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# SO YOU WANNA BE A PHILANTHROPIST?

## COST-BENEFIT CHOICES FOR THE PHILANTHROPIST: PRIVATE FOUNDATION, SUPPORTING ORGANIZATION, OR DONOR ADVISED FUND?

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# SO YOU WANNA BE A PHILANTHROPIST?

## CHOICE OF ENTITY FOR CHARITABLE GRANT-MAKING ORGANIZATIONS

### I. DEFINITIONS AND STATE LAW CONSIDERATIONS

#### A. STATE LAW CONSIDERATIONS - TRUST OR NOT-FOR-PROFIT CORPORATION?

1. Trust
  - a. Older, traditional form of grant-making organizations
  - b. Stronger fiduciary duties to follow donor's original intent.
  - c. Supervision of probate court; more difficult to amend document and make changes to adapt to charitable environment.
2. Not-for-profit corporation
  - a. The current trend is a corporation instead of a trust; greater flexibility.
  - b. Different, more business-like fiduciary standards.

#### B. DEFINITIONS UNDER THE TAX CODE

1. *Private Foundation* - A charity that does not receive contributions from numerous unrelated individuals but, instead, receives most of its financial support either from endowment income or from one family or business.

-- *private non-operating foundation* - a grant-making organization.

-- *private operating foundation* - a private foundation that actively engages in a physical activity (e.g., the Getty Art Museum used to be a private operating foundation). Secs. 170(b)(1)(E)(i) and 4942(j)(3).

2. *Supporting Organization* - A charity classified as a public charity rather than a private foundation because it supports a publicly supported charity. Sec. 509(a)(3).

A supporting organization is one of the few organizations that qualifies as a public charity without having to satisfy the public support test. Thus, a supporting organization will be classified as a public charity even if there is only one donor. Congress concluded that the indirect public scrutiny of a supporting organization by way of a publicly supported charity exempted these organizations from private foundation tax status.

A supporting organization is classified into one of three categories, depending on how its governing body is appointed and its connection with the publicly supported charity or charities the supporting organization is deemed to support:

*Type I – Operated, Supervised Or Controlled By ...*

Where the majority of the governing body of the supporting organization is appointed by the publicly supported charity (oversimplified).

*Type II – Supervised or Controlled In Connection With ...*

Where the governing body of the supporting organization is identical to the governing body of the publicly supported charity (oversimplified). Very rare.

*Type III - Operated In Connection With ...*

Where the majority of the governing body of the supporting organization is not appointed by the publicly supported charity, yet is not controlled by a disqualified person (oversimplified). An example might be a board of directors where two are appointed by the charity, two are appointed by the donor and the tiebreaker is selected by a neutral method.

*Functionally integrated Type III* – Generally, a functionally integrated type III supporting organization is a supporting organization that performs functions of or carries out purposes of the supported organization that, but for the supporting organization, the supported organization would engage in directly. An example would be a Type III supporting organization that serves as the linchpin for multiple corporations that operate a non-profit hospital.

*Non-Functionally Integrated Type III* – (“NFI”) – Any supporting organization that is not functionally integrated, such as one that makes grants to the supported charity. The Pension Protection Act of 2006 made NFI a virtual pariah. An NFI cannot receive a grant from a private foundation and is subject to burdens that other supporting organizations are not subject to. Many NFIs terminated their supporting organization status in 2007.

3. *Donor Advised Fund* – A fund that is part of a larger charity where the donor may *recommend* eligible charitable recipients of grants from the fund. The governing body can accept or reject each recommendation, although as a practical matter charities usually follow the donor's recommendation whenever the recipient is an eligible public charity.

A donor advised fund of a community trust can be administered in a separate trust and be considered a component part of the community trust. Reg. Sec. 1.170A-9(e)(11)(ii). Instead, the overwhelming majority of donor advised funds are accounting entries on the books of a larger charity. Such funds are administered under fund accounting principles.

Legal Definition: Sec. 4966: The term `*donor advised fund*' means a fund or account--

(i) which is separately identified by reference to contributions of a donor or donors,

(ii) which is owned and controlled by a *sponsoring organization*, and

(iii) with respect to which a donor (or any person appointed or designated by such donor) has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in such fund or account by reason of the donor's status as a donor.

Exempted from the definition are funds where all distributions are made to one charity and scholarship funds where a non-controlling member of the selection committee contributed to the scholarship fund.

