Donor-Advised Funds

Donor-advised funds are public charities or subsidiaries of public charities that give donors the ability to make a large gift to the charity and then “advise” — without the legal right to actually direct — the fund on how and when to make specific charitable gifts. Several donor-advised funds, such as the Fidelity Gift Fund and the Vanguard Charitable Endowment Program, have been very successful in raising money on a commercial basis. In addition, a growing number of community foundations, including most of the larger ones, such as the California Community Foundation and the Central New York Community Foundation, offer donor-advised funds.

The donor-advised fund area, once a sleepy backwater of charitable giving, has in recent years gained tremendous acceptance, driven in part by Fidelity’s marketing machine. There are several reasons.

First, a donor-advised fund, whether a commercial or a community foundation, offers the donor the ability to make a gift immediately for tax purposes and decide later when and where to make grants to the charities that will eventually spend the money.

Second, gifts to donor-advised funds qualify as gifts to a public charity for tax deduction purposes. Depending on the specifics of the donor’s situation, this advantage may be worth anything between zero and a large number.

Third, it is simple. A donor simply writes a check or sends money,
not unlike opening a mutual fund account, and may sign an agree-
ment covering the way in which she will advise on grants to be
made. There is no further paperwork for the donor, because the
fund takes care of it all.

Because a donor-advised fund is treated as a public charity for
purposes of income-tax deduction limitations, it can offer some
benefits for donors who want to give more than 30 percent of
their income to charity each year or to donate appreciated prop-
erty other than publicly traded stock. If this is the only reason for
considering a donor-advised fund, however, a donor may wish to
consult an adviser about other possibilities that can allow him to
give a higher percentage of income and maintain better control.

Donor-advised funds can offer some savings in certain situations.
For example, they do not pay excise taxes, as private foundations
do. However, because the excise tax rate for foundations is only
2 percent of earnings (not assets), this advantage is typically very
small—a few hundred dollars a year on $500,000 of assets. A do-
nor-advised fund may also save money on annual fees for donors
who will never have more than $200,000 or so in a charitable en-
tity.

Donor-advised funds spare donors some paperwork, because the
funds handle the compliance work. But with professional founda-
tion management, donors to private foundations are also spared
paperwork. For charitable commitments of about $500,000 or
greater, such a donor can have all the benefits of a private founda-
tion and none of the headaches, for about the same costs.

In spite of, or perhaps because of, these benefits, some donors
are confused about what a donor-advised fund actually is. Some
donor-advised funds encourage the confusion by calling a donor’s
account a “foundation.” A donor-advised fund is itself a charity.
When you give money to a donor-advised fund, you are giving
away your money—irrevocably. The charity that receives it—that
is, the donor-advised fund—then owns the money. “Once a contribution is accepted, it’s an irrevocable charitable contribution to the Gift Fund, to be owned and held by our Trustees,” says the nation’s largest commercial donor-advised fund, Fidelity Gift Fund.

While usually there is no issue, occasionally the donor might end up out-of-luck. For example, the National Heritage Foundation for years offered donor-advised fund accounts which they called “Foundations.” As with all donor-advised funds, contributions to National Heritage Foundation’s donor-advised fund were legally contributions to the National Heritage Foundation. Donor-advised contributors learned the significance of this distinction the hard way in January, 2009 when National Heritage filed for bankruptcy. The bankruptcy court in that case reaffirmed the fact that donor-advised fund donors have no legal claim to the assets, and have merely an “advisory” role. In other words, “sorry fellas.”

