CHARITABLE GIVING WITH DONOR ADVISED FUNDS AND PRIVATE FOUNDATIONS

Introduction

Navigating donors through the field of philanthropy often comes down to helping them choose the right charitable giving vehicle. Donor advised funds and private foundations are popular charitable giving vehicles that offer donors valuable tax advantages. While donor advised funds and private foundations share a similar structure, each one differs in donor control, administrative responsibilities and regulatory requirements. By understanding the nuances of each vehicle, advisors can guide donors toward the giving structure that best aligns with their charitable goals and financial circumstances.

Private Foundations

All organizations that are recognized under Sec. 501(c)(3) are classified by the Internal Revenue Service (IRS) as either a public charity or a private foundation (PF). By default, every 501(c)(3) organization is treated as a PF unless it specifically applies for and receives IRS recognition as a public charity. IRS Pub. 557. Public charities are nonprofits that many individuals commonly associate with public services like schools, hospitals and social welfare organizations. In contrast, PFs are typically funded by an individual, family or corporation and make grants to support other nonprofits rather than operating their own charitable programs.

When a PF is established, it becomes a distinct legal entity. PFs are required to annually file Form 990-PF to the IRS. The IRS makes these filings public. As a result, the PF's financial information, including grants and compensation to officers and directors, is publicly available. A PF's founders or board members must develop governing documents, such as articles of incorporation and bylaws to define the foundation's charitable purpose and structure. The foundation must also obtain an employer identification number (EIN) and establish clear grantmaking guidelines, as these will ensure that the foundation's process for making grants is consistent and aligns with the foundation's mission. A PF's founders should also be prepared for initial start-up costs associated with the formation of the foundation, including legal and filing fees to establish the governing documents and continuing costs for ongoing activities.

Donor Control

One of the main benefits of a PF is the level of control it offers. Founders and their family members can serve on the board of directors or as trustees, deciding how assets are invested, which charitable organizations receive grants and the PF's overall ongoing mission. However, while this level of control provides the greatest donor flexibility and influence, it also carries increased responsibility to comply with IRS regulations that govern the PF's activities.

Minimum Distribution Requirement

PFs are required to make charitable distributions each year. The "minimum distribution requirement" under Sec. 4942 requires PFs to pay out each year an amount equal to 5% of its net investment assets in qualifying distributions, subject to detailed rules in Sec. 4942 and the related regulations. Qualifying distributions can be grants to qualified charities, administrative costs associated with making grants, carrying out the PF's own charitable activities and acquiring

assets. Sec. 4942(h). This requirement is intended to ensure and enforce that PFs operate for charitable purposes, rather than as a perpetual endowment. The minimum distribution requirements spur annual charitable impact and highlight the need for careful budgeting and planning by the foundation's leadership.

Self-Dealing

Because PFs are often organized and maintained by a founder or the founder's family, there are strict rules to ensure that the charitable purpose of the foundation is not abused for private gain. Accordingly, PFs should avoid transactions with disqualified persons. Under Sec. 4941, PFs are prohibited from any direct or indirect transactions with a disqualified person, or it will be deemed an act of self-dealing. For purposes of the self-dealing rules, a disqualified person includes any substantial contributor to the foundation, foundation managers, their children, grandchildren and other lineal descendants, as well as the spouses of these individuals. It also includes certain entities that are owned by, or have an interest in, a disqualified person. Sec. 4946.

Self-dealing occurs when a PF and a disqualified person engage in certain transactions. These transactions include selling, exchanging or leasing property, lending money, providing goods or services, paying compensation, reimbursing expenses or using the foundation's assets or income for the benefit of a disqualified person. Reg. 53.4941(d)-2. Acts of self-dealing are penalized by an excise tax based on the transaction amount. A disqualified person would incur a 10% tax, while a PF manager who knowingly participates in the act would have a 5% tax imposed, which cannot exceed $20,000.

If the violation is not corrected, the disqualified person will owe additional taxes in the form of 200% of the improper benefit, and the PF manager would have an additional tax of 50%, not to exceed $20,000. Sec. 4941, Reg. 53.4941(b)-1. There is no cap on the excise tax for a disqualified person. Because PF managers who knowingly participate in a prohibited transaction can be penalized, donors acting as managers of a PF should carefully oversee all activities to avoid any transactions that could inadvertently trigger self-dealing rules.

Excess Business Holdings

A PF's ownership in a business is subject to strict limits. PFs are permitted to hold no more than 20% of a corporation's stock or business interest. The limit goes up to 35% if there is an unrelated third party that has control of corporate voting stock. These limits apply only when the PF holds more than 2% of the company's stock or interest. Sec. 4943(c)(2). If a PF holds more than the allowable share of a business, a 10% excise tax is applied to the value of the excess business holdings. If the excess holdings are not corrected by the end of the correction period, an additional 200% excise tax is imposed. Sec. 4943(a). If a business interest is acquired by gift or bequest, a PF will have five years to dispose of the interest that violates the excess business holdings rules, with the possibility of extending that period to as much as ten years for certain large and complex holdings if the IRS grants specific approval.

