PERSONAL FINANCIAL PLANNING

Considerations for philanthropic vehicle decisions

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Philanthropic giving involves consideration of several structures and depends on factors including client control, level of contribution or investment, and the ability and willingness of the client's family to participate in administrating the endeavor.

Practitioners who work with clients considering lifetime philanthropic engagements need to know what should be taken into account when choosing a desired charitable vehicle. Options are quite different if a client does not want to or cannot afford to irrevocably part with significant capital — with the exception of using a testamentary charitable lead trust with a private foundation being used as the beneficiary.

Other options span from unrestricted gifts and donor-advised funds (DAFs) to private foundations. Unrestricted gifts do not require significant planning, so this column assumes the client wants continuing involvement in the endeavor.

Quite often, the philanthropic decision boils down to three main factors.

First factor: Importance of the client's retained control

Charitable gifting strategies can often be separated by the level of retained direct or indirect control.

Testamentary charitable planning

The first rung of gifting is simply retention until death, i.e., testamentary charitable planning. Retention maximizes the donor's retention of control over the property as well as his or her access to the capital represented by the estate, and the use and enjoyment of the property and any income or gain therefrom. Charitable testamentary gifts result in a total loss of the income tax charitable contribution deduction.

Family limited entity, LLC, or FLP

The second rung of lifetime charitable gifts is formation of a family limited entity, limited liability company (LLC), or family limited partnership (FLP), followed by gifts of interests in the entity. Such gifts are ordinarily subject to valuation discounts for lack of control and lack of marketability, and they permit the donor (or someone else) to control the cash flow paid out by the entity attributable to the gifted interest.

However, gifts of this type are often difficult to make to either public charities or private foundations. Public charities want an immediately monetizable asset and are often fearful of unrelated business taxable income, so they rarely accept gifts without a short, clear path to monetization. With private foundations, tax problems increase to include the world of prohibited transactions under Sec. 4941 and the excise tax on excess business holdings under Sec. 4943.

Private foundation

The third rung on the charitable side is the creation of a private foundation, where the assets donated to the private foundation must be expressly set aside exclusively for charitable purposes. Private foundations are subject to lower contribution base limitations for purposes of the income tax charitable contribution deduction vis-à-vis public charities, and there are several penalty taxes and penalties, as well as doctrines such as private benefit and private

There are several granular considerations in the decision between a DAF and a private foundation.

inurement to contend with. Both doctrines also apply to public charities, albeit possibly with less harsh effect, given the intermediate sanctions provision of Sec. 4958, a penalty for private benefit less than the "death penalty" (loss of tax-exempt status and prohibitions against self-dealing).

The private foundation represents the second-best way to retain control over charitable gifts. The family retains full grantmaking authority and control over the charitable entity or trust within the confines of the tax law and the tax and state law limitations and restrictions over exclusively charitable assets.

Supporting organization

The fourth rung on the charitable side is the supporting organization. In the supporting organization, the donor surrenders effective control over the operations of the charitable entity and the flexibility of changing the charitable beneficiary or beneficiaries unless a community foundation is used in exchange for effective treatment as a public charity — i.e., relief from the restrictive and punitive private foundation provisions of the Code. However, supporting organizations, while possibly not requiring quite the level of financial commitment as the private foundation, nevertheless still require a sizable investment. It is virtually unheard of for a supporting organization to start with less than $500,000.

Supporting organizations come in three forms. The overwhelming majority of family supporting organizations are so-called Type III supporting organizations, which themselves are further divided into two types: functionally integrated (Type III FISO) and nonfunctionally integrated (Type III non-FISO). Most families prefer Type III non-FISO, but some have been dissuaded since the creation of the new regulatory requirement of minimum annual distributions (Regs. Sec. 1.509(a)-4(i)(5)(ii)).

DAF

The fifth and final rung on the charitable side is the DAF account. With a DAF account, the donor surrenders not only asset control but also ultimate say about the identity of the charitable recipients — but retaining advisory privileges, which today can be almost perpetual — in exchange for deductibility of contributions as if the DAF were a public charity. This relieves the DAF from the often bureaucratic and sometimes burdensome grant taking, grantmaking, and beneficiary oversight.

DAFs can be used to give anonymously, unlike with private foundations. The contributed funds grow tax-free inside the DAF. Unlike private foundations, at least under current law, there is no annual 5% minimum distribution requirement, so the DAF can grow faster. Also unlike private foundations, there is no 1.39% annual tax on investment income.

Second factor: Level of philanthropic contribution or investment

The ultimate financial deciding factor in choosing the best philanthropic vehicle is often the amount of money the client is willing to irrevocably commit. This level of commitment usually points to either a DAF or a private foundation due to the sizable difference between the minimum financial commitments required.

The easier question to answer is what is the minimum initial contribution required to open a DAF account?

It is also not unusual for a wealthy couple to set up a private foundation for their children to assist in running, to teach their children philanthropy and how to get along.

Most DAF sponsors do not require a minimum contribution, but sponsors can differ greatly over whether the account must reach a certain minimum level before advisory grants can be made out of it.

The more difficult question is how much of a contribution is required to justify the creation of a private foundation? If you asked this of five lawyers, you would probably get five different answers, but the important point is that the professional legal and tax work required to start a private foundation are significant.

First, a not-for-profit corporation or wholly charitable trust instrument needs to be formed and qualified as tax-exempt with the IRS. Once the foundation has been formed, it must be administered, which includes taking grant applications, making grants, supervising accountability of grant recipients, filing an annual Form 990-PF, *Return of Private Foundation*, advertising what is required, making the investments of foundation assets, and more. All of these activities require a minimum commitment of $2 million, and probably closer to $5 million, to justify forming a separate private foundation.

The third and final factor: The family's ability and willingness to participate in the proper administration of the philanthropic endeavor

One of the big practical problems in administration of a private foundation is recruiting and supervising people to do administration and governance. It is not unusual for the senior generation of a family to set up a private foundation because they have a passion for philanthropy — usually a particular cause — but their successors may have different time management priorities or vastly different philanthropic interests.

It is also not unusual for a wealthy couple to set up a private foundation for their children to assist in running, for the purpose of teaching their children philanthropy and how to get along. However, these well-intentioned efforts often do not work out long term, for a host of reasons. Some families do not have the interest or ability to manage and run a private foundation. Just as likely, the children will clash in their favored causes, such that the family private foundation is divided and each child ends up with his or her own private foundation.

For the reasons discussed above, a private foundation is often converted to a DAF account instead of formally dissolving under applicable state law and distributing the private foundation's assets to one or more charitable organization recipients. Obviously, with a DAF account, the donor and his or her family have to rid themselves of all management, administrative, investment, and compliance responsibilities and must make recommendations to the DAF sponsor for grants, which takes far less time. Moreover, the family can name a DAF account, and most DAF sponsors today are very flexible and allow virtually perpetual successor advisory rights.

In the supporting organization, the donor surrenders effective control over the operations of the charitable entity and the flexibility of changing the charitable beneficiary or beneficiaries.

Additional more granular considerations in making the decision between a DAF and a private foundation include setup costs and ongoing management and compliance fees, income tax charitable deduction contribution base differentials, and the desirability of employing and compensating family members in the philanthropic endeavor.

The choice of charitable vehicle can be complex, and, as discussed here, that choice depends on careful analysis of many factors. ■

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