

PRIVATE FOUNDATIONS, DONOR ADVISED FUNDS OR BOTH?

Advisors in Philanthropy

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Private Foundation or Donor Advised Fund?

- How does an advisor decide to recommend one or the other?
- Advantages and disadvantages of each of these charitable grant making vehicles

What Is a Private Family Foundation?

- Formed by a person, a couple or a family
- Separate legal entity in corporate or trust form
- Organized and operated exclusively for charitable, literary or educational purposes
- Makes grants to other charities

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Private Foundation Advantages: Control

- Donor can play active role in foundation administration
- Donor or family can control to whom, when and for what purposes grants are made
- Donor controls foundation's investments

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Private Foundation: Donor Recognition

- Donor or family's name is on each check
- Donor can deliver check

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Private Foundation: Grantmaking

- Make grants to U.S. 501(c)(3) public charities
- Make grants directly to individuals facing hardship or emergencies
- Support organizations outside the U.S.
- Set up and run scholarship programs
- Negotiate and monitor multi-year grants to fund longer term projects

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Private Foundation Tax Benefits

- Income tax deduction for lifetime gifts to foundation
 - Cash: Up to 30% of AGI
 - Appreciated publicly traded stock: FMV up to 20% of AGI
 - Other appreciated assets: cost basis up to 20% of AGI
 - 5-year carry forward

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Private Foundation Tax Benefits

- Unlimited estate tax deduction for bequest to private foundation
- Foundation itself is income tax exempt, subject to 2% excise tax on net investment gains

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Private Foundations: Disadvantages

- Required annual charitable grants of at least 5% of asset value regardless of actual income
- Substantial legal, accounting and operational costs to establish and to terminate
- Must establish and manage its own administration and operations

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Private Foundations: Disadvantages

- Must manage its own investments
- Must file separate tax returns each year
- Grant information readily available to public in foundation's tax returns
- Anonymity not possible

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What Is a Donor Advised Fund?

- A Donor Advised Fund (“DAF”) is a separate fund, usually in donor’s name
- Established at public charity (typically community foundation) or commercial vendor
- Donor and donor’s family serve as advisors to the public charity about where charitable grants from the DAF will go

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Advantages of a DAF

- No cost to donor to set up
- Easy to establish
- No separate IRS exemption application
- Established by simple agreement with public charity sponsor

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Advantages of a DAF: Easy to Maintain

- Minimal ongoing annual administration costs
- No separate tax returns or annual taxes
- Investments provided by sponsoring charity, often with advice of donor
- Lower minimum size

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Advantages of a DAF: Donor and Family

- Sponsoring public charity has extensive knowledge of potential grantees
- Sponsor provides education and resources about effective grant making
- Members of donor's family can be fund advisors
- Grants can be anonymous

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Tax Advantages of a DAF

- Donor gets current income tax deduction for gift to public charity
 - Cash: Up to 50% of AGI
 - Appreciated Assets: FMV up to 30% of AGI
 - 5-year carry forward

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DAF Distribution Requirements

- IRS imposed: None, currently
 - 12/5/2011 – US Dept. of the Treasury Report
 - Found average 2006 payout rate of 9.3%
 - Premature to require a minimum
 - 7/11/2012 – Congressional Research Service
 - Found average 2008 payout rate of 13.1%
 - Concerned about how soon funds are put to use
- Organization imposed

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Disadvantages of a DAF

- Cannot make grants to individuals in need
- Cannot reimburse expenses of fundraising activities
- Often end after one or two generations

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DAF Rules Against Private Benefit

- Economic benefit to donor, fund advisor or related party
 - Penalty of 125% of value of the economic benefit
 - Payable by person who recommended the grant or person who received the benefit
- Grants, loans and compensation from DAF to donors
 - Penalty is 25% of value of excess benefit
 - Amount must be repaid to sponsoring charity, but not for deposit to the DAF

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DAF Rules Against Private Benefit

Cannot make DAF Grants to Pay:

- Pledge made by donor/fund advisor
- Tuition for family members of donor/advisor
- Tickets to galas for donor

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Issues with Private Foundations

Code Section 4940. Excise tax based on investment income.

- 2% tax on net investment income; required to make quarterly estimated payments

Code Section 4941. Taxes on self-dealing.

- No sale or leasing of property with disqualified persons. If you have empty office space, you can't lease it, you have to give it for free.

