

WHAT DO DONORS WANT?

In determining how to make gifts, there is a general trend toward the desires of donors to exercise greater control over the funds. Three options currently in frequent use are the Donor Advised Fund, the Supporting Organization and the Private Foundation.

OVERVIEW OF ALTERNATIVES

1. WHEN TO USE A PRIVATE FOUNDATION

In the opinion of your author, a perpetual foundation should be created when there are very substantial assets. Perhaps \$20 million or more should be the minimum requirement. If a foundation is to have sufficient resources to maintain a reasonable level of staffing, then funding of this amount or more is essential. If the funding is not at this level, it is quite likely that the foundation will limp along with less than optimum investment, accounting, grant making personnel and capabilities.

A private foundation enables the donor and/or his family to control the charitable organization. They are able to manage and invest the assets, insure that the appropriate tax returns are filed and review and make the applicable grants. However, since this is a private foundation, they are subject to a host of rules that can make operation relatively expensive.

As a private foundation, there must be no self-dealing. There can be no benefits to the family members and no members can buy, sell, lease or otherwise transact business with the private foundation. There is a minimum distribution requirement and the private foundation must exercise "Expenditure Responsibility." This means that the private foundation must track the grants and make certain that the funds are used appropriately. This "Expenditure Responsibility" can involve a considerable amount of time, effort and expense.

Other private foundation prohibitions include restrictions on excess business holdings on investments that jeopardize the charitable remainder and other restrictions.

Finally, the history of the private foundations suggests that after three or more generations, the grandchildren and great grandchildren of the founders tend to disregard the expressed charitable intent of founders and fund projects that are consistent with the grandchildren's personal preferences. Donors to private foundations should keep in mind the costs and the results of current private foundations in deciding whether or not this is an appropriate alternative.

For many donors with large estates, the private foundation is viewed by the creator as his or her link with immortality. They envision the family name being carried on in the

private foundation, much as the Ford Foundation, Lily Foundation, Rockefeller Foundation, Packard Foundation and other private foundations bear the names of the founders.

However, there are several issues that must be understood when a donor is contemplating creating a private foundation. Although the private foundation does give the family control over distributions, this control comes with a significant price.

Perhaps the greatest myth about the private foundation is that the donor's children can receive large salaries from the foundation. Under Section 4941 of the Code, transfer of a benefit through a sale, lease, salary or other means to children, grandchildren or spouses is prohibited. While there is an "incidental exception" to the self-dealing rules, the exception is expressly conditioned on the test of reasonableness. That is, the professional members of the family could provide qualified professional services to a foundation, but the compensation must be reasonable.

In most cases, family members do not have the qualifications to provide professional investment counsel, professional law or accounting counsel or professional grant making counsel. If they do possess the requisite qualifications, then the salary paid to them must be reasonable for the professional services rendered. In most cases, the salary that can be properly paid to family members is rather modest in comparison to the balance of the inheritance. In short, paying a salary is a very bad idea that under the proper use of the rules will not pass as significant inheritance anyway.

Other concerns about the private foundation also relate to the private foundation rules under Sections 4941 through 4947 of the Internal Revenue Code. The private foundation is subject to minimum distribution requirements, excess business holding requirements and expenditure responsibility. Compliance with these requirements can require a considerable amount of time, effort and expense.

However, perhaps the biggest problem for many private foundations is the lack of expert investment, accounting and grant making capabilities. Unless the foundation is quite large, the earnings of the foundation typically will not permit full time expertise in these areas. Thus, many smaller and medium sized private foundations are run by family members as volunteers with occasional assistance in the investment and accounting area. These family foundations do not effectively manage and distribute assets. There is an extraordinary difference between the Ford, Lilly and Packard Foundations with their billions of dollars of resources in their ability to employ highly skilled investment, accounting and grant making personnel compared to many of the smaller foundations.

2. OPTIONS FOR SUPPORTING ORGANIZATIONS

Since the supporting organization benefits from the investment, accounting and grant making skill of the parent, a supporting organization of \$1 million or more should be possible. Nevertheless, many parent charities might set a desired goal of perhaps \$5 million. If the parent charity is going to devote resources to the supporting organization, then it must be large enough to make significant grants. This supporting organization can

be run quite efficiently and effectively. If family members desire to participate, they can be tutored and encouraged by the professional development staff of the parent charity. The supporting organization can have a field of purpose and the donors can have the certainty of charitable intent that is frequently missing from a private foundation. While many private foundations, after the second or third generation, go in a very different charitable direction than initially intended by the donor, a supporting organization or an educational institution is very likely to be involved in education 100 years from now. Similarly, a medical research organization SO is virtually certain to be involved in medical research. A religious organization a century from now will almost certainly be involved in projects that support that particular religion. Thus, the long-term certainty of charitable intent is far superior with a supporting organization.

