations, usually mutual fund companies, put together a mix of mutual funds into a set group, called an investment pool, that ranges from conservative (bonds, money market) to moderate (stocks and bonds) to aggressive (all or mostly stocks). The ability to change the pool selection varies from annually to anytime.

No investment choice. Many community foundations require donors to use their investment management program for their donor-advised funds. In these situations, planners and clients research

the program's style of management and track record. For donors who are not interested in investment management, not having a choice could be seen as an advantage.

Important Questions

It is important to keep in mind that not all sponsoring organizations operate in the same way. Here are some questions to ask:

- What assets will you accept? Appreciated securities? Real estate? Artwork? Life insurance policies? Limited partnerships?
- What is the minimum to set up a named fund?
- What restrictions do you have on grants? For example, do you allow the donor to grant donations outside the city, state or country? What is the minimum grant amount?
- What flexibility do you have with regard to investments? Are outside investment advisors permitted?
- What are the fees? There could be as many as three fees: a sponsor administration fee, an investment fee (both are usually asset-based) and an account maintenance fee.
- What services do you offer?
 - (1) Stationery with fund name such as "Smith Foundation Fund" on the letterhead?
 - (2) Grant-making support?
 - (3) Interaction with the charity supported by the donor, such as the donor delivering the grant money?
 - (4) Option to remain anonymous or be publicly featured as the grant maker?
 - (5) Amount of staff service available to help the donor decide where to give?
- Does the fund continue in perpetuity or does it stop at the donor's or the spouse's death?

Table 4 compares the four types of sponsoring organizations.

Advantages of Donor-Advised Funds

As you and your client explore whether a donor-advised fund might be appropriate, consider both the advantages and disadvantages. Let's begin with the advantages.

Low contribution minimums by donor of \$10,000 and up. This makes it an affordable tool for most charitably inclined people.

Easy to set up. There are no complicated legal documents. A short, four- to six-page, fill-in-the-blank form is typically all that is necessary to set up a fund.

Cost efficient. No legal or accounting fees are required to start a fund. Usually, the sponsoring organization charges an administration fee ranging from .45 percent to 2.75 percent for a \$100,000 account (less if the account is larger). Some commercial sponsors require the donor to use the organization's mutual funds for the investment, so there would be internal mutual fund fees. If the donor retains an advisor to manage the assets, there could be an additional money management fee.

Simple. Charitable giving can be very complex, but with donor-advised funds, the donor only has a few decisions to make:

- What assets to contribute—cash, highly appreciated securities, private stock? (This assumes the tax planning has been done and the asset to be contributed makes tax sense.)
- Do the donors care which investments are used for their charitable dollars? Do they want investment flexibility?
- What type of charities? Should they be local, national or international?
- Should the fund continue in perpetuity? Should the children assume grant-making responsibilities when the donors are no longer able?
- Which sponsoring organization will best accomplish the answers to the questions above?

Tax benefits. Once an asset is given to a donor-advised fund, an immediate income

tax deduction is taken. Because there is no income received by the donor, the deduction is for the fair market value of the asset. This includes highly appreciated assets, which means that the donor does not pay tax on the capital gain of that asset. In cases where the charitable contribution exceeds the income ability to absorb it, carryovers of unused charitable contributions can go forward five years. In addition, the donated asset is out of the estate, so there could be estate tax savings if the estate is large enough. Finally, because donor-advised funds do not pay taxes yearly (unlike private foundations, which pay one to two percent yearly), the money grows faster than it would outside a charitable fund.

Screening services. Qualified charitable 501(c)3 charitable organizations, public charities, private operating foundations, and most religious organizations and educational institutions are eligible to receive a distribution from donor-advised funds. The sponsoring organization of a donor-advised fund will verify that the charities are qualified, whereas private foundations must verify eligibility themselves.

Flexible. Some charitable entities must distribute money yearly. If a donor is not ready to distribute to specific charities, a donor-advised fund is the perfect place to put a yearly distribution for later decision making. Added flexibility is provided by those sponsoring organizations that do not have a minimum distribution amount per charity (some do). In addition, a donor-advised fund can be set up to give to multiple charities simultaneously. The fund also can gift to certain nonprofit beneficiaries one year and different ones the next year.

