Choose Your Own Adventure: A Comparison of Private Foundations, Public Charities and Other Giving Vehicles

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1. Overview of 501(c)(3) Organizations

   - Organized and operated <u>exclusively</u> for religious, charitable, scientific, testing for public safety, literary, educational … purposes

   - No private inurement or benefit

   - Insubstantial lobbying

   - No political campaign activity

   - Categorized as private foundations or public charities

     – Private foundations are operating and non-operating

     – Public charities are categorized based on activity (government, religious, schools, hospitals); public support (community foundations, DAFs, cultural institutions); and supporting organizations (see below)

2. Overview of 501(c)(4) Organizations

   - Civic Leagues and Social Welfare Organizations

     – Must be nonprofit

     – Organized for promotion of the common good and general welfare of the community as a whole

   - Local Associations of Employees

     – Membership limited to employees of a particular person or persons in a designated locality

– Earnings must be used for charitable, educational or recreational activities

- No Private Inurement Allowed

- Examples of 501(c)(4) Organizations

  – Homeowners Associations

  – Veterans Organizations

  – Community Centers and Community Programs

  – Volunteer Fire Department

  – Parks Association

  – Public Recreational Facilities

  – Service Organizations

- Note that some 501(c)(4) organizations also could qualify as 501(c)(3) organizations

3. Planning with 501(c)(3) Organizations

- Contributions are deductible for income (subject to limitations and restrictions), gift and estate tax purposes

- "Purely" charitable

- 501(c)(3) organizations subject to significant state and federal regulations; more so for private foundations

4. Planning with 501(c)(4) Organizations

- Effective gift tax deduction for lifetime gifts to 501(c)(4) organizations under the Protecting Americans from Tax Hikes Act of

2015 (PATH Act), in which Code Section 2501(a) was amended to specifically exclude from federal gift tax "transfers of money or other property to an organization described in paragraph (4), (5), or (6) of section 501(c) and exempt from tax under section 501(a), for the use of such organization."

- No income tax or estate tax deduction

- A 501(c)(4) organization may engage in a wide variety of activities in furtherance of "social welfare."

  – Neither Code Section 501(c)(4) nor its underlying Treasury Regulations specify the types of activities in which a 501(c)(4) organization is required to engage.

  – The statute and Treasury Regulations do not specifically provide that a 501(c)(4) organization may engage exclusively in grantmaking, though the significant overlap between 501(c)(3) and 501(c)(4) organizations suggest that a 501(c)(4) organization could engage primarily, if not exclusively in charitable grantmaking.

- 501(c)(4) organizations do not seem to fit within the definition of "disqualified person" under Code Section 4946. This is important because a related private foundation could potentially engage in transactions with 501(c)(4) organizations without self-dealing and also not be counted for purposes of excess business holdings, though neither position appears to have been tested.

- 501(c)(4) organizations likewise are not treated as private foundations for purposes of the private foundation excise tax regime.

  – However, 501(c)(4) organizations are subject to "intermediate sanctions" under the excess benefit transaction rules of Code Section 4958.

5. Overview of Supporting Organizations

- Most public charities are either defined by activity (schools, hospitals, churches) or by satisfying the public support test (community foundations, DAFs)

- Supporting organizations are another type of public charity and are defined as such because they provide dedicated support to one or more public charities.

- There are three types of supporting organization:

  – A Type I supporting organization is "operated, supervised or controlled by" a public charity it supports, and its relationship to a supported public charity is comparable to a parent-subsidiary relationship

  – A Type 2 supporting organization is "supervised or controlled in connection with" a public charity it supports, and its relationship to a supported public charity is characterized by common control or management of the supporting organization and the supported public charity

  – A Type 3 supporting organization is "operated in connection with" a public charity it supports and is the most independent – and controversial – of the three types of supporting organizations

  – A supporting organization regardless of type cannot be controlled by disqualified persons (other than foundation managers), limiting the formal role of a donor in the supporting organization's governance

6. Planning with Supporting Organizations

- Allows for a built-in partnership and collaboration with an existing public charity, perhaps creating administrative efficiency and continuity

- Built-in governance succession

- Greater ease for restricted gifts

- Allows donor and her family to have a formal role in governance, though not control

- Treated as public charity, so more preferential treatment as to charitable deductions

- Type 1 and Type 2 supporting organizations avoid private foundation excise taxes (though intermediate sanctions still apply)

7. Overview of Private Non-Operating Foundations

- A private foundation is a tax-exempt charitable entity described under Code Section 501(c)(3)

  – A foundation is distinguished from a *public charity* based on activities or funding

  – Generally, a private foundation is controlled and funded by an individual, family or company, as opposed to the general public

  – Typically, private foundations engage primarily, or even exclusively, in grant-making activities to public charities, as opposed to direct charitable activities

- Private foundations are subject to a strict regulatory regime

  – Code Section 4940 imposes a 2% tax on a private foundation's investment income

  – Code Section 4941 prohibits "self-dealing" transactions, which are most transactions between a private foundation and a broad category of related party known as "disqualified persons"

  – Code Section 4942 requires a private foundation to annually distribute "income" roughly equal to 5% of the foundation's investment assets