A supporting organization is a method to maintain public charity status while creating a charitable foundation. The supporting organization comes in three types – the “Controlled By” Type, the “For the Benefit of” Type or the “In Connection With” Type. With all three types there is the opportunity for family participation. For example, the “Controlled By” Type could have a Board of Directors with four directors elected by the charity and three directors selected by the family. Thus, the supporting organization is controlled by the public charity, while the family members certainly exercise a great deal of influence.

Another type of supporting organization is one where the benefits are limited to a major public charity. With a community foundation that has fairly broad purposes, this can still preserve a great deal of flexibility in the charitable grant process.

Finally, it is possible to satisfy some fairly complex tests and create an entity operated “In Connection With” a public charity. For this organization, the operation and identity of the supporting organization must be sufficiently close to the public charity to qualify for public charity status.

With all of these types of supporting organizations, once again it is possible to benefit from the expertise and experience available through the community foundation or other public charity.

It is possible to create a subsidiary of a public charity that is also entitled to the income, gift and estate tax benefits of a public charity. This “supporting organization” may be either “controlled by” or “operated for the benefit of” the public charity. In most cases, the supporting organization has a majority of the directors elected by one public charity and a minority of the directors selected by family members. However, in some cases, there could be separate charities electing the directors. For example, it is permissible to have four public charities electing four directors and three family members on a board of seven directors.

The supporting organization has several benefits. First, it does have all of the public charity benefits, such as the higher tax deductions and the lack of the private foundation restrictions. This enables the supporting organization to be run at very reasonable

expense without a significant administrative overhead. In addition, the supporting organization benefits from the investment, accounting and grant making expertise of the parent charity. All of these benefits make a supporting organization quite inefficient and effective charitable alternative. Concerns for the supporting organization include the lack of full control on the part of the family. While the family can exercise great influence the ultimate control for most supporting organizations rest with either the parent public charity or parent public charities?

3. DONOR ADVISED FUNDS

Donor Advised Funds are created the amount of \$100,000 or more. Since the Donor Advised Fund is a component fund, it is the least expensive to create and operate. The donor and spouse or the donor's children may generally be involved in the fund. Typically, the family makes recommendations and at least annually the grants are made to the various charities. Once again, this fund operates very efficiently and effectively. It benefits from the expertise of the public charity's investment committee, follows the accounting and audit procedures of the public charity and learns from the grant making expertise of the public charity staff.

While most Donor Advised Funds have been created by community foundations, university's foundations and religious organizations are now starting to create Donor Advised Funds.

A Donor Advised Fund is simply a fund created by a donor who transfers complete control of the fund to the charity. However, since donors typically make additional gifts to the funds, it is logical to expect that the advice given by the donor to the charity will be followed in most cases. Thus, the donor or the family of the donors are able to have a family fund that is controlled by a charity and entitled to all of the public charity income, gift and estate tax benefits. However, the family maintains a significant level of involvement in the fund and in the distributions from the fund.

The concerns of those who are considering a Donor Advised Fund relate to the visibility and control. While the Donor Advised Fund can indeed have a family name attached to it, it's not quite the same as a named private foundation. In addition, although the public charities are going to work very diligently to be responsive to donor desires, there still is ultimate control in the hands of the public charity.

The DAF is established with a gift of cash or property. A public charity manages the fund, however, the donor or the family of the donor is allowed to make recommendations. While the distributions from the DAF must be approved and controlled by a public charity, a DAF is an excellent means for making substantial gifts and retaining a great deal of influence over the final distributions. For example, an individual might be selling a major asset and desires to receive both a charitable deduction and bypass of capital gain. He or she transfers a portion of the appreciated property into a Donor Advised Fund. While the tax benefits are available this year, the

decisions on distribution of the Donor Advised Fund can be made over a period of many years.

The DAF combines the best of both worlds – the most favorable tax benefits and efficient administration with great flexibility in charitable distributions.

4. DONOR ADVISED FUNDS AFTER PPA 2006

One option for a donor who wants to make a gift to charity, does not want to create a private foundation and does not want to pick the charities who will receive the funds right now, but instead wants to distribute them over time, is a donor advised fund (DAF). A DAF is an account that a donor establishes within a public charity - often a community foundation. When a donor makes contributions to the DAF, the donor must give complete control over the donated funds to the public charity. As a result, a donor gets a current income tax deduction for the full amount of the contribution to the DAF. Despite the fact that the donor relinquishes control over the donated funds, the unique aspect of a DAF is that the donor can remain involved by making non-binding recommendations to the public charity as to investment policy and DAF distributions. As a result, the donor is able to fulfill his or her philanthropic goals in a flexible, tax-favored and cost-effective way.