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Issues with Private Foundations

- IRS sees paying a pledge the same as paying your credit card bill “relieving your debt.”
- Tickets/Tables/Golf tournaments, if you purchase a table at an event and invite your family and friends who are not on the board of the private foundation, that’s self-dealing.

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Issues with Private Foundations

Code Section 4942. Taxes on failure to distribute income.

- 30% tax on undistributed investment income (assumed 5% return); 100% tax if that amount remains undistributed by the next year.

Code Section 4944. Taxes on investments which jeopardize charitable purpose.

- These include trading in securities on margin, trading in commodity futures, investments in working interests in oil and gas wells, the purchase of “puts,” “calls,” “straddles” and warrants, and selling short.

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Issues with Private Foundations

Code Section 4945. Taxes on taxable expenditures.

- No lobbying, not even a little.
- Paying kids – executive compensation: donor has an unemployed son who used to make \$250k a year as an investment banker: check a nonprofit compensation study.

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Issues with Private Foundations

California Corporations Code Section 5227. Family board members.

- Not more than 49% of the persons serving on the board of any corporation may be interested persons. If you pay salary to a family member, any brother, sister, ancestor, descendant, spouse, brother-in-law, sister-in-law, son-in-law, daughter-in-law, mother-in-law, or father-in-law of any such person, is an interested person.

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Comparison: Donor-Advised Fund – Private Foundation

Comparisons	Donor Advised Fund	Private Foundation
Tax-exempt status.	Shares public charity status with charity.	Must establish separate tax exempt status as private foundation.
Charitable deduction for cash gifts.	50% of adjusted gross income in any one year.	30% of adjusted gross income in any one year.
Charitable deduction for gifts of long-term capital gain property.	Deduction for full fair market value, limited to 30% of adjusted gross income in any one year.	Deduction for full fair market value of publicly traded stock and at cost basis for other LTCG assets, limited to 20% of adjusted gross income in any one year.
Donor control.	Donor may be allowed to make recommendations as to investments and grants, but charity makes final decisions.	Donor retains complete control over investments and grant making, limited only by IRS requirements.

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Comparison: Donor-Advised Fund – Private Foundation

Comparisons	Donor Advised Fund	Private Foundation
Minimum payout requirements.	None, except by charity's policy.	Must pay out for charitable purposes at least 5% of asset value regardless of annual income.
Creating the foundation.	Established by agreement with community foundation or other charity.	Nonprofit corporation or trust organized as a private foundation.
Start-up costs.	No cost to donor.	Requires substantial legal, accounting, and operational costs similar to corporate startup.
Practical minimum size.	Depends upon charity's policy, often \$10,000 to \$25,000.	Substantial assets required, \$1.0 million and up.
Administration and operations.	Provided by the charity.	Must establish, acquire, and manage on its own.

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Comparison: Donor-Advised Fund – Private Foundation

Comparisons	Donor Advised Fund	Private Foundation
Annual costs.	Minimal, usually set by charity on a break even basis.	Can be costly including administration, accounting, and audit.
Annual taxes.	None.	Generally income tax exempt, but subject to excise tax of up to 2% of net investment gain including capital gains.
Annual tax filings and returns.	None required, reported as part of the charity's annual reporting.	Separate tax and information return must be filed with required schedules.

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Comparison: Donor-Advised Fund – Private Foundation

Comparisons	Donor Advised Fund	Private Foundation
Investments.	Provided by the charity, sometimes with donor's advice.	Must establish, research, and manage own investment vehicles.
Fiduciary responsibility.	Charity fulfills fiduciary responsibilities.	Private foundation board has full fiduciary responsibility.
Liability and risk.	Charity covers liability and risk.	Must be covered by the foundation.

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TAX COMPARISONS BETWEEN PRIVATE FOUNDATION, PUBLIC CHARITIES AND DONOR ADVISED FUNDS

	Private Non-Operating Foundation	Private Operating Foundation	Supporting Organization	Donor Advised Fund (Community Foundation)	Public Charity
Deduction Rules					
Cash Gift	30% AGI	50% AGI	50% AGI	50% AGI	50% AGI
Appreciated Property	20%	30%	30%	30%	30%
Carry-Over Available	5 Years	5 Years	5 Years	5 Years	5 Years
Contributions of Appreciated Property	Cost Basis ¹	FMV	FMV	FMV	FMV

¹Except for publicly traded securities.

