FOUNDATION**SOURCE**

WEBINAR

SMART GIVING: Exploring The Hidden Tax Benefits of Charitable Vehicles

Tax advantages are one of the many benefits for philanthropists who give through charitable vehicles, such as private foundations, donor-advised funds (DAFs), or fiscal sponsors. So, how can today's donors and nonprofits employ these vehicles for maximum tax efficiency?

In a recent Foundation Source webinar, our **Chief Legal Officer Jeffrey Haskell** and **Deputy Legal Officer Jennifer Bruckman-Gorak** shared their insights on ways donors and nonprofits can ensure their charitable giving is tax efficient and options to stretch charitable dollars. Highlights of their presentation follow below.

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How are various charitable vehicles structured for tax-deductible giving?

Let's compare a few types of charitable giving vehicles, as well as direct, out-of-pocket giving to see what types of giving are available with each and whether it's tax deductible.

A ***private foundation*** is an independent legal entity that has its own federal tax ID number and can be formed as a trust or as a corporation. It must apply to the IRS for recognition of its exempt status as a 501(c)(3) organization within 27 months of formation in order for its tax status to be retroactive to the date of incorporation or formation. Its donor can serve on the board of directors and maintain control of the private foundation either alone depending on the state, because some states require a minimum of three directors and other states require only a single director, or with trusted family, friends, and colleagues.

A ***donor-advised fund (DAF)*** is essentially a giving account established at a 501(c)(3) public charity. The public charity serves as the sponsoring organization which manages and administers the various individual DAF accounts. DAF accounts typically provide the donor with a right to make grant and investment recommendations, and they allow donors to receive an immediate tax deduction for their charitable contribution and then recommend grants from the fund over time. The sponsoring charity that houses the DAF account will charge fees for administration, record keeping, and philanthropic services, which will pull from those accounts. There may also be fees for processing illiquid gifts, and international grantmaking when applicable.

A ***fiscal sponsorship*** is an arrangement between a public charity, the sponsor, and another domestic or international organization without US public charity tax status, which we'll call the "project." So, let's say that organization that's running the project wants to raise charitable funds for a charitable program or activity. Although the arrangement can take various different forms, the most common one involves a traditional grant relationship between the sponsoring charity and the project, sometimes called the pre-approved grant relationship.

Under this arrangement, the fiscal sponsor's board determines that the project will further the sponsor's own exempt purposes and create what's known as a restricted fund. Donors will make donations to that restricted fund and the sponsor will grant those funds to the organization carrying out the project. Importantly though, the fiscal sponsor is not committing to grant the outside funds to the organization running the project. To avoid earmarking concerns, the sponsor must retain discretion and control over the funds raised.

When might a fiscal sponsorship be used?

A fiscal sponsorship typically arises out of a need as opposed to a giving strategy. For example, a donor may want to support a particular effort and they learn that the group or entity doing the work does not have public charity tax status. So they go about finding a way to get funding to the effort and the solution is often a fiscal sponsor. Bear in mind, fiscal sponsorship could also be a key component of an organization's fundraising strategy by which they hope to incentivize potential donors to make tax-deductible donations.

Before a donor can consider this approach, a fiscal sponsorship arrangement must be in place between the fiscal sponsor charity and the sponsored organization that's running a charitable program. While the donor can ask the organization running the program to find a fiscal sponsor, it's not an arrangement that the donor can unilaterally initiate or establish, again, on their own.

Lastly, fiscal sponsors charge a fee for each transaction. A donor may not want to pay a fiscal sponsor fee if they don't have to. In other cases, private foundations may prefer outsourcing the vetting, oversight, and risk or exposure to the fiscal sponsor.

Is tax-advantaged asset growth possible with these three vehicles?

Tax-advantaged asset growth is typically only applicable in the context of **private foundations** and **DAFs** because non-cash donations often sit in those vehicles for a significant period of time before either being liquidated or re-granted, whereas, when contributing to a **fiscal sponsor**, it's more of a pass-through situation. Of course, all three options provide a donor with an immediate tax deduction and contributions to all three are irrevocable.

How can donors use each of these vehicles?

With private foundations, the donor retains control over how assets are invested, as well as how grant funds are distributed. The donor, their family, and any others devoting time to the foundation may receive reasonable compensation for their work as well as reimbursement for foundation-related expenses.

With a **DAF**, any contributions made into the DAF account at the sponsoring charity immediately become the property of that charity just as they do with the foundation. However, unlike a foundation, the donor may only recommend, not direct how that contribution should be invested or applied for a charitable purpose.

Although DAFs almost always follow the recommendations of the donor, they're not required to do so, and in fact, they have an obligation to do their own due diligence on grantees and to invest the charity's assets responsibly. In other words, the sponsoring charity can't act as a rubber stamp in carrying out donor recommendations.