Sec. 4966 creates a comprehensive set of rules for DAFs. The DAF definition, distributions, donors, disqualified persons and deductible donations are all specified.

a. Definition of DAF

A DAF has three specific requirements. It must be separately identified, owned and controlled by the sponsoring charity and the donor must have a reasonable expectation of advisory rights. If all three apply, the DAF is subject to various requirements and a number of prohibitions. Sec. 4966(d)(2)(A).

Separate identification is usually accomplished by creating a distinct fund or by naming a fund after a specific donor. Control is measured at the parent organization level. All DAF funds must explicitly note that the parent charity has full control. The existence of advisory rights will be based on the facts and circumstances involved. Even without a formal document, if a donor makes large gifts and regularly recommends gift beneficiaries and purposes that are followed by the donee charity, then a DAF may exist.

b. DAF Exceptions

There are three specific exceptions to the DAF rules. A transfer to a field of interest fund or designated purpose fund will not create a DAF. Sec. 4966(d)(2)(A). This is the case even if the donor does have incidental benefits or involvement in the fund. For example, a donor may be a board member of a charity and make gifts to a specific purpose fund for

that charity without it becoming a DAF. Alternatively, a donor may make an unrestricted gift to a school with a child or grandchild in attendance without creating a DAF.

Under this exception, the fund may make grants to students for travel, study, or other similar purposes, provided that the donor is a member of the grant committee appointed by the charity, he or she does not have control of the committee, all grants are awarded on an objective and nondiscriminatory basis, and the board of directors has approved the process. The grants must also meet the requirements of Sec. 4945(g) for grants by private foundations.

The second exception is a gift to a charity in which the donor retains advisory rights, but all distributions will be within that charity. Sec. 4966(d)(2)(B)(i). Therefore, a gift to a fund with a university for various programs exclusively at that university would not come within the DAF definition. Finally, a fund maintained with a governmental entity is excluded from the DAF definition. Sec. 4966(d)(2)(B)(i).

c. Deductible DAF Donations

DAFs are maintained by Sec. 501(c)(3) public charities, and gifts are typically deductible to the 50% of AGI for cash and 30% of AGI for appreciated property limits for public charities. The gift to DAFs will be deductible under these limits, but after February 14, 2007, the charity must give a "contemporaneous written acknowledgement" of the DAF gift. Sec. 170(f)(18)(B). The receipt must be received prior to the date the donor files his or her tax return for that year, or the due date with extensions, whichever is earlier. A DAF receipt must also state that the charity has exclusive legal control over the contributed assets.

Deductions are not permitted for gifts to DAFs held by Type III supporting organizations that are not "functionally integrated" with the parent charities. Sec. 170(f)(18)(A). In effect, the typical Type III supporting organization that operates in connection with a public charity and makes grants to the charity is now prohibited from maintaining a DAF. However, Type I and Type II supporting organizations may receive deductible DAF contributions. The Type III supporting organization that is operationally integrated into a public charity may also maintain a DAF and receive deductible contributions.

d. Prohibited Payments To Disqualified Persons

Donors and their advisors are now disqualified persons for purposes of payouts or benefits from DAFs. Sec. 4967(a)(1). The disqualified person rules are similar to the private foundation rules. These rules are designed to minimize the improper use of DAFs in any manner that could produce improper benefits to the donor or his or her advisors.

The disqualified person category includes the donor, advisors to the donor, family members and 35% controlled entities. Sec. 4967(a)(1). The family includes donor's siblings, lineal ancestors and descendants, and spouses of lineals.

The DAF may not make any grant, loan, pay salary or reimburse expenses for any disqualified person. In direct contrast to other Sec. 4958 excess benefits, the DAF transfer is subject to an excise tax on the entire benefit, not just the excess over fair market value. A sale or lease of property at fair market value is an exception to the prohibited payment rule. Sec. 4958(c)(2).

The DAF excess benefit rule will require the donor and family members to cover expenses for travel to board meetings and any expenses related to their personal efforts with respect to the charitable transfers. These personal expenses will be potentially deductible under the normal charitable deduction rules. It will no longer be possible for family members to receive substantial salaries for services rendered to the DAF. In addition, an annual winter trip at DAF expense to a tropical climate for the purpose of a family review of DAF grants will not be possible.

These transfers are termed "automatic excess benefit" transactions. There is a penalty for distribution of "more than incidental benefit" to a donor, family member or donor advisor. The penalty is 125% of the benefit on the donor or family member, and potentially a penalty of 10% on the fund manager if he or she knew of the prohibited benefit. Sec. 4966(a)(2).

e. Charitable DAF Distributions

Distributions from DAFs may be made to public charities, Type I and Type II supporting organizations and "functionally integrated" Type III supporting organizations. Sec. 4966(d)(4)(A). The distributions may not be made to an individual. Distributions to the parent charity, to another DAF or to an operating foundation are permitted. However, distributions to a private non-operating foundation are permitted only if the expenditure responsibility is exercised. Sec. 4966(c)(1)(B)(ii).

f. Excess Business Holdings

DAFs are subject to Sec. 4943 excess business holdings rules. Gifts by disqualified persons who together with attributed family and entities hold 20% (or 35% with outside control) of an entity will trigger application of Sec. 4943. Disqualified persons include donors, family members and 35% controlled entities. Sec. 4943(e)(2).