Grant-making support. Some community foundations supply information on the activities of various charities and how to choose charities for grants. This can be invaluable for donors needing guidance. Most other sponsoring organizations do not offer this type of assistance, however, leaving donors on their own for grant-making decisions. Local community foun-

dations also offer the opportunity to be part of a local philanthropic community and perhaps participate in collaborative philanthropy with other donors and local charities.

Enhanced image. Some local community foundations (for funds over a certain amount, such as \$500,000) as well as some independent sponsors use letterhead with the donor-advised fund's name when sending grants to charities. Thus, a donor can choose to have a high profile as a grant maker.

Ability to give anonymously. If a donor wants total anonymity, the sponsoring organization can make the contribution while the donor directs the amount and the recipient.

Legacy of family philanthropy. A donor-advised fund that is set up to give only income can continue in perpetuity, involving later generations in philanthropy.

Parenting tool. Donor-advised funds that involve both parents and children in grant-making can be a rich training ground to pass on family values and establish a tradition of family philanthropy.

Easy decision-making structure. A donor is involved in all decision-making, unlike a private foundation whose board must be consulted, which can be a time-consuming process.

An alternative to a bequest. A straight bequest to a donor's favorite charity is always an option, but a donor-advised fund offers the possibility of an ongoing legacy that is not available with a yearly bequest.

Ability to receive donations from private foundations. Private foundations must distribute five percent of their income yearly and, if they have not made a decision on a specific charity, they could give the five percent to a donor-advised fund for later decision-making. This is also a good system to use for the yearly distribution from charitable remainder trusts or charitable lead trusts. In addition, private foundations that want to terminate can roll their assets to a donor-advised fund.

TABLE 5

A Comparison of Private Foundations and Donor-Advised Funds

		Private Foundation	Donor-Advised Fund
Set-Up Procedure		Must incorporate and apply to IRS for tax-exempt status	Simple agreement
Costs	Set Up	Substantial legal and accounting fees	None
	Ongoing Accounting, Tax Returns and Administration	Must perform financial and administrative services, or contract or hire staff; annual 990-PF tax return required	Sponsoring organization handles all financial, tax and administrative management, and does annual independent audit
	Excise Taxes	Typically 1–2% of investment income annually	None
Tax Issues	Tax Treatment of Contributions as % of Adjusted Gross Income	For cash: 30% For appreciated securities: 20%	For cash: 50% For appreciated securities: 30%
	Valuation of Deduction	Cost basis except full appreciated value for publicly traded securities	Fully appreciated value
Grants	Payout Requirement	5% of assets	Distribution policies vary; check sponsor program guidelines
	Management	Must verify the charitable status of all recipient organizations	Sponsoring organization verifies charitable status of all recipient organizations
Control Issues		Have total control of grant-making as long as it's a qualified organization	The sponsor has final approval on all grants, not donor
		Have control over investment choices	May have some control over investment choices and investment professional, but depends on sponsoring organization set-up
		Have more opportunities to showcase family legacy	Opportunities to showcase family legacy are dependent on sponsoring organization
Family Involvement		Opportunity for family members to work on all aspects of running a family foundation	Opportunity to work on grant-making by all family members without the distraction of administration work
		The original donor does not know how well or poorly the family will produce results together in the future	History of past operations to rely on for performance review
		Uncertainty of how well family will work together over decades and centuries	Sponsoring organizations have procedures, staff and board to ensure an ongoing quality operation
Family Perks		Can be structured	None
Liability Insurance		Any director's and officer's liability insurance, employee bonding, and office insurance must be purchased separately	Automatically covered by sponsoring organization
Privacy		Required to file tax returns on grants, investment fees, staff salaries, etc.; these are public records and are compiled into grant-seeker directories	Individual donors or grants can be kept private; if the donor wishes, the foundation can serve as a buffer between the donor and grant seekers
Possible Problems		More opportunities to violate rules and have conflicts of interest	All responsibility for rule following lies with the sponsoring organization

Disadvantages of Donor-Advised Funds

When considering donor-advised funds, also make your clients aware of the potential disadvantages.

Lack of control—grant-making. The donor can recommend to the sponsoring organization the charities to which he or she wishes to make grants, but the organization

has the final say over the distribution. If a valid charity is recommended, the recommendation will be followed. However, the donor does not have ultimate control of the funds.