– Code Section 4943 prohibits a private foundation, in combination with all disqualified persons, from owning more than 20% of a "business enterprise"

– Code Section 4944 prohibits a private foundation from owning investments that jeopardize its charitable purposes

– Code Section 4945 prohibits a private foundation from making "taxable distributions," which essentially are certain lobbying or political activities, or distributions other than for charitable purposes

8. Planning with Private Non-Operating Foundations

- Typically used as a charitable giving vehicle that is and will remain controlled by a donor and her family

  – Allows for the creation of a philanthropic legacy

  – Allows for the continued control of foundation investments

  – Maximum flexibility for building in governance succession

  – Donors can lock-in charitable purposes that extend beyond their lifetimes

  – Allows for restricted giving

9. Overview of Private Operating Foundations

- Unlike private non-operating foundations, private operating foundations are required to engage primarily in direct charitable activities (such as operating a museum or library), and in doing so, are required to satisfy certain tests.

- A private operating foundation must annually spend at least 85% of its adjusted net income on the active conduct of its charitable activities, which does not include grantmaking to other organizations.

– “Adjusted net income” means gross income (not including gifts, contributions and grants) reduced by allowable deductions (such as expenses incurred for the production or collection of gross income, and operating expenses such as wages and rent).

- A private operating foundation also must satisfy one of three tests: the assets test, the endowment test or the support test.

  – In order for the Foundation to satisfy the assets test, at least 65% of the Foundation’s assets must be devoted to the active conduct of its tax-exempt activity.

  – For the Foundation to satisfy the endowment test, the Foundation annually must spend at least two-thirds of 5% (i.e. 3.33%) of the fair market value of all of its non-charitable assets (e.g. investment assets) on the active conduct of its tax-exempt activity. Typically, if a private operating foundation is able to satisfy the requirement of annually spending at least 85% of its adjusted net income on the active conduct of its tax-exempt activity, it will be able to satisfy the endowment test.

  – The support test requires that at least 85% of the private operating foundation’s support be received from the general public and 5 or more unrelated exempt organizations. In addition, no more than 25% of its support may be received from any one exempt organization and no more than 50% of its support may be derived from investment income.

- Private operating foundations also are subject to the same excise taxes as private non-operating foundations, except the requirement to annually distribute income.

10. Planning with Private Operating Foundations

- Allows a donor to create an organization that engages in direct charitable activities

  – Allows for the creation of a philanthropic legacy

- Allows for the continued control of foundation investments

- Maximum flexibility for building in governance succession

- Donors can lock-in direct charitable purposes that extend beyond their lifetimes

- Preferential treatment with respect to income tax deductions (same as public charities)

- However, this is a significant undertaking

11. Community Foundations and Donor Advised Funds

- Three trends around community foundations and donor advised funds

  - Evolving role of community foundations as anchor institutions

  - Rapid growth of donor advised funds

  - Increased scrutiny of donor advised funds

- Community Foundations

  - A community foundation is a tax-exempt, nonprofit, autonomous, nonsectarian philanthropic institution supported by the public with long-term goals of building funds to carry out donor intentions, support the broad-based interests of a defined area, and provide leadership on important community issues.

  - Over 750 community foundations in the U.S. that range in size of less than $100,000 to more than $10 billion.

  - In 2018, community foundations had $86.8 billion in assets, received over $10.5 billion in gifts, and made more than $9 billion in grants.

– A fund at a community foundation may be endowed or non-endowed, and also may be unrestricted, field of interest, designated, donor advised, or supporting organization.

- Donor Advised Funds (DAFs) Definition and Regulation

– Code Section 4966 describes a donor advised fund as 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

– Code Section 4958 imposes an excise tax on excess benefit transactions between a disqualified person and an applicable tax-exempt organization.

– Code Section 4967 imposes a tax on more than incidental benefit transactions to a DAF advisor.

– Code Section 4943 prohibits a donor advised fund, in combination with all disqualified persons, from owning more than 20% of a "business enterprise".

– In 2017, there were more than 463,000 donor advised fund accounts that held over $110 billion in assets, received $29.2 billion in gifts and made $19.1 billion in grants.

– Donor advised fund assets increased by 27% from 2016 to 2017 and donor advised fund grants increased by 20% in the same period.

- IRS Notice 2017-73 Comments on Application of Excise Taxes to Donor Advised Funds

– Pledges paid from a DAF will not be more than an incidental benefit if sponsoring organization makes no reference to pledge, no donor/advisor received any additional benefit as a result of grant, and donor/advisor does not claim a deduction for the DAF grant.

– Grants from a DAF that enable a donor/advisor to attend a charity-sponsored event would result in a more than incidental benefit, even if the donor/advisor pays the non-deductible portion of the ticket.

– Public support test as applied to DAF grants means that the organization that received a DAF grant must treat it as funded by the individual donor/advisor, treat all anonymous DAF grants as being made by one person, and treat distributions from a sponsoring organization as public support without limitation only if sponsoring organization specified that the grant is not from a DAF or advised by donor/advisor.

