

# Legal 101 for Foundations and Grantmakers

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# Agenda

- A Few Legal Fundamentals
- Grantmaking to Public Charities
- Grantmaking to Non-Charities
- Grantmaking to Individuals
- Donor-Advised Fund Basics
- Alternatives to Grants

# Fundamentals

## 501(c)(3) Basics

- Nonprofit corporation or charitable trust
  - State law concept
  - No private shareholders
  - Attorney General supervision
- 501(c)(3) tax-exempt organization
  - Operated primarily in furtherance of mission
  - Operated for benefit of public – private benefit must not be more than incidental
  - Transactions with insiders must be fair and reasonable to organization
  - No campaign intervention
- Public charity or a private foundation
  - IRS classification
  - Additional operating rules and restrictions

# Private Foundations vs. Public Charities

## 501(c)(3) Organizations

Public charities

Supported by  
donations  
170(b)(1)(A)(vi)

Supported by  
fees  
509(a)(2)

Churches,  
hospitals,  
schools  
509(a)(1)

Supporting  
Organizations  
509(a)(3)  
[3 Types]

Private (non-  
operating)  
Foundations

Private  
Operating  
Foundations

# Common Types of Grantmakers

- Private Foundations
  - Forms:
    - Legacy foundations
    - Family foundations
  - Subject to additional rules as private foundations
- Community Foundations
  - Forms:
    - Geographic
    - Affinity
  - Public charities, not private foundations
- Corporate Foundations / Giving Programs
  - Forms:
    - Separate foundation entity (typically private foundation)
    - Corporate giving, with no separate entity

# Key Private Foundation Rules (or, Why it's Easier to be a Public Charity)

- Minimum distribution requirement
  - 5% payout
- Self-dealing prohibition
  - Prohibits most financial transactions between PF's and their disqualified persons
  - DP's are all board members, officers, substantial contributors, their families and businesses, and all government officials
  - Exception for reasonable compensation for personal services
- Qualifying distributions / no taxable expenditures
  - Grants to public charities, individuals, non-exempt organizations, foreign organizations all treated differently
- Lobbying and political activity prohibition
- Excess business holding limitation
- No jeopardy investments

## Public Charity Classification in Grantmaking

- Important to understand public charity status of both the grantor and the grantee in the grantmaking relationship
  - Public charity vs private foundation
  - Type of public charity
- Primary Considerations
  - Expenditure Responsibility (PFs)
  - “Tipping” Risk
- Review public charity status as part of due diligence
  - Determination letter, IRS exempt orgs site, Form 990 Schedule A



# How to Check

## Minneapolis Foundation

EIN: 41-6029402 | , --, United States

> Other Names

### Publication 78 Data ⓘ

Organizations eligible to receive tax-deductible charitable contributions. Use

**On Publication 78 Data List:** Yes

**Deductibility Code:** PC

## Bush Foundation

EIN: 41-6017815 | Saint Paul, MN, United States

> Other Names

### Publication 78 Data ⓘ

Organizations eligible to receive tax-deductible charitable contributio

**On Publication 78 Data List:** Yes

**Deductibility Code:** PF

<https://www.irs.gov/charities-non-profits/tax-exempt-organization-search>

## Range of Grant Recipients

- Granted funds must always be used for a charitable purpose
- Recipients may include:
  - Public charities—without restrictions
  - Private foundations—with expenditure responsibility (PFs)
  - Governmental entities—for exclusively public purposes (PFs)
  - Foreign nonprofits—with expenditure responsibility or equivalency determination (PFs)
  - For-profit organizations—with expenditure responsibility (PFs)
  - Individuals—under various circumstances

# Grantmaking to Public Charities

# Grantees Subject to Public Support Test

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## Public Support Test and Avoiding “Tipping” of Grantees

- Some grantees must meet an ongoing **public support test** to qualify as a public charity
- Important for **private foundation grantors** to be generally aware of how the public support test works because of potential for tipping a **public charity grantee** into private foundation status
- Two different public support tests –
  - 170(b)(1)(A)(vi) (donative public charities)
  - 509(a)(2) (service providers)

