TOMAYTO, TOMAHTO – THERE REALLY IS A DIFFERENCE: COMPARING PRIVATE FOUNDATIONS AND DONOR ADVISED FUNDS

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    - Presented to The University of Texas School of Law-Conference of Southwest Foundations 31st Annual Nonprofit Organizations Institute, January 15-17, 2014.
    - Published in <u>Family Foundation Advisor</u>, Vol. 12, No. 5, 6 and 7, 2013.
    - Presented to the State Bar of Texas 11th Annual Governance of Nonprofit Organizations, August 22-23, 2013.
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- Author, "Roundtable Discussion: Charitable Giving With Oil and Gas Interests"
    - Presented to The American College of Trust and Estate Counsel 2013 Fall Meeting, October 24-27, 2013.
- Co-author, "Charitable Remainder Trusts"
    - Presented to the Planned Giving Council of Houston, March 28, 2013.
- Co-author and co-presenter, "Legal & Tax Uncertainty: How to Work with Your Donors to Plan for It"
    - Presented to the North Texas Chapter of the Partnership for Philanthropic Planning, March 12, 2013.
- Co-author and co-presenter, "Nuts & Bolts: Estate & Charitable Planning 101"

    - Presented to the North Texas Chapter of the Partnership for Philanthropic Planning, March 12, 2013.
- Co-author and co-presenter, "The Design and Implementation of Conflict of Interest and Gift Acceptance Policies"
    - Presented to the Fort Worth chapter of the Texas Society of CPAs, September 25, 2012.
- Co-author, "Gifting of Unusual Gifts with a Focus on Oil and Gas and Real Estate"
    - Presented at the 29th Annual Nonprofit Organizations Institute, January 18-20, 2012.

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I. INTRODUCTION

"Although 98% of high net-worth clients give to charity, only 55% report discussing philanthropy with their professional advisors." E.R. Heisman, 41 Estate Planning, No. 7, 27 (July 2014).

This should be a huge wake-up call to all of us who are advisors! We have such a meaningful opportunity to engage our clients in a deeper conversation, bringing their philanthropic goals to the discussion. We need to be proactive in asking the questions of our clients – "What type of charitable goals do you have?" or "Is leaving a charitable legacy important to you?" This particularly applies to donor advised funds (which will be referred to as "DAFs" throughout), as they are the fastest growing giving vehicle in the U.S. philanthropy scene. *Id.*

Although our conversations with clients should include various types and forms of charitable giving, this article will focus on and compare private foundations with DAFs, providing considerations to be discussed with your charitably-minded client, followed by some suggested key language for use in your practice when implementing one of these planning vehicles.

II. WHICH IS RIGHT FOR YOUR CLIENT?

When a client expresses interest in some sort of charitable giving legacy, there are several considerations to be explored before suggesting a private foundation or DAF as the appropriate vehicle to pursue. These considerations include the level of giving the client is contemplating, how involved the family will be, the federal tax regulations unique to each type of giving vehicle, and what type of administrative burden the family is willing to bear, among others.

Ever since there was a federal income tax, there have been exemptions, deductions and other incentives to encourage charitable giving. In the 1960's, Congress perceived an abuse of the private foundation technique and in response adopted a host of rules and regulations regarding their governance. Primarily, Congress was concerned that families were using their private foundations to own businesses or funnel money illegally to the founders and insiders. Silk, Roger D. and James W. Lintott, "How to Ensure a Private Foundation Meets Compliance Requirements", Estate Planning Journal (WG&L), Oct. 2000. Since these foundations are funded with gifts from a very limited group of individuals, there is really no public oversight and the IRS took action to enforce and regulate these entities; thus, the restrictions on prohibited transactions were born, which will be discussed in detail below.

In contrast, while the first record of DAFs were in the 1930's at community foundations (such as the New York Community Trust and the Winston-Salem Foundation), Congress not even define the DAF until the Pension Protection Act of 2006. Internal Revenue Manual, 7.20.8. The DAF really gained popularity after 1992, when the financial service industry realized how easily they could also help donors meet their charitable goals through the DAF vehicle. E.R. Heisman, 41 Estate Planning, No. 7, 27 (July 2014). The DAF skyrocketed between 2011 and 2012, with an increase in DAFs of almost 35%. *Id.* While a private foundation itself is a separate entity, the DAF is instead a component fund of a public charity; the DAF is almost a hybrid of a private foundation and public charity: it shares some of the same prohibited transactions and excise tax rules of private foundations.

III. COMMONALITIES

A. Leaving a Legacy

With either a private foundation or DAF, your client can pass along their charitable ideals through generations and leave a legacy with an unlimited lifespan. Either vehicle can be used to involve a client's children or heirs in philanthropy and provide an educational element exposing those children to the charitable space. Dryburgh, Erik and Gregor Kremenliev, "The Charitable Inheritance Teaches Children About Philanthropy", Estate Planning Journal (WG&L), Dec. 1998. A family's involvement in philanthropic work together can develop community leadership skills in the younger generations. Additionally, both of these vehicles can be used to "test-drive" the senior generation's philanthropic plan, either by involving younger generations in the DAF advising process or as junior board members of the family private foundation.

B. UBIT

While there are some significant tax differences between foundations and DAFs, tax exempt organizations, including private foundations and public charities alike, are subject to tax on unrelated business taxable income (UBTI) at the regular corporate (or trust, if applicable) income tax rates, subject to a $1,000.00 exemption; excessive UBTI can even jeopardize the organization's tax-exempt status. I.R.C. §§ 511, 512. Further, some practitioners consider the realization of reportable UBTI as increasing their audit exposure on other activities of the organization. Caudill, William H. "Unrelated Business Activities:

Strategies for Coping", University of Texas School of Law Nonprofits Organizations Institute, Jan. 2014.

UBIT is triggered when the organization has income from an activity which it regularly carries on, for the production of income from the sale of goods or performances of services, and which is not substantially related to the exempt purposes of the organization. Treas. Reg. §1.513(b); *U.S. v. Am. Bar Endowment*, 477 U.S. 105 (1986). Most passive income is not subject to UBIT, but may be if it is from a controlled entity or from debt-financed property. *See* Guthrie, Shannon G., "Advanced Unrelated Business Income Tax Issues", State Bar of Texas Governance of Nonprofit Organizations Course, Chapter 11, Aug. 2013. The policy behind the concept of taxing unrelated business income is to eliminate unfair competition: the unrelated business activities of the nonprofit sector are to be placed on the same tax basis as the for-profit marketplace with which they compete. *See id.; see also* Fuentes Toubia, Nicola, "UBIT: Advanced Issues and Practical Applications", presented to the University of Texas School of Law Nonprofit Organizations Institute, Jan. 2014. Further, when an exempt organization participates in a joint venture with a for-profit entity, that for-profit venture conducts its affairs to produce a profit, not to pursue the charity's exempt purposes. Thus, the functions of an exempt organization are subject to strict scrutiny when engaging in business activities.

UBTI generally occurs in two situations: (1) when the organization has income from an unrelated trade or business, and (2) when the organization has income earned in regards to unrelated debt-financed property ("UDFI"). *Id.*

There are three basic prongs to incurring UBIT under the first scenario: (1) the activity must constitute a trade or business, (2) the activity must be regularly carried on by the organization, and (3) the conduct is not substantially related to the exempt functions of the organization. I.R.C. § 513(a); Treas. Reg. § 1.513-(a). A trade or business is an activity which is carried on for the production of income from the sale of goods or performance of services; this element will consider the existence of a profit motive in the activity. In the determination of whether the activity is "regularly carried on", the IRS will analyze how frequently the nonexempt activity occurs, comparing the manner of conduct and continuity of the activities to those of their for-profit counterparts. For example, business activities which are engaged in only periodically would not be considered "regularly carried on" (such as an annual 10k or bake sale), but if the commercial activity is typically seasonal, such as selling beach chairs during the summer, the activity may be considered to be regular. The time spent preparing for the activity is also considered in the computation of the organization's time involved in the business activity. PLR 201251019.

The IRS will determine whether a business is substantially related to the exempt purpose of the organization based on the nature, scope and motivation for conducting the activity. A business is substantially related only if the causal relationship is such that the activity contributes importantly to the accomplishment of the exempt purposes, which in turn depends on the facts and circumstances in each case.

The IRS does allow for certain activities to be exempt from UBTI, as well as some modifications to UBTI that exclude certain income from this calculation. Some exceptions include the convenience exception, the exception for entertainment events at fairs, the trade show exception and hospital services exception. The volunteer exception allows an activity in which substantially all of the work in carrying on such business is performed for the organization without compensation. The convenience exemption allows activity which is carried on primarily for the convenience of the organization's members, students, patients, officers or employees to be exempt. An example of this is the placement of vending machines on college campuses; although the income activity is unrelated, it is carved out of taxation as UBTI because it exists for the convenience of the students. I.R.C. § 514. An activity which consists of selling merchandise which was donated to the organization (such as a Goodwill store) is an exception to UBTI under the thrift shop exception. Qualified sponsorship payments are also an exception from UBTI, so long as there is no arrangement or expectation that a person/donor will receive a "substantial return benefit" other than the use or acknowledgement of that person's trade or business name or logo. It is irrelevant whether the sponsored activity is related or unrelated to the charity's exempt purposes. Treas. Reg. § 1.513-4(c). Income derived from the distribution of low cost articles incident to the solicitation of charitable contributions is exempt, such as a mass mailing of donation requests along with pens, notepads or address labels with the charity's name and logo. I.R.C. § 513(h).

Once the gross income from the unrelated trade or business is calculated and reduced by the appropriate deductions, the remaining amount of UBTI may be further reduced by certain modifications contained in Code 512(b). For example, passive income is not seen as a source of unfair competition with for-profit entities and thus is not subject to UBIT. This includes dividends, interest, annuities, royalties, rents from real property, and rents from personal property leased with the real property (so long as the rents from personal property are an incidental amount, 10%, of the total rents received or accrued under the lease).

Debt financed income is defined as income or gain from debt financed property, which is property held to produce income and with respect to which there is acquisition indebtedness. I.R.C. § 514. Acquisition indebtedness can be debt incurred by the exempt organization itself in acquiring or improving the property (i.e. property purchased by the organization with borrowed funds), or it could be incurred before or after the acquisition or improvement of the property, so long as the indebtedness would not have been incurred but for the acquisition or improvement, and in the case of later debt, the fact that the debt would be incurred was foreseeable at the time of acquisition or improvement. *Id.* It includes new debt as well as debt assumed by the organization (such as a mortgage or similar lien). *Id.* Property is considered "debt financed" if there was acquisition indebtedness at any time during the taxable year. The property can be real property or tangible or intangible personal property; this may include rental real estate, mineral production property, securities and leased equipment. *See* Guthrie, S. The sale of debt financed property within one year of retirement of the debt will cause UDFI that year. I.R.C. § 514(b)(1).

However, UDFI does not include mortgaged property acquired by gift or bequest, unless the organization, in order to acquire the equity in the property by gift or bequest, assumes and agrees to pay the indebtedness secured by the mortgage, or if the organization makes any payment for the equity in the property owned by the decedent or the donor. I.R.C. § 514.Additionally, if the organization uses the property to perform its exempt function, or the property is used in an unrelated trade or business which was already included in the calculation of UBTI, then the UDFI will not be included in UBTI (thus preventing double taxation). *Id.* Rents from real property which are financed with acquisition indebtedness are included in UBTI (even though rental income is usually excluded); however, if the property is being substantially used in a manner that is substantially related to the performance of the organization's exempt functions, then all rental income would be excluded from UBTI. When a tax-exempt organization holds property subject to a mortgage, and which is not being used for its exempt purposes, it may be possible to avoid UBIT liability during a 10-year grace period following acquisition. I.R.C. § 514(c); SETTING THE STAGE FOR CHARITABLE GIVING, SS045 ALI-ABA 1. The same causal connection rules which apply to determine when organizations are subject to UBTI also apply to determine whether the property meets the definition of UDFI.

The primary purpose of a tax-exempt organization must be one or more of its exempt purposes. Stated differently, a single non-exempt purpose, if substantial, is enough to destroy exemption regardless of the number of truly exempt purposes. (The Supreme Court held, in *Better Business Bureau of Washington D.C., Inc. v. United States*, 326 U.S. 279 (1945), that the presence of a single non-exempt purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly exempt purposes.) While the IRS has ruled that there is no "quantitative limitation" on the amount of unrelated business activities or income, it has also said unrelated business activities generally should be less than a substantial portion of the organization's overall activities. Rather than setting out a specific limitation, the IRS considers the percentage of the organization's time spent on unrelated business activities and the percentage of the organization's revenue generated by the unrelated business activities. The IRS has ruled that where the organization regularly spends more than 50% of its time and/or regularly derives more than 50% of its annual revenue from unrelated business activities, it risks loss of exemption as the IRS considers this evidence of a non-exempt purpose being a primary purpose.

C. Private Inurement Doctrine

1. Application

The private inurement doctrine applies to private foundations and public charities alike. Implicit in the requirement that the organization be operated for an exempt purpose is the requirement that it not be operated for private benefit. Within the larger concept of the prohibition on private benefit is the private inurement doctrine, of particular import to the subject of federal standards of care for decision makers.

2. Definition

Included in the definition of an organization exempt under § 501(c)(3) is the requirement that no part of the net earnings of the organization inure to the benefit of any private shareholder or individual. This language constitutes an absolute prohibition on allowing the assets of the organization to be used for the benefit of a person having a personal and private interest in the affairs of the organization along with the ability to control the affairs of the organization.

3. Result

Private inurement can result in the revocation of tax-exempt status of private foundations or other exempt organizations. You will see later on that as a part of the drafting principles, a prohibition against private inurement is highly recommended.

D. Deduction Limits

The Federal gift and estate tax deduction is without limit, other than the amount of the transfer itself, and is granted without distinguishing between the type of charitable beneficiary. However, under Code Section 170(e), the type of contributed property and the type of the charitable donee determine the amount of the donor's income tax charitable deduction.

1. Basis or Fair Market Value?

All contributions of ordinary income property to a charitable organization must be reduced by the amount of ordinary income or short-term capital gain that the donor would have recognized had the contributed property been sold at its fair market value at the time of contribution. I.R.S. Pub. 526 (April 2007). The amount of the donor's deduction is thus effectively limited to basis for property that is not a long-term capital asset. *Id.* This includes gifts of property such as dealer property, inventory and capital assets held for one year or less. *Id.*

A donor is entitled to a charitable deduction of the greater of fair market value or basis for a contribution of tangible personal property, which will be put to a use related to the donee's exempt purposes. If the property will not be put to a related use, the donor's deduction is limited to the property's basis. "Unrelated use" means a use unrelated to the exempt purpose or function of the charitable organization. I.R.C. §170(e). If the tangible personal property asset is sold and the proceeds used by the charity for its exempt purposes, this is considered an unrelated use, and the deduction will be limited to basis. I.R.S. Pub. 526 (April 2007). Items such as royalties and partnership interests are considered intangible personal property, and thus would not come under this special rule for tangible personal property. Hoffman, Mark D., "Tangible Personal Property", Planned Giving Design Center, May 2, 2003.

Contributions of capital gain property generally are deductible at the asset's fair market value. I.R.S. Pub. 526 (April 2007). "Capital gain property" is defined as capital assets held for more than one year. Capital assets include most items of property a donor owns and uses for personal purposes or investment, such as stocks, bonds, jewelry, coin or stamp collections, and cars or furniture used for personal purposes. *Id.* Capital assets also include certain real property and depreciable property used in the donor's trade or business and, generally, held more than one year (although, in certain circumstances the donor may have to treat this property as partly ordinary income property and partly capital gain property). *Id.* Real property is land and generally anything built on, growing on, or attached to land. *Id.*

However, the fair market value of a capital gain asset must be reduced to the property's cost or other basis if given to certain donees. Generally, this is required if: (1) the property (other than qualified appreciated stock) is contributed to certain private non-operating foundations, (2) the donor chooses the 50% limit instead of the special 30% limit for capital gain property, when making a contribution to a public charity or other 50% organization (i.e. a private operating foundation), (3) the contributed property is intellectual property or taxidermy property, or (4) the contributed property is tangible personal property put to an unrelated use by the charity or has a claimed value of more than $5,000 and is sold, traded, or otherwise disposed of by the qualified organization during the year of the contribution, and the qualified organization has not made the required certification of exempt use (such as on Form 8282, Donee Information Return, Part IV). I.R.S. Pub. 526 (April 2007).

2. AGI Limits

Additionally, with any charitable donation, the donor's income tax deduction is limited to a portion of the donor's Adjusted Gross Income ("AGI") for each year, but the donor may be able to carry the excess contributions forward to subsequent years. A donor is generally limited to 50% of his AGI when making a gift of cash or non-appreciated property to a public charity or private operating foundation ("50% organization"); a gift of long-term capital gain property to the same organization will be limited to 30% of the donor's AGI.