National Heritage Foundation is the exception. A donor-advised fund will generally take the donor’s advice, but is not required to take such advice. In fact, the Internal Revenue Service (IRS) takes a negative view of any pledge by a donor-advised fund to follow donor advice. In the Tax Reform Act of 1969, which established the current laws dealing with private foundations, Congress made quite clear that it considered control over a foundation to be a privilege, and that in exchange for that privilege, foundations had to adhere to a complex set of requirements and limitations. The agency objects to attempts to offer the benefits and avoid the rules. In accordance with those rules, Fidelity makes it very plain that Fidelity, not the donor, controls the money. “As a donor, you may recommend grants,” states Fidelity’s marketing material. That recommendation is then reviewed by the fund trustees or staff. “If the recommendation is not approved, we will try to notify you and obtain a recommendation for a grant to an alternative charitable organization.” In other words, they’ll try to accommodate you, but your funds become their money, and they’ll ultimately do as they see fit.
A private foundation, in contrast, gives the donor full, legal control. And if a foundation is managed by a full-service professional management firm, administration is nearly as simple for the donor as it would be with a donor-advised fund. The difference is that the donor need not worry about whether his wishes will be followed.

While most donor-advised funds follow donors’ advice most of the time, this could change. The IRS, in its 2001 Exempt Organizations Instruction Program (EOIP), said that it “will look closely at” donor-advised funds that say they will “follow donor advice as to charitable distributions all the time.” They finally got around to issuing further clarification in 2006. We review those changes in some depth in Chapter 14.

Another concern about donor-advised funds is that they are susceptible to public pressure to avoid controversy. A popular “Mom-and-apple-pie” charity can quickly become highly controversial, as the Boy Scouts has. Once that happens, public and political pressure may be placed on donor-advised funds to stop directing funds to such charities—regardless of the donor’s wishes. Private foundations, in contrast, can support any cause as long as it is a recognized charity.

A new potential problem for donor-advised funds has been created by the antiterrorism measures enacted since September 11, 2001, targeting charities that support—or are believed to support—terrorism. A donor-advised fund is legally a single charity. But it might agree to make a grant to any charity that a donor to the fund designated. What happens if one of those recipient charities turns out to be a supporter of terrorism? Will the government freeze the assets of the donor-advised fund? While this is probably not likely, it still applies and does raise the possibility that those who give money to a donor-advised fund are linking their fate to the actions of hundreds or thousands of other people whom they do not even know.
A number of people who have put money into donor-advised funds found that the sponsors made it difficult to distribute money to unpopular causes, or causes they didn’t deem important. One of the largest disputes between a donor and a community foundation has dragged on for several years between the Chicago Community Trust and the Searle family, led now by Daniel Searle. He is the son of pharmaceutical magnate John G. Searle (most famous for his company’s Nutra-Sweet products) who provided the funding in question. The Office of the Illinois Attorney General states, “The issue centers on whether and to what degree [John G.] Searle intended the Chicago Community Trust to defer to the Searle ‘family consultants’ in the granting of monies from the fund.”

While the relationship between the Searles and the Trust is not exactly a donor-advised fund relationship, it shares the critical element of donor advice without legal control. Under the will of the elder Searle, the Chicago Community Trust was to administer certain funds, currently about $20 million a year, in conjunction with advice and input from the Searle family. In 2011, about $40 million was frozen in an account at the Harris Bank in Chicago, and the dispute resulted in a lawsuit. Ironically, the Searles argued that the Chicago Community Trust should behave more like donor-advised funds and the Trust countered that it was attempting to act in the best interests of everyone. “Really what this all comes down to . . . is a relationship that has deteriorated over time,” Tina-Marie Adams, a spokeswoman for the Searle family, told the Chicago Tribune. That’s as good as any comment for an implied warning to those considering entering into such long-term, nonbinding relationships.

The Searle’s lawsuit dragged on until 2004, when it was settled under terms that were kept quiet. The Searle Fund continued at the Chicago Community Trust, where it remains. However, whether by coincidence or not, shortly after the suit was settled, the President of the Chicago Community Trust, Donald Stewart, stepped down after only four years in the position.
While this case is notable for its magnitude, it is hard to know exactly how often donor-advised funds disregard a donor’s wishes. Again, disputes are often embarrassing for both sides, so that neither has much desire to publicize them. And, usually, donors have no standing to complain. After all, they agreed to the terms specifying that they didn’t have control, and to attempt to assert a legal claim would be tantamount to admitting that they obtained improper tax benefits.