C. POSSIBLE LEGAL SANCTIONS UNDER THE TAX LAWS

	<u>PF</u>	<u>SO</u>	<u>DAF</u>
1. Revoke 501(c)(3) status for not being a charity (excess lobbying, political activity, etc.)?	Yes	Yes	*
2. Intermediate sanctions for <i>excess benefit transactions</i> under Sec. 4958? (Excess benefit transaction taxes are supercharged for DAFs and SOs)	No	Yes	Yes
3. <u>Private foundation excise taxes</u>			
-- <i>The 2 percent excise tax on net investment income. Sec. 4940.</i>	Yes	No	No
-- <i>Prohibitions on self-dealing / excess benefits with donors.</i>			
- Absolute prohibition on paying a donor (or family member) for services? Secs. 4958( c)(2) and 4958( c)(3) - compare Sec. 4941(d)(2)(E).	No	Yes !	Yes!
- Prohibition on property transaction with donor? Sec. 4941(d)(1)(A)	Yes	No	No
-- <i>The excise tax for failure to distribute income. Sec. 4942. Private foundations are required to make annual "qualifying distributions" of their "minimum investment return" (generally, 5% of the foundation's net investment assets).</i>	Yes	No ( <i>Yes-Type III NFI</i> )	No
-- <i>The excise tax on excess business holdings. Sec. 4943. A private foundation must dispose of stock in a business within five years if it (or if it and "disqualified persons" such as family members) holds more than 20% of the stock of the business.</i>	Yes	No ( <i>Yes-Type III NFI</i> )	<b>Yes!</b>
-- <i>The excise tax on investments that may jeopardize charitable purposes. Sec. 4944. Jeopardizing investments generally include those that show lack of business prudence, such as trading in uncovered puts and calls.</i>	Yes	No	No
-- <i>The excise tax for "taxable expenditures" and "expenditure responsibility" requirements. Sec. 4945. A payment for any non-charitable purpose is a taxable expenditure. In addition, a taxable expenditure includes a grant to any person or organization (other than a public charity) unless the private foundation exercises "expenditure responsibility" to follow up on the outcome of the grant.</i>	Yes	No	No

\* It depends. If a DAF is a separate trust that is a component part of a community trust, then it could be reclassified as a separate charity, such as a private foundation. Reg. Sec. 1.170A-9(e)(11)(ii). If the DAF is basically an accounting entry on the books of a larger charity, it would not (in the author's opinion) qualify as a separate charity, since a charity must be a trust, corporation or association and meet the other requirements under Form 1023 to be a charity. In the author's opinion, a checking account cannot qualify as a charity. There are, however, others who feel that DAFs that are accounting entries could be classified as separate charities. Assuming that a DAF that is only an accounting entry on the books of a larger charity cannot be made into a separate charity, then any potential sanctions would be imposed on the larger charity rather than on the fund.

\*\* The Pension Protection Act of 2006 provides that a "non-functionally integrated" supporting organization must annually distribute a percentage assets, and it looks like it will be 5%.

## II. DONOR ADVISED FUNDS

### A. DEFINITION

Code Section 4966(d)(2) DONOR ADVISED FUND-

(A) IN GENERAL- Except as provided in subparagraph (B) or (C), the term 'donor advised fund' means a fund or account--

(i) which is separately identified by reference to contributions of a donor or donors,<sup>1</sup>

(ii) which is owned and controlled by a *sponsoring organization*,<sup>2</sup> and

(iii) with respect to which a donor (or any person appointed or designated by such donor) has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in such fund or account by reason of the donor's status as a donor.<sup>3</sup>

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<sup>1</sup> “The first prong of the definition requires that a donor advised fund be separately identified by reference to contributions of a donor or donors. A distinct fund or account of a sponsoring organization does not meet this prong of the definition unless the fund or account refers to contributions of a donor or donors, such as by naming the fund after a donor, or by treating a fund on the books of the sponsoring organization as attributable to funds contributed by a specific donor or donors. Although a sponsoring organization's general fund is a "fund or account," such fund will not, as a general matter, be treated as a donor advised fund because the general funds of an organization typically are not separately identified by reference to contributions of a specific donor or donors; rather contributions are pooled anonymously within the general fund. Similarly, a fund or account of a sponsoring organization that is distinct from the organization's general fund and that pools contributions of multiple donors generally will not meet the first prong of the definition unless the contributions of specific donors are in some manner tracked and accounted for within the fund. Accordingly, if a sponsoring organization establishes a fund dedicated to the relief of poverty within a specific community, or a scholarship fund, and the fund attracts contributions from several donors but does not separately identify or refer to contributions of a donor or donors, the fund is not a donor advised fund even if a donor has advisory privileges with respect to the fund.” *Technical Explanation of H.R. 4, The "Pension Protection Act of 2006,"* Joint Committee on Taxation, JCX-38-06 (August 3, 2006) at page 342-343.

<sup>2</sup> Code Sec. 4966(d)(1) defines a sponsoring organization as any organization which is described in section 170(c) [i.e., eligible recipients of charitable income tax deductions, though governments are exempt] that maintains 1 or more donor advised funds, except that a private foundation will not be considered to be a sponsoring organization.

<sup>3</sup> “Advisory privileges are distinct from a legal right or obligation. For example, if a donor executes a gift agreement with a sponsoring organization that specifies certain enforceable rights of the donor with respect to a gift, the donor will not be treated as having "advisory privileges" due to such enforceable rights for purposes of the donor advised fund definition....

“A further requirement of the third prong is that the reasonable expectation of advisory privileges is by reason of the donor's status as a donor. Under this requirement, if a donor's reasonable expectation of advisory privileges is due solely to the donor's service to the organization, for example, by reason of the donor's position as an officer, employee, or director of the sponsoring organization, then the third prong of the definition is not satisfied. For instance, in general, a donor that is a member of the board of

(B) EXCEPTIONS- The term ‘donor advised fund’ shall **not** include any fund or account--

(i) which makes distributions only to a single identified organization or governmental entity [i.e., a *designated fund* or an *endowment fund*], or

(ii) with respect to which a person described in subparagraph (A)(iii) advises as to which individuals receive grants for travel, study, or other similar purposes ...[if conditions are met].<sup>4</sup> ,

(C) SECRETARIAL AUTHORITY- The Secretary **may exempt** a fund or account not described in subparagraph (B) from treatment as a donor advised fund--

(i) if such fund or account is advised by a committee not directly or indirectly controlled by the donor or any person appointed or designated by the donor for the purpose of advising with respect to distributions from such fund (and any related parties), or

(ii) if such fund benefits a single identified charitable purpose [i.e., a *field of interest fund*, but only if that fund is exempted in regulations to be issued in the future].