When the charitable donee is a private non-operating foundation, a donor is limited to 30% of his AGI for a gift of cash or property, other than appreciated property. For gifts of appreciated property, the deduction is capped at 20% of the donor's AGI for the year. Keep in mind that the contribution deduction for gifts of appreciated property to a private non-operating foundation is further limited to the lesser of the donor's basis in the asset or its fair market value, unless the asset is qualified publicly traded stock. I.R.C. § 170(e)(1)(B)(ii).

The excess of the allowable deduction(s) may be carried forward for five years, and must be deducted in order: (1) first, the remaining 50% of gifts in excess of the current year's 50% gifts (earliest year first); (2) second, carryovers of gifts to the 30% charities; (3) third, carryovers of the long term capital gains property gifts limited to 30%; and (4) fourth, carryovers of the long term capital property gifts limited to 20% of the contribution base. I.R.C. § 170(b); Treas. Reg. §1.170A-8; Phelan, Marilyn E. & Robert J. Desiderio, Nonprofit Organizations Law and Policy (Am. Casebook Series, Thomson/West 2d ed. 2007) (2003), at 389-91.

3. Pease Limitation

The American Taxpayer Relief Act of 2012 reinstated the "Pease" Limitation. Subject to the limitations noted above, a donor's Federal Income Tax deduction for a gift to a qualified charity in any year is further reduced by the lesser of 80% of the donor's Itemized Deductions for that year (excluding medical expenses, investment interest, wagering losses in excess of wagering gains and casualty losses) or 3% of the amount by which the donor's AGI for that year exceeds that year's AGI Threshold Amount (i.e. married filing jointly: $300,000). (*Compare to the scenario of an estate payable to a qualified charity: the value of property transferred at death to a qualified charity is 100% deductible in determining the amount of federal estate tax*).

IV. PRIVATE FOUNDATIONS

A. Foundations in General

The word "foundation" can be deceptive, as it may refer to any number of nonprofit organization types. I.R.C. § 509(a) defines a private foundation as any domestic or foreign organization described in I.R.C. § 501(c)(3) other than the following types of public charities:

1. Organizations that are, by definition or by activity, public charities I.R.C. § 509(a)(1); I.R.C. § 170(b)(1)(A)(i)-(v) ("traditional" public charities);
2. Organizations receiving a substantial amount of support from the general public or from governmental entities, I.R.C. §509(a)(1); I.R.C. §170(b)(1)(A)(vi) ("publicly supported charities")
3. Organizations receiving a substantial amount of support from the general public or from governmental entities, I.R.C. § 509(a)(2) ("gross receipts" or "service provider" publicly supported charities);
4. Organizations excluded from private foundation treatment due to their close association with public charities treated as other than private foundations, I.R.C. § 509(a)(3) (Supporting Organizations); and
5. Organizations organized and operated exclusively to test for public safety, I.R.C. § 509(a)(4) (beyond the scope of this outline).

In other words, an I.R.C. §501(c)(3) organization is presumed to be a private foundation unless it demonstrates that it fits one of the exceptions listed above. This outline does not address public charities other than community foundations in the context of DAFs.

1. <u>Private Nonoperating Foundation</u>

The most common type of private foundation is the nonoperating foundation. It does not directly perform any charitable programs or services. It generally receives its funding from one primary source, such as an individual, a family or a corporation, and does not generally actively raise funds or seek grants. It is required to distribute approximately 5% of its assets annually to public charities. Donors' charitable income tax deductions are more limited than when made to a public charity.

2. <u>Private Operating Foundation</u>

The operating foundation has a stated charitable purpose and carries out its own programs. It generally seeks grants rather than awarding grants to other charitable organizations. The operating foundation must expend substantially all of its net investment income directly for the purposes of its own charitable activities. Although donors receive the more liberal public charity income tax deduction limitations, this type of foundation remains subject to the private foundation restrictions because its source of funding is generally from one individual, family or corporation.

B. Tax Treatment by Donors of Contributions

1. <u>Gifts of Cash and Non-Appreciated Property</u>

For gifts to private non-operating foundations, a donor's income tax deduction is limited to an amount equal to thirty percent (30%) of the donor's adjusted gross income in the taxable year (as opposed to 50% for gifts of cash and other non-appreciated property to public charities and to other foundations that are treated as public charities for donation purposes (private operation foundations, exempt operating foundations, and conduit foundations)). Any excess can be carried forward for the next five years. However, the deduction may be zero if the donor has contributed capital gain property to public charities in excess of the 30% deduction limitation. Corporate contributions are limited to 10% of taxable income with a five year carry forward of excess contributions. See IRC § 170(b)(2) and § 170(d)(2)(A).

2. <u>Gifts of Appreciated Property</u>

For gifts to private non-operating foundations, a donor's income tax deduction is limited to twenty percent (20%) of the donor's adjusted gross income on gifts of appreciated property (as opposed to 30% for gifts of appreciated property to public charities and to other foundations that are treated as public charities for donation purposes). Additionally, gifts of appreciated assets are limited to a deduction of only the donor's basis in the asset, unless the asset is publicly traded stock. Any excess can be carried forward for the next five years.

3. Itemized Deduction Limitation

As seen above, a donor's federal income tax deduction for a gift to a qualified charity (whether public charity or a private foundation) in any year is additionally reduced by the lesser of 80% of the donor's itemized deductions for that year (excluding medical expenses, investment interest, wagering losses in excess of wagering gains and casualty losses) or 3% of the amount by which the donor's adjusted gross income for that year exceeds that year's adjusted gross income threshold amount.

C. Federal Tax Sanctions Applicable to Private Non-Operating Foundations

1. Excise Taxes and Prohibited Transactions

Sections 4940-4945 of the Code provide for excise taxes related to certain required actions and prohibited transactions. Included among the excise tax scheme are taxes against decision makers referred to as foundation managers. Foundations and in some cases, foundation managers are subject to imposition of excise taxes related to acts of self-dealing (§ 4941), excess business holdings (§4943) jeopardizing investments (§ 4944), and taxable expenditures (§ 4945). Foundations are also subject to an annual excise tax on net investment income (§4940).

2. Net Investment Excise Tax - §4940

The private foundation must pay an annual excise tax equal to 2% of the foundation's "net investment income." The net investment income equals gross income (interest, dividends, rents, royalties and realized capital gains), minus all ordinary and necessary expenses paid or incurred for the production or collection of such income. It includes the gain on the sale of appreciated property because the foundation receives a carry-over basis from the donor. However, if the assets are gifted upon the death of a donor, the assets receive a step-up in basis as to the date of the donor's death. The ordinary and necessary expenses paid or incurred for the production and collection of such income and which are not subject to the excise tax include: brokerage fees, investment management fees and director fees applicable to managing the investments. This excise tax is reported on the foundation's annual Form 990-PF. These excise taxes must be paid on a quarterly estimated basis. The first quarterly payment being due 4 and ½ months after the beginning of the tax year (May 15 for calendar year filers), even though the tax return is not due to be filed until 4 and ½ months after the end of the tax year. I.R.C. § 6655.

a. Penalties

Failure to pay the excise tax in a timely fashion subjects the foundation to penalties and interest applicable to other corporate filers.

b. Reduction of Excise Tax

The excise tax may be reduced from 2% to 1% provided that the foundation meets a "maintenance of effort" test. To meet such test, the foundation must demonstrate that its qualifying distributions paid out before the end of the tax year equal or exceed the sum of (a) the 5-year average payout times current years assets, plus (b) 1% of net investment income. If this test is met, the applicable tax is reduced to 1%.

c. Application in Estate Administration

Under Treas. Reg. § 53.4940-1(d)(2), a distribution from an estate does not retain its character for purposes of I.R.C. § 4940 when received by the distributee foundation. Thus, investment income earned by an estate will be treated as a contribution when received by the foundation beneficiary. See Rev. Rul. 80-118, 1980-1 C.B. 254, which provides that interest income on a bond not reported by an estate is taxable to the private foundation under I.R.C. § 4940.

3. Prohibition Against Self-Dealing - §4941

a. Self-dealing includes any direct or indirect:

1. sale or exchange or leasing of property between the private foundation and a Disqualified Person;
2. lending of money or extension of credit between a private foundation and a Disqualified Person;
3. furnishing of goods, services, or facilities between a private foundation and a Disqualified Person, unless such goods, services or facilities are made available to the general public on at least as favorable a basis as they are made to the Disqualified Person, Treas. Reg. § 53.4941(d)(3)(b)(1);
4. payment of compensation (or payment or reimbursement of expenses) by a private foundation to a Disqualified Person, unless compensation is payment for personal services (narrowly defined by the Service), is reasonable, necessary and not excessive Treas. Reg. § 53.4941(d)(3)(c)(1);
5. transfer to, or use by or for the benefit of, a Disqualified Person of the income or assets of a private foundation; and,
6. agreement by a private foundation to make any payment of money or other property to a government official [as defined in I.R.C. § 4946(c)] other than an agreement to employ

such individual for any period after the termination of his government service if such individual is terminating his government service within a 90 day period. I.R.C. § 4941(d).

b. Disqualified Person

Because of the retention of control involved with private foundations, there are restrictions upon acts of self-dealing under I.R.C. § 4941(d) by certain Disqualified Persons of the foundation I.R.C. § 4946 defines the term "Disqualified Person." A Disqualified Person, with respect to a private foundation, is:

(1) A substantial contributor to the foundation.

Substantial contributor is defined in I.R.C. § 507(d)(2) as any person who contributes an aggregate amount in excess of $5,000 to the foundation, if his or her total contributions are more than 2% of the total contributions received by the foundation (since its inception) before the close of the taxable year of the contribution. Substantial contributor also includes:

A family member of a substantial contributor (spouse, descendants and spouses of descendants), or any other person who would be a Disqualified Person by reason of his relationship to such person.

Persons owning more than 20% of an entity which is a substantial contributor to the foundation. I.R.C. § 4946(a)(1)(C),

Where the substantial contributor is a corporation, the term also includes any officer or director of such corporation.

(2) A foundation manager,
(3) A member of the family of anyone described in (a) or (b) above, and
(4) A corporation in which persons described in (a),(b), and (c) above own more than 35% of the total combined voting power (more than 35% of profit interest of a partnership or more than 35% of beneficial interest of a trust.)

c. Reimbursement for Expenses

Reimbursement to a director (Disqualified Person) for travel expenses causes the foundation and the director (i.e. a foundation manager) to be potentially liable for penalty taxes for self-dealing, for making noncharitable expenditures, or possibly both. (Additionally, a foundation can lose its exempt status if any of its net earnings inure to the benefit of a private person.)

(1) Reasonable and Necessary.

Such reimbursement of expenses will not be taxed if the expenses are reasonable and necessary to carrying out the exempt purposes of the foundation and are not excessive. I.R.C. § 4941(d)(2). The Code does not explain what is "reasonable and necessary." Treas. Reg. § 53.3941(d)-3(c)(1).

(2) Business Expense Deductions.

Generally, business expense deductions under Treas. Reg. § 1.162-2(1) include travel fares, meals and lodging and expenses incident to travel. Travel expenses are not included if the trip is primarily personal in nature. Treas. Reg. 1.162-2(a).

(3) Not Excessive.

The Code does cross-reference Treas. Reg. § 1.162-7 to determine what is "excessive." Under Treas. Reg. § 1.162-7, an amount spent on director's services will not be deemed "excessive" if it is only such as would be paid "for like services by like enterprises under like circumstances." Treas. Reg. 1.162-7 (i.e. as the organization would pay to someone independent of the foundation.)

(4) Cash Advances.

Additionally, a director cannot receive a cash advance for expenses in excess of $500 unless extraordinary expenses are included. Treas. Reg. 53.4941(d)-3(c)(1). Upon receipt of such a cash advance, the director must then account to the foundation under a periodic reimbursement program for actual expenses incurred. If this is done, then the cash advance, additional replenishment of the advance upon receipt of supporting vouchers, or the temporary addition to the advance to cover extraordinary expenses anticipated to be incurred in fulfillment of the assignment will be not considered to violate any act of self-dealing. Only a director or employee is entitled to a cash advance. Treas. Reg. 53.4941(d)-3(c).

d. Compensation
(1) General Prohibition.

If a foundation pays compensation, including payment or reimbursement of expenses, to a disqualified person, generally such payment constitutes self-dealing. I.R.C. § 4941(d)(1)(D); Treas. Reg. 53.4941(d)-2(e). However, there are exceptions to this general rule.

(2) Exception for Personal Services Reasonable and Necessary.

The payment of compensation by a private foundation to a disqualified person for the performance of personal services which are reasonable and necessary to carry out the exempt purpose of the private foundation shall not be an act of self-dealing if such compensation (or payment or reimbursement) is not excessive.

Personal services includes services of a broker serving as agent for the private foundation, but not the services of a dealer who buys from the private foundation as principal and resells to third parties. The exception for payment of compensation for the performance of personal services which are reasonable and necessary to carry out the exempt purpose of the foundation shall apply regardless of whether the person receiving compensation is an individual.

The test for whether compensation is excessive is the same test for whether a business expense is excessive under Treas. Reg. § 1.162-7. This requires the organization to obtain comparable data for compensation for the particular services.

e. Penalties: Excise Tax on Self-Dealing Transactions

(1) Initial Penalty: Disqualified Person.

Any Disqualified Person who engages in an act of self-dealing is assessed an excise tax of 10% of the amount involved in the transaction for each year that the transaction is uncorrected.

(2) Initial Penalty: Foundation Managers.

Additionally, a foundation manager who willingly participates in the act knowing it is prohibited is subject to a tax of 5% of the amount involved (not to exceed $20,000 for each such act) for each year that the transaction is uncorrected.

(3) Additional Penalty: Disqualified Person.

If the transaction is not timely corrected and the 10% initially assessed was not timely paid, the Disqualified Person is subject to being assessed an additional tax of 200% of the amount involved.

(4) Additional Penalty: Foundation Manager.

Any foundation manager who does not correct the transaction may also be subject to an additional assessment of 50% of the amount involved (up to $20,000 for each such act.)

(5) Joint and Several Liability.

If more than one foundation manager is liable under this section, such persons are jointly and severally liable.

4. <u>Minimum Distribution Requirements (Tax on Failure to Distribute Income)</u>

A private foundation must generally distribute at least 5% of its assets on an annual basis in qualifying distributions. These assets are those not used in furtherance of the exempt purposes of the foundation, such as the building at which the foundation offices, capital equipment and fixtures are located, but are generally cash, stocks, bonds and other investment assets. This minimum distribution is required to prevent foundations from holding gifts, investing the assets and never spending the assets on charitable purposes.

a. Time Period for Distribution

A foundation has 12 months after the close of the taxable year to satisfy the minimum payout requirement for that taxable year. Any foundation can retroactively satisfy last year's payout requirements with the current year's qualifying payment. If a foundation has a shortened first taxable year, then the foundation will have an additional 12 months to complete the prior year's minimum distribution requirement.

b. Qualifying Distributions

Generally, a private foundation's Qualifying Distributions will consist of grants to qualified charitable organizations (I.R.C. § 501(c)(3) organizations). Qualifying distributions also include grants to charities and non-charities for "charitable purposes," costs of all direct charitable activities (such as running a library or art gallery, providing technical assistance to grantees, maintaining a historical site, conducting a conference, etc.), amounts paid to acquire assets used directly in carrying out charitable purposes, set asides, program-related investments and all reasonable administrative expenses necessary for the conduct of the charitable activities of the foundation.

(1) Grants to individuals.

Since a qualifying distribution may be made to a non-charity, it is possible for a grant to an individual to be a qualifying distribution, subject to the I.R.C. § 4945 restrictions on taxable expenditures for grants to individuals for travel, study or any similar purpose (see discussion below). Accordingly, grants, scholarships or other similar payments to individuals may be qualifying distributions, but only if the foundation maintains some "significant involvement" in the active programs in support of which the grants are made. Treas. Reg. § 53.4942(b)-1(b)(2). "Significant involvement" will be met if: 1) an exempt purpose of the foundation is the relief of poverty or human distress and the grants must be made or awarded without the assistance of an intervening organization or agency, Treas. Reg. § 53.4942(b)-1(b)(2)(ii)(A); or 2) the foundation has developed some specialized skills, expertise or involvement in the area to which the grant pertains and hires a staff to supervise and conduct the foundation's work in this area. The grants are then made to encourage involvement in the area. Treas. Reg. § 53.4942(b)-1(b)(2)(ii)(B). Whether or not a grant is made "directly" for the active conduct of the foundation's exempt activities will be determined according to the facts and circumstances of the particular case. Treas. Reg. § 53.4942(b)-1(b)(2). If a foundation only selects, screens and investigates applicants for grants or scholarships and the grantees perform their work alone or under the supervision of some other organization, then the grants will not be treated as qualifying distributions; however, the administrative expenses incurred in screening may still be treated as qualifying distributions. Qualifying distributions in excess of the minimum payout may be carried forward for 5 years.