- Donor Advised Fund Scrutiny

  – Unlike private foundations, DAFs do not have a minimum annual payout requirement and some have advocated for things like a minimum annual payout, a term-of-years maximum existence of a DAF, and a charitable income tax deduction only when grants are made from a DAF.

  – DAFs are not required to report their list of grant partners and some believe that this secrecy contradicts the public charity nature of DAFs and could result in DAF activities that are contrary to the public benefit.

  – Donor relationships with DAFs are advisory only and some feel that this is illusory and that the donor exercises too much control over the DAF.

  – Some believe that the lack of minimum payout rate encourages “stockpiling” of assets to generate fee revenue for DAF sponsors.

12. Hybrid Charities and Impact Investing – B-Corps, Benefit Corporations, L3Cs and Charitable LLCs

- Two converging trends culminating in this veritable alphabet soup of structures and strategies for "doing good while doing well"

  – Growth of impact investing

  – Pressures and uncertainties related to traditional funding streams for nonprofits, social enterprise

- "Investing for Impact" is a longstanding and continuously evolving concept and industry

  – Roots in Muslim Sharia investing

  – John Wesley and the Methodists establishing what were essentially the first investment screens (sin stocks)

  – 1960s civil rights

  – 1970s Ralph Nader and voting proxies concerning consumer protections and environmental issues

  – Creation of South Shore Bank- community investment and birth of the CDFI industry

  – 1980s advocacy for divestment from South Africa

  – 1990s with the Calvert, Domini, Parnassus…

  – To today when Impact Investing is "mainstream" and growing

- Impact investing recently has experienced huge growth

  – $30.7 Trillion invested in SRIs globally as April 2019 – about half in Europe, followed by United States, with Japan growing rapidly with $2.2 Trillion

– Rise of “conscious consumerism” – voting with our wallets

- Across nonprofit sector, organizations are seeking ways to diversify their revenue streams

  – Decline in charitable giving from individuals in 2018 (see Giving USA), after several years of increases

  – Impact of Tax Cut and Jobs Act -- millions of taxpayers no longer itemize and change in tax law reduced the marginal tax benefit of giving to charity by more than 30 percent in 2018, raising the after-tax cost of donating by about 7 percent according to Tax Policy Center

  – Resurgence of market volatility and projected lower returns across major asset classes is not good news for charitable giving

  – New for-profit enterprises useful for diversifying revenue streams for charity

- B Corporations

  – Not actually an entity type, but rather a certification by a 3rd Party business (B Lab) that recognizes the company’s commitment to certain sustainable practices

  – ShoreBank was an early B corporation

  – Stamp of approval for for-profit businesses that meet rigorous standards of social and environmental and performance, accountability and transparency (governance)

  – Comparable to Fair Trade for coffee, USDA for milk or LEED certification for buildings

  – Specific legal requirements may include changes to the articles of incorporation, governance documents, bylaws, provisions for shareholders

– Protects the core principles and mission through new management, new investors, new ownership… Bake the sustainability and mission into the corporation

- Benefit Corporations

  – Legal business entities, available in over 20 states and growing

  – Purpose is to create a solid foundation for long-term mission alignment and value creation

  – It protects mission through capital raises and leadership changes, creates more flexibility when evaluating potential sale and liquidity options, and prepares businesses to lead a mission-driven life post-IPO

  – Essentially a traditional corporation with modified obligations committing it to higher standards of purpose, accountability and transparency

  – Purpose: Benefit corporations commit to creating public benefit and sustainable value in addition to generating profit; this sustainability is an integral part of their value proposition

  – Accountability: Benefit corporations are committed to considering the company's impact on society and the environment in order to create long-term sustainable value for all stakeholders.

  – Transparency: Benefit corporations are required to report, in most states annually and using a third party standard, showing their progress towards achieving social and environmental impact to their shareholders and in most cases the wider public.

- L3C (Low-Profit Limited Liability Company)

  – Hybrid with characteristics of for-profit and nonprofit entities

– It is a variation of an LLC, a private organization of which there are equity owners who can receive distributions of profits and appreciation of the value of the business.

– However, like a nonprofit, it must be formed in the furtherance of some charitable or educational purpose or mission

– L3C is allowed to generate <u>modest</u> profits from the business, but only so that it can conduct business to help a certain cause, and in essence, operates to better social welfare in some way

– Designed to make it easier for socially responsible businesses to attract money from foundations and private investors, and can accept both traditional debt and equity financing, as well as PRI investments from foundations

– In certain instances can be considered a nonprofit if all of its members are nonprofits and meets several other criteria

- Charitable LLC

– Currently, there is no legal definition of "charitable LLC"

– Typically refers to LLCs that engage in charitable or philanthropic endeavors, act as pass-through entities, provide limited liability to their members, and transfer any profits/losses incurred to the members

– If the LLC makes money, its members will receive the money and pay taxes on it and if the LLC makes a charitable distribution, its members will receive the charitable deduction

– Unlike a private foundation, can engage in advocacy and lobbying without limitation, as well as partisan political activity

– Not required to operate solely for charitable purpose, no required distributions, control for the LLC founder(s)

– LLCs are not required to publicly disclose information regarding their activities or compensations

13. Questions, Final Thoughts