PHILANTHROPY 101

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I. WHY DO I WANT A DONOR ADVISED FUND OR PRIVATE FOUNDATION?

A. Large charitable deduction in year of contribution – offset high income year.

B. Ability to control charitable gifting

C. Have family involved in charitable planning/philanthropy

II. WHAT

A. Two main vehicles

1. Donor Advised Fund – Funds hold $140 billion

2. Private Foundation

a. operating

b. non-operating

B. Donor Advised Fund

1. Easy to create through third party

2. No set up costs

3. No annual costs – no tax returns needed

4. Easy to administer

C. Private Foundation

1. More complicated to create

a. trust

b. corporation

2. Need to file exemption application with IRS for tax exemption (Form 1023)

3. Annual tax return (Form 990-PF)

4. Family can be in **total control** of Foundation

5. Compensation can be paid to family members for their services to the Foundation, within reason (Possible audit red flag?)

6. Can continue for generations

III. <u>DONOR ADVISED FUND ("DAF") IRC §4966</u>

A. Fund created by a charity in which the donor <u>recommends</u> distributions to public charities, governing body can reject the recommendation (almost never happens)

<u>Fairbairn v. Fidelity Investments Charitable Gift Fund</u>, 2021, USDC, N.D. California

B. Examples:

1. Universities

2. Fidelity Charitable Giving Account

3. Schwab Charitable Fund

4. Jewish Federation of Metropolitan Detroit

C. Permissible grants

1. Any public charity or private operating foundation

2. Sponsoring organization of DAF

3. Any other DAF

4. Foreign charity (only if used for charitable purpose)

D. Prohibited grants from DAF

1. To any natural person

2. Any organization where proceeds not actually used for a charitable purpose

E. There are penalties on both the sponsoring organization and the donor for improper distributions

F. Compensation cannot be paid to a family member for any services from the DAF

G. DAF can be created with a modest contribution, typically $5,000 or $10,000. Fidelity has no minimum initial contribution requirement

H. Can be created very quickly – typically online – no application or approval needed from the IRS because sponsoring organization already obtained exemption.

I. High contribution limits – generally, contributions can be deducted like other contributions to a public charity. Not eligible for Qualified Charitable Donation.

J. Grants typically paid out promptly to the recipient charity

K. Privacy – grants to charities can be made anonymously

L. Sponsoring organization takes care of investing, although many sponsoring organizations (such as Fidelity) provide a variety of funds for investment

M. Can name successor individuals to control distributions to charities. Who gets funds if no successor?

N. Sponsoring organizations typically charge very modest fees.

IV. <u>PRIVATE FOUNDATIONS ("PF")</u> IRC §501(c)(3)

A. Types

1. Non-operating – typical foundation which is formed by family to make grants to public charities

2. Operating foundation – a private foundation that actively

engages in activity on its own behalf

3. Advantage of PF - <u>CONTROL</u>

B. Formation of private foundation

1. Choice of type of entity - trust or corporation

2. Corporation is more advantageous – wide body of law regarding non-profit corporations. Can create different classes of Directors – one per family line, as an example.

3. Typically created as a corporation in which the directors elect new directors and officers annually.

4. Private foundation in Michigan only requires one director

5. File Articles of Incorporation with State of Michigan

6. Need to file with Michigan Attorney General to get exemption from Charitable Solicitation License

7. Need to file annual tax return, Form 990-PF, with IRS and copy to Attorney General's office

8. Michigan Attorney General's office supervises charitable entities, including private foundations.

C. Tax issues

1. Need to complete and file Form 1023 to get ruling from IRS that the foundation is tax-exempt under IRC 501(c)(3)

2. Can be a long application

3. IRS has also issued Form 1023-EZ. This is a shorter form and can be used if the estimated income of the PF is under $50,000 and the PF has assets under $250,000.

4. Form includes proposed budget for 3 years

5. If filed with IRS within 27 months of formation, tax exemption when granted will be retroactive to date of formation – protects donations received before exemption is issued

6. Form 990-PF must be filed each year by the private foundation. Due by the 15th day of the 5th month after the close of the tax year.

7. Failure to file Form 990-PF for 3 consecutive years will cause loss of tax exemption by IRS – can apply for reinstatement

8. Charitable donations to a private foundation have lower tax benefits than donations to DAF

    a. donations of appreciated long-term capital gain property, such as closely held stock or real estate, limited to basis – not fair market value

    b. donations of cash

9. Must distribute an amount each year equal to the minimum investment return, which is 5% of the average fair market value of the foundation's assets – if not – can be a 30% income tax on the amount not distributed to meet the 5% test.

10. Amounts distributed in excess of the 5% requirement carry over and can be applied to the minimum distribution amount for the subsequent 5 years.

11. Excise tax – a private foundation must pay a 1.39% tax on its total net investment income

    a. net investment income is gross investment income less deductions incurred in connection with the generation of the investment income

    b. rate was 2% but was reduced by the Tax Cuts and Jobs Act to a flat 1.39%

12. Activities of PF are public record – Form 990 – PF lists the charitable distributions made by the PF along with the income statement and balance sheet for the PF.

D. Purpose of Foundation

1. Must be organized and operated exclusively for a tax-exempt purpose

2. Cannot use any of its income or assets for the benefit of private individuals

3. Most private foundations invest their funds and make distributions to public charities

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4. Cannot form a private foundation for the benefit of one individual, even if have good intentions

    a. IRS Private Letter Ruling 202109007 revoked tax exemption of entity that was formed to provide services to adults with disabilities

    b. however, the majority of the services and payments were used for the benefit of one of the board members and her family

    c. thus, the private foundation was formed for a private interest rather than a public interest, so the tax exemption was revoked

E. What <u>NOT</u> to do

1. Make any political contributions

2. Engage in self-dealing

    a. any transaction between the foundation and a disqualified person

    b. disqualified persons include officers or directors of the foundation and substantial contributors to the foundation

    c. also includes the family of a disqualified person and businesses in which disqualified persons have more than a 35% interest

3. Examples of self-dealing

- sale, exchange or leasing of property between foundation and disqualified persons

- lending of money or extension of credit to disqualified persons

- furnishing of goods, services or facilities to disqualified persons

- use of foundation assets by disqualified person

4. Self-dealing can apply even if a fair market value is paid or even if the foundation is not harmed.

5. Exceptions to self-dealing

    a. providing of facilities or services to foundation without charge

    b. loan of money to foundation without interest or other charges

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6. There are severe penalties if the self-dealing transaction is not corrected

    a. need to rescind the transaction

    b. 10% penalty if self-dealing transaction is corrected

    c. penalty can increase to a tax equal to 200% of the amount involved if not corrected

7. Foundation cannot satisfy a binding pledge that a disqualified person made to another charity. Can satisfy a non-binding pledge

8. Foundation cannot pay for tickets to a gala and give the tickets to the disqualified person or third parties

9. Many other normal transactions can be self-dealing, so need to review with your attorney

V. PROPOSED LEGISLATION

1. Accelerating Charitable Efforts (ACE) Act

    a. DAF – would require all assets to be distributed within 15 years of contribution to the DAF. Limits would be imposed on contributions to a DAF that doesn't meet this requirement.

    b. would create new rules for a "qualified community donor advised fund" controlled by a qualified community foundation

    c. would impose other new rules on a DAF

    d. private foundations – would disqualify contributions from a private foundation to a DAF unless DAF makes a qualifying distribution of the contribution in the same year.

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