(2) Administration Expenses

Administration expenses do not include investment expenses incurred in managing the endowment. Accordingly, investment management fees, brokerage fees, custodial fees, salaries, or board meeting expenses to oversee investments do not count toward meeting the minimum payout requirement. All other administration expenses that are necessary and reasonable can be taken into consideration. Administration expenses that do count toward the payout include salaries, benefits, trustees' fees, professional fees, travel expenses, general overhead, training, publications, office supplies, telephone, rent, preparation of tax returns, defending legal matters, obtaining rulings from the Service, state and federal filing requirements, costs to purchase newspaper ad announcements of the availability of the tax return for public inspection, cost of annual report and year-end audit. The amount of "grant" administrative expenses paid during any taxable year which may be taken into account as qualifying distributions cannot exceed the excess of (i) 65% of the sum of the foundation's net assets for such taxable year over, (ii) the aggregate amount of grant expenses paid during the two preceding taxable years which were taken into account as qualifying distributions. I.R.C. § 4942(g)(4). Furthermore, unreasonable expenditures for administrative expenses, including compensation and consultant fees, will be taxable unless the foundation can prove that the expenses were paid or incurred in the good faith belief that they were reasonable and that the payment or incurrence of such expenses was consistent with ordinary business care and prudence. Treas. Reg. 53.4945-6(b)(2). Reasonableness is determined upon a case by case facts and circumstances determination. Treas. Reg. 53.4945-6(b)(2); Rev. Rul. 77-161. Expenses should be able to be validated by the foundation and somehow associated with the exempt purpose of the organization or the payment of the expenses may be construed to be "private inurement" and risk the exempt status of the organization.

(3) Set-Asides

Set-asides are funds of the foundation which are applied for to the Internal Revenue Service in advance to set aside over a multiple year period, not exceeding 5 years, for a specific project. Such set-asides are treated as qualifying distributions. If the Internal Revenue Service approves such set-asides, the full amount of the multi-year grant may count toward payout in the first year.

c. Calculating the 5% Distribution Amount

a. 12 Month Average

The foundation first must calculate the 12 month average of its assets, which allows for fluctuation in investment markets. Any reasonable and consistently applied method can be chosen. In a short taxable year, the payout will be determined based upon the average of the numbers in the short year.

b. 1.5% Reduction of 12 Month Average

The 12 month average of the fair market value of the foundation's assets may be reduced by 1.5% of the "cash deemed held for charitable purposes." This takes into account that any foundation needs cash to conduct its ongoing business operations. Accordingly, cash given and held for the endowment is reduced by 1.5%.

c. Calculate 5% of net of (a) & (b)

Multiply the net of (a) & (b) by 5%.

d. Reduce the amount of (c) by taxes

The net figure obtained in (c) above is reduced by taxes paid by the foundation during the year. This is the "distributable amount" that the qualifying distributions must equal each year. Note Pertaining to Estates: Treas. Reg. § 53.4942(a)-2(c)(2)(ii) provides that the asset base for determining the minimum investment return of a private foundation does not include "the assets of an estate until such time as such assets are distributed to the foundation or, due to a prolonged period of administration, such estate is considered terminated for federal income tax purposes pursuant to Treas. Reg. § 1.641(b)-3.

Private foundations may no longer count grants or payments to supporting organizations that are directly or indirectly controlled by persons who are disqualified persons of the foundation as part of their qualifying distributions.

d. Excise Tax on Failure to Distribute Income (I.R.C. §4942)

Minimum requirements for distribution of income: The foundation must make qualifying distributions in an amount equal to or greater than 5% of the aggregate fair market value of assets not used directly to carry out the foundation's exempt purposes for each taxable year. A qualifying distribution is one paid to accomplish one or more charitable purposes under I.R.C. § 4942(g). If such amount is not distributed by the close of the following taxable year, the foundation is assessed a penalty of 30% of the difference between the amount actually distributed and the amount which should have been distributed. An additional penalty of 100% of the undistributed amount is assessed if the original penalty is assessed and the distribution is not timely made. I.R.C. § 4942. The penalties apply only to the foundation and not the foundation manager.

5. Excess Business Holdings - §4943

To prevent private foundations from having an advantage over other businesses which operate in the taxable income sector, Congress and the Internal Revenue Service have adopted restrictions on a private foundation's ability to engage in certain business activities.

a. Permitted holdings

The foundation may own 20% of the voting stock in a corporation, reduced by the percentage of voting stock held by all Disqualified Persons. If control of the entity can be shown to be held by Non-Disqualified Persons, the foundation and the Disqualified Persons may own 35% of the entity's voting interest. The foundation may hold a non-voting interest, but only if all Disqualified Persons together hold no more than 20% of the voting interest or no more than 35% of the voting interest if effective control is with a Non-Disqualified Person(s). The foundation may own a de minimis 2% of the voting stock or value.

b. 5 year period to dispose

A private foundation has 5 years to dispose of excess business holdings acquired by gift or bequest. The disposal must be to a non-Disqualified Person. Additionally, during the 5 year period, the excess business holdings will be treated as held by a Disqualified Person (rather than by the foundation).

In reducing excess business holdings, the foundation cannot impose on the transferee any material restrictions or conditions that prevent the transferee from freely or effectively using or disposing of the transferred interest (otherwise, the foundation will be treated as the owner of the interest until all restrictions or conditions are eliminated). In PLR 95551033, the IRS concluded that a transfer of stock to a designated fund at a community foundation was not subject to a material restriction. In PLR 8416033, a private foundation proposed to transfer stock to a newly created supporting organization. There were common board members to both the foundation and the supporting organization. Prior to the transfer, the business wanted to obtain from all shareholders (including the foundation) a right of first refusal if the stock were sold. The IRS ruled the right of first refusal would not be a material restriction because it was imposed by the company on all shareholders, and did not restrict the right of the supporting organization to dispose of the stock freely and effectively.

A private foundation can dispose of excess business holdings by transferring stock to one or more public charities. Certain supporting organizations, however, are subject to excess business holdings restrictions (as are DAFs), including non-functionally integrated Type III supporting organizations and Type II supporting organizations if the donor(s) to the supporting organization control the supported organization. For more information on how excess business holdings rules apply to supporting organizations, see James P. Joseph and Andras Kosaras, "Advancing Philanthropic Goals While Divesting Excess Business Holdings", Taxation of Exempts, 3-11 (May/June 2009).

c. Unusual gifts and bequests

A private foundation may be granted an additional 5 year period to dispose of an excess business holding received by an unusually large gift or bequest, or holdings with complex business structures.

d. Business enterprise

The private foundation is not permitted to retain excess business holdings, as defined in I.R.C. §4943(c). For the entity in which an interest is held, to be considered a business holding, must be engaged in a business enterprise. An entity is not engaged in a business enterprise if 95% or more of gross income is from passive activity, I.R.C. § 4943(d)(3), or if the business is a functionally related business (i.e. to the foundation's charitable purpose) defined in I.R.C. § 4942(j)(4). Investment in such assets as passive rental real estate or marketable securities is not a business enterprise.

e. Excise Tax on Excess Business Holdings (I.R.C. §4943)

Restrictions on retention of excess business holdings. The foundation is taxed on its excess business holdings in the amount of 10% of the value of the excess business holding. A penalty of 200% is imposed on the foundation if the initial penalty is assessed and the excess business holding is not timely corrected. I.R.C. § 4943 (b). Although the private foundation has a 5 year time period to dispose of the excess business holding, the disposition of such holding is subject to the restrictions against acts of self-dealing.

D. Duties of Prudent Investment

Whether managing a private foundation or a public charity, the foundation or charity's directors and officers must ensure compliance with their state and federal duties of prudent investment and management of the public's assets, as well as the donor's intent. Directors of these exempt organizations are the keepers of the charity's funds and the guardians of the organization's mission. To exercise prudence means to understand the relationship between potential risk and potential return and to create a balanced portfolio based upon a reasoned investment strategy. *Because the donor or advisor to a DAF does not make the investment decisions related to the DAF (the investment decisions lie in the hands of the sponsoring organization), this section will focus on the investment duties as they relate to private foundations.*

1. Fiduciary Duties

Fiduciary duties are a product of common law, with some aspects having been codified in state business organization and trust codes. These duties are generally defined as the duties of care, loyalty and obedience. The duty of care simply stated is the duty to stay informed and exercise ordinary care and prudence in managing the organization. *See Internat'l Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 576 (Tex. 1963). Regarding investments, the duty of care is often referred to as the duty of prudence: a decision maker must act in good faith and exercise the degree of care a person of ordinary prudence would exercise in the same or similar circumstances. Directors and officers must make decisions reasonably believed to be in the best interest of the organization, based on the objective facts available to the decision-maker at the time. Tex. Bus. Org. Code § 22.221.

The duty of loyalty requires the decision makers to have undivided loyalty to the organization: he must act for the benefit of the organization and not for his personal benefit, avoiding conflict of interest scenarios. *See Landon v. S&H Marketing Group, Inc.*, 82 S.W.3d 666, 672 (Tex. App.-Eastland 2002, no pet.). While the breach of the duty of loyalty gives rise to a tort claim under state law, it may also implicate federal tax law, as such a breach typically gives rise to private inurement, self-dealing, and/or excess benefit transactions (discussed above).

The duty of obedience requires the managers of exempt organizations to remain faithful to and pursue the goals and purposes of the organization. The decision maker should follow the organization's governing documents, applicable laws and donor restrictions, to ensure the organization satisfies its charitable purposes and fulfills its reporting and regulatory requirements. The duty of obedience demands that the charitable assets are not diverted to non-charitable uses and the investment strategy be consistent with the organization's mission.

2. UPIA and UPMIFA

The law of prudent investment is also found in the statutory guidance and duties related to the investment and management of the assets of charitable organizations, through the adoption of the Uniform Prudent Investor Act (UPIA) and the Uniform Prudent Management of Institutional Funds Act (UPMIFA). UPIA governs the investment and management of trust assets, including charitable trusts with either individual or institutional trustees. A trustee who invests and manages trust assets owes a duty to the beneficiaries of the trust to comply with the prudent investor rule.

In Texas, UPMIFA applies to "institutions" managing "institutional funds" or "endowment funds", and only to the extent a gift instrument does not provide otherwise. UPMIFA does not apply to program-related assets, defined as assets held by an institution primarily to accomplish a charitable purpose, rather than being held for investment. "Institution" is defined to include: (1) a person, other than an individual, organized and operated exclusively for charitable purposes; (2) a government or governmental subdivision, agency or instrumentality, to the extent that it holds funds exclusively for a charitable purpose; and (3) a trust that has both charitable and noncharitable interests, after all noncharitable interests have terminated. *See* Tex. Prop. Code § 163.003(4). "Institutional fund" means a fund held by an institution exclusively for charitable purposes. The term does not include: (1) program related assets; (2) a fund held for an institution by a trustee that is not an institution; or (3) a fund in which a beneficiary that is not an institution has an interest, other than an interest that could arise upon violation or failure of the purposes of the fund. *See* Tex. Prop. Code § 163.003(5). UPMIFA specifically imposes the common law duty of loyalty (discussed above) upon institutional managers, and requires the institution to manage and invest the fund considering the charitable purposes of the institution, those of the fund, and any donor intent as expressed in a gift instrument. Tex. Prop. Code § 163.004(b).

UPMIFA also addresses the investment requirements of endowment funds, with specific presumptions of prudent expenditures in section 163.005 of the Texas Property Code. Under UPMIFA, "endowment fund" means an institutional fund or part thereof that, under the terms of a gift instrument, is not wholly expendable by the institution on a current basis. The term does not include assets that an institution designates as an endowment fund for its own use. Tex. Prop. Code §163.003(2). Terms designating a gift as an endowment, or a direction or authorization in the gift instrument to use only “income”, “interest”, “dividends”, or “rents, issues, or profits”, or “to preserve the principal intact”, create an endowment fund of permanent duration unless other language in the gift instrument limits the duration or purpose of the fund. These terms do not otherwise limit the authority of the institution to appropriate the funds for expenditure or accumulation.

There are some differences between UPIA and UPMIFA, but they each rely on a modified version of the traditional prudent investor rule, requiring decision-makers to consider the charitable purposes of the organization in making investment decisions, consider economic factors, balance risk and return, and attempt to maximize overall return within the level of risk tolerance acceptable to the charity under its investment policy. Under each statute, each investment is to be evaluated in the context of the trust’s or organization’s portfolio as a whole, and as a part of an overall investment strategy with risks and return objectives reasonably suited to the trust/fund. UPIA: Tex. Prop. Code § 117.004; UPMIFA: Tex. Prop. Code § 163.004.

Further, the trustee or manager must diversify the organization’s (or trust’s) investments, unless the decision maker reasonably determines that, because of special circumstances, the purposes of the trust/fund are better served without diversifying. UPIA: Tex. Prop. Code. § 117.005; UPMIFA: Tex. Prop. Code § 163.004(e)(4). Any investment may be considered, so long as it is consistent with the obligations of prudence under UPIA or UPMIFA, as applicable. However, the trustee/directors must make reasonable efforts to verify facts relevant to the management and investment of the trust/fund. UPIA: Tex. Prop. Code § 117.004(d); UPMIFA: Tex. Prop. Code § 163.004(c)(2). A manager with special skills or expertise will generally be held to a higher standard – i.e. the standard of a reasonable person with those same skills and expertise.

The manager of the charitable organization may delegate investment and management functions that a prudent trustee/manager of comparable skills could properly delegate under the circumstances. In choosing to delegate, the decision maker must exercise reasonable care, skill and caution in selecting the agent and managing the terms of the delegation to be consistent with the terms of the charitable entity, as well as in overseeing the proper compliance with the terms of the delegation by such agent. UPIA: Tex. Prop. Code § 117.110; UPMIFA: Tex. Prop. Code § 163.006. Because an institution or trust should only incur appropriate and reasonable costs in managing and investing the charitable assets, delegating a management function to an outside agent should be thoughtfully considered.

The duties of prudence under UPIA/UPMIFA may go one step further than merely allowing, and may actually demand, delegation of certain functions. If the organization lacks directors or trustees with a level of acumen appropriate to certain investments of the organization, it should seek professional guidance in a third-party agent and delegate those investments as appropriate. The directors should be mindful of the fees associated with the delegation, to ensure they are acting prudently in managing the organization’s liquid resources. In choosing an outside manager for delegation of an asset or investment, the directors must complete a thorough vetting process of not only the investment team, but also the key principals and money managers that will be involved. This should include a background check, reference checks, and interviews with the key individuals and any superiors of those individuals most closely linked to the management of the organization’s assets.

3. <u>Federal Requirements</u>

A private foundation must not make investments which would jeopardize the carrying out of the exempt purpose as prohibited by I.R.C. § 4944. Although no investment is a per se violation, this rule requires close scrutiny of foundation managers’ standard of care. Caution should be exercised in the consideration of speculative investments. This restriction applies to investment actions by the foundation managers and does not apply to assets received by a private foundation by gift or bequest.

a. Jeopardizing Investments

An investment shall be considered to jeopardize the carrying out of the exempt purposes of a private foundation if it is determined that the foundation managers, in making such investment, have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes.

In the exercise of the requisite standard of care, the foundation managers may take into account the expected return (including both income and appreciation of capital), the risks of rising and falling price levels, and the need for diversification within the investment portfolio. The determination of whether the investment of a particular amount jeopardizes the carrying out of the exempt purposes of a foundation shall be made on an investment by investment basis, in each case taking into account the foundation’s portfolio as a whole.

No category of investments shall be treated as a per se violation of section 4944. However, the following are examples of types or methods of investment which will be closely scrutinized to determine whether the foundation managers have met the requisite standard of care and prudence:

1. Trading in securities on margin
2. Trading in commodity futures
3. investments in working interests in oil and gas wells
4. the purchase of "puts" and "calls" and "straddles"
5. the purchase of warrants
6. selling short

b. Exceptions to Jeopardizing Investments

Section 4944 shall not apply to an investment made by any person which is later gratuitously transferred to a private foundation.

Section 4944 shall not apply to an investment which is acquired by a private foundation solely as a result of a corporate reorganization within the meaning of section 368(a).

c. Penalties: Excise Tax on Jeopardizing Investments

(1) Initial Penalty: Foundation.

If a foundation makes jeopardizing investments, a tax is imposed on the foundation equal to 10% of the amount of the improperly invested assets.

(2) Initial Penalty: Foundation Manager.

Additionally, each foundation manager who willfully participated in the making of the investment knowing that it jeopardized the carrying out of the foundation's exempt purposes is assessed a tax of 10% of the amount of the improper investment (not to exceed $10,000 for each such act).

(3) Additional Penalty: Foundation.

If the jeopardizing investment is not disposed of within the taxable period, the foundation is assessed an additional tax of 25% of the amount improperly invested.

(4) Additional Penalty: Foundation Manager.

Each foundation manager who willfully participated in the making of the investment knowing that it jeopardized the carrying out of the foundation's exempt purposes is assessed an additional tax of 10% of the amount of the improper investment (not to exceed $20,000 for each such act) if the jeopardizing investment is not disposed of within the taxable period.

(5) Taxable Period.

The taxable period begins on the date of investment and ends the earlier of (i) the date of the mailing of a deficiency; (ii) the date on which the tax is assessed; or (iii) the date on which the investment is removed from jeopardy.