For DAFs that receive a gift of a business interest, generally the property must be sold within five years, or potentially ten years with Treasury approval. This provision is designed to remove the ability of family members to maintain control of the family business through a DAF.

g. Creative Use of DAFs

Most DAFs exist to permit annual gifts to qualified exempt public charities. For those DAFs that are invested in securities, make no payments to donors and family members and annually make grants only to public charities, the DAF rules will present no major

obstacles.

However, creative uses of DAFs may be rather limited. Sales of DAF assets to family members must now be explicitly at fair market value. In addition, the private foundation excess business holdings rules apply to DAFs. Generally, transfer of business interests into DAFs will require sales of the assets within five years, or potentially ten years with Treasury permission. Finally, the annual Form 990 includes reporting requirements for the number of DAFs, their assets and distributions.

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5. VARIANCE POWER

The variance power is among the powers granted to a community foundation by its organizing documents. In its most usual formulation, the variance power authorizes community foundation to modify donor restrictions on the distribution of funds for any specific charitable purpose or to specified charitable purposes or to specified organizations if the community foundation's governing body determines that the restriction has become, "unnecessary, incapable of fulfillment, or inconsistent with the charitable needs of the community or area served." Treas.Reg 1.170A-9(e)(11)(v)(B)(1).

6. PRIVATE FOUNDATION CONVERSION

a. ADVANTAGES OF PRIVATE FOUNDATION CONVERSION

The IRS, with Revenue Ruling 2003-13, created a penalty free process of converting a private foundation to an affiliated fund within a public foundation. The advantages of such a conversion include:

- .. No longer bound by the 5% annual disbursement rule
- .. Eliminates the annual excise tax on net investment income
- .. Reduces cost of administration by not having to comply with IRS required tax filings and audits
- .. Continued involvement of family members in the grant making process
- .. Increased privacy as an affiliated fund at the Nebraska Community Foundation is not made public knowledge unless requested by the family
- .. Greater tax benefits for future contributions
 - Gifts of cash deductible up to 50% of AGI vs. 30% for private foundations
 - Gifts of appreciated assets deductible up to 30% of AGI vs. 20% for private foundations

- Gifts of appreciated assets deductible at full fair market value vs. cost basis for private foundations

b. IMPORTANT CONSIDERATIONS

This conversion to an affiliated fund of a community foundation will not create noticeable change; it is a seamless process:

- All grant making recommendations made by the Fund Advisory Committee of the new fund, usually the existing board of the private foundation
- Investment recommendations may be made by the Fund Advisory Committee
- The Fund Advisory Committee determines the “public face” of the fund

c. THE CONVERSION PROCESS FOR PRIVATE FOUNDATIONS

The community foundation is a 501(C)(3) public charity and must have permanent status (a charity that has been in existence for at least 60 months and is deemed to be in full and current compliance). If all of the assets of a private foundation are transferred the private foundation may terminate and will not owe any Sec. 507 (c) tax and is not required to give notice to Treasury (or the IRS). The steps in this process include:

- Implement an agreement that will govern the new affiliated fund
- The private foundation board needs to approve the concept and the agreement for the new fund. This is often expressed through a resolution drafted by the private foundation’s attorney
- The private foundation transfers its remaining assets to the new affiliated fund
- The private foundation files a final tax return and a dissolution notice with the Secretary of State

7. RESTRICTED FUNDS

Field of interest fund gifts can fulfill many purposes. For example, a scholarship might be limited to a particular geographic area or student major. When creating restricted funds, it is always important to remember that funds may last for a long time and there could be significant changes. For example, a scholarship to study methods for improving the production of whaling oil would have lapsed into oblivion approximately one century ago when oil from the ground replaced whale oil as a primary fuel source. Likewise, there are other types of specific purposes that may no longer be applicable. When designing restricted gifts, it is important to keep in mind a sufficiently general purpose that it is not likely to be made irrelevant by changes in technology.

The flexibility of a restricted gift can be preserved in several ways. First, the gift can be made without restriction to the charity and a letter that requests but does not require a

general purpose or a field of interest can be created by the donor. This is an excellent means for attempting to help the charity use the funds correctly, while preserving flexibility for the charity. Most charities are very good about attempting to achieve the goals of the donor and this non-legally binding method is an excellent way to achieve the objectives of both the donor and the charity.