Finally, with a **fiscal sponsor,** the donor will make a specific purpose grant to the sponsor charity's restricted fund that was established to support the project. The sponsor is obligated to distribute the funds in support of the program for which the restricted fund was established. However, the fiscal sponsor retains the right to work with a different entity to carry out the program if need be. So there's no guarantee that the funds will go to the intended recipient. That being said, similar to DAFs, the fiscal sponsor charity typically will grant the raised fund to the organization running the program absent any issues or problems the sponsor might be having with that organization.

It's important to note that donors can't make grants to fiscal sponsors that are earmarked for a named group or organization as opposed to merely the name of a project that may currently be carried out by such an organization. It's very important because if a donor were to require that the fiscal sponsor re-grant the funds to a particular organization that is not an IRS approved 501(c)(3) charity, the contribution from the donor would be treated as made directly to that organization. This means that the donor would not receive a tax deduction, which defeats the entire purpose of using a fiscal sponsor in the first place. Lastly, as with DAFs, there's really no reason for a fiscal sponsor to cover any donor expenses.

How can donors use each of these vehicles for tax efficiency?

Often when discussing donations to private foundations versus public charities including DAFs and fiscal sponsors, the focus will be on the potentially "better" tax deductions offered by public charities in terms of the higher adjusted gross income or AGI caps. However, those numbers are only important relative to the

donor's current year AGI. It's pretty rare for a donor's contributions to exceed their current year AGI limit, and even if they do, they can carry the excess forward up to five years.

Also, if desired, donors can stack donations by giving up to the allowable amounts to a private foundation, for example, and then contributing the rest to a 501(c)(3) charity to take advantage of the higher caps applicable to public charities. This could include a regular public charity, DAF, or fiscal sponsor.

How can each of these vehicles make grants?

Private foundations offer a lot of flexibility when it comes to grantmaking. A foundation can make grants directly to individuals including scholarship, hardship, and emergency grants. And donors who serve on the foundation can therefore retain control over the eligibility criteria and selection process. Foundations can also make grants to foreign organizations and even for-profit organizations as long as it's in support of a charitable purpose. They can also run their own direct charitable programs and cover any related expenses. A foundation also has a 5% annual payout requirement, meaning that each year it must grant out approximately 5% of its prior year's asset average.

DAFs are typically used to make straightforward gifts to other US 501(c)(3) charities. They are permitted to make grants to foreign organizations as well as to private foundations, but some sponsoring charities will adopt internal policies prohibiting such grants out of their DAF accounts, presumably due to the additional due diligence required under IRS rules. Over the years, we've seen an increased willingness from DAFs to make grants to foreign organizations, but in our experience, many are still unwilling to make grants to private foundations.

Unlike private foundations and DAFs, a **fiscal sponsor** arrangement is used under very specific circumstances, namely when a non-501(c)(3) project, whether domestic or foreign is seeking funding and wants donors to be able to receive a deduction. Although fiscal sponsors can be used to support projects run by individuals as well, this is not very common.

When giving with these three vehicles, how much can be deductible and what types of charitable activities are permissible?

In some cases, it comes down to whether a deduction is important to the donor or not. For example, if a donor wants to provide hardship grants to individuals but doesn't need the deduction, they may decide to just give directly out of pocket. On the other hand, if they want to be able to run their own direct charitable program, but they also want to be able to take a deduction for expenses related to the program, then a private foundation is the way to go.

In other cases, the focus might be on control over who actually receives the funds. Although DAFs and fiscal sponsors are generally known for carrying out the requests of donors, they are not legally obligated to do so. Only direct out-of-pocket giving or giving through your own foundation will provide that level of certainty.

Click here to watch the webinar and view the chart for more details.

Granting to Individuals (GTI)

What if a donor wants to give directly to certain individuals instead of to a nonprofit or charity?

Of these three vehicles—a private foundation, DAF and fiscal sponsor—the only one that enables a donor to make grants to particular individuals and receive a tax deduction is a private foundation.

When granting to individuals with a private foundation, does the donor need to get IRS approval in advance to avoid a taxable expenditure?

The general rule of thumb is that IRS approval is necessary only if the grant has no strings or conditions attached to it that require the funds to be used for travel, study, or similar purposes.

What are the general IRS requirements for granting to individuals through a private foundation?

A grant made to an individual must further a purpose that's recognized by the IRS as one that's charitable. Common examples would include the alleviation of human suffering and the advancement of education.

Disqualified persons or insiders are not eligible to receive foundation grants because the tax rules prohibit disqualified persons from reaping a financial benefit from their foundation. If they do, they're personally subject to tax penalties known as self-dealing. Disqualified persons include those who run the foundation, like the foundation's directors, officers, trustees, substantial donors or in the parlance of the IRS, substantial contributors, and certain family members of all such persons.