E. Operations

1. <u>Internal Management</u>

Although most often managed by a board of directors, Texas law does allow for a member-managed nonprofit organization. In a member-managed organization, the member takes on the duties of a director, and Texas law requires a member annual meeting. If there is a Board of Directors, Texas law requires that at least three people make up the board; these individuals have the voting rights that carry responsibility for making strategic decisions, evaluating, reviewing, overseeing and approving corporate actions. In any event, the management establishes policy of the foundation in accordance with its purposes as set forth in the entity's organizational documents. It also works with donors in acceptance of donations and using the foundation's assets in accordance with its exempt purpose.

Officers may hold multiple offices, but the same person may not serve as both President and Secretary. The officers of the foundation owe duties to implement decisions and policies as established by the Board.

2. <u>Hiring Professional Management</u>

Staff may be needed to administer the programs and handle operations. Directors of the private foundation usually delegate day-to-day management to an executive committee or an executive director. However, a small private foundation that makes grants only once per year generally operates without the necessity of a staff. As noted above, directors should hire appropriate professional advisors as warranted.

a. Delegation of Authority to Invest:

(1) Trusts

The Uniform Prudent Investor Act (Chapter 117 of the Texas Trust Code) was adopted in 2003. It replaces the modified "prudent man" investment standard with the "prudent investor" rule based on the American Law Institute's Restatement (third) of Trusts: Prudent Investor Rule (1992). Under the Uniform Prudent Investor Act, the Trustee must generally diversify the assets of the trust. The Act also codifies the common law duties of loyalty and impartiality. The Trustee may delegate investment and management functions, but may be held liable for actions of the agent under certain circumstances. (See Section 117.011 of the Texas Trust Code). These standards apply effective January 1, 2004 to new and existing trusts.

(2) Corporations

The Board of Directors of a nonprofit corporation is not subject to liability for any action or omission by an advisor if the Board of Directors has acted in good faith and with ordinary care in selecting the advisor. Texas Business Organizations Code ("BOC") § 22.224. The Board of Directors can contract with appropriate investment advisors, trust companies, banks, investment counsel or managers and delegate to them full power and authority to: (i) purchase or otherwise acquire stocks, bonds, securities, and other investments on behalf of the corporation; and (ii) sell, transfer or otherwise dispose of any of the corporation's assets and properties at a time and for a consideration that the advisor deems appropriate.

3. Developing Operating Procedures

Operating procedures should be adopted and strictly followed so as to avoid excise tax complications and avoid jeopardizing the private foundation's charitable status. These procedures include grant application guidelines, and should include, where necessary, review and compliance with procedures to be followed when making grants to foreign grantees, individuals or non-charitable entities. A written statement about the foundation's guidelines, policies, programs of interest, any geographic limitations or other restrictions should be adopted by the board of directors.

4. Making Grants

Grants are distributions by the foundation to other organizations to perform charitable activities within their domain and under their control and such grants must be in an annual amount of at least 5% of the annual fair market value of foundation's assets not used directly to carry out the foundation's exempt purposes, after considering certain qualifying expenses. These grants may be to public charities (those which have received an IRS determination letter stating that the organization is an I.R.C. § 501(c)(3) organization and that it is not a private foundation because it is either classified under I.R.C. § 509(a)(1), 509(a)(2) or 509(a)(3)) or to a governmental unit such as a school board, fire department or public library (as long as the purpose for the grant is a charitable purpose) or to social welfare or civic action organization (under I.R.C. § 501(c)(4)), or trade associations and professional organizations (under I.R.C. § 501(c)(6), such as trade associations, chambers of commerce, real estate boards, boards of trade and similar professional organizations.) However, grants to such civic action organizations or social welfare organizations or trade associations and professional organizations require the foundation to conduct expenditure responsibility in order to avoid penalties. (See discussion regarding "expenditure responsibility.")

a. Grant Making Policy

The foundation should establish policies defining programs of interest and establishing objectives to be served. It should also establish its function and position as how to further its charitable purpose. Many private foundations designate a grant committee to review grant applications and make recommendations to the board of directors.

b. Grant Application Guidelines

Processes for receiving, examining and deciding on grant applications should be established on a clear and logical basis and should be followed in a manner consistent with the organization's policies and purposes. The foundation's written statement about the foundation's guidelines, policies, programs of interest, any geographic limitations or other restrictions should be provided to applicants. Status reports to applicants should be given promptly.

c. Discretionary Grants

The board of directors may also establish a policy allowing each board member to designate grantees of his or her own choosing up to a predetermined amount. An advantage to discretionary grants is that if each board member can designate a portion of the minimum distribution amount, then he or she would not be as self-motivated on discussing and deciding upon the distributions of the remaining minimum distribution amounts, but a conflict of interest may arise as to the director making decisions in favor of certain grantees.

d. Review of Applications

The directors may evaluate applications and put into written form their interests in certain applications. Foundation staff may further investigate potential grants.

e. Grant Agreement

The foundation should require each grantee to sign a Grant Agreement which binds the grantee to use the grant funds for the purposes provided.

f. Reclaiming of Grant Funds

If the grantee fails to follow the Grant Agreement, the foundation can demand repayment of the grant funds.

g. Recordkeeping

The foundation should obtain and maintain documentation reflecting that distributed funds were used for charitable purposes. These records should include:

1. A copy of any Grant Agreement;
2. Reports regarding grant, if any; and
3. Copy of grantee's IRS tax exempt determination letter and documentation that EO Select Check was consulted (available at www.irs.gov and the relevant portion can be printed for the file); and if the grantee is not a public charity, the foundation must keep complete documentation on its expenditure responsibility (see discussion above), or, in the case of a grantee that is a non-U.S. charity, equivalency determination documentation (see discussion above).

h. Grants to Entities of Which a Disqualified Person Serves on the Board of Directors:

(1) Self-Dealing

The foundation may make a distribution to an organization on which a Disqualified Person serves on the board of directors without violating the rules against self-dealing if the Disqualified Person receives no more than an incidental and tenuous benefit from the grant. See Treas. Reg. § 53.4941(d)-2(f)(2). See also Rev. Rul. 75-42, 1975-1 C.B. 359, where the Service determined that two individuals serving as trustees of both organizations did not violate rules against self-dealing because the benefit to Disqualified Persons was only incidental; and Rev. Rul. 82-136, 1982-2 C.B. 300, where the Service determined that a violation of rules against self-dealing did not occur where a bank served as trustee of two foundations where one was making a grant to the other and determined that any benefit received by the Disqualified Person (the bank) was incidental. Determinations should be made on a case by case basis as to whether any benefit is incidental or tenuous.

(2) Controlled Organization

A distribution from the grantee organization is not a qualifying distribution if the donor organization is a "controlled organization". An organization is treated as controlled by the private foundation if one or more of its Disqualified Persons may by aggregating their votes or positions of authority, require the donee organization to make an expenditure or to prevent it from making an expenditure, regardless of the method by which the control is exercised or exercisable. Treas. Reg. § 53.4942(a)-3(a)(3). This is the case whether or not such control is actually exercised.

However, even if the donee organization is a controlled organization, a grant from a foundation will still qualify as a qualifying distribution if within the year in which the grant is made:

1. The donee organization expends for charitable purposes described in I.R.C. § 170(c)(2)(B) an amount equal to the value of the grant not later than the end of the recipient's first taxable year after the taxable year in which the grant is received;
2. If the recipient is a private operating foundation, the redistribution is treated by the foundation as made out of corpus, as if the charity were a private nonoperating foundation; and,
3. The donor foundation obtains adequate records or other sufficient evidence reflecting that the redistribution has been made, the names and addresses of the recipients of the redistributed amount and the amount received by each, and that the redistribution would be treated as made from corpus as if the public charity were a private nonoperating foundation. I.R.C. § 4942(g)(3); Treas. Reg. § 53.4942(a)-3(c)(1).

5. <u>Advisory Board</u>

Often directors form an advisory board to advise them on policy matters. This advisory board is generally made up of professionals and other persons having expertise in differing areas that impact the foundation. This board lacks governing authority over the private foundation and cannot legally bind the private foundation.

6. <u>Governance</u>

The private foundation through its board of directors, committees and managers, should adopt policies as to governance and other related matters. Although not mandated, care should be taken to consider adoption of policies appearing on Form 990-PF.

7. <u>Compensation and Other Expenses</u>

No part of the net earnings of a private foundation may inure to the benefit of any individual. Private inurement can cause the exempt organization to lose its tax exempt status. However, payments of compensation that are reasonable and necessary and not excessive may be paid to employees, consultants and others. Such compensation does not violate the restriction upon acts of self-dealing. Directors of private foundations often, however, serve without compensation. The private foundation may pay for the directors' liability insurance and reimburse the director for out-of-pocket expenses (subject to the restrictions upon acts of self-dealing). Federal law requires that the salaries and benefits of the private foundation's highest paid employees (>$50,000) and all directors be disclosed to the public on the foundation's annual information return.

8. Outside Audit

Although not required, many foundations obtain outside audits to shield the directors from potential liability.

9. Insurance

Private foundations should and generally do purchase liability insurance and property insurance. Often, the insurance includes that for officers and directors ("D&O Insurance"). D&O Insurance protects the foundation and the directors from the costs of legal defense and the payment of certain losses where there is no bodily injury or property damage but is generally resulting from some wrongful act, including breach of duty, neglect, error, misstatement, misleading statement, omission, or other acts done or wrongfully attempted. Claims generally covered included those for wrongful termination, discrimination in employment, sexual harassment, breach of fiduciary duty, self-dealing violations and failure to timely file tax returns. The D&O policy generally is designed to pay attorney's fees and court costs.

10. Employment

The private foundation must comply with all federal, state and local employment laws, including withholding and other taxes applicable to private sector employers.

11. Documents Subject to Inspection

Applications for exempt status, annual returns (Form 990-PF) and unrelated business income tax returns (Form 990-T) must be made available for public inspection at the private foundation's office. Annual returns for many exempt organizations are available at www.guidestar.org.

V. DONOR ADVISED FUND

A. Operations and Features

A DAF is a helpful and popular alternative for the modern day donor who does not want to run his or her own private foundation. A DAF is created by an outright gift, by either an individual or another entity such as a private foundation, to the sponsoring charitable organization which has legal control over the fund. Treas. Reg. § 1.170A-9(e)(11)(ii); Levitt, D.A., "Impact Investing Through a Donor-Advised Fund", 25 Taxation of Exempts, No. 5, 3 (March/April 2014). The sponsoring organization typically has a large network of internal management and investment advisors, which provide oversight to the collection of DAFs, yielding a significant level of service to the donor that he may not be able to achieve with his own private foundation. The sponsoring organization is usually a local community foundation or the charitable affiliate of a financial services provider. *See* Levitt. The donor can name the DAF after their family or use a completely anonymous name. The assets contributed to the DAF (which can include a variety of asset types) will be invested by the sponsoring organization and grow tax-free over time.

The DAF agreement allows the donor (or someone appointed by the donor) to advise the charity on what distributions to make from the DAF; however, the sponsoring public charity is the legal owner of the funds and thus has the ultimate control over the distributions. It is crucial that the advisor's rights to the DAF are just that – advisory only – and that all ownership and control is transferred to the sponsoring organization. While this does require some level of trust on the part of the donor, this is in the basic nature of the DAF giving vehicle.

Some sponsoring organizations offer mission-related allocation with existing general investment pools, investment pools specifically dedicated to a mission related purpose, and other options provided as an opportunity to further donors' chosen social missions. *Id.*

A donor who has illiquid assets can convert those assets into philanthropic capital through the use of a DAF. Additionally, a private foundation may create a DAF to receive the types of assets it deems inappropriate to accept and manage itself, while still fulfilling its charitable purpose.

DAF investments are subject to the UBIT rules explained above; however, mission-related investments would avoid UBIT if they qualify as "substantially related" to the charity's exempt purposes. To otherwise avoid UBIT, the DAF should invest in assets meeting a statutory exception, such as limited partnership interests owning only passive investments. While the sponsoring public charity would be responsible for reporting and paying any UBIT, the tax would likely be allocated to the individual DAF in which the investment is made. *Id.*

A private foundation (which could include a charitable trust) may find a DAF useful in certain scenarios and can include the contribution as a qualifying distribution in the year of the contribution. *Id.* It may also be possible for a foundation's distribution to a DAF to reduce its excise tax on net investment income from 2% to 1%. Choi, William, "Donor-Advised Funds: Practical Problems with Equally Practical Solutions", CV018 ALI-CLE 385, 402. The assets distributed to the DAF can then be advised over time, and the foundation avoids the complex management and oversight of assets that it does not have the resources to handle itself. It is suggested, however, that the private foundation should avoid just passing grants through a DAF or indefinitely parking assets in the DAF. Rather, the foundation should approach the DAF with a consistent plan of contributing funds and recommending distributions to a variety of grantees. *Id.*

B. Creation

To establish a DAF, the donor would enter into an agreement that gives the donor (and/or others) the right to suggest from time to time to the organization the proposed recipients of distributions from the fund and the timing and amount of these distributions – such person(s) are identified as the "donor advisors".

To ensure that the fund is treated as a component fund of the particular public charity maintaining it, the agreement must provide that the charity is not required to follow donor's advice and that the charity will have ultimate control over distributions from the fund. In practice, the charity is likely to follow most, if not all, of donor's suggestions. However, an IRS ruling suggests that, in order for such a fund to qualify as an advise-and-consult fund which is not a private foundation, the charity maintaining the fund may be required, from time to time, to make distributions to organizations other than those suggested by the donor. *Id.*

C. Tax Treatment by Donors of Contributions

An individual donor can take an immediate charitable contribution deduction in the year the gift to the DAF is made, because the donated property becomes the asset of the sponsoring organization upon donation. Because DAFs are typically maintained by public charities, donors receive more favorable tax treatment for their contributions than making the same gift to a private foundation: a gift of property such as real estate or closely held business interests is entitled to a deduction for fair market value when contributed to a public charity, including a DAF, but limited to basis when making the same contribution to a private foundation. In addition, the limits on a taxpayer's deductions which can be taken each year are greater than with a gift made to a private foundation (50% of AGI for cash and 30% for appreciated property, as opposed to 30% and 20%, respectively). *See* Heisman, 41 Estate Planning, No. 7, 27; Levitt, 25 Taxation of Exempts, No. 5; Choi, CV018 ALI-CLE 385.

D. Federal Tax Sanctions Applicable to DAFs

The Pension Protection Act of 2006 ("PPA") extended certain excise tax provisions to DAFs including the private foundation excess business holdings rules and a more stringent form of the excess benefit transaction prohibition on public charities. DAFs do not have a minimum payout requirement, although that may soon change with the Treasury having been put to the task of further studying the issue. The PPA mandated the Treasury Department specifically consider whether the existing deduction rules for contributions to DAFs are appropriate, whether DAFs should be subject to distribution requirements and whether a donor's advisory role in the investment or distribution of donated funds is consistent with a completed gift. 38.06 Community Foundation, WG&L Estate Planning Treatises, Estate Planning and Wealth Preservation: Strategies and Solutions – Henkel, note 62.2a. A copy of this study was submitted to Congress on December 5, 2011. Co-investments involving a DAF and donor or donor advisor may raise concerns of improperly benefitting the donor or donor advisor and incurring some of these taxes. Levitt, D.A., "Impact Investing Through a Donor-Advised Fund", 25 Taxation of Exempts, No. 5, 3 (March/April 2014). However, tax guidance in this area is very limited, as there are no Treasury regulations interpreting the Code provisions imposing these restrictions, making the tax concerns of a sponsoring organization more complex with unclear results.

