THE BENEFITS OF DONOR-ADVISED FUNDS VS. PRIVATE FOUNDATIONS

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People who currently have a private foundation should consider terminating it by "rolling it over" into a donor-advised fund at a reputable charitable community foundation or a similar organization. Many wealthy people approach us about starting a private foundation, and for a good reason. For our high net worth clients with charitable aspirations, private foundations can be a very effective way to maximize income tax deductions, reduce estate taxes, allow donors to control their destiny, and promote philanthropy within the extended family. However, there are also a lot of costs and compliance requirements associated with private foundations. From complex tax law, to extensive accounting requirements, to having to deal with requests for money, a private foundation also adds a lot of burden for people who are already busy and have better things to do than worry about tax-exempt/nonprofit corporation legal compliance.

Benefits of donor-advised funds

After working with various clients ranging from area foundations to high net worth individuals to tax-exempt organizations of all shapes and sizes, we have come to realize that donors can have their cake and eat it too, within reason. This means they can get all the tax benefits of a private foundation, they can have a large degree of control over the assets, and they can promote philanthropy. Additionally, donors can shift a substantial portion of the liability and a majority of the cost to another organization for a reasonable fee.

Donor-advised funds are equivalent to and may even offer a better solution than private foundations. Donor-advised funds have less associated costs, less compliance hassle, and provide donors sufficient control to allow them to be effective tools for family wealth planning. A "public" tax-exempt charitable organization sponsors a donor-advised fund, which means gifts of appreciated property qualify for better tax deductibility under the Internal Revenue Code (the "Code").

People who currently have a private foundation should consider terminating it by "rolling it over" into a donor-advised fund at a reputable charitable community foundation or a similar organization. If done properly, this will shift all the burdens of a private foundation to the donor-advised fund sponsor and will allow the donor to retain investment direction and control over who gets the money and when. All of this is accomplished without triggering any private foundation termination tax or self-dealing excise taxes; traps that private foundations fall into all the time.

Donor-advised funds may offer donors a better solution than private foundations.

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IRS guidance on converting private foundation to donor-advised fund

A private letter ruling and a notice from the IRS are currently the best guidance we have at our disposal to shed light on how to convert a private foundation to a donor-advised fund. While such private letter rulings and notices are considered very low level IRS guidance that should not be relied upon by taxpayers to whom the ruling was not issued, they do provide good guidance to see how the IRS might approach a specific situation. Utilizing good tax counsel can provide a reasonable opinion that offers legal comfort to the private foundation and the managers of the private foundation who are both subject to the various excise tax traps present.

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Ltr. Rul. 200009048. A private letter ruling, Ltr. Rul. 200009048 (the "PLR"), sets out how a private foundation should terminate properly to avoid a termination tax. The private foundation ("foundation") is exempt from federal income tax under Code Section 501(c)(3) and is a private foundation under Section 509(a). The foundation will transfer all of its assets to a community foundation ("community foundation") pursuant to Section 507(b)(1)(A). The foundation has no expenditure responsibility grants outstanding under Section 4945(h). The foundation will then dissolve and notify the key district of the IRS of such dissolution.

Under the facts of the PLR, the community foundation is exempt from federal income tax under Section 501(c)(3) and is not a private foundation under Section 509(a), because the community foundation is a publicly supported organization described in Sections 509(a)(1) and 170(b)(1)(A)(vi) pursuant to Reg. 1.170A-9(e)(11). The community foundation is described in those Code sections for the continuous period of at least 60 months immediately preceding the foundation's transfer of all of its assets to the community foundation.

Under a donor-advised fund agreement between the foundation and the community foundation, on the transfer of the private foundation's assets the community foundation will create a donor-advised fund, which will be used to provide charitable donations to publicly supported organizations described in Sections 509(a)(1) and 170(b)(1)(A)(vi). The donor-advised fund will have an advisory committee, consisting of the persons who are currently on the board of directors of the private foundation, who will make non-binding recommendations to the community foundation's board of directors on the amounts of the distributions and the beneficiaries of the funds from the foundation. The community foundation's board of directors are not bound by the advice of this advisory committee, which acts in an advisory capacity only and is subject to the community foundation's policies for donor-advised funds.

To the extent that the community foundation may follow the advice of this advisory committee, the community foundation will do so only after the community foundation has made its independent determination that such advice is consistent with the community foundation's exempt purposes. The community foundation will distribute as much of the income or principal of the fund as the community foundation deems appropriate after consultation with the advisory committee. The community foundation is not subject to any material restrictions or conditions on its use of the assets from the foundation and will have full ownership and control of such assets.

Additionally, the PLR explains that by undertaking such a transfer the foundation avoids all of the private foundation excise taxes under Sections 4940 to 4945.