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directors of the sponsoring organization may provide advice in his or her capacity as a board member with respect to the distribution or investment of amounts in a fund to which the board member contributed. However, if by reason of such donor's contribution to such fund, the donor secured an appointment on a committee of the sponsoring organization that advises how to distribute or invest amounts in such fund, the donor may have a reasonable expectation of advisory privileges, notwithstanding that the donor is an officer, employee, or director of the sponsoring organization.

“The third prong of the definition is applicable to a donor or any person appointed or designated by such donor (the donor advisor)..... For example, if a donor recommends that a committee of a sponsoring organization that will provide advice regarding scholarship grants for the advancement of science at local secondary schools should consist of persons who are the heads of the science departments of such schools, then the donor generally would not be considered to have appointed or designated such persons, i.e., they would not be treated as donor advisors.” *Technical Explanation of H.R. 4, The "Pension Protection Act of 2006,"* Joint Committee on Taxation, JCX-38-06 (August 3, 2006) at page 343-345.

<sup>4</sup> The exemption allows, for example, members of a scholarship selection committee to contribute to the scholarship fund without having the fund be considered a donor advised fund, provided that: “(I) such person's advisory privileges are performed exclusively by such person in the person's capacity as a member of a committee all of the members of which are appointed by the sponsoring organization, (II) no combination of persons described in subparagraph (A)(iii) (or persons related to such persons) control, directly or indirectly, such committee, and (III) all grants from such fund or account are awarded on an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the board of directors of the sponsoring organization, and such procedure is designed to ensure that all such grants meet the requirements of paragraph (1), (2), or (3) of section 4945(g) [the private foundation scholarship provisions].”



## B. PERMITTED AND RESTRICTED ACTIVITIES

### 1. **Permissible Grants from A Donor Advised Fund**<sup>5</sup> – Grants to the following grant recipients are permissible:

**a) Any public charity or private *operating* foundation organization, except Type III and other disqualified type I or Type II supporting organizations are ineligible.**<sup>6</sup>

The eligible recipients are public charities and private *operating* foundations. A “functionally integrated” type III supporting organization is eligible, such as the lynchpin supporting organization that often holds together a charitable hospital’s complicated web of affiliated corporations.

**b) The sponsoring organization of the donor advised fund**

**c) Any other donor advised fund.** This permits donors to move donor advised funds from one sponsoring organization to another, which can be especially helpful when an individual moves to a new community.

**d) A foreign charity or a non-charity organization (e.g., a civic organization or a chamber of commerce), but only if the proceeds are actually used for a charitable purpose.** To qualify for this exception, the sponsoring organization must investigate and verify (“expenditure responsibility”) the charitable use of the funds by meeting the standards that private foundations must meet for comparable grants to avoid the private foundation “taxable expenditure” excise tax. Whereas a private foundation could make a grant to an individual under this standard (e.g., a commissioned work of art), a donor advised fund cannot -- the recipient must be an organization.

### 2. **Prohibited Grants from A Donor Advised Fund**<sup>7</sup>

**a) Taxable Distributions Defined** -- Grants to the following grant recipients are considered taxable distributions:

**b) any natural person** (i.e., a human being),

**c) any organization where the proceeds were not actually used for a charitable purpose or where the sponsoring organization of the donor advised fund failed to**

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<sup>5</sup> Sec. 4966(c)(2).

<sup>6</sup> Sec. 4966(d)(4) describes a disqualified supporting organization as (i) any type III supporting organization (as defined in section 4943(f)(5)(A)) which is not a functionally integrated type III supporting organization (as defined in section 4943(f)(5)(B)), and (ii) a Type I or Type II supporting organization where the donor (or any person designated by the donor) directly or indirectly controls the supported organization.

<sup>7</sup> Sec. 4966(c)(1).

**exercise expenditure responsibility to investigate the use of the grant.** As described above, grants to three eligible recipients are exempt from the expenditure responsibility requirement: grants to a public charity or a private *operating* foundation organization (except for Type III or other disqualified supporting organizations), the sponsoring organization of the donor advised fund or any other donor advised fund, or

**d) any grant for a non-charitable purpose.**

### **3. Penalties on Taxable Distributions --**

#### **a. Sec. 4966 -- Taxes on Taxable Distributions.**

##### **(a) Imposition of Taxes-**

(1) ON THE *SPONSORING ORGANIZATION*- There is hereby imposed on each taxable distribution a tax equal to 20 percent of the amount thereof. The tax imposed by this paragraph shall be paid by the sponsoring organization with respect to the donor advised fund.

(2) ON THE *FUND MANAGEMENT*- There is hereby imposed on the agreement of any *fund manager*<sup>8</sup> to the making of a distribution, knowing that it is a taxable distribution, a tax equal to 5 percent of the amount thereof. The tax imposed by this paragraph shall be paid by any fund manager who agreed to the making of the distribution.