1. <u>Excess Benefit Transactions</u>

a. Section 4958 Generally

Public charities are not subject to the private foundation excise taxes, but are instead subject to intermediate sanctions for excess benefit transactions involving a "disqualified person." Transactions between the public charity and a disqualified person must be made at fair market value; any excess benefit above the value of what the disqualified person gave to the charity, including the provision of services, is considered "excess benefit." I.R.C. § 4958. The rules apply an excise tax on both the disqualified person and any organizational manager who participated in the transaction which improperly benefited the disqualified person. *Id.*

A disqualified person under this provision is defined as a person who, at any time during the five-year period before the date of the transaction, was in a position to exercise substantial influence over the affairs of the organization. *Id.* That person's family and business, if he or she owns 35% or more of that business, are also included in the definition of "disqualified person." *Id.* Persons who have substantial influence would include presidents, chief executive officers, chief operating officers, treasurers, and persons with a material financial interest in a provider-sponsored organization. Treas. Reg. § 53.4958-3. Persons who are deemed to not have substantial influence include tax exempt organizations listed in section 501(c)(3), certain 501(c)(4) organizations, and employees receiving economic benefits of less than a specified amount each taxable year. *Id.* In other instances, facts and circumstances will govern; facts and circumstances that tend to show substantial influence include: someone who founded the organization, a person who is a substantial contributor, whether the person's compensation is primarily based on revenues derived from activities of the organization, whether the person has or shares authority to control or determine a substantial portion of the charity's capital expenditures, whether the person has managerial authority or is a key advisor to someone with managerial authority, and whether the person has a controlling interest in an organization which is a disqualified person. *Id.*

Payments to a disqualified person are rebuttably presumed reasonable, and therefore not an excess benefit transaction, if: (1) the transaction was approved by an authorized body of the organization composed of non-conflicted individuals; (2) prior to making the determination of approval, the authorized body obtained and relied upon appropriate comparability data; and (3) the authorized body adequately documented the basis for the determination concurrently with making its decision of approval. Treas. Reg. § 53.4958-6. If all three of these requirements are met, the Service can only rebut the presumption if it develops sufficient evidence to rebut the value of the data relied upon by the authorized body. *Id.*

The consequences of an excess benefit transaction involve a two-tier excise tax on the disqualified person, as well as an additional excise tax on an organizational manager who knowingly participates. I.R.C. § 4958. The disqualified person must pay an excise tax equal to twenty-five percent (25%) of the excess benefit and return the excess benefit to correct the error. *Id.* The term "correct" means, with respect to any excess benefit transaction, undoing the excess benefit to the extent possible, and taking any additional measures necessary to place the organization in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards. *Id.* The organization is not required to rescind the underlying agreement; however, the parties may need to modify an ongoing contract with respect to future payments. http://www.irs.gov/Charities-&-Non-Profits/Charitable-Organizations/Intermediate-Sanctions-Excess-Benefit-Transactions. Additionally, if the excess benefit transaction is not corrected within the taxable period, the disqualified person must pay another two hundred percent (200%) tax of the excess benefit. *Id.* An organizational manager who participated in the transaction, knowing it was such a transaction, is liable for an excise tax of ten percent (10%) of the excess benefit, up to $10,000, unless the participation was not willful and was due to reasonable cause. If the organizational manager was also the disqualified person who received the excess benefit, he or she can be subject to both of the excise taxes. *Id.*

b. Application to DAFs

The PPA extended the excess benefit rules of section 4958 to DAFs, and made the prohibition harsher in application to DAFs than public charities. Section 4958(c)(2) provides that any grant, loan, compensation or "other similar payment" from a DAF to a disqualified person is automatically considered an excess benefit transaction. This would mean items such as expense reimbursement or compensation are considered excess benefit transactions in the context of a DAF. For transactions involving a DAF, disqualified persons include donors, donor advisors, their family members (spouse, ancestors, children, descendants, siblings and their spouses) and certain 35% controlled entities related to them. The full amount of such payment is considered the amount of the excess benefit, not just the differential between the value of economic benefit provided to the disqualified person and the consideration received by the organization, as it is under the general 4958 rules.

The excise tax of 25% of the excess benefit must be paid by the disqualified person receiving such benefits. I.R.C. § 4958(a). Also, the disqualified person must in essence correct the excess benefit by returning the amount of the excess benefits to the sponsoring organization; however, the correction cannot be held in a DAF. *Id.*; Joint Committee on Taxation, *Technical Explanation of H.R.4, the "Pension Protection Act of 2006", As Passed by the House on July 28, 2006, and As Considered by the Senate on August 3, 2006* (the "JCT" Report"; JCX-38-06) page 347. An additional 10% tax can be imposed on a fund manager who agreed to making the distribution, knowing it would be considered an excess benefit. I.R.C. § 4958.

Thus, any DAF investment should avoid a payment or loan to a donor advisor disqualified person. For example, if the donor is the general partner in a limited partnership of which the DAF is an owner, and he receives compensation in his role, the DAF could be considered to be providing compensation to the donor advisor, triggering these excess benefit penalties. Levitt, D.A., "Impact Investing Through a Donor-Advised Fund", 25 Taxation of Exempts, No. 5, 3 (March/April 2014).

In addition to these automatic excess benefit transactions, any other transaction involving a disqualified person and the DAF, or involving an investment advisor and the sponsoring organization, would be subject to the general rules of section 4958. *See id.* When the transaction involves the sponsoring organization, but not necessarily a DAF, the group of disqualified persons also includes an investment advisor (and related parties or entities) with respect to the sponsoring organization. The term "investment advisor" means, with respect to any sponsoring organization, any person (other than an employee of such organization) compensated by such organization for managing the investment of, or providing investment advice with respect to, assets maintained in DAFs owned by such organization. I.R.C. § 4958.

A payment pursuant to a bona fide sale or lease of property is not included within the term "other similar payment" for purposes of the automatic excess benefit rules. Rather, such sale would be subject to the general rules of section 4958. Thus, if a donor to a DAF purchased securities (originally contributed by the donor to the DAF) from the DAF, the purchase is subject to the rules of 4958 because the donor is a disqualified person to the DAF; but, section 4958 would only cause excise tax if the purchase was made for less than fair market value (for example, if the purchase is made for less than the amount the donor claimed the securities were worth for purposes of his charitable deduction). If the donor were to purchase the securities directly from the sponsoring organization, rather than from the DAF, the transaction would not even be within the purview of 4958. However, if a donor is contemplating the purchase back of an asset from his or her DAF, even at fair market value (preferably using the same appraisal information which is being used for his initial gift), the donor should consider whether a different form of a charitable planning vehicle would be a more viable option than his or her own DAF.

Some sponsoring organizations may want to obtain a certification from donor advisors that the distribution the advisor is recommending will not result in an impermissible benefit to the donor, donor advisor or related parties. Assuming the fund manager does not have actual knowledge that such distribution will result in an impermissible benefit, then obtaining such certification can potentially enable fund managers to avoid penalties; however, the fund manager should be fully cognizant of the law and how the law may apply to the facts. Choi, William, Donor-Advised Funds: Practical Problems with Equally Practical Solutions, CV018 ALI-CLE 385, 402.

2. <u>Application of Private Foundation Excise Taxes</u>

a. Prohibited Insider Benefit

Section 4967 imposes an excise tax on insider benefits, if due to a donor advisor recommendation, the sponsoring organization makes a distribution by which a DAF Insider (either the donor, donor advisor, or a related party, i.e. a member of his/her family or a 35% controlled entity of them) receives, directly or indirectly, more than an incidental benefit. The legislative history of the PPA provides that there is "more than an incidental benefit" under this section if as a result of the DAF distribution, a donor or donor advisor receives a benefit that would have reduced a charitable contribution deduction if the benefit was received by the donor or donor advisor as part of the contribution in a direct donation to the sponsoring organization. Joint Committee on Taxation, *Technical Explanation of H.R.4, the "Pension Protection Act of 2006", As Passed by the House on July 28, 2006, and As Considered by the Senate on August 3, 2006* (the "JCT" Report"; JCX-38-06) page 350. For example, if a donor advises a distribution to a public radio station and receives token benefits such as key chains with the station's logo, because the benefits received would not have reduced the donor's charitable contribution deduction had he made the contribution directly, the donor is not considered to have received more than an incidental benefit. Choi, CV018 ALI-CLE 385. The DAF Insider receiving such benefit as a result of the distribution must pay a tax equal to 125% of such improper benefit; if multiple persons are liable for that distribution, all such persons will be jointly and severally liable. In addition, the fund manager who agreed to the distribution, knowing it would confer an insider benefit, will be assessed a tax equal to 10% of such amount, up to $10,000 per improper distribution. I.R.C. § 4967. However, if the transaction also incurred a tax under section 4958 as an excess benefit transaction, the tax under this prohibition will not be imposed.

b. Taxable Distributions

If a taxable distribution is made from a DAF, a 20% excise tax on the amount of the distribution is imposed on the fund sponsoring organization, and a 5% tax is imposed on a fund manager who agreed to the distribution knowing it was a taxable distribution. I.R.C. § 4966. A taxable distribution is any distribution (1) to a natural person or (2) to any other person, if the distribution is not for a charitable purpose, or if the sponsoring organization does not exercise expenditure responsibility. Expenditure responsibility is another private foundation concept (of section 4945(h)), but has not been specifically applied to DAFs through IRS guidance.

Distributions are not "taxable" if made to: (i) certain 50% charities (public charities and private operating foundations), other than disqualified supporting organizations, (ii) the sponsoring organization of the DAF and (iii) another DAF. Thus, a sponsoring organization can make distributions from a DAF to most public charities and to other types of grantees (other than individuals) so long as it is for a charitable purpose and the organization exercises expenditure responsibility over the grants.

A disqualified supporting organization is a Type III supporting organization which is not functionally integrated, and a Type I or Type II supporting organization if the donor (or donor's appointee) and any related parties directly or indirectly control a supported organization of the supporting organization. *Id.* Reliance criteria has been provided to private foundations and sponsoring organizations that sponsor DAFs in determining whether a potential grantee is a proper supporting organization, in Revenue Procedure 2011-33, 2011-25 IRB. 34 Am. Jur. 2d Federal Taxation ¶ 18967.

c. Excess Business Holdings

The PPA also extended the private foundation excess business holdings rules to DAFs. Disqualified persons for this purpose includes a donor, donor advisor, his/her family members and entities which are at least 35% controlled by either. DAFs receiving gifts of interests in a business entity have 5 years to dispose of the holdings over the permitted amount, with the possibility of having an additional 5 years if approved by the Treasury Secretary.

3. Prudent Investment/Application of UPMIFA

As seen earlier, certain federal tax rules apply to sponsoring organizations which affect their investment decisions; however, uncertainty lies in the intersection of some of these principles and the prudent investment standards. An outstanding question is whether an investment must be considered prudent in terms of the overall assets of the sponsoring organization or in terms of each individual DAF. Levitt, D.A., "Impact Investing Through a Donor-Advised Fund", 25 Taxation of Exempts, No. 5, 3 (March/April 2014). To the extent a sponsoring organization segregates a DAF and makes investments separately from each DAF, rather than pooling funds, a state attorney general could very well take the position that each individual DAF is an "institutional fund" subject to UPMIFA. This position could make it more difficult to meet the goal of a diversified portfolio, as each investment would make up a larger portion of the DAF's overall portfolio assets. A state attorney general could also look into the issue of whether the managers of the sponsoring organization have violated fiduciary duties by not properly diversifying the individual DAF. Until more guidance is provided, the safer course of action is to attempt to achieve diversification at both the DAF and sponsoring organization levels.

Further, because donor intent can override the statutory investment standards, a sponsoring organization should procure a written record of the donor's approval of specific investments, or types of investments, that the donor desires to be a part of his or her DAF. It may be well advised that the organization obtain a letter from the donor at the time of the initial contribution authorizing the investments the sponsoring organization otherwise would not want to make under the standards of prudent investment. However, it is debatable as to whether the sponsoring organization should go as far as to allow the donor to approve, and recommend, an investment outside of the organization's investment policy - this could be viewed as an imprudent management of the organization's assets. For example, the Council on Foundations suggests that allowing the approval of an investment as well as an investment strategy outside of the organization's standard investment policy could be seen as excessive donor control over the DAF. *Id.*

Private foundations have the ability to rely on the exception from the jeopardizing investment rules for program-related investments ("PRIs"); however, there is no parallel definition of a PRI for a public charity, including DAF sponsoring organizations (and the 4944 jeopardizing investment restrictions have not been extended to apply to DAFs). *Id.* PRIs are those investments made primarily to accomplish the organization's exempt purposes, rather than to produce income. To qualify as a PRI, the following must be met: (i) the primary purpose of the investment is to further at least one exempt purpose of the foundation, (ii) the production of income or appreciation of property may not be a significant purpose of the investment, and (iii) no electioneering (and only very limited lobbying) purposes may be served by the investment. If an investment is considered an allowable PRI for a foundation, it seems reasonable that the same or similar investments would be permissible for other organizations less heavily regulated than private foundations. *Id.*

The uncertainty lies in whether the IRS will distinguish PRIs from other investments of a DAF. If an investment by a DAF would be a PRI to a private foundation, should that investment provide the tax advantages to the DAF as it would to a private foundation? For example, PRIs are exempt from a foundation's excess business holding restrictions, which have now been applied to DAFs. Additionally, there is the question of whether a DAF investment could be exempt from the state law prudent investor standards, if it would be considered a PRI to a private foundation. *Id.*

If a donor is specifically concerned about these uncertainties regarding the proper investments of a DAF, the donor could create a field of interest fund or designated fund at a sponsoring organization, which are not included within the Code definition of a DAF, and thus would not be subject to these rules. *Id.* A field of interest fund involves multiple donors, who pool their funds to support a particular charitable field or program area, such as education or medical research. *Id.;* Choi, CV018 ALI-CLE 385. Unlike the advice for a DAF, the designation of a field of interest can be legally binding on the charity sponsoring the fund, subject only to an ability to change the field of interest in a limited capacity (and depending on the charity's variance power). Choi, CV018 ALI-CLE 385. A designated fund is one that makes distributions to one or more specified charities: it allows a donor to provide long-term funding to a charity when the donor has concerns regarding the charity's own ability to manage the funds. Again, the charity generally cannot make distributions to other charities unless it becomes impossible or impractical to follow the donor's designation (and any successor charity must be substantially similar). *Id.*

VI. COMPARE AND CONTRAST

Since many donors see family involvement as an important priority in giving, either a foundation or DAF presents potential for an advisor to build a bridge to the next generation. The biggest difference between the two is that a foundation is its own legal entity, controlled by the founder/donor, while the DAF is an account controlled by the sponsoring public charity. Clearly, the creation of a private foundation requires much more administratively, both initially and annually, than do DAFs, and private foundations must comply with a variety of special rules and sanctions. The allowable contribution deductions for gifts to private foundations are less than those afforded to public charities (and thus a DAF).

In addition to the charitable deduction benefits to individual donors, DAFs provide several advantages to donors: (i) DAFs are relatively simple and quick to establish; (ii) the sponsoring organization administers the fund, relieving the donor of the complexities of administration; (iii) the sponsor organization assumes all risk related to managing and investing the assets; and (iv) compliance with some of the strict private foundation requirements are not necessary, as discussed above. 38.06 Community Foundation, WG&L Estate Planning Treatises, Estate Planning and Wealth Preservation: Strategies and Solutions – Henkel, note 62.2a.; E.R. Heisman, "Donor-Advised Funds Gain Popularity for Charitable Giving", 41 Estate Planning, No. 7, 27 (July 2014). The main disadvantage is that the donor must surrender absolute control over the fund, although the supporting organization has a practical incentive to cooperate with recommendations by the donor. 38.06 Community Foundation, WG&L Estate Planning Treatises, Estate Planning and Wealth Preservation: Strategies and Solutions – Henkel, note 62.2a.

A private foundation may actually itself use a DAF when it needs to pay out its required 5%, but wants or needs more time to determine exactly where those funds are to be distributed, when it desires anonymity, or when it desires to make a gift outside of its core purpose areas.

However, if a donor desires to have control of the organization's distributions and is not concerned about the reduced income tax percentage deduction limitations applicable to private foundations, the donor may want to consider creating a private foundation. Further, if the donor is interested in international giving, or if he/she desires to make gifts to individuals, such gifts would need to be made through a private foundation.

A. Donor Control

Establishing and funding a private foundation allows the donor to feel satisfied that he or she is returning something to society. It provides more control to the donor than does a donation to a community foundation or supporting organization because the donor has the right to distribute the foundation assets to organizations (public charities) he or she prefers and he or she can stay in control of the foundation's investments. Thus, the foundation often makes the donations for the family. Additionally, the family can stay in control over time by specially drafting into the organizational documents that family members are to serve on the board of directors. It also gives the younger family members an opportunity to participate in a meaningful endeavor and become familiar with the charitable goals, intentions and business and management philosophies of the foundation creator. If the foundation employs family members, compensation must be reasonable under I.R.C. § 4941. This should be contrasted with the prohibition arising from the Pension Protection Act of 2006 on payment of any compensation to substantial contributors or their family members by supporting organizations. Additionally, the private foundation is not beholden to public memberships, nor is it required to continuously raise funds. Further it enables the donor to evaluate grant seekers' proposals against the charitable goals of the foundation without being bombarded by the charities and provides anonymity in giving. It also is a vehicle which allows for contributions to foreign organizations.

Quite the opposite, the DAF does not allow the donor much control following the gift being made, nor does the donor have any control over the investments. The gift becomes the property of the sponsoring organization which then has ultimate authority regarding all aspects of the gifted property: investment, management, and disposition. While the donor may *advise* the sponsoring charity as to what grants he or she would like to be made, the decision is no longer in his/her control and the asset management of the DAF are typically limited to the investment pools offered by the sponsoring organization. Further, note should be taken that some sponsoring organizations only allow the family to have advisory privileges for a certain amount of time (such as one or two generations) and then the DAF reverts to the sponsoring organization.

The silver lining to this downfall of the DAF option is that the donor also does not have the responsibilities related to the management of the DAF like the administrative responsibilities of a foundation.

B. Start-Up and Administration

DAFs in the U.S. outnumber all other charitable giving vehicles (including charitable remainder trusts, charitable remainder annuity trusts, charitable lead trusts, pooled income funds, and private foundations) combined. E.R. Heisman, 41 Estate Planning, No. 7, 27 (July 2014). This tremendous growth is due to the flexibility and ease in creating and managing DAFs: they can be created relatively quickly, the sponsoring organization can accept a large variety of assets, and donors can select among pre-approved investments and recommend grants online. Additionally, the donor does not need to have millions of dollars to have a philanthropic vehicle—like a private foundation. The DAF alternative saves donors both time and money in achieving their philanthropic vision. *Id.*

There are typically no start-up costs for establishing a DAF, while the start-up costs of creating a private foundation can be substantial: legal fees in addition to filing fees will amount to thousands of dollars, plus the time (usually several months) from the beginning of the process until receipt of the IRS determination letter. Further, the ongoing administrative burdens of running a private foundation will cost time while the administrative burdens of a DAF are born by the sponsoring charity, not the donor.