Deduction Limits

Since PFs allow donors to have a high degree of control, the tax treatment of contributions to PFs is more restrictive than it is for public charities. The stricter rules are largely due to PFs being controlled by a smaller group of individuals or family members, as opposed to being broadly supported by the public. As such, there is a deduction limit of 30% of donor's adjusted gross income (AGI) for contributions of cash. For contributions of appreciated property, the deduction limit is 20% of donor's AGI.

There is a subset of PFs, known as private operating foundations (POFs), which provide more favorable tax benefits than traditional PFs. POFs are PFs that engage in activities in furtherance of their charitable purpose, meaning they conduct their own charitable programs. Gifts to POFs will qualify for higher tax deduction limits. Contributions of cash are subject to a deduction limit of 50% of a donor's AGI, and gifts of appreciated property are deductible up to 30% of a donor's AGI. For the purposes of this article, we will focus on non-operating PFs.

Example 1 - Paul and Stephanie Grantwell are long-time philanthropists who recently sold a portion of their family's business. After the sale, they decided to establish the Grantwell Foundation, a non-operating PF that will make annual grants to education and healthcare organizations in their community. In 2025, the couple has an AGI of $750,000 and contributes $300,000 in publicly traded stock that has appreciated over time. The donors receive a fair market value charitable deduction for their gift.

Because their foundation is a non-operating PF, their charitable deduction is subject to the 20% AGI limit for appreciated property. In this case, Paul and Stephanie can deduct $150,000 of their gift in the current year. The remaining $150,000 can be carried forward and deducted over the next five years.

While PFs offer donors significant control and flexibility, the combination of administrative responsibilities, start-up costs and strict regulatory requirements are best suited for donors that are prepared and willing to manage a PF's nuanced compliance obligations. For donors who wish to support charitable causes without assuming these obligations, donor advised funds (DAFs) may provide an attractive alternative.

Donor Advised Funds

A DAF is an account that is maintained and operated by a public charity organized as a Sec. 501(c)(3) organization, called a sponsoring organization. Typically, DAFs are created when a donor fills out the sponsoring organization's DAF application or agreement and makes an irrevocable contribution to fund the account. To qualify as a DAF, the account must meet the following requirements: the DAF must be separately identified, it must be owned and controlled by the sponsoring organization and the donor must reasonably expect to have advisory privileges over the fund. Sec. 4966(d)(2)(A).

Separate identification can be accomplished by creating a distinct fund or by separately identifying contributions from the donor. Ownership and control are determined at the level of the sponsoring organization, meaning that all the DAF documents must explicitly state that the organization retains full legal control over the fund. In some cases, even without a formal document, a DAF may be deemed to exist if a donor makes large gifts and regularly recommends grant recipients.

The sponsoring organization is responsible for all administrative, legal and recordkeeping functions associated with a DAF. These duties would include managing investments, issuing tax receipts and preparing all IRS filings. Unlike PFs, the sponsoring organization does not file separate Form 990s for each DAF. Contributions and grants would be reported by the sponsoring organization, and many organizations allow donors to recommend grants anonymously. Since the sponsoring organization assumes these management responsibilities, donors can give to a DAF without the operational obligations that come with a PF, making it appealing for those who prefer more discretion in their giving without the administrative burdens that come with a PF.

Donor Control

Once an asset is contributed to a DAF, the donor has relinquished all ownership of the asset. However, because the donor holds an advisory privilege, a donor can stay involved by offering non-binding recommendations on how the funds should be invested and where the grants should be made. The sponsoring organization ultimately approves the grants so long as they meet IRS requirements.

It is important to understand that ***advisory privileges do not equate to legal control***, and certain types of funds are specifically excluded from being treated as DAFs. Under Section 4966(d)(2)(A), a contribution to a field of interest fund or a designated purpose fund will not create a DAF. Likewise, contributions to a fund where the donor retains advisory rights, but all distributions support a single charity or a fund maintained by a governmental entity, would also not create a DAF. Sec. 4966(d)(2)(B)(i).

More than Incidental Benefit and Excess Benefit Rules

Similar to PF's self-dealing rules, DAFs must also avoid transactions that provide more than an incidental personal benefit to disqualified persons. Disqualified persons include the donor, family members and 35%-controlled entities. Sec. 4967(a)(1). Family members would consist of the donor's siblings, lineal ancestors or descendants and their spouses. DAFs are prohibited from making grants, loans or payments that provide disqualified persons with more than an incidental benefit. ***For example, a donor cannot use a DAF grant that covers the deductible portion of a ticket to a nonprofit event, even if the donor covers the non-deductible portion***. In contrast, the recognition of the donor recommending the DAF grant may be considered a permissible incidental benefit.

If a disqualified person receives a prohibited excess benefit, the donor and the parties involved may be subject to excise tax of 125% of the amount involved. Sec. 4967(a). A DAF manager who knowingly participates can also be penalized with a 10% tax, up to $10,000. Sec. 4967(d). Taxes within Sec. 4967 will not be imposed on the same distribution if there has already been tax imposed under Sec. 4958.