TAX COMPARISONS BETWEEN PRIVATE FOUNDATION, PUBLIC CHARITIES AND DONOR ADVISED FUNDS

	Private Non-Operating Foundation	Private Operating Foundation	Supporting Organization	Donor Advised Fund (Community Foundation)	Public Charity
Operational Rules					
Investment Tax ¹	2%	2% ²	None	None	None
Tax on Self-Dealing	Yes	Yes	N/A	N/A	N/A
Pay-Out Requirements	5%	Yes	No	No	No
Tax on Excess Holdings	Yes	Yes	No	Yes ³	No
Public Support Test	No	No	No	Yes	Yes
Tax on Certain Grants	Yes	Yes	No	No	No

¹Tax reduced to 1% for each taxable year the Foundation's pay-out for charitable purposes is increased by an equivalent amount.

²May be eliminated if certain requirements are met.

³If foundation or DAF disposes of the holding within 5 years, no penalty applies. With IRS approval, can get additional 5 years to dispose of the holding.

Other Community Foundation Vehicles

- Field of Interest Fund
 - Donor indicates specific areas of interest
 - Fund makes grants to mission-aligned public charity grantees
- DAF as corporate “foundation”
 - Established by corporation
 - Grants made in corporate name
- Restricted Fund
 - Donors can support specific organizations through regular grants
- Scholarship Funds
 - Donor can support students of any age, background or education level by selecting from different fund options

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LET'S SOLVE SOME PROBLEMS

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Case Study #1: 5% Payout

Facts:

Private foundation may not meet its 5% payout requirement

Why?

- Time got away from them
- Private foundation investments earned more than expected, so the 5% is a lot more than projected
- Private foundation made big challenge grant to public charity. Late in the year, public charity notifies private foundation it can't meet the challenge requirements

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Case Study #1: 5% Payout

Solution:

- Grant the 5% to a donor advised fund established by the foundation's founders or directors
- Allows flexible grant payout management
- Avoids 30% penalty for failure to distribute 5%

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Case Study #2: Integrating Family Board Members

Facts:

- Long-term private foundation
- When family members reach a certain age, they automatically become members of the board
- New board members feel disenfranchised
- Inability to approve grants by year-end

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Case Study #2: Integrating Family Board Members

Solution:

- Foundation sets up a DAF
- Foundation makes 5% payout to DAF
- Each board member advises on grants from a portion of the DAF

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Case Study #2: Integrating Family Board Members

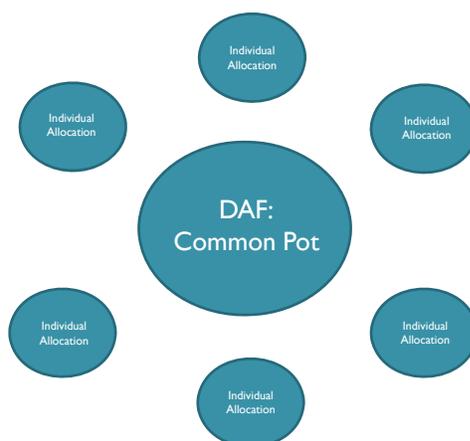
Result:

- Avoids 30% excise tax for failure to distribute
- Overcomes the feelings of disenfranchisement
- Provides research and other programmatic support

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Case Study #2: Structure



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Case Study #3: Training and Ownership for Next Generation

Facts:

- Parents created private foundation
- Children serve on the board
- Family as a whole approves grants
- To control administrative burden, private foundation makes a few very large grants for Alzheimer's research once a year

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Case Study #3 – Training and Ownership for Next Generation

- Children would also like to make smaller, more frequent grants to charities of interest to them.
- Children see private foundation as their parents'. Parents' goal was to have children feel it was theirs.

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Case Study #3 – Training and Ownership for Next Generation

Solution:

- Private Foundation establishes a DAF for each child and matches child's DAF contributions 2 for 1.
- Each child can make much smaller more frequent grants from the child's DAF.
- At the annual board meeting of the private foundation, parents and children discuss each child's giving for the past year.