Notice 2017-73. Notice 2017-73, 2017-51 IRB 562, provides the approaches the IRS is considering regarding certain issues with donor-advised funds of sponsoring organizations. The Notice also discusses potential excise taxes under Sections 4966, 4967, and 4958. According to the Notice, the Treasury Department and the IRS are of the view that to facilitate distributions from donor-advised funds to charities, the Treasury Department and the IRS are considering proposed regulations under Section 4967 that would, if finalized, provide that distributions from a donor-advised fund to a charity will not be considered to result in a more than incidental benefit to a donor under Section 4967 merely because the donor has made a charitable pledge to the same charity (regardless of whether the charity treats the distribution as satisfying the pledge), provided that the sponsoring organization makes no reference to the existence of any individual's pledge when making the donor-advised fund distribution.

Specifically, the IRS provided in the Notice that a distribution from a donor-advised fund to a charity to which a donor has made a charitable pledge (whether or not enforceable under local law) will not be considered to result in a more than incidental benefit to the donor if the following requirements are satisfied:

- The sponsoring organization makes no reference to the existence of a charitable pledge when making the donor-advised fund distribution;
- No donor receives, directly or indirectly, any other benefit that is more than incidental (as discussed in this Notice and as further defined in future proposed regulations) on account of the donor-advised fund distribution; and
- A donor does not attempt to claim a charitable contribution deduction under Section 170(a) with respect to the donor-advised fund distribution, even if the distributee charity erroneously sends the donor a written acknowledgment in accordance with Section 170(f)(8) with respect to the donor-advised fund distribution.

Conclusion

A private foundation can terminate its status as a private foundation and should not encounter any excise taxes for transferring all of its assets to a community foundation's donor-advised fund. By doing so, the owners of the private foundation maintain all the benefits and relieve themselves of most of the associated burdens of operating a private foundation. The foundation must make sure that the community foundation does the following:

- The community foundation makes no reference to the existence of a charitable pledge when making the distribution;
- No member of the board of the foundation nor any member of their family receives, directly or indirectly, any other benefit that is more than incidental (as discussed above and as further defined in future proposed regulations) on account of the distribution; and
- No individual or entity attempts to claim a charitable contribution deduction under Section 170(a) with respect to the distribution, even if the distributee charity erroneously sends a written acknowledgment in accordance with Section 170(f)(8) with respect to the distribution.

The foundation may wish to contact prior grantees to inform them of this plan of termination and use of a donor-advised fund for future giving. A smoother transition may unfold if the foundation's key people continue to work with the grantees for possible future grants from the donor-advised fund of the community foundation via recommendations of the donor advisors.

The foundation should distribute all of its assets to the community foundation's donor-advised fund in order to have a complete termination of the private foundation. A final Form 990-PF should show zero remaining balance in the private foundation and will give notice of the termination to the IRS.

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The foundation needs to make sure that before the final distribution to the donor-advised fund, administrative expenses associated with winding down will be pre-paid to avoid any self-dealing excise taxes. All liabilities must be satisfied (including any rent or related equipment expense) and the foundation must pay all outstanding pledges prior to any transfers. No outstanding pledges or expenses can exist when the foundation makes the final distribution to the community foundation's donor-advised fund.

A foundation should consider retainers be given to any vendors, such as the accountants and attorneys to cover final costs and fees of termination. The foundation also needs to plan for the accrued Section 4941 investment income tax, of 1% to 2% on net investment income up until the day of termination.

If the foundation wants to have a specific investment strategy implemented, the donors should negotiate that up front with the community foundation. Similarly, if the foundation would like to maintain their current investment advisor to continue in advising the donor-advised fund, the community foundation may permit this.

IRS filing requirements—Form 990-PF. Because of the foundation terminating by transferring all of its assets to the community foundation, a tax-exempt charitable organization that is not a private foundation, there are no additional notice requirements for federal purposes other than filing the final Form 990-PF.

When filing the Form 990-PF with the IRS there must be attached to the return:

- A statement that describes the transaction.
- A certified copy of the liquidation plan and resolution.
- A schedule that lists the name and address of the community foundation.
- An explanation of the nature and fair market value of the assets distributed to each recipient.
- A statement that a final distribution of assets was made and the date it was made.

Finally, an organization must indicate that it has ceased to exist and check "Final return" in Item G of the Heading section on page 1 of the return.

State filing requirements. Do not forget to file in the states where a private foundation is required to file a state return. For example, in Texas, when filing the 990-PF with the Texas Office of the Attorney General:

- Attach a PDF of the Form 990-PF to an email addressed to: 990PFFilings@oag.texas.gov.
- Entitle the PDF the name of the foundation, "The _____ foundation."
- Use the PDF/foundation name, The _____ foundation, as the subject line of your email.
- Do not include any other text in the body of the email.
- Do not submit copies of any return other than Form 990-PF for private foundations.
- Once the Form 990-PF is submitted, you will receive an automatic reply indicating receipt of the return for your records.
- Do not also mail a duplicate hard copy.

If you are unable to submit the Form 990-PF in Texas by email, you may mail a copy to the following address:

Office of the Attorney General
Financial Litigation and Charitable Trusts Division
P.O. Box 12548
Austin, TX 78711-2548