The DAF excess benefit rules also require donors and disqualified persons to personally cover expenses tied to their involvement with the DAF, such as travel costs for attending board meetings or expenses related to their personal efforts with respect to charitable contributions. Paying inflated wages or making loans to the donor or a disqualified person would be an excess benefit transaction.

Historically, a DAF could not satisfy a donor's legally binding pledge because doing so was viewed as relieving the donor of a personal financial obligation. Sec. 4966(a). IRS Notice 2017-73 provided more flexibility. Under the Notice, ***a DAF grant may be used in a way that incidentally fulfills a pledge as long as the pledge is not referenced in the grant materials, the donor receives no additional benefit, and the donor does not claim a new charitable deduction***. Donors may still not commit DAF funds, but a pledge may effectively be satisfied under these conditions without violating the excess benefit rules.

If a disqualified person receives a prohibited excess benefit, the donor or the parties involved may be subject to excise tax of 25% of the benefit received. Sec. 4958(a). A DAF manager who knowingly participates can also be penalized with a 10% tax, up to $20,000. Sec. 4958(d)(2). In direct contrast to other Sec. 4958 excess benefits, the DAF transfer is subject to an excise tax on the entire transaction, not just the excess over fair market value. In addition, if the transaction is not corrected within the correction period, an additional tax of 200% will be imposed on the disqualified person. Sec. 4958(b).

Excess Business Holdings

The excess business holdings rules under Sec. 4943 that are also applicable to PFs also apply to DAFs. When a DAF receives a gift of a business interest, the sponsoring organization must ensure that neither the DAF nor a disqualified party retains too much control over the business. If the donor, along with the disqualified party, already own 20% of the voting stock of a business (or up to 35% control of a business with an unrelated third party), a contribution of that business interest to a DAF will trigger the excess business holdings rules. Therefore, if a DAF receives a business interest that creates excess holdings, the sponsoring organization must dispose of the interest within five years or up to ten years if the IRS grants approval.

There is a de minimis exception to the prohibition on excess business holdings. If the DAF owns not more than 2% of the voting stock and not more than 2% of the value of all outstanding shares, it will not be deemed an excess business holding. If there are excess business holdings, the DAF will have five years to dispose of the excess holdings, with an additional five-year extension if granted by the IRS. If it is not corrected, a 10% excise tax applied to the highest

value of the excess holdings in the year. If it is not timely corrected, an additional 200% tax will apply.

Deduction Limits

A benefit of DAFs is that donors can claim an income tax deduction in the year they contribute to a DAF, regardless of when grants are ultimately made to other nonprofits. Cash contributions generally have a deduction limit of 60% of a donor's AGI, while gifts of appreciated assets are deductible up to 30% of a donor's AGI. If a donor's contributions exceed these AGI limits in a given year, any unused deductions may be carried forward for up to an additional five years. DAF grants do not create charitable deductions for the donor.

Over the past decade, the aggregate average DAF grant payout rate has generally been more than 20% annually. Unlike PFs, DAFs are not subject to a minimum annual distribution requirement, which means donors may allow the assets to grow tax-free in the DAF and choose the timing of their charitable grants. This makes DAFs a useful tool for donors who want to secure a deduction in a high-income tax year but prefer to support nonprofits gradually over a longer period.

Example 2 - Brenda owned a small consulting firm, and she sold a portion of the business in 2025, which resulted in an unusually high-income year. She would like to make a charitable gift, but she is unsure which charity she should give to. To take advantage of a charitable deduction, she contributes $300,000 of appreciated stock to an existing DAF held by her neighborhood food pantry. Her AGI for the year is $750,000.

Brenda receives a fair market value deduction on her $300,000 contribution, which helps offset her higher 2025 tax bill, and she also avoids capital gains tax on the appreciated stock. She can deduct $225,000 of her gift in the current year. Because DAFs have no required annual payout, the contributed assets can continue to grow tax free, which provides her with ample time to thoughtfully determine the charities she wants to support.

Conclusion

Choosing between a PF and a DAF will largely depend on the donor's goals, desired level of involvement and tolerance for administrative responsibility. While PFs allow donors a greater degree of control and the ability to involve family in the governance of the foundation, it will require significant time, expense, effort and oversight. By contrast, DAFs offer a simplified approach. While DAF donors relinquish control over the assets, they retain advisory privileges that allow active involvement with the fund without the complexities of managing a separate legal entity.

For some donors, DAFs and PFs may not be mutually exclusive and, rather than selecting one over the other, they use the two vehicles side by side. In these cases, the DAF can serve to complement or lighten the workload of an existing PF. Ultimately, both PFs and DAFs serve as powerful tools for charitable impact. By understanding the distinctions of each vehicle, advisors can guide donors towards the charitable giving vehicle that best aligns with their philanthropic

goals and financial needs.

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