Legal 101 for Foundations and Grantmakers

Greg Larson
Catie Bitzan Amundsen

Minnesota Council on Foundations

September 21, 2022

Lathrop GPM

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

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

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)

Grantees Subject to Public Support Test

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

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 (and perhaps funding the expense of doing so)
- **Being flexible** in structuring grant terms (might need to grant a smaller amount now and consider another grant in the future—note that installment payments will not help if the grantee uses accrual 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**
  - **Fiscal sponsor retains "variance power"**
- **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 or 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

- **Grants for travel, study, or other similar purposes—**
  - 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

Grants for travel, study, or other similar purposes—

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

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

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 disproportionally small, at approximately 10% of an investor’s total investable assets

Questions?

Contact Information

Greg Larson
800 South 8th Street
500 IDS Center
Minneapolis, MN 55402
Phone: 612-632-3276
Email: Greg.Larson@lathropgpm.com

Catie Bitzan Amundsen
800 South 8th Street
500 IDS Center
Minneapolis, MN 55402
Phone: 612-632-3277
Email: Catie.BitzanAmundsen@lathropgpm.com