

Doing Well by Doing Good – How to Be an Effective Philanthropist

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LEAH M. BISHOP
Loeb & Loeb LLP
10100 Santa Monica Boulevard
Suite 2200
Los Angeles, CA 90067
(310) 282-2353
lbishop@loeb.com



DISCLAIMER

- This presentation is based on the tax law in effect on March 9, 2017. The law will change.
- To what? *No one knows.*
- When will it change? *No one knows.*
- For philanthropists, it may be worse. Lower tax rates and a balanced federal budget? Something has to give.
- “Something” may include a cap on deductions, including charitable contributions.

INTRODUCTION – WHAT STRATEGY?

- Charitable giving offers the personal satisfaction that comes with participating in an important cause, while also providing a financial benefit to the donor.
- Which strategy is right for you?
 - If you do not yet have a particular charity in mind, a private foundation, donor advised fund, or a support organization makes the most sense.
 - These vehicles are virtually free of income and capital gains taxes and provide an immediate tax deduction up to full value of the gift, even through the assets can be distributed to charity over a very long time.

GIFT AGREEMENT?

- You may be committed to a particular institution. For you, the issue is not retained control over the recipient of the funds.
- Rather, you want to ensure that your philanthropic objectives will be carried out once the funds are in the hands of the institution.
- This may require a carefully drafted gift agreement.

FACTORS TO EVALUATE

The following should be considered in evaluating which is the best option:

- Family Legacy
- Tax Benefits
- Simplicity/Complexity of Structures
- Cost of Establishing and Maintaining
- Compliance Issues
- Investment Options
- Freedoms/Restrictions on Activities
- Donor Controls
- Termination

PRIVATE FOUNDATION – WHAT IS IT?

- Internal Revenue Code (“IRC”) § 509 provides that an IRC § 501(c)(3) organization is a private foundation unless it satisfies the requirements to be a non-private foundation, commonly known as a public charity.
- Generally, a private foundation is a nonprofit, tax-exempt organization established to maintain or aid scientific, educational, charitable, religious, or other philanthropic activities, and which is usually controlled and supported by a single source, such as a family or a company, rather than the general public.
- A private foundation is exempt from state and federal income taxation and contributions to a private foundation are deductible by the donor for income tax purposes. Unlike a public charity, however, a private foundation permits a donor to maintain a high degree of control over the foundation’s funds.

PRIVATE FOUNDATION – DO I WANT ONE?

- The most common reason to form a private foundation is to perpetuate an individual's strong desire to aid society and to serve as a family memorial. It is critical that this strong charitable motivation exist. Tax savings are seldom the controlling motivation in the decision to create a private foundation.
- Once this desire is clear, a private foundation provides enormous flexibility for family charitable giving and serves as a vehicle for involving future generations in philanthropy.
- Does the size of the proposed foundation justify the establishment of an independent organization? Expenses include (without limitation) attorneys' fees, accountants' fees, excise tax on net investment income, and ruling request fees. If the organization is subject to registration in California (because it is "doing business" in California), then if its gross revenue (including charitable contributions) in a taxable year exceeds \$2,000,000, an audit is required.

INCOME TAX TREATMENT

The IRC's deduction rules favor public charities over private foundations.

How much is deductible if the contribution is property rather than cash?

- When a contribution of long-term capital gain property is made to a public charity, the deductible amount is generally the fair market value of the property. There is an exception for tangible personal property to a non-related use organization.
- When a contribution is made to a private foundation, the deductible amount is generally the lower of basis and fair market value. There is an exception for “qualified appreciated stock” per IRC § 170(e)(5).

How much of the deduction can be used?

- To a public charity
 - Cash, ordinary income property, or short-term capital gain property is deductible up to 50% of adjusted gross income (“AGI”).
 - Long-term capital gain property is deductible up to 30% of AGI.
- To a private foundation
 - Cash and ordinary income property is deductible up to 30% of AGI.
 - Long-term capital gain property is deductible up to 20% of AGI.
- Five-year carry forward: Excess contributions that are not deductible because of the percentage limitations may be carried over and deducted in the next five years. The deduction is lost if the five-year period expires before the entire gift has been deducted or if the donor dies. (If this occurs, special consideration should be given to the election under IRC § 1.170A-8(d)(2)(i)(b).)
- There are complicated rules regarding the interplay of the deductibility ceilings when a donor contributes to public charities and private foundations.

OPERATING A PRIVATE FOUNDATION

- Private foundations are subject to special restrictions and limitations because of a history of abuses. Examples: maintaining control of family businesses through a foundation; keeping children on the payroll; grants to family members for scholarships; payment of rent to the founder; improper use of tickets to events.
- The rules are highly technical and counterintuitive and the penalties for non-compliance are severe.
- The penalties are not a ticket to engage in impermissible conduct; the penalties are in addition to the requirement that the impermissible conduct be corrected.
- The California Attorney General has taken the position that private foundation excise taxes are imposed only if the foundation is mismanaged. Therefore, the Foundation's directors are personally liable for any such taxes imposed on the foundation. The Attorney General may require that the directors indemnify the foundation for any excise tax it pays.