There are other limitations to commercial donor-advised funds. One is that they offer few investment options. Financial services companies that run donor-advised funds generally require donors to put their money into their own mutual funds or other investment vehicles. A donor cannot hold stock in a donor-advised fund; if he donates stock, the fund will sell it and invest the proceeds in its own mutual funds. Furthermore, the choice of mutual funds is restricted not just to that company’s funds, but to specified funds—which impose additional costs, beyond the administration fee charged by the donor-advised fund itself. Fidelity Gift Fund, the largest commercial donor-advised fund, offers only four investment choices, each consisting of a pool of its own mutual funds. Even among these four, Fidelity has the ultimate say as to where the money is invested. As we see in Chapters 9 and 10, limited investment flexibility can sometimes be quite costly.

Private Foundations

In essence, a private foundation is a tax-exempt charity that is funded and controlled by an individual or a family. A private foundation may be set up as a not-for-profit corporation or as a trust. Whichever arrangement you choose, a private foundation is treated the same for tax purposes. However, there are certain advantages that usually make the not-for-profit corporation more appealing than the trust.
The Not-for-Profit Corporation

Establishing a foundation as a not-for-profit corporation is a routine matter. As with a for-profit corporation, incorporation requires filing a certificate of incorporation with the state and adopting by-laws, which describe the internal workings of the organization. The primary difference is that a not-for-profit corporation usually has no shareholders. Instead, it may have members who elect a board of directors, which in turn appoints the officers. Alternatively, the board of directors can elect its own successors.

There are several advantages to the corporate form for a foundation: limited liability for officers and directors, greater flexibility (than a trust would have) to adapt the organization’s structure as circumstances change, and the ability to have perpetual life (still not available for trusts in most states). Another feature of the corporate form is that it permits changes in the foundation’s charitable goals. While some founders view this flexibility as a negative, we have found that you can have the best of both worlds by using a corporate form but maintaining control by having the donor make restricted grants to the foundation. Not-for-profit corporations, just like for-profits, are managed by their directors or officers. Certain management tasks, such as investment management and administration, may be delegated to professional advisers. Officers and directors, including family members, may be paid reasonable compensation for services actually performed.

Corporate form requires that the usual corporate formalities be observed, such as annual meetings and minutes. While these can be done simply, even perfunctorily, many families view them as a useful way to expose younger members to corporate workings.

The Trust

To establish a private foundation as a trust, the founder must sign a written document making a gift, in trust, to one or more trustees.
The founder himself can be the trustee. A trust is generally located in the founder’s home state. The registration rules vary from state to state.

Within limits, the terms of the trust can be broad or narrow, as desired. For example, a founder could write very narrow language into the trust document (see Chapter 7), or very broad language. For this reason, some founders believe that a trust gives them more control because it can be more difficult to change a trust, as compared to a corporation. However, structuring a trust very narrowly is not inherently better than making restricted gifts to the foundation, and may inadvertently (because of the difficulty of making changes) tie the hands of the trustee—even if the trustee is the founder—when unforeseen changes occur.

A trust has one or more trustees, just as a corporation has directors. Trustees generally select their successors. Trustees may receive reasonable compensation for services actually performed, although some states have more restrictive rules for trustee pay than for corporate director pay. Conversely, California imposes strict rules that often make the corporate form a bad choice for foundations in that state. Because investment management is traditionally seen as part of the trustee’s duty, payments to professional investment managers may reduce the amount that can be paid to trustees under state law. These kinds of rules vary from state to state.

There are other drawbacks to creating a foundation as a trust. Perhaps the most important is that trustees have a fiduciary duty to the beneficiaries. This is a higher standard than the “business judgment” rule that applies to corporate directors, and can make it more difficult to attract outsiders as trustees. In addition, beneficiaries of a trust may have standing to sue that they would not have if the foundation were a corporation.

