Advanced Planning
Perspectives

Charitable Planning with Donor Advised Funds

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Introduction: Hypothetical Client Situation

Randy, a long-time executive at a publicly-traded company, owns $1 million of highly-appreciated company stock with basis of only $100,000. The shares have appreciated exponentially since they were first acquired 10 years ago and would be subject to significant capital gains taxes if Randy sold the shares today.

Randy and his wife, Jacqueline, typically have a combined adjusted gross income (AGI) of approximately $335,000 per year, which, after itemized deductions, usually places them in the 24% federal marginal tax bracket. However, earlier this year, Randy received a one-time $3 million distribution of deferred compensation so their income is projected to spike into the highest marginal federal tax bracket (37%) this year before reverting back to lower tax brackets in future years.

With the help of their professional advisory team, Randy and Jacqueline determine that, based on conservative assumptions, they have already accumulated more than enough assets in their core investment portfolio to support their desired standard of living for the rest of their lives. However, a large portion of their net worth is still tied up in the highly-appreciated company shares and they would like to diversify out of the concentrated stock position while the share price is high.

Randy and Jacqueline have a passion for philanthropy within their local community and are now contemplating ways to expand their charitable giving efforts. For the past few years, they have been gifting a total of $10,000 per year in cash to a variety of local charities. After their professional advisors determine that they could easily give away $1 million to charity without adversely affecting their financial independence, Randy and Jacqueline decide to earmark that amount for charitable giving during their lifetime.

Their accountant prepares a multi-year tax projection and suggests that they consider making a lump sum charitable gift in the current year in order to take advantage of the one-time spike in their marginal tax rates and to help reduce their overall income tax liability. For multiple reasons, they would save more in taxes by making a lump sum charitable gift this year versus spreading the gifts over future years when they will be in lower tax brackets.

However, Randy and Jacqueline are hesitant to immediately give away significant sums directly to any particular charities because they are not yet certain which charities would best fulfill their charitable goals. They would like to maximize their income tax deductions, but also would like more time to conduct their due diligence, develop an intentional gifting program, and involve their children in the grant-making process. As part of their charitable giving plan, Randy and Jacqueline's professional advisors recommend that they implement a Donor Advised Fund (DAF) strategy.

Donor Advised Fund as a Potential Charitable Giving Solution

A Donor Advised Fund is a type of charitable giving vehicle that can help families and individuals meet philanthropic and tax planning goals – by maximizing the value of a charitable deduction in a high-income year even if they have not yet decided upon the specific charity (or charities) to ultimately receive their donations. Somewhat similar to a private foundation, a DAF is a tax-advantaged investment account that is earmarked for charitable giving. Compared to a private foundation, however, a DAF is generally less expensive to operate, does not have annual distribution requirements, can grow tax-free without excise taxes, and can provide greater income tax deductions.

Donor Advised Funds are sponsored and administered by public charities. A donor makes an irrevocable gift to the public charity, and, in turn, the public charity establishes a separate account for the donor. Once gifted, assets in the DAF account are legally owned by the public charity, but the donor is permitted to retain certain advisory privileges, including the ability to make investment elections and the ability to recommend grants to other public charities.

An Immediate Tax Benefit

A Donor Advised Fund allows a donor to separate the timing of a charitable tax deduction from the actual charitable donation. Because a contribution to a DAF is treated as a gift to a qualified public charity, a donor receives an upfront tax deduction in the year of a donation even though the distribution to the ultimate charitable recipient can be postponed to a later date.

For donors who experience a liquidity event that triggers a spike in taxable income (as can happen with the sale of a business, the exercise of a large number of stock options, or the receipt of deferred compensation), a contribution to a DAF in the same tax year as the liquidity event can provide the donor with an opportunity to maximize the tax benefits of a charitable donation. Here's how:

1. A spike in taxable income will likely place the donor in a higher-than-normal marginal tax bracket and, therefore, the value of a charitable deduction will be worth more than in lower-income years.
2. By contributing to a DAF instead of a private foundation, the taxpayer may realize a larger tax deduction because DAF contributions are privy to higher deduction limits than are contributions to a private foundation. Specifically, charitable deductions for DAF contributions are limited to 60% of Adjusted Gross Income (AGI) for cash gifts and 30% of AGI for appreciated securities. In comparison, charitable deductions for contributions to private foundations are limited to 30% of AGI for cash gifts and 20% of AGI for appreciated securities.
3. The combination of higher AGI limits and a spike in taxable income creates the opportunity to fit in a larger tax deduction in the year of the liquidity event than in future years. Those who are planning to make significant charitable gifts throughout their lifetime may consider "front-loading" their contributions to a DAF in the year of the liquidity event in order to maximize their tax deduction. This strategy can also work well for high-income earners who want to maximize their charitable deductions during their remaining pre-retirement years before an expected drop in their marginal tax rates in retirement.