(2) LIMIT FOR MANAGEMENT- With respect to any one taxable distribution, the maximum amount of the tax imposed by subsection (a)(2) shall not exceed \$10,000.

#### **b. Sec. 4967 -- Taxes on Prohibited Benefits.**

##### **(a) Imposition of taxes.**

(1) **On the donor, donor advisor, or related person.** There is hereby imposed on the advice of any person described in subsection (d) to have a sponsoring organization make a distribution from a donor advised fund which results in such person or any other person described in subsection (d) receiving, directly or indirectly, *a more than incidental benefit* as a result of such distribution, **a tax equal to 125 percent of such benefit.** The tax imposed by this paragraph shall be paid by any person described in subsection (d) who advises as to the distribution or who receives such a benefit as a result of the distribution.

(2) **On the fund management.** There is hereby imposed on the agreement of any fund manager to the making of a distribution, **knowing that such distribution would confer a benefit**

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<sup>8</sup> Sec. 4966(d)(3) defines a fund manager as “(A) an officer, director, or trustee of such sponsoring organization (or an individual having powers or responsibilities similar to those of officers, directors, or trustees of the sponsoring organization), and (B) with respect to any act (or failure to act), the employees of the sponsoring organization having authority or responsibility with respect to such act (or failure to act).”

described in paragraph (1), a tax equal to **10 percent of the amount of such benefit**. The tax imposed by this paragraph shall be paid by any fund manager who agreed to the making of the distribution.

**(b) Exception.** No tax shall be imposed under this section with respect to any distribution if a tax has been imposed with respect to such distribution under section 4958.

**(c) Special rules.** For purposes of subsection (a)--

(1) Joint and several liability. If more than one person is liable under paragraph (1) or (2) of subsection (a) with respect to a distribution described in subsection (a), all such persons shall be jointly and severally liable under such paragraph with respect to such distribution.

(2) Limit for management. With respect to any one distribution described in subsection (a), the maximum amount of the tax imposed by subsection (a)(2) shall not exceed \$10,000.

### **c. Legislative History**

***Automatic excess benefit transactions*** – “Any grant, loan, compensation, or other similar payment from a donor advised fund to a person that with respect to such fund is a donor, donor advisor, or a person related to a donor or donor advisor automatically is treated as an excess benefit transaction under section 4958, with the entire amount paid to any such person treated as the amount of the excess benefit. Other similar payments include payments in the nature of a grant, loan, or payment of compensation, such as an expense reimbursement. Other similar payments do not include, for example, a payment pursuant to bona fide sale or lease of property, which instead are subject to the general rules of section 4958 under the special disqualified person rule of the provision described below. Also as described below, payment by a sponsoring organization of, for example, compensation to a person who both is a donor with respect to a donor advised fund of the sponsoring organization and a service provider with respect to the sponsoring organization generally, will not be subject to the automatic excess benefit transaction rule of the provision unless the payment (of a grant, loan, compensation, or other similar payment) properly is viewed as a payment from the donor advised fund and not from the sponsoring organization. “Any amount repaid as a result of correcting an excess benefit transaction shall not be held in any donor advised fund.” *Technical Explanation of H.R. 4, The Pension Protection Act of 2006,* Joint Committee on Taxation, JCX-38-06 (August 3, 2006) at p. 347.

***More than incidental benefit - penalty tax - New Sec. 4967 Penalty Tax*** – Under the provision, if a donor, a donor advisor, or a person related to a donor or donor advisor of a donor advised fund provides ***advice as to a distribution that results in any such person receiving, directly or indirectly, a more than incidental benefit, an excise tax equal to 125 percent of the amount of such benefit is imposed against the person who advised as to the distribution, and against the recipient of the benefit.*** Persons subject to the tax are jointly and severally liable for the tax. In addition, if a manager of the sponsoring organization (defined in a manner similar to the term "foundation manager" under section 4945) agreed to the making of the distribution, knowing that the distribution would confer a more than incidental benefit on a donor, a donor advisor, or a person related to a donor or donor advisor, the manager is subject to an excise tax equal to 10 percent of the amount of such benefit, not to exceed \$ 10,000. The taxes on more

than incidental benefit are subject to abatement under generally applicable present law rules.

In general, under the provision, there is a more than incidental benefit if, as a result of a distribution from a donor advised fund, a donor, donor advisor, or related person with respect to such fund receives a benefit that would have reduced (or eliminated) a charitable contribution deduction if the benefit was received as part of the contribution to the sponsoring organization. If, for example, a donor advises a that a distribution from the donor's donor advised fund be made to the Girl Scouts of America, and the donor's daughter is a member of a local unit of the Girl Scouts of America, the indirect benefit the donor receives as a result of such contribution is considered incidental under the provision, as it generally would not have reduced or eliminated the donor's deduction if it had been received as part of a contribution by donor to the sponsoring organization. *Technical Explanation of H.R. 4, The "Pension Protection Act of 2006,"* Joint Committee on Taxation, JCX-38-06 (August 3, 2006) at page 349-350.