## Avoiding Tipping—Consequences

- Impact of Tipping on **Grantee**
  - Becomes subject to **more onerous rules** applicable to private foundations
  - **May disqualify grantee from receiving certain grants** (some grantors will not make expenditure responsibility grants)
  - Less favorable charitable deduction limits for donors
- Impact of Tipping on **Grantor**
  - May result in **taxable expenditure** (to which penalties apply) **if the PF grantor knew or should have known** that its grant would tip the grantee

## Avoiding Tipping—Due Diligence

### Support Test for Donative Public Charities

- **Normally** receives at least **1/3 of its total support** from a governmental unit or direct or indirect contributions or grants from the public
  - “Normally” means over a rolling **5-year measurement period**
- Contributions from a single source (e.g., individual, private foundation) are counted as “good support” only to the extent they do not exceed **2%** of the grantee’s total support over the 5-year measurement period
  - Grants from government or other public charities are 100% good support
- If fail 1/3 support test, can retain public charity status by receiving **at least 10% “good support”** and meeting a facts-and-circumstances test demonstrating potential for attracting public support
- May exclude **“unusual grants”** from public support test calculation

## Avoiding Tipping—Due Diligence

### Support Test for Service-Provider Charities

- **Normally** receives at **least 1/3 of its total support** from combination of contributions, grants, membership fees, and gross receipts from mission-related services
- Normally receives **no more than 1/3 of its total support** from gross investment income and UBTI
- Same rolling 5-year measurement period
- May exclude **“unusual grants”** from public support test calculation
  - But NOT the investment income generated by the unusual grant funds



## Avoiding Tipping—Unusual Grants

- The exclusion for **unusual grants** is generally intended to apply to contributions or bequests from **disinterested parties** where the contributions or bequests:
  - (1) are attracted by reason of the organization's publicly supported nature,
  - (2) are **unusual or unexpected with regard to amount**, and
  - (3) would, by reason of their size, **adversely affect the organization's status** as normally being publicly supported.
- **Grantee may seek an advance ruling from IRS** that a proposed grant will constitute an unusual grant

## Avoiding Tipping—Other Strategies

- **PF grantors can be good partners to their grantees by:**
- **Educating grantees** on the tipping issue
- **Encouraging grantees to seek legal and accounting advice** on the issue
- **Being flexible** in structuring grant terms (installment payments over time may help, depending on grantee's method of accounting)
- **Considering grant alternatives** such as loans (not counted in support calculation until/unless forgiven)
- Considering paying some of the grant from a DAF (but CAUTION! This is a loophole that is likely to close)

# Grantmaking to Non-Charities

# Fiscally Sponsored Grantees

- **Fiscal sponsorship**

- **Public charity provides oversight, management, and administrative services** to a project that is not itself a public charity
- Public charity acting as the “fiscal sponsor” determines that the project is a charitable activity, and that fundraising to support the project furthers its own charitable purposes
- Governed by a fiscal sponsorship agreement
  - Note that there is **more than one way to structure a fiscal sponsorship**
  - Always ask for a **written fiscal sponsorship agreement** and **ask questions about relationship**

## Fiscally Sponsored Grantees

- **Done right:** Allows a PF to make a grant to a public charity to support charitable activity of a grantee that is not itself a public charity without having to exercise expenditure responsibility
  - Ensure written fiscal sponsorship agreement is in place
  - **All parties treat the grant as made directly from the PF to the public charity**
- **Done wrong:** Results in a taxable expenditure for PF (to which penalties apply) because the IRS will treat the grant as being made to a grantee that is not itself a public charity
  - **Grant is earmarked for the ultimate grantee**
  - Fiscal sponsor and grantee act as if grant is a “pass through” to the grantee

## Expenditure Responsibility

- **Purpose:** Ensure sufficient oversight that charitable grants are used to further exempt purposes
- **If grantor is a private foundation,** it must perform expenditure responsibility for grants to grantees that are not public charities and government entities
  - For example:
    - Private foundations, foreign charities, for-profits, other exempt entities such as 501(c)(4) or 501(c)(6)
    - And Type III supporting orgs that are “not functionally integrated”
- **If grantor is a public charity** making grants to non-charitable grantees, **follow ER “light”**