Because some foundations are trusts, and are therefore governed by trustees, and some are corporations and therefore governed by
directors, the terms “trustee” and “director” are commonly used interchangeably in the nonprofit world. We generally use the term “director” in this book.

**Private Foundations: Why the Gold Standard?**

For a donor with substantial assets, no other charitable vehicle can match the unique combination of flexibility, control, and tax advantages offered by private foundations. A private foundation offers its founder the ability to make a difference in the world, build a permanent legacy, gain personal satisfaction and recognition, and keep control in the family forever. (It also offers an array of tax and financial benefits, which we will cover in greater detail in the next chapter.)

**Make a difference.** A truly effective foundation is much more than a sum of money set aside for philanthropic use. It is the carefully cultivated, ever-evolving product of the founder’s vision, drive, and ethical will. The ways in which foundations make a difference are as varied and interesting as their founders.

For example, the Arthur Schultz Foundation, headquartered in western Wyoming, is dedicated to promoting environmental conservation and providing access to recreation for the disabled. The Russell Sage Foundation, founded in 1907 by Margaret Olivia Sage in New York, funds research into the social sciences with the goal of improving social policies. The James S. McDonnell Foundation, founded in 1950 by the aviation pioneer and cofounder of the McDonnell Douglas Corporation, aggressively encourages the “improvement of mankind” through its 21st Century Science Initiative.

When Congress was debating restrictions on foundations in the 1960s, a supporter of foundations, noted philanthropist Irwin Miller, the former CEO of Cummins Engine who built the company into a major player in its market, commented that “while
foundations are the most peculiarly American manifestation of the philanthropic impulse, they do not operate as simply as traditional charity; taking the long view, and working with professional skills, they have grown more sophisticated and specialized in their approach to problems.”

Create a legacy. Charitable foundations have a long and honorable history. When Plato died in 347 b.c., he left income from his estate for the perpetual support of his academy. Control passed through heirs who each designated their successor, and the academy thrived until 529 a.d., when Roman emperor Justinian terminated it for spreading pagan doctrines. While 856 years is not exactly forever, Plato’s foundation surely ranks among the most long-lived individual institutions in the history of humankind.

When Benjamin Franklin died, he left 1,000 pounds sterling to the cities of Boston and Philadelphia with detailed instructions for use of the money. Franklin directed that some of the earnings be used initially for loans to young married couples, allowing principal and interest to grow, with the first use of the accumulated funds to be made 100 years later. The endowment helped finance the Franklin Institute of Philadelphia and the Franklin Institute of Boston, and the remainder continues to grow today.

Andrew Carnegie and John D. Rockefeller are often viewed as the pioneers of the modern charitable foundation. In 1899, Rockefeller told a group gathered to commemorate the tenth anniversary of the University of Chicago, “Let us erect a foundation, a trust, and engage directors who will make it a life work to manage, with our personal cooperation, this business of benevolence properly and effectively.” The foundations established by Rockefeller and Carnegie are still active today, doing good work and carrying on their founders’ names.

But a private foundation offers more than a long-lasting legacy. Because it is private, it can be and do exactly what the founders
and directors want—even if what they want is considered unconventional by others. The John D. and Catherine D. MacArthur Foundation pursues an unconventional path. Founded in the late 1970s upon the death of industrialist John D. MacArthur (his wife died in 1981), it has become known for its “genius” grants—unrestricted grants, with no required reports or expected outcomes, given to “exceptionally creative individuals, regardless of field of endeavor.” The MacArthurs’ son, Roderick, a trustee of the foundation, revels in the foundation’s freedom to pursue its own vision. “This [the private foundation] is the only institution in our society that does not have constituencies that it has to keep looking to. All the others have to worry about pleasing a lot of people, so they’re bound to tend toward conventional wisdom, respectability, and the lowest common denominator. . . . Foundations should be striving to do the kinds of things that the government cannot do. I repeat, cannot do: things that are not politically popular, things that are too risky, things that are just too far ahead of what the public will put up with. . . . A private foundation, where the board of directors is answerable only to itself, is in a completely different situation, and if it doesn’t take advantage of that uniqueness, it’s just blowing its opportunity, and perhaps even its moral obligation.”