## **PROHIBITION ON PAYING COMPENSATION TO A FAMILY MEMBER FOR ANY SERVICES FROM A DONOR ADVISED FUND OR A TYPE III NFI SUPPORTING ORGANIZATION**

### **EXCESS BENEFIT TRANSACTION – Section 4958( c):**

**(2) Special rules for donor advised funds.** In the case of any donor advised fund (as defined in section 4966(d)(2))--

(A) the term “excess benefit transaction” includes *any grant, loan, compensation, or other similar payment* from such fund to a person described in subsection (f)(7) with respect to such fund, and

(B) the term “excess benefit” includes, with respect to any transaction described in subparagraph (A), *the amount of any such grant, loan, compensation, or other similar payment.*

**(3) Special rules for supporting organizations.**

(A) In general. In the case of any organization described in section 509(a)(3)--

(i) the term “excess benefit transaction” includes--

(I) any grant, loan, compensation, or other similar payment provided by such organization to a person described in subparagraph (B), and

(II) any ...

**Section 4958(f)(7) Donors and donor advisors.** For purposes of paragraph (1)(E), a person is described in this paragraph if such person--

(A) is described in section 4966(d)(2)(A)(iii),

(B) is a member of the family of an individual described in subparagraph (A), or

(C) is a 35-percent controlled entity (as defined in paragraph (3) by substituting "persons described in subparagraph (A) or (B) of paragraph (7)" for "persons described in subparagraph (A) or (B) of paragraph (1)" in subparagraph (A)(i) thereof).

**(8) Investment advisors.** For purposes of paragraph (1)(F)--

(A) In general. A person is described in this paragraph if such person--

(i) is an investment advisor,

(ii) is a member of the family of an individual described in clause (i), or

(iii) is a 35-percent controlled entity (as defined in paragraph (3) by substituting "persons described in clause (i) or (ii) of paragraph (8)(A)" for "persons described in subparagraph (A) or (B) of paragraph (1)" in subparagraph (A)(i) thereof).

(B) Investment advisor defined. For purposes of subparagraph (A), the term "investment advisor" means, with respect to any sponsoring organization (as defined in section 4966(d)(1)) any person (other than an employee of such organization) compensated by such organization for managing the investment of, or providing investment advice with respect to, assets maintained in donor advised funds (as defined in section 4966(d)(2)) owned by such organization.

### **III. REDUCED INCOME TAX CHARITABLE DEDUCTIONS FOR A GIFT TO A PRIVATE NON-OPERATING FOUNDATION**

#### **Gifts of Appreciated Stock or Real Estate**

A donor can claim a larger income tax deduction for a gift of certain *appreciated long-term capital gain property, such as closely-held stock or real estate*. Secs. 170(e)(1)(A) and (b)(1)(C) for gifts of capital gain property to a public charity; Sec. 170(e)(1)(B)(ii) for gifts to a private foundation.

Example: Donor owns closely-held stock with a tax basis of \$20,000 but a market value of \$100,000. If the donor contributes the stock to a public charity, donor can claim an income tax deduction of \$100,000. If the donor contributes the stock to a private *non-operating* foundation, donor can only deduct the tax basis of \$20,000. By comparison, if the donor contributes the stock to a private *operating* foundation, donor can deduct the full appreciated value of \$100,000. Secs 170(b)(1)(A)(vii), 170(b)(1)(E)(i) and 4942(j)(3).

Special rule for publicly traded stock: Gifts of appreciated publicly traded stock made to a private *non-operating* foundation qualified for a full market value deduction. Sec. 170(e)(5).

#### IV. FACTORS FOR A DONOR TO CHOOSE BETWEEN A PRIVATE FOUNDATION, ADVISED FUND OR A SUPPORTING ORGANIZATION

##### A. PRIVATE FOUNDATION

###### 1. Negative factors for the donor:

- **Set-up and administrative cost and requirements** – At establishment: document creation, Federal Form 1023 (application for tax exemption) filing, state incorporation or other filings. Annually: Form 990-PF filing; accounting and administrative costs.
- **Reduced charitable income tax deductions**, especially if the donor contributes appreciated real estate or appreciated closely-held stock.
- **Payout requirement** – A private foundation must distribute an amount equal to its “minimum investment return.” The minimum investment return is defined by law as 5% of the average fair market value of all the foundation’s assets, as determined by periodic appraisal. Failure to make charitable distributions at the required level will result in tax liability. Private foundations holding closely-held stock that doesn’t pay a dividend or non-income producing real estate may have difficulty meeting payout minimums without additional cash contributions.
- **Limits on stock holdings** – A private foundation may not hold more than 20% of the voting shares of any corporation, public or private.
- **Limits on speculative investments** – A private foundation may not invest in a manner that jeopardizes the security of its principal. The Internal Revenue Service pays special attention to foundation investments in highly speculative securities or futures.
- **Grants process** – Organizational structure may impede rapid decision-making and check issuance.
- **Privacy concerns** – Annual 990 filings are required to be available to the public and widely available and searchable on the Internet.
- **Fiduciary duty** - The funds or assets given to a private foundation no longer belong to the donor; they belong to the trust or the corporation. In most circumstances, the governing board of the foundation – including the donor or donors – must perform their duties in good faith, in the organization’s best interests (not personal interests) and with the same degree of care that an ordinarily prudent person in a like position would use under similar circumstances. Failure to meet this standard of care or legal duty of care (such as squandering the assets) will be violation of fiduciary duty. In case of such a violation, most states empower the state attorney general to intervene.
- **Grants to individuals** – Grants made for scholarship or fellowship purposes must be made on an objective and non-discriminatory basis according to procedures approved in advance by the Internal Revenue Service.
- **Advocacy and lobbying** – Private foundations are prohibited from attempting to influence the outcome of any election. With some exceptions, private foundations are also prohibited from lobbying or attempting to influence legislation. Advocacy and lobbying rules may be different at the Federal and state level.