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Case Study #4: Targeting Critical Needs Efficiently

Facts:

- Jeff created a private foundation on his death
- Closest friends and advisors comprise the board
- Private foundation has \$20,000 grant minimum

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Case Study #4: Targeting Critical Needs Efficiently

Problem:

- The private foundation wants to respond to funding requests from smaller high quality charities

Solution:

- Private foundation makes \$250,000 grant to field of interest fund at community foundation
- Community foundation makes 25 grants of \$10,000

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Case Study #4: Targeting Critical Needs Efficiently

- Community foundation's existing grantmaking structure and process allow private foundation to fund small projects without changing its grant guidelines or increasing administration

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Case Study #5: Anonymity Planning

Facts:

- All private foundation grants are listed on its 990-PF tax returns, which are readily available online
- Anyone can see the private foundation's asset balance, directors and contact information

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Case Study #5: Anonymity Planning

Problem:

- A private foundation is not private at all. Unsolicited grant requests pour in. Investment advisors solicit directors for the private foundation's business. Donors want privacy.

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Case Study #5: Anonymity Planning

Solution:

- Private foundation creates a DAF and makes its grants anonymously through the DAF. Community foundation tax returns must show all grants, but not what fund they came from.
- All unsolicited grant applications are sent to community foundation for review and culling. The private foundation website makes clear that all discretionary giving is done through the community foundation.

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Case Study #6: Complete Foundation Termination (one DAF)

Facts:

- Family wants to completely terminate private foundation due to:
 - Loss of value in 2008 recession
 - Constraints on private foundations
 - Administrative burden

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Case Study #6: Partial or Complete Foundation Termination

Solution:

- Family establishes a DAF
- Private foundation grants all of its assets to the DAF
- Family members are DAF advisors
- Private foundation terminates as an entity with no assets

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Case Study #7: Complete Termination on Divorce (two DAFs)

Facts:

- Parents created private foundation together many years ago
- Size of foundation is around \$1 million
- Parents are divorcing

Problem:

- Too expensive to split private foundation into two private foundations, one for each parent

Solution:

- Terminate private foundation into two DAFs, one for each parent

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Dissolving a Private Foundation into a DAF

Steps for dissolving a private foundation:

- Board resolution
- Letter to CA's Attorney General requesting a waiver of objections to the dissolution and transfer
- Wind-up affairs
- File a Certificate of Dissolution
- File a final financial report and RRF-I form with the Attorney General
- File final informational tax returns with the IRS and CA Franchise Tax Board
- Notify IRS of dissolution

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Case Study #8: Partial Foundation Termination: Maintaining Family Harmony

Facts:

- Parents created private foundation long ago
- Children and their spouses are directors

Problem:

- All is well until daughter Ann marries a man all of the other children dislike
- Ann and her husband become deeply involved with a cause outside the private foundation's mission

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Case Study #8: Partial Foundation Termination: Maintaining Family Harmony

Solution:

- Partially terminate private foundation by distributing Ann's share to a DAF, with Ann as fund advisor
- Allows Ann to support her charitable causes and reduces intra-family tensions

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Case Study #9: Complete Termination: Foundation Succession Planning

Facts:

- Mom and dad, now in their 80s, created private foundation 40 years ago. It has meant a lot to them.
- Their only son is not interested in the private foundation, and their friends are all their age.

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Case Study #9: Complete Termination: Foundation Succession Planning

Solution:

- Mom and dad terminate the foundation into a field of interest fund at a community foundation to support the same causes as the private foundation
- The fund retains the private foundation's name
- The fund has a staffed, competitive application process to ensure grants are going to the best programs
- The fund will last in perpetuity

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Case Study #10: Charitable Lead Trust Gifts

Facts:

- Max and Christine recently set up a charitable lead trust.
- They wanted to set up a private foundation to receive the charitable lead payments.

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Case Study #10: Charitable Lead Trust Gifts

Problem:

- If Max and Christine, as directors of their private foundation, can vote on grants from the foundation of funds received from the charitable lead trust, the charitable lead trust assets will be in their estates for estate tax purposes. IRC Sec. 2036 control issue.

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Case Study #10: Charitable Lead Trust Gifts

Solution:

- Create a DAF with Max and Christine as fund advisors.
- Because they retain only advisory powers, the lead trust will remain out of their estates.

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Case Study #11: An Easier Way to Make International Grants

Facts:

- Maria's private foundation recently made a grant to a charity in Ethiopia.
- Maria wants to continue to support foreign charities.