A Testing Ground for Stewardship

Potential benefactors may be hesitant to commit significant sums to a chosen charity because they are concerned about an organization's ability to use the donations effectively and efficiently. By using a charitable intermediary such as a DAF, a donor can receive an upfront tax deduction and distribute funds to chosen charities in increments while continuing to evaluate the charities' stewardship before committing additional sums. This strategy can give a donor more control over the use of charitable gifts and guard against organizational changes that may shift a charity's mission away from the donor's intent. For example, if a chosen charity fails to demonstrate fiscal responsibility or no longer shares the donor's intent, the donor can simply re-direct future DAF distributions to another charity.

A Conduit for Illiquid Assets

Many charitable organizations, especially smaller ones, are ill-prepared or unable to accept in-kind donations of non-cash assets, such as appreciated stock, high-end art collections, or shares in a privately-held company. Many national DAF custodians, including those run by large financial institutions, have the expertise to accept and process gifts of illiquid assets. Using a DAF as a conduit for donating illiquid assets to smaller charities can increase a donor's available gifting options and tax benefits.

To Create a Lifetime Gifting Record

A DAF can offer donors and their families a centralized hub for recording and administering a lifetime of charitable activities. For families that engage in philanthropy together, parents can use a DAF as a tool to teach their children about stewardship and intentional giving. In addition, parents can name their children as successor advisors to the DAF and allow their children to inherit the ability to make grant recommendations.

An Option for Anonymous or In Memorandum Gifting

While distributions made from a DAF to a specific charity usually include the name of the granting DAF, donors can also choose to make grants anonymously or in memory of a loved one. This feature gives donors the ability to choose how a specific gift will appear to an organization – and, possibly, to the public.

How Do Donor Advised Funds (DAFs) Work?

In our example, Randy and Jacqueline establish a Donor Advised Fund (which they name "The Randy and Jacqueline Charitable Fund") and contribute $1 million of appreciated company stock to the DAF in the current year. Since the company shares are publicly-traded, the value of the charitable gift is equal to the $1 million fair market value as of the date of the contribution. (For publicly-traded company shares held longer than one year, the fair market value is typically calculated using the mean of the high and low price reported on the date of contribution.) However, Randy and Jacqueline's charitable deduction for the current year is limited to 30% of their adjusted gross income and any charitable gifts in excess of the AGI limit can be carried forward for 5 additional tax years. Assuming an AGI of $3,335,000 [Calculation: $335,000 "normal" AGI plus an additional $3,000,000 for Randy's deferred compensation payout], they can deduct the full $1 million because it is less than $1,000,500 (30% of their current year AGI of $3,335,000). Assuming a federal marginal tax rate of 37%, the $1 million charitable gift will save them approximately $370,000 in federal income taxes (plus potential state income tax savings). In addition, by funding the charitable gift with highly-appreciated shares, Randy and Jacqueline will avoid recognizing capital gains on the company stock, which, assuming a 23.8% federal capital gains rate (including a net investment income surtax of 3.8%) and a $100,000 basis in the shares, translates into an additional $214,200 of federal tax savings (plus potential state tax savings).

Once the company shares have been contributed to the DAF, the shares are then sold free of income taxes and the proceeds reinvested in a diversified investment strategy selected by Randy and Jacqueline. The investments within the DAF can continue to grow tax-free and outside of their estate. The available investment options are typically pre-selected by the DAF custodian, but some DAF custodians allow donors to recommend a professional investment advisor to manage a custom portfolio for larger DAF accounts.

Randy and Jacqueline intend to grow their DAF account balance during their remaining working years while they conduct their due diligence on potential charitable recipients, develop a more intentional philanthropic program, and involve their children in the grant-making process. During the next few years, they plan to first make small gifts to a number of charities to test each organization's stewardship before narrowing the list of candidates for larger, more impactful gifts.

When Randy and Jacqueline are ready to make distributions to specific charities, they submit grant recommendations to the DAF custodian, which reviews the recommendations. The DAF custodian's due diligence typically involves ensuring that the proposed recipients are qualified charities that are eligible to receive the gifts and that the transactions do not run afoul of any other rules (such as prohibitions against fulfilling a donor's existing pledge and against receiving goods or services in exchange for the gift). DAFs are eligible to make grants to public charitable organizations that are tax-exempt under IRS Code Section 501(c)(3) and to certain private operating foundations. In addition, some DAF custodians permit grants to certain foreign charities.

If the custodian approves the recommendation (keep in mind that they are under no obligation to do so), the custodian handles the disbursement of funds to the chosen charity. It is also important to remember that Randy and Jacqueline would not receive an additional charitable deduction for grants made from their DAF since they already received a deduction when they contributed to the DAF.

Technically, there are currently no IRS-mandated minimum distribution requirements for donor advised funds. Unlike a private foundation, DAF balances can potentially grow indefinitely without mandatory distributions. However, some DAF custodians may impose payout rules and minimum account activity restrictions.