## 2. Advantages of a private foundation to a donor:

- **Control! Control! Control!** – Subject to the private foundation statutes, the person who establishes a private foundation has absolute control over the operation of a private foundation. This includes:
  - identity of charitable grant recipients
  - types of investments
  - appointment of the governing body
- **Potential employment of family members for charitable purposes.** Often wealthy parents have a child who is actively engaged in charitable enterprises. A private foundation can pay reasonable compensation to a disqualified person for personal services that are reasonable and necessary to carry out the exempt purposes of the private foundation. Sec. 4941(d)(2)(E).
- **Recognition and attribution** – Some donors perceive that a private foundation conveys additional prestige or enhances reputation beyond that available through a DAF.

## B. DONOR ADVISED FUNDS

### 1. Negative factors for donor:

- **Legal control** – The sponsoring organization (e.g., a community foundation) or other public charity has legal control over the fund. The donor only has an advisory role, although the sponsoring organization usually follows the donor's advice substantially all of the time whenever there is a grant recommendation to a public charity.
- **Grant limitations** – Some sponsoring organizations may be unwilling / unable to make grants requiring expenditure responsibility, grant internationally, or impose other restrictions.
- **Cannot execute a legally binding pledge.**
- **Potential excise taxes** for grants to ineligible beneficiaries – Secs. 4966 & 4967
- **Compensation** – Family members cannot be compensated for services.

### 2. Advantages of donor advised funds:

- **Lower costs** – No legal fees to establish a trust or corporation or to apply to the IRS for tax-exempt status; annual costs are typically lower because of accounting and investment economies of scale.
- **Accessible at wide range of donor levels** – Most sponsoring organizations will establish a DAF with a modest initial gift of \$5k to \$10k.
- **Speed and convenience** – A DAF can be established in as little as thirty minutes. There is no need to apply to the IRS for tax-exempt status. This can be especially important for year-end contributions and situations when stock or real estate is in the process of being sold and time is of the essence.
- **Increased deductibility** – Irrevocable contributions are eligible to be deducted from federal taxes like other contributions to any public charity, up to 50% of AGI for cash gifts. Contributions exceeding these limits may be carried forward for up to five years, but the donor must take the maximum available deduction each year.

- **Rapid grantmaking** – Most DAFs issue grants weekly and offer online access to fund information.
- **Privacy** – Sponsoring organizations do not report on individual donations or grants. Data is aggregated across funds. Grants can be made completely anonymously, referring only to the sponsoring organization.
- **Expertise** – If the fund is at a community foundation, donors have access to the staff of the community foundation who are informed of the community's charitable needs and other matters that may be of interest to the donor. Most often these services are provided at no extra charge to the donor.
- **Options for administration** – If the fund is at a community foundation, a donor has the option of having the assets administered in a separate trust or corporation. It can be treated as a "component fund" of the community foundation for federal tax purposes, even though it is a separate entity under state law. Reg. Sec. 1.170A-9(e)(11)(ii). The fund is exempt from filing a tax return, even if it is a separate trust. Reg. Sec. 1.170A-9(e)(14)(i) (last sentence) and Ltr. Rul. 8621112 (Feb. 28, 1986). Instead, its financial transactions are consolidated with those of other funds on the community foundation's Form 990. This facilitates anonymous gifts and greater privacy.

## V. Creating and Administering Donor Advised Funds

### A. ADMINISTRATIVE RESPONSIBILITIES FOR DONOR ADVISED FUNDS

1. Accounting, acknowledgment and stewardship
  - a) Typically requires robust fund accounting and integrated data base software
  - b) Donor acknowledgments need careful attention to language requirements<sup>9</sup>
  - c) Guidelines outlining impermissible grant purposes, or those that provide "more than incidental benefits" to a donor, advisor, their families, or other related third parties. Includes: Goods or services received while attending a gala or fundraising event; admission to a charitable event; goods or services bought at a charitable auction; membership benefits if any portion of the membership fee is *not* tax deductible; support for a donor or advisor's own fundraising commitment, such as a walk, bike ride, or run; raffle tickets; school tuition and other required fees, such as enrollment fees and deposits; scholarships when the donor and/or advisor have sole or majority discretion regarding the recipients.
  - d) System for verifying and tracking charitable status for grant beneficiaries (Guidestar, IRS Business Master File)
2. System for gift tracking, including soft credits, interfund transfers, stock valuations

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<sup>9</sup> Per Pension Protection Act of 2006, gift acknowledgments to donors must affirm that "the sponsoring organization has exclusive legal control over the contributed assets."



## B. COMMON ADMINISTRATIVE AND LEGAL CHALLENGES

### 1. Contributions

a) Suitable assets – Almost any transferable asset, with attention to marketability, appraisal requirements, ownership structure, transfer and carrying costs

b) Advantaged assets – Transfer of long term appreciated assets (publicly or closely-held securities, real estate) confers additional tax savings on capital gain taxes; donor contributes actual securities instead of selling assets and donating proceeds; sponsoring organization sells assets (no capital gain taxes due from exempt entity) and adds net proceeds to donor advised fund. Pending corporate redemption offers best case scenario for private C-corp shares .

c) Problem assets – Assets that are not readily marketable delay charitable impact. Sponsoring organization usually needs to secure additional gifts cover carrying costs, which cannot be paid from the donor advised fund. Donor advised funds can pay pre-determined administrative fees to address transactional costs. Assets triggering the excess business holding rules.