Unlike establishing a private foundation, there a minimal initial gift needed to justify the creation of a DAF. The amount needed to fund a DAF will depend on the sponsoring organization's own internal requirements ($5,000 to $25,000 is standard). However, it will most certainly be a lower threshold than that which makes the formation of a private foundation "worth" the legal fees and months it takes to create. This may come as a welcome surprise, and comforting thought, to your charitably-inclined client who may be considering a relatively small gift now, but may also want to build onto those gifts in the future and/or use the DAF in his or her estate plan at death. Typically, we suggest that a client who wants to create a private foundation should envision making at least $1M gift, with additional gifting in the future.

Once the DAF is established, the sponsoring organization handles all of the investments, recordkeeping, tax receipts and grant administration. This allows the donor to focus on their charitable initiatives, rather than keeping up with the administrative requirements of a private foundation. Further, small private foundations usually do not have the resources themselves to complete these tasks and may need to hire staff or outside advisors to manage these administrative and tax matters. Private foundations also must stay current with board meetings, file tax returns and other standards of good governance. If a donor does not want the administrative burden of operating a private foundation, the donor should consider creating a donor advised fund through a community foundation.

C. Grant Recipients

While the private foundation does have substantial hurtles to its creation, one benefit is the broad type of grants that can be made, while the grants which can be made from the DAF are more restricted: donors cannot recommend that charitable grants be made to individuals, or pay tuition to private schools or colleges. Additionally, donors cannot receive any goods or services in exchange for their grant, like a ticket to a gala. E.R. Heisman, 41 Estate Planning, No. 7, 27 (July 2014). Conversely, private foundations can support international organizations, establish scholarship programs, grant directly to individuals in need (with oversight) and run their own charitable activities. https://www.foundationsource.com/resources/library/private-foundation-vs-donor-advised-fund-comparison-chart/.

D. Tax Benefits to Donor

DAFs offer the maximum income tax deductions possible under federal law: donors receive an immediate income tax deduction upon contribution to their DAF. The limit will be between 30% and 50% of the donor's AGI, depending on the type of asset contributed, in comparison with the 20% or 30% AGI limitation applicable to gifts made to private foundations. Additionally, contributions to a DAF are eligible for a full fair market value deductions, whereas gifts of certain assets to a private foundation are limited to deducting the asset's cost basis.

It is important to keep in mind that although the potential charitable deduction for the donor is greater when making a gift to a DAF than a private non-operating foundation[1], this will really only matter to a donor whose charitable gift represents a significant portion of his or her adjusted gross income. Lesley Bosch Annen and Gary Garcia, "Family Foundation vs. Donor-Advised Fund: Choosing the Right Philanthropic Entity for Your Client," <u>Family</u>

[1] Gifts of long-term capital gain property other than publicly traded securities donated to a private non-operating foundation are limited to the donor's basis in the property, but a gift of the same property to a donor advised fund is not subject to the same restriction.

Foundation Advisor, Vol. 13, No. 3, March/April 2014, p. 7.

DAFs can be a great approach for a donor in the year of a windfall, such as the receipt of a large inheritance or liquidation of a business, in order to reduce income tax burdens. Heisman, 41 Estate Planning, No. 7, 27. If a donor were to liquidate securities and donate the proceeds to his or her DAF, the amount would be reduced by capital gains, whereas if the donor donated the securities directly to the DAF, the donor could avoid capital gains and allow the charity to sell the securities (if the charity deems sale prudent). *Id.*

DAFs can also be useful for making contributions of illiquid and interesting asset classes, while the management of bizarre assets by a foundation is more burdensome. Examples include a Boeing 747, $800,000 of trees or a Mexican beach house, all of which have been steered into DAFs, so that the wealthy individuals could keep their liquid securities, but still make charitable gifts in strategic ways of assets they do not normally consider a key part of their overall wealth for everyday living expenses. Dagher, Veronica, "Keep the Stock, Donate the Beans," THE WALL STREET JOURNAL, Nov. 28, 2011, available at http://online.wsj.com/news/articles/SB10001424052970204394804577007992610748490. These methods provide a way for some individuals to make a larger gift than they could have made if solely relying on more liquid assets. Note, that when contributed to a DAF, asset types other than cash, cash equivalents or publicly traded securities are typically liquidated immediately by the sponsoring organization. https://www.foundationsource.com/resources/library/private-foundation-vs-donor-advised-fund-comparison-chart/.

Finally, because of the difference in tax treatments, if a donor has or desires to create a charitable remainder trust, the remainder charity should be a public charity, and thus his/her DAF would be a proper recipient of that remainder.

E. Privacy

Unlike the private foundation, the creators, donors and substantial contributors to a DAF can retain complete anonymity, if desired. The name of the DAF can be unrelated to the family and the donor's name never has to be disclosed.

A private foundation must file annual reports which disclose the board members, grant recipients, etc., which do not allow the donor to remain anonymous. A private foundation's tax returns (990PF) also must list the name of the managers (i.e. board members), while the donor advisors are not listed on a publicly filed document.

F. Excise Taxes

The trade-off of a private foundation's benefit of donor control is the application of the excise tax system, including annual excise tax of 2% on net investment income, which prevents the private foundation from abusing the greater flexibility and control that it has.

The private foundation has its payout requirements (discussed above), while no payout minimum applies to a DAF. (Keep in mind, the sponsoring organization may itself have its own suggested or advised minimum payouts but there is no federal requirement currently).

However, the DAF is not without any excise tax penalties of its own: DAFs are subject to more strict excess benefit rules when compared to the self-dealing rules of a foundation (*no* compensation is allowed to be paid from a DAF, while reasonable/necessary compensation is allowable from a private foundation and *no* expense reimbursement may be made from a DAF), and the excess business holding rules are equally applicable to both types of giving vehicles.

G. Certainty in Law

There are currently no regulations with respect to Code section 4966 (establishing the DAF principals), while we have a slew of regulations applicable to private foundations. Specifically, there is still some uncertainty in how UPMIFA applies to DAFs and what rules may be changed in the near future regarding the management and distributions required of DAFs; in contrast, private foundations are a more established charitable giving technique, with the rules and regulations having been fleshed out over a longer time period. Although the tax restrictions may seem overwhelming, there is a longer history of foundations and thus more guidance providing a level of certainty on the management and operations of the foundation vehicle.

VII. DRAFTING CONSIDERATIONS AND FORMS

A. Private Foundation

Because a private foundation is an entity, the first choice made will be what form of entity is desired: either a corporation (governed by the Texas Business Organizations Code) or a trust (governed by the Texas Trust Code).

Creating a private foundation is really a two-step process: the organization must be formed at the state level, then the organization applies for federal income tax exemption with the IRS. Thus, the governing documents must fulfill the requirements of both state and federal law. The complete establishment process can take several months to even a year, including the wait time to receive an exemption letter from the IRS.

Since the costs of reporting, hiring professional advisors (legal, tax reporting and investment, etc.) and the reporting requirements of the foundation are significant, it is not generally considered cost effective in the mind of many legal advisors to create such a private foundation unless the donor has significant charitable inclinations and the funding is expected to be $1,000,000 or more (though some institutions are providing administrative services to encourage smaller foundations).

1. Choice of Form

When you and your client have decided a private foundation is the preferred charitable giving method, the first step is to determine the choice of form at the state law level. Within the broad rubric of the nonprofit sector only a limited number of organizational forms are eligible for tax-exempt status: (1) charitable trust; (2) nonprofit corporation; (3) unincorporated association; and (4) limited liability company. Each of these types of entities has unique characteristics and considerations. Because the charitable trust and nonprofit corporation are most commonly used for private foundations, they will be discussed first.

a. Charitable Trusts:

Charitable trusts are the oldest type of nonprofit entity tracing their roots back to the Statute of Charitable Uses of 1601. 43 Elizabeth, Chapter 4 (England 1601). A charitable trust is created by a settlor irrevocably transferring property to a person or entity as trustee with the intention of creating a charitable trust. Charitable trusts created in Texas are governed by the Texas Trust Code as well as common law relating to trusts and are subject to the oversight authority of the Texas Attorney General. Aside from the benefit of having many years of established case law, many organizers choose charitable trusts as the organizational form of their entity because of the rigidity of trusts. A settlor is able to establish the trust with specific purposes and be assured that the trust will operate for those purposes absent court intervention. The settlor also has the security of knowing the trustee(s) will be held to a stricter application of fiduciary standards in performing his or her duties.

While the rigidity of trusts can be viewed as a benefit, that same feature may be viewed as inflexibility and thus may be viewed as a detriment to others looking to choose an entity. The ability to modify a trust requires court intervention and is not automatic. Trustees must follow different rules as to their investments as well as their ability to delegate duties. Trustees are additionally subject to more stringent conflict of interest and self-dealing prohibitions and must meet a higher standard for indemnification as compared to directors of unincorporated associations or nonprofit corporations.

b. Nonprofit Corporations:

Perhaps the most commonly used entity for exemption under Section 501(c) is a nonprofit corporation. Nonprofit corporations in Texas are governed by Chapter 22 of the Texas Business Organizations Code ("BOC"). See Tex. Bus. Orgs. Code Ann § 22.001 et. seq. The BOC defines a nonprofit corporation as a corporation no part of the income of which is distributable to a member, director or officer of the corporation. See id. at § 22.001(5). It is helpful to note here that income may be distributed to individuals performing services on behalf of the corporation in the form of salary as long as those salaries are reasonable and commensurate with the services rendered. Nonprofit corporations in Texas may be organized for any lawful purpose, but keep in mind that to qualify for recognition of exemption the corporation must be organized with an appropriate purpose identified (e.g. religious, charitable, educational, etc. for Section 501(c)(3) organizations). Pursuant to Chapters 2 and 22 of the BOC, nonprofit corporations have the ability to perpetually exist, to sue and be sued in their corporate name, purchase, lease, or own property in the corporate name, lend money (so long as the loan is not made to a director), contract, make donations for the public welfare, and exercise other powers consistent with their purposes. See Tex. Bus. Orgs. Code Ann. §§ 2.001-002, 2.101-102, 3.003 and 22.054. While having extensive powers, nonprofit corporations remain internally flexible with the power to amend their operations and purposes through board (or member) action. Whereas unincorporated associations lack extensive statutory guidelines and case law guidance, nonprofit corporations in Texas have Chapter 22 and its predecessor, the Texas Non-Profit Corporation Act, with extensive case law interpreting it, as well as the ability to analogize to for profit corporate law.

There are few drawbacks to organizing as a nonprofit corporation, particularly when the organization will be seeking federal tax exemption under Section 501(c)(3). While establishing and maintaining a nonprofit corporation does require more work (and therefore more expense) as compared to an unincorporated association, the same work will have to be done for an unincorporated association in the event that it is seeking federal tax exemption. Furthermore, while a nonprofit corporation is subject to the Texas franchise tax, certain federal exemptions (including under Sections 501(c)(3) and 501(c)(4)) qualify the organization for exemption from the franchise tax as well. Finally, many of the various rules that are required for nonprofit corporations applying for exemption (such as specific dissolution clauses and the like under Section 501(c)(3)) are a requirement for any organization seeking exemption. Absent specific circumstances such as an organizer wishing to set up a Section 501(c)(3) entity as a charitable trust to take advantage of the specific characteristics and benefits of such an entity, it is generally most beneficial to organize as a nonprofit corporation.

c. Nonprofit Unincorporated Associations:

Unincorporated associations are the default nonprofit organization in Texas. Texas defines a nonprofit unincorporated association as an unincorporated organization, other than one created by a trust, consisting of three or more members joined by mutual consent for a common, nonprofit purpose. See Tex. Bus. Orgs. Code Ann. § 252.001 et seq. Formation of an unincorporated association is not governed by statute and does not require any organizational documents although an unincorporated association will typically have articles of association, a constitution, or bylaws. The existence of an unincorporated association in Texas is governed by Chapter 252 of the BOC. That chapter clarifies that an unincorporated association is a separate legal entity from its members with powers to promote the aims and purposes of the organization and advance the members interests by all legitimate and legal means. Unincorporated associations have the right to sue or be sued, sue or be sued by a member, acquire, hold, encumber, transfer real or personal property without the need for trustees, be a beneficiary of a trust, contract, will, or policy of life insurance, apply for property tax exemption, and apply for federal tax exemption under Section 501(c)(3) or another section. The IRS has acknowledged that a typical nonprofit unincorporated association will be treated as a corporation when it is formed under a contract or bylaws and has elective officers empowered to act for the association. It should be noted that the IRS will expect to see some type of governing document such as articles of association, with certain provisions regarding organization, operation and dissolution of the association in order to qualify for 501(c)(3) status. These provisions will be discussed more fully below.

Benefits of operating as an unincorporated association relate primarily to the informal nature of such an entity. Unincorporated associations are relatively quick and easy to establish and are internally as flexible as the founder's desire. Finally, unincorporated associations have the ability to rely on statutory authority in Texas to assure that they are recognized as separate legal entities such that members do not have personal liability in tort or contract absent special circumstances.

On the contrary, there are numerous drawbacks to organizing as an unincorporated association. First and foremost, while Texas has adopted Chapter 252 of the BOC (which was derived from the Uniform Unincorporated Nonprofit Association Act, only in place since 1995), there is little case law interpreting either Chapter 252 or its predecessor act, leaving an element of the unknown. Second, because unincorporated associations are so flexible, a founder has less assurance that his or her wishes as to the direction and purposes of the organization will remain unchanged. Many unincorporated associations find they have trouble with potential lenders who are more comfortable dealing with corporations than with unincorporated associations. Finally, choice of law concerns exist where an unincorporated association acts outside Texas as not all states recognize such an entity. Practically speaking, for an unincorporated association to qualify for federal tax exemption under Section 501(c)(3) the unincorporated association must make itself look and act quite a bit like a nonprofit corporation through adoption of a governing instrument with the requisite provisions for exemption thereby lessening the benefits discussed above.

d. Considerations in Choosing the Form:

The charitable organization may be created during life or through testamentary disposition. If created testamentary, the Will should allow for the executor to create the charitable organization and should state that the charitable organization is created for charitable purposes to make distributions to qualified charities. A corporation is generally the preferred entity for the charitable organization as it provides greater protection from liability for the organization's officers and directors. Their decisions in a corporation structure are evaluated on the business judgment rule as opposed to the more strict fiduciary standards applicable to trustees of trusts. On the other hand, a trust does not have to hold annual meetings, adopt Bylaws or comply with state enacted not-for-profit statutes as does a corporation.

If the donor desires to make the charitable gift through his or her testamentary documents, but the foundation or DAF has not yet been created, special care will be required to draft those provisions. Appendix A contains some example language that can be used in either a will or trust as part of the donor's estate plan, to make a philanthropic legacy gift without creating the foundation or DAF during lifetime.

Further, in the event a testamentary gift is made to a private foundation and a beneficiary disclaims all or a part of his/her bequest, the foundation must be sensitive to the result of such disclaimer: to the extent the foundation's assets include disclaimed funds, the disclaimant needs to be restricted from the decision-making as to such funds.

2. Drafting and Requirements to Maintain Tax Exemption

Regardless of the form chosen, the private foundation's governing documents must include certain provisions under the respective Texas law governing the entity form as well as under the Internal Revenue Code.

Under the Code, the governing documents need to include (1) the requirements under Code Section 508, (2) a purpose limited to those accepted under Section 501(c)(3) and (3) a proper termination and dissolution provision. The Certificate of Formation ("CoF") is what establishes the entity at the state level (with a charitable trust, this would instead be the trust agreement) and is filed with the Secretary of State. Because corporations are the most often used form for foundations, this section will focus on the corporate CoF. The CoF should contain the basic information: the corporation's name, whether it will have members, the registered agent/registered address, names and addresses of the initial board members, purposes, a dissolution provision, and the name and address of the organizer.

The Bylaws govern the day-to-day operation of the organization, and are subject to the CoF and state statutory aw. Although they are not filed with the Secretary of State, usually, the Bylaws are included with the Form 1023/1024 filed with the IRS for federal exemption. The Bylaws should include: (a) name, purposes, and powers; (b) members (if applicable); (c) board of directors (if applicable); (d) types of meetings (annual/special); (e) the ability to form committees; (f) notices; (g) officers, employees and agents; (h) contracts, checks, deposits and funds; (i) amendments; (j) indemnification; and (k) operation and dissolution.