## Expenditure Responsibility

- Requirements:
  - Conduct **pre-grant inquiry**
  - Enter into **written grant agreement**
  - Receive and review **grantee reports**
  - **Annual report** to IRS on Form 990-PF
  - Retain **records**
  - Investigate any **diversion** of funds

# Grantmaking to Individuals



## Grants to Individuals—Purposes

- Scholarships and fellowships
- Prizes and awards
- To achieve a specific objective, produce a report or similar product, or improve or enhance a literary, artistic, musical, scientific, or other capacity, skill, or talent of the grantee
  - The objective is the *grantee's* objective
  - When the purpose is to achieve the *grantor's* objective, likely a payment for services, not a grant
- Demonstrated need (aid to poor or distressed)
  - Disaster relief
  - Employer-sponsored assistance programs

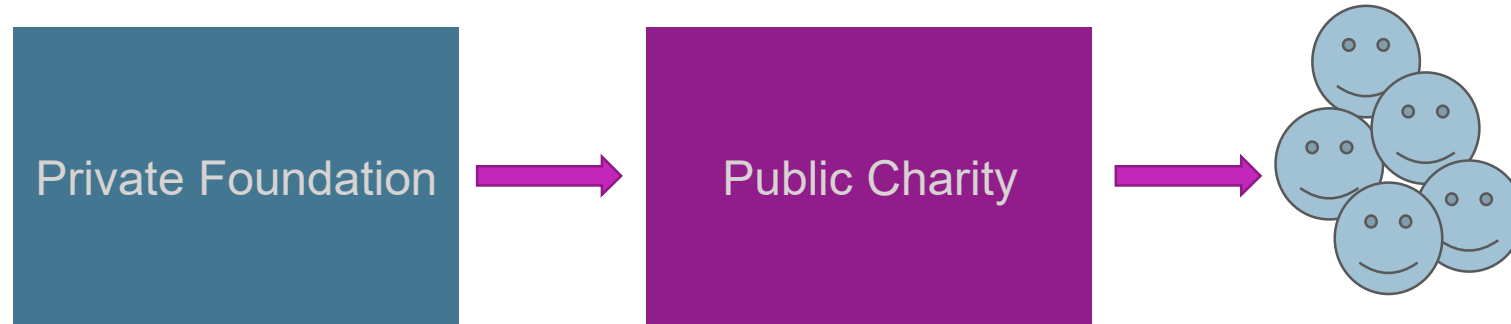
## Grants to Individuals—Special Rules for Private Foundations

- A grant from a private foundation to an individual for “**travel, study, or other similar purposes**” is a taxable expenditure (i.e., prohibited) unless:
  - It is awarded on an objective and nondiscriminatory basis;
  - It is awarded pursuant to a **procedure approved in advance** by the IRS; and
  - It is demonstrated that the grant is—
    - A **scholarship or fellowship**
    - A **prize or award** excluded from gross income
    - For the purpose of **achieving a specific objective or improving of a skill/talent of grantee**

## Grants to Individuals—Special Rules for Private Foundations

- **IRS advance approval of grant-making procedures** may be obtained at the time of initial application for tax-exempt status, or through a separate application process
- **Approval is of a set of procedures**, not a specific program
- **No single set of procedures is required** (may vary with type of program)
- In general, foundation is expected to exercise sufficient oversight over the grants to satisfy itself that the funds are used as intended

## Grants to Individuals—Special Rules for Private Foundations



Can we avoid the pre-approval process by using an intermediary?