### 2. Charitable grants / special situations

#### a) Limitations:

- Program, grantmaking and vendor expenses cannot be paid from the DAF except within fee structure of sponsoring organization.
- Can be difficult to create fee structure for variable expenses.
- Fundraising expenses cannot be paid from the DAF; donors wishing to “fundraise” with events or sponsorships need to cover expenses from other sources and provide net proceeds

b) Grant purposes – individual designation / “missionary wording” – Most frequently arises in connection with religious organizations that require field personnel to secure contributions for their own support. Grants are conveyed to the recipient organization with language such as *“These funds are designated for general operating support of your agency. The donor who recommended this gift has suggested that the funds be used in support of NAME(S) here, but that decision is entirely within the discretion of your agency.”*

### 3. Pledge made by donor who expects amount to be paid by PF, SO or DAF –

#### a) Private foundation law

- Distinction between legally-binding pledge and non-binding
- Situations that trigger self-dealing penalty

- Solutions – Provide alternative commitment language for donors to convey to beneficiary organization. Allow DAF (not advisor or donor) to make legally binding pledge.
4. Problems when a grant may provide a personal benefit to the donor
    - a) Penalties on the charity
    - b) Penalties on the donor who recommends such a grant
    - c) Steps to intercept the problem before it happens
      - Policies and guidelines
      - In-person orientation, handbook, web-based information for advisor reference and administrative back-up
      - Well-trained employees handling transactions who are empowered to handle donor relations or delegate issues when necessary
      - Internal flags for terms that may indicate an issue (such as pledge, membership, gala, ticket) or odd grant amounts that may signal a specific pledge amount of payment being made from the DAF (\$33,333.34, for example)
  5. Administration of donor advised fund when there are multiple advisors
    - a) Clear statement of authority on fund agreement or documentation with name of fund advisor(s). Access to fund information can be separated from grant recommendation authority.
    - b) Structural and policy solutions for multiple advisors
      - Name spokesperson in agreement. Donor determines decision-making process.
      - Sponsoring organization tracks recommendation history for multiple advisors.
      - DAF #1 makes grant to DAF #2. Advisory responsibilities are not shared.

## C. TRANSITIONING A PRIVATE FOUNDATION OR PUBLIC CHARITY TO DONOR ADVISED FUND

1. Review of organization documents
  - a) Articles of incorporation, including charitable purpose
  - b) By-laws for operational considerations and/or mandate for distribution of assets to specific charities on termination
  - c) *Recommended action: Amend by-laws if needed for termination to public charity*

2. Review of organization's financial obligations
  - a) Outstanding grant obligations, pledges, expenses
  - b) Estimate of termination expenses to be retained
  
3. Approval of terms
  - a) Agree on fund to receive assets, future role of board members in other capacities (advisory committee, etc.)
  - b) *Recommended action: Organization's board votes to approve asset transfer and corporate dissolution*
  
4. Organization makes investment manager recommendation
  - a) Recipient charity conducts review of current assets to recommend in-kind or cash transfer
  - b) *Recommended action: Organization advises current investment manager of pending dissolution and disbursement*
  
5. Verification of tax filings
  - a) Organization legal counsel and tax accountant verify completion of all prior required tax filings and payments
  - b) Transfer of appropriate records for retention by recipient sponsoring organization
  - c) *Recommended Action: Complete final tax filing and provide copy of return to sponsoring organization*
  
6. Dissolution of terminating corporate entity
  - a) *Recommended action: board votes to dissolve*
  - b) Legal steps as appropriate to state statute requirements and authority (notification/ application to Superior Court / Attorney General)
  - c) notification to IRS with final 990-PF

# **SO YOU WANNA BE A PHILANTHROPIST ?**

**CHRISTOPHER R. HOYT**

**Professor of Law**

**University of Missouri (Kansas City) School of Law**

**SHERYL AIKMAN**

**Vice President of Development**

**The Community Foundation of**

**Western North Carolina**

# PHILANTHROPIC CHOICE OF CHARITABLE ENTITY

- **Private Foundation**
- **Supporting Organization** “Friends of ..”
  - Type I
  - Type II
  - Type III
    - *Functionally integrated*
    - *Non-functionally integrated (“NFI”)*

# PHILANTHROPIC CHOICE OF CHARITABLE ENTITY

- **DONOR ADVISED FUND**
  - a fund or account owned by a sponsoring public charity where the donor (or person appointed by the donor) can recommend grants or investments

# PHILANTHROPIC CHOICE OF CHARITABLE ENTITY

- **DONOR ADVISED FUND**
  - **lower administrative costs**
  - **grants to any public charity**
  - **very popular: grants from donor advised funds already exceed 10% of grants from private foundations**

# LEGAL REGULATION & TAXES

## SELF DEALING TAXES

	<b>PF</b>	<b>SO</b>	<b>DAF</b>
• Prohibit sale ?	<b>Yes</b>	<b>No</b>	<b>No</b>
• Prohibit loan ?	<b>Yes</b>	<b>Yes</b>	<b>Yes</b>
• Prohibit paying donor for services?	<b>No</b>	<b>Yes</b>	<b>Yes</b>