To be eligible for recognition of exemption from federal income tax, an organization must satisfy the requirements for the applicable exemption classification. With respect to Section 501(c)(3), an organization must have a proper organizational structure (as addressed above), and must be organized and operated exclusively for charitable purposes. See Reg. 1.501(c)(3)-1(a). Pursuant to Section 1.501(c)(3)-1(b)(1)(i) of the Regulations, an organization is organized for exempt purposes if its organizational documents limit its purposes to one or more exempt purposes and do not otherwise empower the organization to engage in a more than insubstantial manner in activities which are not in furtherance of one or more exempt purposes. To demonstrate compliance with this "organizational" test, an organization must show that its assets are dedicated to an exempt purpose. See Reg. 1.501(c)(3)-1(b)(4). Such dedication is accomplished by way of a dissolution provision requiring that upon dissolution, the assets of the organization will be distributed for exempt purposes or to the Federal government, or to a State or local government, for a public purpose.

With respect to the operational test, Section 1.501(c)(3)-1(c)(1) of the Regulations provides that "[a]n organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more such exempt purposes specified in section 501(c)(3)." In other words, "exclusively" means "primarily"; however, a single nonexempt purpose if substantial in nature, is enough to destroy exemption. Furthermore, Section 1.501(c)(3)-1(d)(1)(ii) of the Regulations provides that to be organized and operated for one or more exempt purposes the organization must serve a public rather than a private interest. This last requirement is a requirement that no part of the net earnings inures to the benefit of a private individual. Appendix B contains sample language of the required terms discussed here.

Section 508 requires a private foundation to include in its governing documents: (i) a requirement for the income each year to be distributed so as to avoid excise tax under Section 4942, and (ii) to prohibit the foundation from engaging in any self-dealing, retaining any excess business holdings, from making jeopardy investments and from making taxable expenditures.

Section 1.501(c)(3)-1(c)(3) provides that an action organization—that is an organization that is attempting to influence legislation by propaganda or otherwise—is ineligible for exemption as it is not operated exclusively for exempt purposes. Finally, case law has appended the foregoing elements with the requirement that an organization must not be violative of public policy in order to qualify for exempt status.

While the foregoing are the elements for an organization to demonstrate its qualification under Section 501(c)(3), organizations that are not seeking exempt status under such section but are rather seeking exemption under other sections will need to carefully review such other sections to determine the requirements for exemption. By way of example, to be exempt under Section 501(c)(6) (professional organizations, business leagues, chambers of commerce, real estate boards, boards of trade, and professional sports leagues), the organization must be an association of persons having some common business interest, the purpose of the organization must be to promote that common business interest rather than operating for profit, the organization must not engage in a business ordinarily conducted for profit, and the activities of the organization must be directed to the improvement of business conditions of one or more lines of business. Each of the foregoing elements has its own definitional structures. Accordingly, care should be taken when applying for exemption as an "other than 501(c)(3)" organization that consideration is given to the specific elements which must be met for the applicable exempt classification.

3. Involving Future Generations

One way to involve the younger and future generations in the management of a foundation is to create a junior board, giving those board members either advisory privileges only (with no vote), so they can be involved in regular board meetings and gain some experience in the foundation realm before graduating to voting board member status. The donor may want to go one step further and give the junior board a set amount of grant distribution rights, such as 20% of the total to be granted each year.

For example:

> "Child 1, Child 2, and Child 3 shall serve as an advisory board committee with the designation of 'junior directors.' Such individuals are encouraged to attend meetings of the Directors, participate in investigation and due diligence regarding potential grants, and suggest potential grants to be considered by the Board of Directors."

To ensure that the blood lines of the founder continue to be involved in management, the foundation can be governed by members, with one member representing each family line, and those members having the ability to appoint the board as well as direct a set amount of the distributions each year. The Bylaws can be drafted to ensure the management succession of the family line members is contained within each blood line, and can give the rights to each family line the ability to direct an equal (or unequal, as appropriate) share of the distributions to be made each year. A sample is included in Appendix C.

4. Initial and Ongoing Reporting Requirements

a. Initial Filings

(1) Application for Recognition of Exemption Under Section 501(c)(3)

I.R.C. § 508(a)(1) provides that an organization organized after October 9, 1969, generally will not be treated as exempt under I.R.C. § 501(c)(3) until it notifies the Internal Revenue Service that it seeks recognition of exemption under that section. If the required notice is filed late, the exempt status, if granted, will not be retroactive and will not apply to any period prior to date of such filing.

1. Form of Notice: The proper Notice is provided on Form 1023 – Application for Recognition of Exemption Under § 501(c)(3) of the Internal Revenue Code.
2. Time of and Place for Filing Notice: The Form 1023 must be filed with the Ohio District Office (Covington, Kentucky) within 27 months from the end of the month of its organization, which is the date it becomes an organization described in I.R.C. § 501(c)(3). Treas. Regs. § 1.508-1(a)(2)(i), (iii). If the organization fails to file Form 1023 or files late, it will not be treated as exempt for any period prior to the filing of the notice. Treas. Regs. § 1.508-1(a)(1)(i); Rev. Rul. 77-207, 1977-1 C.B. 152.
3. Substantially Complete Filing: A substantially completed filing begins the running of the 270-day period in which the key District Director must rule on the application. (See discussion below as to "substantially complete" Form 1023.)

   a. Incomplete Submission: If an organization submits an incomplete Form 1023 within the required time period for filing, and files such additional information as the Internal Service may request within the additional time period set by the Internal Revenue Service, even though beyond the 27-month filing deadline, the organization is deemed to have met the requirements of I.R.C. § 508(a). Treas. Regs. § 1.508-1(a)(2)(ii).
   b. Requirement to Make Substantial Changes to Articles: If the organization is required to alter its activities or to make substantial amendments to its articles of organization, the ruling or determination letter recognizing exemption will be effective as of the date of the change.
   c. Nonsubstantive Changes: If non-substantive amendments are required to be made to the articles of organization, the exemption is normally recognized retroactively to the date of formation. Rev. Proc. 90-27, 1990-1 C.B. 514.
   d. District Director's Failure to Rule Within 270 day period: If a ruling is not issued by the key District Director within the 270 day period, the organization can seek a declaratory judgment.
   e. Substantially Complete Form 1023: A substantially complete Form 1023 contains the following:

i) The signature of an authorized individual;
ii) The organization's employer identification number;
iii) Statement of receipt and expenditures and a balance sheet for the current year and the three preceding years (or for the number of years of the organization's existence, if less than four years). [Note: If the organization has not yet commenced operations or completed one accounting period, financial data for the current year and proposed budgets for the two succeeding accounting periods are sufficient.]
iv) Statement of actual and proposed activities, Treas. Regs. § 1.501(a)-1(b)(2)(iii), and a description of anticipated receipts and contemplated expenditures.
v) A copy of the Articles of Organization, trust indenture or other organizational or enabling document signed by a principal officer or accompanied by a written declaration signed by an authorized individual certifying that the document is a complete and accurate copy of the original. Any articles of organization must indicate compliance with any applicable local recording statute.
vi) If the organization is a corporation or unincorporated association which has adopted bylaws, a current copy thereof;
vii) User fee payment for determination letter request: a check made payable to the United States Department of Treasury in payment of the user fee applicable to the organization. Rev. Proc. 93-23, 1193-1 C.B. 538, § 6.12 sets the user fee at $850.00 for initial applications for exempt status for organizations seeking exemption under I.R.C. § 501(c) whose actual or anticipated annual gross receipts exceed $10,000. Applications for exempt status (other than pension and profit sharing plans) that have had annual gross receipts averaging not more than $10,000 during the preceding four years, or new organizations anticipating gross receipt averaging not more than $10,000 during their first four years must pay a user fee of $350.00. If the organization does not include the correct user fee with the application, the application will be returned.

The Internal Revenue Service often requests additional information from the organization seeking exempt status. An organization must timely and completely furnish any additional information requested or subject itself to dismissal of its petition for declaratory relief for failure to exhaust its administrative remedies. Rev. Proc. 90-27, 1990-1 C.B. 514.

(2) Local Applications

Application should also be made to state and local taxing authorities for exemption from franchise taxes, real and personal property taxes, rent taxes and sales taxes. Application should be made to the Texas Comptroller of Public Accounts for exemption from the Texas franchise tax based on the foundation's status as a I.R.C. § 501(c)(3) organization. The application is available on the Comptroller's website (http://www.window.state.tx.us/). Publication 96-1045, Guidelines to Texas Tax Exemptions, available on the website of the Texas Comptroller, provides detailed information as well as statutory references with respect to tax exemptions along with links to the appropriate application forms.

(3) Registration With Charities Bureaus

Registration with the charities bureaus of the Attorney General's Office (or other State Department) where applicable. No such registration is required in Texas. If the foundation will operate in another state, the foundation should confirm whether it will have registration requirements in that state.

b. Ongoing Filings and Reports

(1) Form 990-PF

Each private foundation must file an annual information return, Form 990-PF, on or before the 15th day of the fifth month following the close of the foundation's annual accounting period, which is generally May 15 if the foundation is on a calendar year. All foundations are on a calendar year reporting basis unless a fiscal year is elected. The Form 990-PF is required to be filed also with the Attorney General of any state in which the principal office of the foundation is located, the foundation was incorporated or created, or to which the foundation reports in any fashion concerning its organization, assets, or activities. The deadline for filing Form 990-PF may be extended by filing Form 8868. The foundation may be fined $20 (or $100 for larger foundations) per day for failing to timely file Form 990-PF.

Under I.R.C. §6104(d), a tax-exempt organization, including a private foundation, must allow public inspection at its principal office (and at certain regional or district offices) and to comply with such requests, made either in person or in writing, for copies of the organization's application for recognition of exemption and the organization's three most recent annual information returns. An "annual information return" is defined to include any return that is required to be filed under I.R.C. § 6033 (meaning Form 990-PF and Form 4720 pertaining to private foundations). The private foundation must also, unlike other tax-exempt organizations, disclose to the general public the names and addresses of contributors, consistent with I.R.C. § 6104(d)(3). The term "tax-exempt organization" includes nonexempt private foundations and nonexempt charitable trusts described in section 4947(a)(1) that are subject to the information reporting requirements of I.R.C. § 6033.

(2) Form 990-T, Exempt Organization Business Income Tax Return

If the private foundation has $1,000 or more of gross unrelated business income, it must file a return to report and pay tax on that unrelated business taxable income, if any. The foundation may be required to pay tax quarterly using Form 990-W Estimated Tax on Unrelated Business Taxable Income. Pursuant to the Pension Protection Act of 2006, a private foundation must allow public inspection of its Form 990-T to the same extent as inspection of its Form 990-PF.

(3) Form 4720, Return of Certain Excise Taxes

If the private foundation or a disqualified person is liable for any of the penalties described in IRC §§4941-4945, Form 4720 must be filed to report and pay such penalties. It is due at the same time as the Form 990-PF.

(4) State Reports

In addition to furnishing the Attorney General with a copy of form 990-PF, the Foundation should file the following, if applicable:

- Texas Corporate Franchise Tax (Margin Tax) Report: This report must be filed with the Texas Comptroller of Public Accounts by the foundation if it is a corporation, though upon application the foundation will be exempt. Generally, no tax will be due. If this report is due before the foundation is granted exempt status and any tax is due, the foundation may be able to receive a refund of the tax, if any is due, upon receipt of the foundation's exemption.
- BOC 22.357 Public Information Report: Every four years, the foundation may be required to file with the Texas Secretary of State a report which states the name of the corporation, its address, the name and address of its registered agent and the names and addresses of its officers and directors.
- Texas Workforce Commission Status Report: If the foundation has 4 or more employees, it must complete a Texas Workforce Commission Status Report and file it with the Tax Department of the Texas Workforce Commission (formerly Texas Employment Commission).

(5) Employer Returns

If the foundation has employees, it must withhold, deposit, pay and report federal income taxes, social security taxes, and federal unemployment taxes, unless specifically excluded by statute.

(6) Substantiation Documentation

A charitable organization must issue substantiation letters to its donors where the donation has a value of $250 or more and the donor desires to claim a charitable income tax deduction for the donation. The substantiation must be in writing and must be obtained before filing the tax return for the tax year in which the deduction is claimed. Because the charitable organization does not seek a charitable deduction under I.R.C. § 170, (except for charitable deductions claimed on Form 990-T) it is not generally required to obtain and retain substantiation letters from the charities it supports. Note that donors who itemize deductions must have a bank record or a written communication from the charity to substantiate any monetary contribution (cash, check or other monetary gift), regardless of the amount, effective January 1, 2007. Additionally, if the gift received is appreciated property and is sold within 3 years of acquisition, the foundation must prepare and file Form 8282. Publication 1771, Charitable Contributions – Substantiation and Disclosure Requirements, explains the federal tax law for organizations such as charities and churches that receive tax-deductible charitable contributions and for taxpayers who make contributions. Publication 1771 allows written acknowledgement to be provided electronically, such as via e-mail addressed to the donor.

B. Donor Advised Fund Agreement

1. <u>Key Elements</u>

The form of a DAF Agreement is largely driven by the community foundation or sponsoring organization public charity (which I will generally refer to as the community foundation) and is typically only a few pages in length. However, some community foundations offer great flexibility and customization in the drafting of the agreement, to tailor it to your donor.

Arguably the most important element in a DAF agreement is that the gift be made irrevocably to the community foundation, with all ultimate decisions regarding disposition of the gift in the discretion of the community foundation. Once the donor makes the gift, he cannot pull it back, attach strings, or dictate exactly where the funds must go once placed into the DAF.

What the donor *can* do through the agreement is suggest broad interest groups or charitable purposes which he prefers and which he would like to guide the recommendations of future advisors and the community foundation in making distributions from the DAF. The donor advisor(s) appointed in the agreement will have the ability to *recommend* distributions to the community foundation, although the charity itself will have ultimate say over what distributions are made from the DAF.

The agreement can even require that the community foundation give the then-serving donor advisors a certain amount of notice of their right to recommend beneficiaries, so that the advisors are sure to be aware of their advisory privileges and the DAF does not become a distant memory to future advisors. The donor may want to include provisions that prohibit distributions being made if the advisors fail to make recommendations within a set time frame of having received such notice of their advisory privileges. Even with such provisions, the agreement must clearly state that the community foundation has the ultimate power to accept or reject any recommendations which are made by the advisor(s). Sample language is provided at Appendix D.

An important feature the donor likely will want to include in the agreement is provision for successor donor advisors. This is particularly true if the donor wishes for the DAF to serve as a philanthropic tool for multiple generations, carrying a family legacy down his/her lineal line. Example language is attached at Appendix E which can be used to ensure that the advisory privileges are maintained within the family for as long as possible. Further, in the event there are no more family members living, able and willing to serve in the capacity of donor advisor, the agreement can specify what happens to the fund, and if/when the donor would like the fund to sunset. One option would be providing for the conversion of the DAF to a field of interest fund ("FOI") at the same community foundation to be used for those causes specified in the agreement and/or consistent with the recommendations made over the life span of the DAF. Example language of such conversion can be found at Appendix F.

2. <u>Donor Control From the Grave</u>

No, that's not a typo – even though the donor cannot really control the disposition of a DAF, we all know that giving up control is hard to do. If you do have a donor who is struggling to release control, there is a certain level of *direction* that can be drafted into the DAF agreement, to give the donor peace of mind that the sponsoring organization has sufficient motivation to continue its standards of reliability, service and investment that gives the donor comfort about placing his trust in the charity. In the event that in the future, the community foundation fails to carry out the terms of the agreement or ceases to comply with stated principals of investment, management, etc., the DAF could be "gifted over" to another sponsoring organization. While this type of provision is not suggested for every DAF agreement, it is possible to craft with the following provisos: (a) there should be guidelines and clear standards the community foundation must meet, with a reasonable way for it to remedy any shortcomings (this may include specific investment success models); (b) upon the failure of the stated conditions, the then-serving donor advisor(s) can "trigger" the gift-over language, although they cannot choose where the funds are distributed; and (c) the recipient must be chosen by the donor in the agreement, fixed at the time the agreement is executed, or by the community foundation, not by an advisor. Sample terms can be found at Appendix G.

VIII. CONCLUSION

The biggest advantage to the private foundation is continued donor control and flexibility, within the confines of federal regulations; however, because it is its own entity, the foundation requires the greater amount of administration, initially and ongoing. Further, the deduction for income tax charitable contributions is more limited than a contribution made to public charities. DAFs allow donors to focus more on their charitable initiatives rather than on the administrative details, although this comes at the cost of giving up control to the sponsoring organization. While either vehicle allows for the donor to build a giving legacy, the donor, with your guidance as advisor, will have to weigh the costs and benefits of each in the context of the overall charitable vision, in order to make the appropriate choice.

APPENDIX A

SAMPLE TESTAMENTARY LANGUAGE FOR FOUNDATION OR DAF TO BE CREATED

Foundation:

"From the remaining property of this trust, following the distributions made above, the Trustee shall then distribute the remainder of this trust, to the foundation created by Settlor during her lifetime, or if none, the Trustee shall create such a private foundation as a Qualified Charity for the benefit of charities similar to the types of charities Settlor benefitted during her lifetime."