## Grants to Individuals—Disaster Relief

- IRS pre-approval not required
- Foundations may provide assistance in the form of funds, services, or goods to **meet the basic needs of disaster victims or persons experiencing an emergency hardship** such as illness, house fire, or trauma following a crime.
- Must be based on an **objective determination of need**
  - Donations can't be earmarked for specific person or family
  - Recipients need not be totally destitute to be needy/distressed
  - Shouldn't pay for expenses otherwise covered by insurance
- Special rules for **employer-sponsored assistance programs**:
  - To ensure the program is not impermissibly serving the related employer—
    - The class of beneficiaries must be sufficiently large or indefinite;
    - The recipients must be selected based on an objective determination of need; and
    - The recipients must be selected by an **independent selection committee** or adequate substitute procedures must ensure that any benefit to the employer is incidental and tenuous.
      - Committee is independent if a majority of members are not in a position to exercise substantial influence over affairs of the employer

# Donor-Advised Fund Basics

## Donor-Advised Funds (“DAFs”)

- What is a donor-advised fund?
  - A fund or account held by an existing public charity (the “sponsoring organization”), often a community foundation, created by a donor’s gift to that charity
  - Identified by reference to a donor or donors
  - Over which the donor retains “advisory privileges” regarding the distribution or investment of amounts held in such fund
  - Owned and controlled by the public charity
    - Not a separate trust or legal entity
    - No IRS filing or reporting by the fund
  - Governed by a gift agreement

## Donor-Advised Funds—Operations

- How does a DAF operate?
  - Either segregated funds or commingled with separate accounting
  - May be restricted as an endowment fund or for specified purposes
  - Cannot be so restricted that public charity lacks full control
  - Distributions are limited by charity's purposes in Articles of Incorporation and 501(c)(3) application
  - Commonly pay an administrative fee to the sponsoring organization



## Donor-Advised Funds—Role of the Donor

- Donor or designated persons/entity retain advisory privileges to:
  - Recommend grants
  - Appoint successor advisors
  - Recommend investment strategies
- Limitations
  - Donor has no legal right to direct the public charity to spend the funds
  - Selection of grant or scholarship recipients must remain with public charity
    - Or, a scholarship committee or educational institution selects recipients

## Donor-Advised Funds—Restrictions

- Restrictions on DAFs
  - Cannot make grants to individuals (except certain scholarships and disaster relief programs ok)
  - Like PFs, must conduct expenditure responsibility over grants to non-public charities
  - Some self-dealing prohibitions
  - Excess business holdings limitations

## Donor-Advised Funds—The Donor “Sell”

- Benefits
  - Donor has no ongoing operational responsibilities
  - May choose to provide input, including family in advisory capacity
  - Greater tax benefit due to higher deductibility limits
  - Allows an immediate deduction, with grants made over time like a PF
  - No excise tax on investment income or minimum distribution requirement
  - Can manage publicity or keep private
- Drawbacks
  - Donor surrenders control over the investment and use of assets
  - Important self-dealing and excess business holdings restrictions
  - Fees to charity may be required for management

# The ACE Act and Possible Future Regulation of DAFs

- IRS and legislators continue to take a close look at DAFs
  - Concern of parked dollars (especially in commercial DAFs) rather than distributed for charitable purposes
  - Concern about endowments, especially at colleges with high tuition costs
  - Use of DAFs to circumvent public support test
- IRS Notice 2017-73
- Accelerating Charitable Efforts (“ACE”) Act
  - PF grant to DAF does not count toward 5% payout unless distributed by DAF in same year
  - Grants from DAFs no longer “good” public support for public support test
  - PF administrative expenses to disqualified persons are not qualifying distributions
  - New excise tax on sponsoring organizations if DAF fails to distribute within certain timeframe
    - Exception for DAF at qualified community foundation, under \$1M with 5% payout requirement
  - Proposed only
- Consistently on IRS priority work plan