# LEGAL REGULATION & TAXES

	<b>PF</b>	<b>SO</b>	<b>DAF</b>
• Minimum 5% payout?	<b>Yes</b>	<b>Yes</b> <i>(NFI)</i>	<b>No</b>
• Excess Bus. Holdings?	<b>Yes</b>	<b>Yes</b> <i>(NFI)</i>	<b><u>Yes</u></b>
• Jeopardy Investments?	<b>Yes</b>	<b>No</b>	<b>No</b>
• Taxable expenditures?	<b>Yes</b>	<b>No</b>	<b>No*</b>

# DONOR ADVISED FUNDS

## FUNDS THAT ARE NOT DAFs

- **Designated for a charity**
- **Scholarship not controlled by donor**
- **Regulations might exempt when:**
  - **Committee not controlled by donor**
  - **Restricted charitable purpose**

# DONOR ADVISED FUNDS

## **PERMISSIBLE GRANTS:**

- **Any public charity or private operating foundation, except a Type III NFI S.O.**
- **The sponsoring public charity**
- **Another donor advised fund**
- **A foreign charity or civic organization, but only if “expenditure responsibility” (like a private foundation) to assure charitable purpose.**

# DONOR ADVISED FUNDS

## **PROHIBITED GRANTS:**

- **A human being**
- **For a non-charitable purpose**
- **Grants to an organization other than a public charity where the sponsoring charity failed to exercise “expenditure responsibility”**

# DONOR ADVISED FUNDS

## PENALTIES

- **ON CHARITY: 20%**
- **ON EMPLOYEE: 5% (max \$10,000)**
- **ON DONOR ADVISOR – 125% penalty if “more than insubstantial personal benefit” (tuition)-- employee who knows: 10% penalty**
- **EXCESS BENEFIT TRANSACTION – different law than applies to public charities**

# PERSONAL PLEDGES MADE BY PF's or DAF's DONOR

- **PRIVATE FOUNDATION**

Cannot pay a pledge that is “legally binding”,  
but can pay a pledge that is not legally binding.

- **DONOR ADVISED FUND**

- Law uncertain – waiting for regulations

- Right now pledges drive staff nuts at DAFs

- ABA letters to Dept Treasury to permit  
pledges; shouldn't be hit with 125% penalty  
like tuition

# INCOME TAX FACTORS

- **Gifts to a private non-operating foundation of appreciated property: can only deduct cost basis for gifts of real estate or closely-held stock**
  - Better to give these assets to public charity (DAF or S.O.) so can deduct the higher market value
- **Public charity (incl. DAF and S.O.) has higher annual deduction limitation (50% AGI) than P.F. (30%)**

# PRIVATE FOUNDATION

- **POSITIVES – control! control! control!**
  - governing body, grants & investments
- **NEGATIVES**
  - lower income tax deduction for gifts of real estate or closely-held stock
  - strict and harsh private foundation taxes
  - high administrative costs – tax return, etc



# DONOR ADVISED FUND

- **NEGATIVES**

- loss of legal control over investments
- cope with policies of administering charity
- excise taxes on excess business holding, etc

- **POSITIVES**

- lowest administrative costs (no tax return)
- public charity tax status for donations
- access to staff of community foundation

# SUPPORTING ORGANIZATION

## **NEGATIVES & POSITIVES SIMILAR TO DAF, BUT ALSO:**

- **greater sense of independence and identity to have a separate corporation or trust compared to just an account**
- **way to avoid policies that are an issue (e.g., limit on future generation involvement with DAF?)**

# SUPPORTING ORGANIZATION COSTS & BENEFITS

- **Tax benefit from contribution**
- **Administrative costs of separate entity**
  - **organization costs**
  - **annual costs -- Form 900 (or 990-PF)**
- **Having a separate entity – separate investments ; separate policies ; feeling of separate identity**

# **ADMINISTRATION OF DONOR ADVISED FUNDS**

**SHERYL AIKMAN**

**Vice President of Development  
The Community Foundation of  
Western North Carolina**

# SYSTEMS

- **Robust fund accounting**
- **Integrated data base**
- **Meet legal requirements in donor acknowledgments**
- **Guidelines to prevent impermissible grants**
- **Verify charity status for grantees**

# GIFTS IN . . .

- **Most assets are suitable as DAF gifts**
- **Long-term appreciated assets convey additional tax savings**
- **Special assets often have special challenges**
  - **Limited marketability**
  - **Timing restrictions**
  - **Carrying costs for organization**

# GRANTS OUT . . .

- **DAF may only distribute charitable grants**
  - **No vendors, expenses, individuals**
  - **Expenditure responsibility**
  - **“Missionary wording”**

# OPTIONS FOR PLEDGES

- **Educate fundholders**
- **Simple alternative language**
- **Partner with other organizations**
- **Sponsoring organization can make pledge from DAF**



# GOOD PRACTICES

- **Policies and guidelines**
- **Orient donors**
- **Train employees**
- **Use internal flags and cross-checks**
- **Manage multiple advisors**

# TRANSITIONS

- **Private foundation to DAF**
- **Public charity to DAF**
- **Charitable trust to component fund**