**Achieve personal satisfaction and recognition.** In the late 1990s, Karen Maru File, an associate professor of marketing at the University of Connecticut, conducted a survey of philanthropists who had established their own private foundations. She found that 86 percent said their giving had become much more gratifying, and 79 percent said they felt less barraged by solicitations from charities.

Another important benefit is the recognition that comes from having a private foundation. Researcher Teresa Odendhal, author of several books on philanthropy and foundations, quotes one donor who created a private foundation: “If you are an individual making small contributions, you are magically transformed when you
become a foundation making small grants. I feel that I am taken very seriously.”

A 1999 article in Scientist Magazine predicted that in the coming millennium, the private foundation would become the status symbol of choice. And in the first decade of the this millennium, the number of foundations has continued to grow, despite two of the worst stock market dives in the past century, as seen in Figure 1.1. In 2011, the New York Times reported that status is a major factor for some donors. “Of course,” says the January 28 Wealth Matters column, “There are reasons that go well beyond charitable giving….Status is the obvious one….”

![Figure 1.1 Growth in Foundations](image)

**Figure 1.1 Growth in Foundations**

Donors who intend to have their children eventually run their foundations will also benefit—not merely by having a status symbol, but by being able to give more. As one adviser who also has his own foundation told the authors, “It’s a great way to give my kids my influence, and it makes good financial sense, too.”
Maintain family control. As we saw in the discussion of other charitable vehicles above, control over how money is spent is often an issue. With private foundations, the donor retains full control. Indeed, the Searle family learned its lesson, and the current generation, led by Dan Searle, has an active private foundation, the D&D Foundation, which was created in 1983. A spokesperson for D&D speculated that the elder Searle made the now-troublesome arrangement with the Chicago Community Trust only because at the time, in the mid-1960s, his generation did not see control as such an important matter.

Control extends to all aspects of a foundation: the name; who is on the board; when, how, and to whom the money is donated; how the money is invested; and the choice of the bank or institution that will actually hold the funds.

Conclusion

The table on the following page summarizes and compares the key features of the charitable vehicles discussed in this chapter.

As this table shows, only the private foundation offers legal control along with its tax benefits. A private foundation also offers more flexibility—in how to invest and how to spend the money—than the alternatives. As for eventual disposition of assets, if a donor creates a private foundation but later changes her mind and wants to stop running it, she can still give some or all of the foundation assets to a donor-advised fund. The reverse is not true: A donor-advised fund may not contribute to a private foundation.

In addition, if its assets are large enough, a private foundation can be very cost-effective. While it is possible to spend upwards
of $20,000 to set up a foundation, it does not necessarily cost that much. It may be $10,000 or less. Many full-service foundation companies—especially those providing financial management services, grants administration, and full foundation management—set fees based on a foundation’s assets. For example, a foundation might pay an annual fee of 1 percent of total assets to a company that handles all the foundation’s financial and administrative operations.

Most donor-advised funds do not impose a set-up fee, but they tend to charge higher annual fees. Fees for donor-advised funds
vary quite a bit, with the typical cost running about 1.5 percent of assets, which consists of an administrative fee of 1 percent of assets, plus investment management fees of approximately 0.5 percent.

Private foundations and donor-advised funds both play an important role in the charitable universe, and in general neither can be decisively preferred on the basis of cost alone. Donor-advised funds and private foundations each offer a unique combination of grant-making control, investment flexibility, and tax benefits. The next chapter looks at these tax benefits in greater depth and discusses several ways to take advantage of them.

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