# Alternatives to Grants

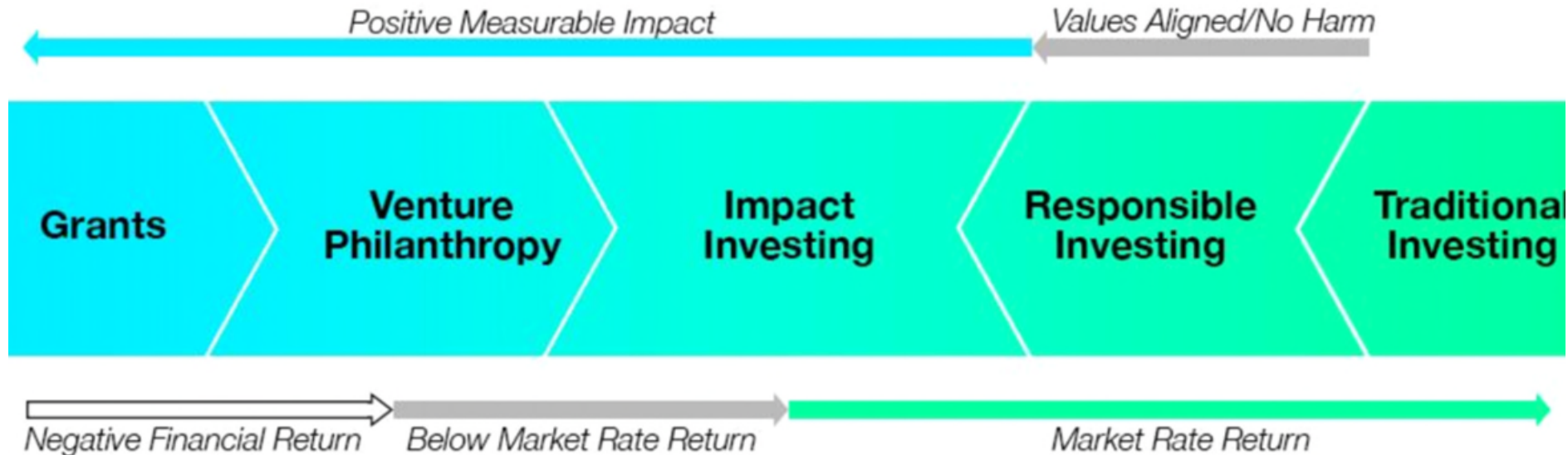
# Grant Alternatives: Impact Investing

## Philanthropic Activities

Program Related Investments

## Investment Activities

Mission Related Investments



[www.cogentconsulting.net](http://www.cogentconsulting.net)

# Socially Responsible Investing and MRIs

- Socially Responsible Investing
  - Standard investment strategy, but with “socially responsible” lens
  - Industry standard ROI expected
  - E.g., Portfolio screening for “ESG Factors”
    - Environmental, social, governance
- Mission-Related Investments (“MRIs”)
  - Further integration of foundation’s asset management & charitable aims, such as fostering community benefit through economic development
  - Investments in for-profit businesses
  - Not charitable – must consider ROI and risk of the investment

# Program-Related Investments

- “Primarily charitable”
  - Examples in Treasury Regulations
- Key IRS requirements
  - Primary purpose is to accomplish one or more of the foundation’s exempt purposes
    - Investment would not have been made but for its relationship with the foundation’s purposes
  - Profit is not a primary purpose
    - Would for-profit investors be likely to make the investment on the same terms as the PF? If yes, not satisfied.
    - But may charge interest or earn return on investment – typically low
  - Influencing legislation or taking part in political campaign is not a purpose



## Program-Related Investments

- Loans, loan guarantees, equity investments, including private equity
- Investees may be charitable organizations or for-profit ventures for charitable purposes
- If to a non-501(c)(3), expenditure responsibility is required
- Entire amount counts as qualifying distribution

## Program-Related Investments

- Must be carefully structured to satisfy IRS PRI rules
- Up front analysis to determine if IRS requirements for PRI satisfied
- Legal agreements document all terms and ensure compliance with IRS rules
  - Reps and warranties
  - Use of funds
  - Unwind if cease qualifying as a PRI
- If not a PRI, could be a jeopardizing investment
  - 30-days after ceases to qualify as a PRI

## Equity Lens in Investments

- Impact investing offers opportunity to seek diverse-owned and diverse-led investees
- Diverse-owned PE firms keep outperforming benchmarks
  - Diverse PE funds in NAIC Diverse Private Equity Index consistently outperforms median Cambridge U.S. Private Equity funds during most vintage years
  - Diverse PE Funds outperformed others 56.3-62.5% of the time
  - Over longer time horizons, Diverse PE Funds outperform median and upper quartile funds
  - Yet, allocation to diverse-owned managers remains disproportionately small, at approximately 10% of an investor's total investable assets

**Questions?**

# Speakers



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