"…to The ____ Family Foundation, or if not in existence at the time of the death of the Surviving Settlors, the Trustee shall create such a private foundation as a Qualified Charity as defined in paragraph 1.17 of this Agreement, for the benefit of those Qualified Charities which Settlors benefitted during their lifetimes (the "new foundation"). Such new foundation shall be created as a member-run organization so that each of Settlors' children shall become members at the age of twenty-five (25) if not otherwise age twenty-five (25). The initial members of such new foundation shall be A and B."

DAF:

"After the payment of debts and expenses of the Surviving Spouse and all state and federal estate, inheritance and death taxes and generation-skipping transfer taxes, the Trustee shall establish a donor advised fund to be known as The ______ Fund with the ___________ Community Foundation, in accordance with the distribution provisions in "Schedule A" attached hereto (unless Settlors have otherwise entered in to an Agreement with __________ Community Foundation as to the Fund terms), and shall distribute all remaining property of Trust D to such Fund." *Schedule A in this example listed certain distributions the trust Settlors would have recommended to the DAF had they been living.*

"The Trustee shall distribute Five Hundred Thousand and No/100 Dollars ($500,000.00) to a donor advised fund to be established by the Trustee, with A and B as the Donor Advisors, with the Community Foundation of _________ and to be named The Eagle Donor Advised Fund."

"…Seventy-five percent (75%) to The ____ Fund ("Fund") to be established at Community Foundation, Fort Worth, Texas, such fund to distribute one hundred percent (100%) of its income, on an annual basis, to qualified charitable organizations for the benefit of animals in Parker County and Tarrant County, including Parker Paws if such organization qualifies, but not to the organization known as "PETA" or "People for the Ethical Treatment of Animals." Additionally, the Community Foundation shall send an annual report of the Fund, including a list of grant recipients, to XYZ, or his appointee, it being Settlors' intent that XYZ, or his appointee, monitor the Fund and distributions on Settlors' behalf."

APPENDIX B

SAMPLE PURPOSE CLAUSE

Purposes. The Corporation is organized and shall be operated exclusively for religious, charitable, scientific and educational purposes within the meaning of Section 501(c)(3) of the Internal Revenue Code of 1986 or the corresponding provision or provisions of any subsequent United States revenue law (the "Code"), including, but not limited, to reaching at-risk youth to change the direction of their lives, by using horses and athletics to educate and connect with them and build their spiritual, mental and physical health and wellness, spreading the Gospel of Jesus Christ, to build relationships and to conduct, accomplish and carry on its objectives, functions and purposes or any part thereof set forth in the governing documents of the Corporation as amended from time to time, within or without the State of Texas. The assets and property of the Corporation are hereby pledged for use in performing its charitable purposes.

This Corporation is additionally organized to promote, encourage, and foster any other similar religious, charitable, scientific or educational activities; to accept, hold, invest, and reinvest and administer any gifts, legacies, bequests, devises, funds and property of any sort or nature, and to use, expend, or donate the income or principal thereof for, and to devote the same to, the foregoing purposes of the Corporation; and to do any and all lawful acts and things which may be necessary, useful, suitable, or proper for the furtherance of accomplishment of the purposes of this Corporation. Provided however, no act may be performed which would violate Section 501(c)(3) of the Code as it now exists or as it may hereafter be amended.

OPERATION AND DISSOLUTION CLAUSE

Nonprofit Operation. The Corporation is organized and operated primarily for the purposes set forth under Article One of these Bylaws. It is to be operated in such a way that it does not result in the accrual of distributable profits, realization of private gain resulting from payment of compensation in excess of a reasonable allowance for salary or other compensation for services rendered or realization of any other form of private gain.

Distribution of Assets. The Corporation pledges its assets for use in performing the Corporation’s charitable functions. It directs that on discontinuance of the Corporation by dissolution or otherwise, the assets are to be transferred to a charitable, educational, scientific or similar organization(s) with like purposes that qualifies under Section 501(c)(3) of the Code and is not a private foundation as determined by the Corporation’s then-existing Board of Directors.

APPENDIX C

FAMILY LINE SUCCESSION

Section 2.2. Membership Succession.

a) The term "Family Line" shall mean, for each of the Members set forth in Section 2.1 above, such Member and his or her Lineal Descendants. Spouses of Members shall be considered part of such Member's Family Line. Each Family Line shall have one Member representing such Family Line. A "Lineal Descendant" means a person's biological and adopted children and other lineal descendants of any degree whether currently living or later born. A child in gestation who is born alive shall be considered a child throughout the period of gestation. If a Member should die, resign or be unable or unwilling to serve or continue to serve as a Member, such Member may appoint (in a written instrument signed by such Member) his or her successor Member from among such Member's Family Line. If such Member does not appoint a successor Member, then the eldest living Lineal Descendant of such Member, so long as such individual is at least twenty-five (25) years old and willing to serve, shall automatically (and without any further action being necessary) be appointed to serve as the Member for the applicable Family Line. In the event there is no living member of the applicable Family Line willing and able to serve, and subject to Section 2.2(c) below, the right of succession for such Family Line shall terminate.

b) Any successor Member to a Member shall have the power to appoint his or her successor, provided such successor is a member of the same Family Line and is a member of the appointing Member's same generational level (unless there are no members of such generational level, whereupon such appointment may be made from the members of the next generational level). If such successor Member fails to appoint his or her successor, then the eldest living member of such Family Line, so long as such individual is at least twenty-five (25) years old and willing to serve, shall automatically as of the effective date of the vacancy in the position of Member for such Family Line, and without any further action being necessary, serve as successor Member for the Family Line.

c) If, at the time of the appointment under (a) or (b) above, or at the time of any subsequent vacancy in the position of Member for a Family Line, as applicable, the eldest living member of the Family Line has not yet attained age twenty-five (25), then a successor shall be appointed to serve as Member for such Family Line (each an "Appointed Member"). An Appointed Member shall be treated as a Member in all respects under these Bylaws. Any Appointed Member need not be a Lineal Descendant of a Member but, in the event the individual is not a Lineal Descendent of a Member, to be qualified to fill the vacancy such individual appointed to such position must possess comparable education, financial credentials, skill and sophistication as the remaining Members. The Appointed Member shall serve until the earlier of his or her death, resignation, removal from office or until a member of such Family Line attains twenty-five (25) years of age and is willing to serve; at which time, (A) such member of such Family Line will automatically, and without any further action being necessary, be appointed as a Member in full and immediate replacement and substitution of the Appointed Member and (B) the Appointed Member will be deemed to have resigned. Notwithstanding the foregoing, in the event the last living member of such Family Line dies prior to attaining age twenty-five (25), the right of succession for such Family Line shall terminate and the Appointed Member will be deemed to have resigned.

d) If a Family Line's right of succession terminates pursuant to this Section 2.2, then the remaining Members shall continue as Members of the Foundation representing their respective Family Lines.

FAMILY LINE DISTRIBUTIONS

Article Four

Charitable Distributions

Section 4.1 Definitions. For purposes of this Article Four, the following definitions shall apply:

(a) Foundation Statutory Requirement. The "Foundation Statutory Requirement" shall mean the annual distributable amount as defined in Section 4942(d) of the Code and corresponding Treasury Regulations.

(b) Family Line Contributions. "Family Line Contributions" shall mean the sum of all contributions made to the Foundation by members of a specific Family Line.

(c) Family Line Account. "Family Line Account" shall mean twenty percent (20%) of the Foundation's non-exempt use assets as of the date of these Amended and Restated Bylaws plus the sum of all contributions made to the Foundation by members of a specific Family Line less all charitable distributions made by such Family Line, plus interest earned by the Foundation in an amount proportionate to such Family Line Account compared to the overall assets of the Foundation. Each Family Line Account shall be tracked in accordance with each Family Line as a segregated fund on the books and records of the Foundation, but may be comingled for purposes of investment.

(d) Foundation General Fund. "Foundation General Fund" shall mean twenty percent (20%) of the Foundation's non-exempt use assets as of the date of these Amended and Restated Bylaws less all charitable distributions made from the Foundation General Fund, plus interest earned by the Foundation in an amount proportionate to the Foundation General Fund compared to the overall assets of the Foundation. The Foundation General Fund shall be tracked as a segregated fund on the books and records of the Foundation, but may be comingled for purposes of investment.

Section 4.2 Nature of Distributions. Charitable distributions may be made in the form of gifts, grants, direct charitable expenditures, or program-related investments and may be made to any recipient as long as the making of such charitable distribution is permitted for a private foundation. Charitable distributions shall be directed in accordance with this Article Four.

Section 4.3 Distributions from Family Line Accounts. Each Family Line, acting by and through the director(s) representing such Family Line, shall be responsible for directing that part of the Foundation's Statutory Requirement that is proportionate to the amount of such Family Line's Account. In the event a Family Line is composed of more than one director, decisions regarding the Family Line's distributions shall be made by majority vote of the directors in such Family Line. In the event a Family Line's right of succession terminates under the provisions of Section 2.2, such Family Line's Family Line Account shall be allocated equally among the remaining Family Lines.

Section 4.4 Distributions from Foundation General Fund. The Board of Directors shall be responsible for directing that part of the Foundation's Statutory Requirement that is proportionate to the amount of the Foundation General Fund. Distributions from the Foundation General Fund must be made to qualified public charities favored by Founders during their lifetime in order to honor Founders, the founders of the Foundation.

Section 4.5 Prohibited Distributions. Notwithstanding anything to the contrary, the Foundation shall be prohibited from making any distribution that would satisfy a director's personal pledge or obligation.

Section 4.6 Allocation of Expenses. Expenses incurred by the Foundation shall be classified as Program-Level Expenses or Entity-Level Expenses. Program-Level Expenses shall be those expenses that have been specifically requested, commissioned, or approved by a Family Line for the conduct of such Family Line's distributive activities under Section 4.3 above, including, but not limited to, legal fees, travel expenses, and other expenses that specifically relate to a Family Line's distributions. Entity-Level Expenses are expenses of the Foundation that are not classifiable as Program-Level Expenses, but rather apply broadly across the Foundation's activities. Program-Level Expenses shall be allocated to and payable from the distributive share of the Family Line requesting, commissioning, or approving such expenses. Entity-Level Expenses shall be allocated to the Foundation generally. Taxes imposed on the Foundation under Chapter 42 of the Code (other than the net investment income tax) shall be treated as Program-Level Expenses allocable to the Family Line whose action or inaction resulted in the imposition of such tax.

APPENDIX D

SAMPLE NOTICE PROVISIONS FOR DAF

It is understood that the Donor, (hereafter referred to as [Donor Advisor]) shall have the right from time to time to submit to the Board of Directors of the Community Foundation the names of grantees (beneficiaries) to which the Donor Advisor recommends distributions. Provided, however, the Community Foundation shall give annual notice to the Donor Advisor (or Successor Co-Donor Advisors, as applicable) of his/her right to recommend beneficiaries. If the Donor Advisor (or Successor Co-Donor Advisors) does not make a recommendation to the Community Foundation within thirty (30) days of receiving such notice, then the Community Foundation shall not make distributions from the Fund for that year.

Notwithstanding the foregoing, it is expressly understood that the recommendations from the Donor Advisor (or Successor Co-Donor Advisors, as applicable) as to beneficiaries shall be solely advisory and the Board of Directors of the Community Foundation may accept or reject these recommendations applying reasonable standards and guidelines with regard thereto. Each charitable beneficiary must qualify for tax exemption under the provisions of the IRS.

APPENDIX E

SAMPLE SUCCESSOR DONOR ADVISOR LANGUAGE

The privileges of the Donor Advisor will be continuous until his death. At the death of the Donor Advisor, the Fund shall continue as the ___________ Charitable Fund with daughters, **A** and **B** serving as Successor Co-Donor Advisors. Each of **A** and **B** shall have the power to appoint a lineal descendant of hers who is at least age eighteen (18) as Successor Co-Donor Advisor to succeed her as a Successor Co-Donor Advisor.

If either of **A** or **B** should die, resign, or cease to serve in her capacity as Successor Co-Donor Advisor, then the successor she has appointed shall become the Successor Co-Donor Advisor, to serve with the survivor or other of **A** and **B**. Provided, however, if such daughter has failed to name a Successor Co-Donor Advisor, then the oldest living lineal descendant of the deceased daughter who is at least age 18 shall become a Successor Co-Donor Advisor, or if none, the remaining daughter shall serve as the sole Successor Donor Advisor until the oldest living lineal descendant of the deceased daughter has attained age 18, at which time, such descendant of the deceased daughter shall become a Successor Co-Donor Advisor. Such Successor Co-Donor Advisor shall have the power to appoint his or her own Successor Co-Donor Advisor in the same manner as each of **A** and **B** may appoint their own successors, as provided above, such that there is always a Successor Co-Donor Advisor who is a lineal descendant, at least age eighteen (18), of each of **A** and **B**. Provided, if the last living lineal descendant of one of the daughters should die or resign as a Successor Co-Donor Advisor, and no successor is named or willing to serve, the remaining Successor Co-Donor Advisor may serve as sole Successor Donor Advisor.

APPENDIX F

SAMPLE LANGUAGE FOR CONVERSION AND TERMINATION OF DAF

At the death of the last Successor Co-Donor Advisor serving, or if he or she should resign as advisor, the Fund shall become a Field of Interest Fund ("FOI Fund"), maintaining the original name of the Fund, the Field of Interest being reflective of prior grant recommendations and charitable vision of the Donor Advisor (or Successor Co-Donor Advisors, as applicable) and those causes as specified pursuant to Schedule B attached hereto.

Further, if no grant recommendations are received from the Donor Advisor (or Successor Co-Donor Advisors, as applicable) in five (5) consecutive calendar years, the Fund will terminate as a donor-advised fund, and shall become an FOI Fund, maintaining the original name of the Fund. The Community Foundation will award grants from the FOI Fund, reflecting the prior grant recommendations and charitable vision of the donor advisors over the history of the Fund and those causes as specified pursuant to Schedule B attached hereto. It shall be the intent of the Community Foundation to continue to keep faith with the intents, desires and purposes expressed by the Donor Advisor (or Successor Co-Donor Advisors), as evidenced by the their prior grant recommendations and charitable vision, as well as the allocations provided in Schedule B.

Upon the Fund converting to an FOI Fund, such FOI Fund shall be fully and completely distributed within five (5) years within the terms contained herein, such that the FOI Fund terminates no later than five (5) years following the conversion of the Fund to an FOI Fund.

APPENDIX G

GIFT-OVER OF DAF

While the Community Foundation is not bound by the advice offered by the Donor Advisor (or Successor Co-Donor Advisors), the Community Foundation is bound by the Donor's stated Investment Success and Field of Interest Distributions Criteria as described in Schedule B.

As evidence of the Foundation's desire to honor the charitable intentions, preferences and restricted gift components expressed by the Donor in Schedule B, the Community Foundation commits that, in the event the Community Foundation has not met or can no longer meet the Fund's needs for oversight and continuity, and the Community Foundation has been given reasonable opportunity to remedy the shortcomings, upon request of Donor Advisor (or Successor Co-Donor Advisors), the Community Foundation will approve the movement of the Fund's assets and records to XYZ Community Foundation [OR: another Community Foundation as selected by the Community Foundation ("Recipient Organization") upon the recommendation of the Donor Advisor (or Successor Co-Donor Advisors). Such Recipient Organization must be a publicly supported organization described in IRC 509(a)(1) and 170(b)(1)(A)(vi) which meets standards similar to Community Foundation National Standards for reliability and service] without other requirements imposed on the Donor, Donor Advisor, Successor Co-Donor Advisors, or other Community Foundation except for acknowledgment that such new fund will contain the provisions in Schedule B, a receipt of funds from the Recipient Organization and reasonable release from the Recipient Organization and Donor Advisor (or Successor Co-Donor Advisors). For purposes of this determination, failure to meet the Fund's needs for oversight and continuity shall be evidenced by one or more of the following:

a. The Foundation's organizational documents, governance or policies and procedures are changed such that the Foundation's ability to carry out the charitable intentions, preferences and restrictions of the Donor as expressed in Schedule B are impaired (the Foundation is required to give the Donor Advisor (or Successor Co-Donor Advisors) 90 days' advance notice of an organizational, governance or policy change);
b. The Foundation ceases to exist or to qualify for exemption under IRC 501(c)(3);
c. The Foundation engages in any immoral or financially irresponsible conduct that might tend to bring the Donor or Donor Advisor (or Successor Co-Donor Advisors) into public disrepute, contempt, scandal, or which might otherwise tend to reflect unfavorably upon the Donor or Donor Advisor (or Successor Co-Donor Advisors); or,
d. The Foundation otherwise fails to comply with the terms of this Agreement.

In the event of a disagreement between the Community Foundation and Donor Advisor (or Successor Co-Donor Advisors) as to whether one of the above-stated provisions has been triggered, the dispute will be decided by a proceeding in the district court in Tarrant County, Texas or by binding arbitration, as determined in the sole discretion of the Donor Advisor (or Successor Co-Donor Advisors). In the event the dispute is submitted to arbitration, the arbitration shall proceed before a single agreed-upon arbitrator or, in the event no agreement can be reached with a single arbitrator, before a panel of three arbitrators with each party selecting one arbitrator and the two arbitrators selecting the third arbitrator. Any such arbitration proceeding will take place in Fort Worth, Texas.