Problem:

- It cost a lot in legal fees because of the due diligence required.
- Maria needs a more efficient way to make grants to foreign charities.

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Case Study #11: An Easier Way to Make International Grants

Solution:

- Maria sets up a DAF.
- Her private foundation makes grants to the DAF.
- The community foundation has experience in and routines for conducting the due diligence on the foreign charity.

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Case Study #12: Corporate Foundation Alternative

Facts:

- Debbie and Ken own D&K, Inc., a manufacturing company
- Once had plants in 5 states
- Recession forced:
 - Closure of 2 plants
 - Layoffs of 17 corporate office employees

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Case Study #12: Corporate Foundation Alternative

Goals:

- Fund charitable foundation with low basis building that housed closed plant
- Make grants into communities where plants closed
- Establish employee charitable contribution \$1-for-\$1 matching program
- Get a maximum tax benefit to D&K, Inc. for charitable contribution of the building

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Case Study #12: Corporate Foundation Alternative

Challenges:

- Scarce human resources to run corporate private foundation
- Complexity/administrative burden of running employee matching program
- Deduction for donation of building to private foundation limited to cost basis
- If private foundation sells building, 2% or 1% excise tax on realized gain

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Case Study #12: Corporate Foundation Alternative

Solution:

- D&K, Inc. sets up a DAF
- Company contributes building to DAF
- Company gets deduction at FMV
- Community foundation sells building; no excise tax on realized gains
- Community foundation handles all investment management, compliance, administration and check distribution

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Case Study #12: Corporate Foundation Alternative

- D&K, Inc.'s Director of Community Affairs is DAF advisor and recommends grants into communities where plants closed
- D&K, Inc.'s Director of Community Affairs is a primary contact for employee matching program
- No additional D&K staff needed
- Community foundation researches and provides advice on best local charities

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Case Study #13: Scholarship Fund

Facts:

- Jeff established a private foundation after selling his architectural firm.
- First grant funded a scholarship in architecture at his alma mater.

Goal:

- Create an architectural scholarship program for local college bound students, not limited to his alma mater.

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Case Study #13: Scholarship Fund

Challenges:

- Private foundation needs IRS pre-approval for scholarship plan
- Self-dealing issues
- Need private foundation administrator to:
 - Establish policies/guidelines
 - Publicize scholarships
 - Collect, review and cull applications
 - Coordinate recommendation letters/transcripts
 - Staff selection committee
 - Notify winners
 - Cut checks

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Case Study #13: Scholarship Fund

Solution:

- Establish scholarship fund at community foundation
- Community foundation handles all administrative matters

Note: Donor cannot participate in selection committee through private foundation or community foundation but can meet, mentor and/or track the progress of scholarship recipients

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Case Study #14: The Donor's Trusted Investment Advisor

Facts:

- Ann-
 - Has done well financially
 - Is loyal to her trusted investment advisor of 20 years
 - Is concerned a community foundation will not manage her donated funds as well
 - Wants to support a soup kitchen which is new but very successful

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Case Study #14: The Donor's Trusted Investment Advisor

- Ann-
 - Opens a restricted fund at the community foundation
 - Donates at least \$500,000
 - Specifies all income gets paid to soup kitchen in quarterly installments

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Case Study #14: The Donor's Trusted Investment Advisor

- Advisor manages investment of 95% of Ann's fund assets
- Community foundation provides broad philanthropic support
- Soup kitchen has the benefit of an endowment but doesn't have the \$500,000 on its balance sheet (which could impede fundraising)
- If soup kitchen terminates, Ann can redirect her restricted fund to one or more similar organizations.

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Valuable Community Foundation Custom Services

- One on one conversations with family foundation board members to discern their personal grantmaking interests and to provide feedback on the mission and direction of the family foundation
- Vetting and research of potential organizations of choice
- Presentation to the family foundation board on the aggregate findings of the interview process

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Valuable Community Foundation Custom Services

- Compilation of board meeting materials, both in electronic and hard copy
- Suggestions of decision making models for the family to consider as they vote on grants
- Drafting, execution and monitoring of grant agreements, including measurable outcomes tied to funding, along with reporting due dates and requirements

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When considering whether a client should have a private foundation or other type of philanthropic fund or entity, the best answer may be “both.”

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