The group of people who are eligible to receive a grant from the foundation constitutes its charitable class. This class must be large enough and sufficiently open-ended or indefinite to ensure that the number of people in the class cannot be reduced to a fixed list.

Can a foundation make grants to people who are known to those running the foundation?

As long as those individuals are not disqualified persons (insiders), the foundation can make such grants. However, if the foundation makes only a few grants per year, some may doubt that the class of eligible recipients was ever really broad enough from the start, so it would be far preferable to make at least some if not most or all of the grants to individuals who are not personally known to the foundation's managers beforehand.

Can a foundation make grants only to people known to those serving on the foundation?

Generally, no, because that would be a fixed group of people. It's really crucial to establish a referral channel such as one that might be composed of social workers, clergy persons, healthcare providers, school principals—essentially those likely to be faced with a constant stream or flow of eligible candidates or your foundation's grant program. This would help ensure that the charitable class is open-ended.

Watch the webinar here to learn more about making grants to individuals.

Expenditure Responsibility (ER) Grants

Can grants be made to an organization that is doing something charitable but isn't an actual nonprofit or charity?

When making a grant to a foreign (non-charitable) organization other than a 501(c)(3) public charity, a foundation must follow a certain set of procedures in the IRS regulations known as **expenditure responsibility** to ensure that the funds are used solely for charitable purposes.

In other words, of all the various types of entities a foundation may grant to, the only types that would not require expenditure responsibility are public charities (and government entities which are part of the IRS definition of public charity). Additionally, grants to individuals will never require expenditure responsibility and neither will the payment of expenses for goods or services.

What does the process of expenditure responsibility entail?

First, we have the **pre-grant inquiry,** which is the private foundation doing its research or its homework on the grantee organization, including gathering various information about it, from budget to the background of the people running it, to try and determine whether the grantee will likely be able to carry out the charitable purpose of the grant.

And so once that step is complete, the next step would be to enter into a **formal written agreement** between the two parties that contains certain terms that are required by the regulations. Now, unless the grantee is another foundation, the grantee must establish a separate bank account or bookkeeping account in the general ledger. Grantees must annually report back to the grantor on the progress made towards fulfilling the charitable purpose of the grant. And then a cumulative final report will be due once all the grant funds are fully expended.

So lastly, the foundation must attach a **special schedule** to its tax return, the 990-PF, for any year in which it made an expenditure responsibility grant, any year in which those funds have not been fully spent by the grantee, and any year in which a report has been received.

Are there any special considerations when it comes to expenditure responsibility grants?

The grant cannot be used for general operating support unless the grantee happens to be another foundation. One way to get around this is to "projectize" the grant, meaning that the grantee will articulate a project that is actually composed of the core work of the grantee. Secondly, the grant funds cannot be used for expenses previously paid by the grantee. That would be considered the equivalent of a general unrestricted grant, which is prohibited. And lastly, the funds can't be used in a way that the grantor foundation couldn't use the funds. So in other words, the foundation can't use an expenditure responsibility grant to bypass the foundation rules.

Now, we all know that compliance with IRS rules is of utmost importance generally, but in the context of expenditure responsibility, the IRS is especially unforgiving. If one step in the process is missed or one error is made reporting it on the return, the foundation will be treated as if it never exercised expenditure responsibility.

Direct Charitable Activities (DCAs)

Similar to public charities, a private non-operating foundation can operate its own charitable programs or events known as **direct charitable activities or DCAs**.

Why would a foundation want to conduct a DCA?

Its donor or manager might have special expertise or a particular vision for the foundation, or the foundation's donors may want to get down in the trenches, so to speak, in carrying out their charitable mission. There might also be a desire to inform public policy or advance public knowledge of a charitable area. Some examples could include a soup kitchen, the publication of an educational book or literature, a job training event for disadvantaged youth, or the production of a documentary to raise awareness about a social issue.

Certainly an individual could do these things, but they won't get a charitable deduction if they incur these out-of-pocket expenses. This is about stretching charitable dollars; making the contribution to the foundation, getting your deduction, and having the foundation make these expenditures is all great.

There's no difference between a DCA expense and any other charitable expense in that such expenses count towards the satisfaction of the 5% payout requirement. DCA expenses are just a portion of the foundation's total expenses that it can present to the IRS on a special informational section of the return as part of a foundation program.

This is a condensed, edited version of the conversation. Get full insights by watching the entire video of the presentation here.

ABOUT FOUNDATION SOURCE

Foundation Source empowers people and companies to create a better world through philanthropy. We support more than 27,000 charitable organizations with innovative technology backed by philanthropic expertise.

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