COMMON CHALLENGES – SELF-DEALING

- IRC Section 4941 prevents a private foundation from entering into most business transactions with any “disqualified person.”
- Disqualified persons include, among others, substantial contributors to the foundation and their family members and any director of the foundation.
- The self-dealing prohibition is quite broad and technical.
- Common sense or business judgment alone cannot be applied to evaluate whether a proposed act will constitute self-dealing.
- Common examples of self-dealing issues:
 - Tickets to fundraisers;
 - Travel expenses; and
 - Pledges and other personal obligations.

COMMON CHALLENGES –DISTRIBUTION RULES

- IRC § 4942 sets forth minimum distribution rules – generally 5% of the aggregate fair market value of all of the assets of a foundation other than those used in carrying out the foundation’s exempt purposes. Earning 5% is not an easy tax.
- IRC Section 4945 penalizes “taxable expenditures” by a private foundation, which are defined generally as amounts paid or incurred by the foundation:
 - to influence legislation or any public election;
 - to achieve a purpose other than a charitable purpose; or
 - to make grants to:
 - individuals (unless such grants are made pursuant to a program approved in advance by the Internal Revenue Service); or
 - organizations which are not public charities (i.e., foreign charities, other private foundations, including private operating foundations, or non-exempt entities), without exercising extensive supervisory control of the grant (“expenditure responsibility”) to ensure its proper use.

PRIVATE FOUNDATIONS – THEN WHY?

- Family philanthropy
 - Legacy
 - Next generation
- High impact philanthropy
- Collaborative philanthropy
- Control over timing
- Control of investments
- Because it's fun

DONOR ADVISED FUND (“DAF”) – WHAT IS IT?

- The donor makes an unconditional and outright gift to the donee charity.
- The donee charity creates a fund in the donor’s name.
- The assets contributed to the donee charity become the property of the donee charity and the donor retains no legal right to direct or control the donee charity’s use of the funds.
- The funds are not maintained as a separate entity, but are simply a bookkeeping entry in the charity’s records.
- The donor is merely entitled to advise the donee charity about the use of the funds. The donor’s advice is entirely non-binding, and the donee charity is free to accept or reject it.

DONOR ADVISED FUND – HOW DOES IT OPERATE?

- Charities that sponsor DAFs are extremely cooperative.
- If the advice is rejected, there is probably a good reason. Sponsoring charities generally accept the advice of an advising donor except when the potential grantee is not a qualified charity or is administered in a manner that indicates some serious problem (excessive administrative costs, impending bankruptcy).

DONOR ADVISED FUND – ADVANTAGES

- A DAF is a public charity, not a private foundation. Therefore the better tax rules apply and the private foundation operational rules do not apply.
- A fund can generally be established quickly.
- A DAF incurs lower set-up and ongoing administrative costs compared to those of private foundations.
- Through the use of investment pools and consolidated investment management, economies of scale may provide better investment results.
- The DAF is not required to disclose a list of its contributors.
- Under a DAF, the donor may choose to remain anonymous when making grants.
- As there are no separate annual tax filings (e.g., Form 990) required for a specific donor advised fund, the operations of the fund do not become available to the public.

DONOR ADVISED FUND – DISADVANTAGES

- The DAF must retain the right to control the donated property, including the right to sell it and invest any proceeds and the right to override donor advice as to timing and recipient of any grant.
- A DAF may not be used to fulfill an existing pledge.
- Historical issues associated with DAFs have generally been eliminated as DAF sponsors have gotten more sophisticated.
 - Investments
 - Unusual assets
 - Foreign grants
 - Pledges

SUPPORT ORGANIZATION

- A support organization is a public charity, not a private foundation. Therefore the better tax rules apply and the private foundation operational rules do not apply.
- There are three types of support organizations, known as “Type I,” “Type II,” and “Type III.” This outline addresses only Type I support organizations.
- The supported organization selects a majority of the board; the founders select a minority of the board.
- A support organization is a separate entity with its own identity and name (selected by the donor).
- A support organization invests its own funds.
- A support organization makes its own grants.
- Often the supported charity can offer strategies and support for the philanthropic training of the donor’s children and grandchildren, helping to ensure that the donor’s philanthropic values are perpetuated.

GIFT AGREEMENTS – PART I

You are planning to make a large gift to a charity to which you are committed. You want to ensure that your philanthropic objectives will be carried out once the funds are in the hands of the institution.

Issues to consider:

- Endowment and spending policy issues
- Does the institution take an administrative fee?
- Who is the donor? Individual and foundation issues; personal benefits
- Payment schedule: lifetime or testamentary
- In cash, in kind, or partly in each; marketable securities
- Use of funds; how narrow or broad are your goals for the gift?
- Naming rights
 - How much control?
 - Building - location, signage.
 - Faculty chair – papers, publications, newsletters, letterhead

GIFT AGREEMENTS – PART II

- Changed circumstances, like new construction or the termination of a program
- Publicity or anonymity – donor consent required?
- Reports to the donor – frequency, detail
- Other donor involvement
 - Meeting students who receive scholarships
 - Selecting speakers at a distinguished speakers program
 - Reviewing resumes of potential department chairs
- If the charity does not perform, what remedy do you want?
 - Specific performance?
 - Reversion of funds (if the client is a private foundation)?
 - Funds delivered to another institution?

DOING WELL BY DOING GOOD

- **Whatever you decide to do, keep in mind that charitable giving is a joyful experience. It should be fun and fulfilling.**
- **Do not let the tax rules and the complexity interfere with the joy!**