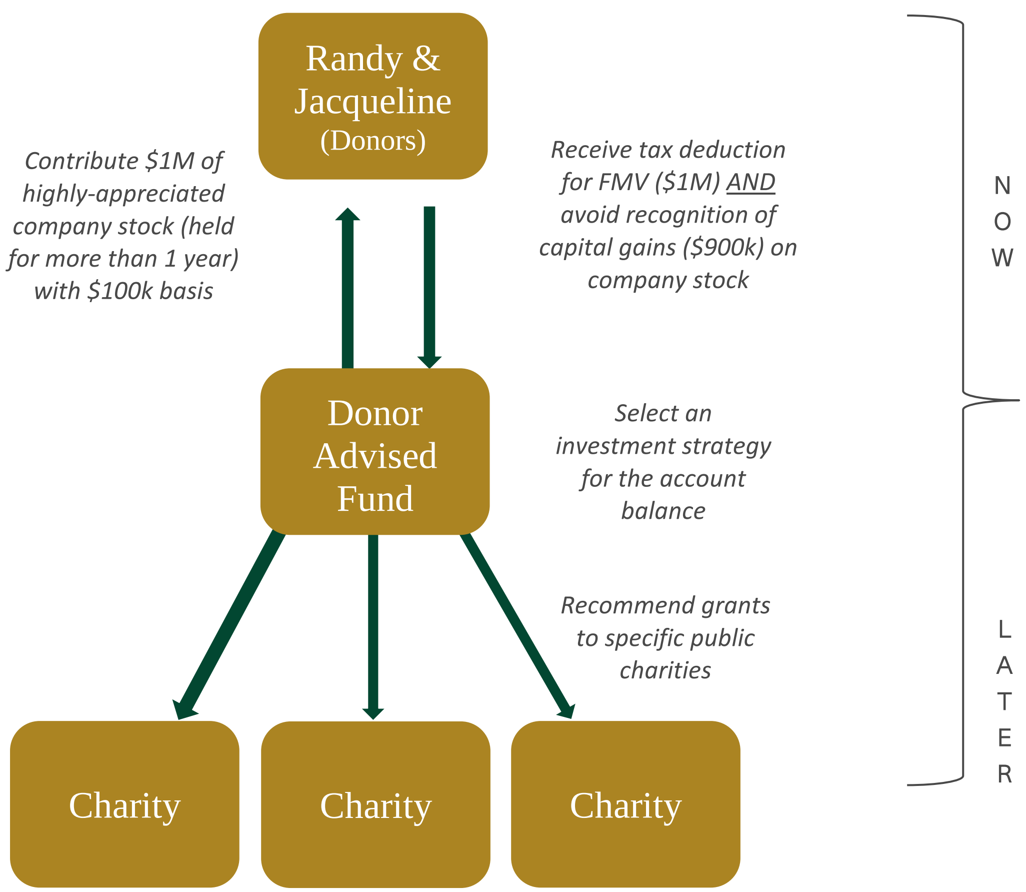
As Randy and Jacqueline make grants from their DAF throughout their lives, the DAF can serve as a centralized source of recordkeeping for their family's philanthropic activities. In addition, the DAF custodian handles the administrative burden of annual reporting, record-keeping, and other tax & legal responsibilities.

Going forward, Randy and Jacqueline will use their DAF to eliminate the hassle of year-end charitable gifting. Before establishing their DAF, they often rushed to donate cash or appreciated stock to a number of charities in late December in order to qualify for a charitable deduction in a particular tax year. However, with the DAF, they can now make distributions to those charities as they deem appropriate according to each charity's needs without worrying about the timing for tax deduction purposes. Instead of making additional donations directly to individual charities, they now collaborate with their professional advisory team in the fourth quarter of each year to project that year's taxes and determine how much, if any, they should donate in aggregate to charity. Then, they contribute assets (preferably highly-appreciated stock) to the DAF and then recommend grants from the

DAF to the individual charities. Doing so simplifies the administrative hassles and allows them to be more intentional in their philanthropy.

Randy and Jacqueline use a donor advised fund to simplify their estate planning. They would like to leave a portion of their estate to charity when they are no longer living. In their estate planning documents, they previously listed several different charities to each receive specific percentages of their estate, but would like the flexibility to change the specific charitable recipients and the specific percentages allocated to each charity. Before the DAF, each change required a visit to their estate attorney to execute an amendment to their revocable trust. However, with the DAF, they can now name their DAF as the charitable beneficiary of their revocable trust. When they want to make changes to the charitable beneficiaries, they can simply revise the DAF's beneficiary designation without the hassle or expense of trust amendments.

Randy and Jacqueline also have the flexibility to design a succession plan for their donor advised fund, including the ability to name successor account holders and direct distributions to charities when Randy and Jacqueline are no longer around. By naming their children as successors, Randy and Jacqueline could allow their children to inherit the ability to make contributions, grant recommendations, and investment allocations, as well as name future successors. If multiple successors are named, some DAF custodians allow the original DAF to be split into multiple DAFs so that each named successor can oversee their own separate DAF account. Alternatively, Randy and Jacqueline may choose to name one or more charities to receive some or all of the remaining DAF account balance upon their death.



Conclusion

Donor Advised Funds (DAFs) can be a powerful planning tool for donors who are seeking both an upfront tax benefit and the flexibility to defer decisions on their ultimate charitable recipients. As with any charitable giving strategy, the use of a DAF should be tailored to meet your family's unique philanthropic goals and financial situation.

UPDATE: Authored by Kevin K. Chung, Advanced Planner. Originally published in 2016; updated in May 2020.