Lack of control—investments. Investments typically can be selected from a prescribed list of options, but some sponsoring organizations do not offer a choice. The donor must use the system the sponsoring organization provides.

Lack of flexibility. Some people like to grant beyond the local area in which they live, but some donor-advised funds, such as those through community foundations, restrict the amount that can be granted outside the local area.

No income. Donor-advised funds are not a technique to be used if the donor wants income from the donated asset. If income is a priority, the donor should con-

sider vehicles such as pooled-income funds or a charitable-remainder trust.

No ability to hire staff. Because all work associated with donor-advised funds is done by the sponsoring organization, the donor cannot hire themselves or family members to do the work as they might with a private foundation.

Numerous choices. Because there are many ways to set up a donor-advised fund, the donor and his or her advisor must sort out the options and select the best fit.

Donor-Advised Funds Versus Private Foundations

Although private foundations have been written about more than donor-advised funds, the latter can offer advantages to both small and large donors, compared with private foundations.

In essence, donor-advised funds are simple to start and run, and have grant-making as their main focus. Private foundations allow the donor to have more control and visibility, but more work and cost are involved. Table 5 compares the two.

Donors should weigh the following factors when choosing between a private foundation and a donor-advised fund:

Size of initial contribution. Opinions vary on this subject, but most experts agree that donors with \$5 million or more to contribute should consider a private foundation, while donors with \$1 million or less may be better advised to consider a donor-advised fund. A typical administration fee charged for \$1 million donor-advised fund would be one percent, which would cap yearly expenses at \$10,000.

Desire for control. A wealthy donor, particularly an entrepreneur, often likes the control that a private foundation offers. In addition, there may be opportunities for family members to work in the foundation and be paid by the foundation. Expenses for family meetings to do the foundation governance and grant-making can be cov-

ered. Attorneys, CPAs and investment brokers all can be handpicked. A key question, however, is how well the foundation will run after the initial donor is gone.

Desire to be visible. All private foundations are public record. One benefit of a foundation with the family name on it is prestige.

Tolerance for complexity. If a family can deal with tax, legal and financial matters, a private foundation makes sense. If not, a donor-advised fund is a simple alternative.

Functionality of the family. How well does the family function in terms of its decision-making capabilities? If the family is not strong in this area, grant-making may be all the family can handle and a donor-advised fund may make more sense than a private foundation.

Case Examples

Flexibility is the hallmark of donor-advised funds. Here are three illustrations of how these funds were used in different situations.

- A family had been doing “checkbook philanthropy”—writing many checks to many organizations—up to a yearly total of \$25,000. The family used a donor-advised fund to accumulate funds and to research one or two projects to which they could contribute and have more impact.
- A family wanted to have a broad-based giving spectrum and become a part of an organization that could help them network with community needs. They chose a donor-advised fund at their local community foundation, which had over 200 other donor-advised funds and a staff with an abundance of grant-making experience.
- A donor who set up a private foundation was wise enough to realize that over time, his family could run into problems in trying to manage the foundation. To remedy this potential situation, he set up conditions within the private foundation document to require that the foundation be rolled into a donor-advised fund if

For More Information

American Endowment Foundation,
(888) 440-4233,

www.aefonline.org

Christian Community Foundation,
(719) 447-4715,

www.thefoundations.org

League of California Community
Foundations, www.lccf.org

MycfoFoundation, (877) 692-3611,

www.mycfo.com

National Philanthropic Trust & Giving
Capital, (215) 277-3030,

www.givingcapital.com

irreconcilable disagreements arose among family members.

As these examples illustrate, donor-advised funds can solve a range of needs. Advisors who are versed in this option can offer clients a valuable service. Advisors with this expertise typically can be located by contacting community foundations or independent donor-advised fund sponsors. From there, the applicability of donor-advised funds to individuals' and families' charitable-giving intentions and dreams is limited only by one's imagination.



Endnotes

1. *The Chronicle of Philanthropy*, survey of 75 donor-advised funds, May 30, 2002, <http://www.philanthropy.com>.
2. “A Flexible and Growing Service to Donors: Donor-Advised Funds in Community Foundations,” Council on Foundations, September 2002.
3. “Sweet Charity,” *Bloomberg Personal Finance*, October 2002.
4. *The Chronicle of Philanthropy*, as cited in *Financial Planning* magazine, “Everybody into the Pool,” November 2002.