Donor Advised Funds, PRIs and The L³C

"Shall We Dance"?

By: Michael Martin
for Americans for Community Development

Americans for Community Development

. . . . the organization for the L³C

Introduction

The Low-profit Limited Liability Company, or "L^{3}C", is a cross between a nonprofit organization and a for-profit corporation. The entity is designated as low-profit with charitable or educational goals. Vermont was the first state to enact this new type of company, in April of 2008. Since then some eight or nine additional jurisdictions have adopted this legislation and some twenty-one to twenty-two other jurisdictions have it under consideration, either formally or informally. Vermont's legislation creating such a company, modeled the required purpose clause for an L^{3}C, verbatim, upon the Program Related Investment regulations under the Internal Revenue Code, hence the L^{3}C was designed, from the outset, to attract and hold endowment type investments from private foundations, while at the same time holding for profit type investments. One might say the L^{3}C's charitable purposes were built into its very DNA. Accordingly, the L^{3}C can be a valuable tool when the founders are seeking investments in the form of Program Related Investments or "PRIs", or when the founders want to lock in a charitable mission and have a set of investors who will support that mission.

L^{3}Cs and Program Related Investments

However, the ability of the L^{3}C to attract Program Related Investments from private foundations, during its four or so years of existence, has not translated into actual experience, in the manner the creators of this entity had initially hoped. This is true for at least two major reasons: First, in this authors' personal experiences and observations, working with clients and prospective clients who have formed L^{3}Cs, the "push back" from foundations to making a PRI from their endowment funds has arisen out of either a lack of understanding and education, by private foundation managers and their advisors, as to how PRIs actually work and/or fear of what might happen with regard to the foundations exempt status, if they get it wrong. In addition, the time delay and cost of a private letter ruling or lengthy legal opinion to garner the necessary comfort level for a foundation to make a PRI is also frequently cited as a reason to hold back; Second, based on a pure objective and quantifiable analysis, private foundations simply have not been handing out PRIs. Consider the following facts. A 2006 survey of more than 72,000 private foundations showed that private foundations collectively made qualifying distributions in the aggregate amount of $43 billion; however, PRIs accounted for less than 1% of these qualifying distributions (or $430,000,000, at a time when private foundations held in excess of $600,000,000,000 in endowment funds), despite PRIs being a strong tool to advance charitable purposes (see The

Private Foundation Center, Aggregate Data by Private Foundation Type, 2006 [released 2008], available at http://private foundationcenter.org). Of course the fact that there is currently no process to confirm that a private foundation's proposed investment will comply, both initially and over time, with the PRI regulations under Treas. Reg. §53.4944-3(a) and, additionally, there is no uniform standard for forming entities to serve as recipients of PRIs (and obtain "determination letters" from the IRS, in the same fashion state formed non-profits currently do), may also contribute significantly to the above result.

Can Donor Advised Funds Invest in L^{3}Cs?

With such a dismal performance and track record, despite such initial high hopes, might there be another source of nonprofit funds and capital for L^{3}C creators and their advisors to explore, beyond private foundations? Indeed, yes. The authors, along with L^{3}C proponents and commentators alike, have, for at least the last year, been discussing and exploring whether Donor Advised Funds, or "DAFs", might be a more fertile field to examine. So the question, straight up, among our colleagues in the organized tax bar and elsewhere, was "Can Donor Advised Funds make Program Related Investments into an L^{3}C?" Simply stated, can a Donor Advised Fund and an L^{3}C dance together, without getting tangled up in their shoelaces? The response was a resounding; "Well, technically speaking, yes, I think so, if they exercise expenditure oversight." However, the potential issue and concern is whether such distributions might be considered taxable expenditures or distributions (under IRS rules and regulations governing DAF distributions).

Pending IRS Regulations on Taxable Expenditures

The IRS, as it turns out, is currently looking at the issue of taxable distributions from Donor Advised Funds and considering proposed regulations under the DAF rules, as to what constitutes "taxable expenditures", so no one, it seems, is interested in getting too far out in front, until the Service issues some clear guidance; and rightfully so. Not being one to sit idly by, while waiting for wisdom to come down from on high, the authors undertook their own independent analysis of the Internal Revenue Code and regulations, to see what could be gleaned from the rules already on the books. Although we must admit, the prospect of getting out in front with some actual funded projects, assuming a willing DAF, is tempting, if nothing else, on the theory that it is

easier to get forgiveness (or grandfathering) than permission. This might be especially true if the funded projects actually end up carrying out the underlying fundamental purposes for PRIs, as set out in the examples in the present Program Relating Investment regulations. The balance of this paper is a summary of what we found, based on our review.

Donor-Advised Funds

Generally, a donor advised fund is a separately identified fund or account that is maintained and operated by a section 501(c) (3) organization, which is called a Sponsoring Organization. Each account is composed of contributions made by individual donors. Once the donor makes the contribution, the organization has legal control over it. However, the donor, or the donor's representative, retains advisory privileges with respect to the distribution of funds and the investment of assets in the account. Examinations of these arrangements may result in the following Service actions in appropriate cases: (a) disallow deductions for charitable contributions under Internal Revenue Code Section 170 for payments to the fund; (b) impose section 4966 excise taxes on sponsoring organizations and managers of donor-advised funds; (c) impose section 4958 excise taxes on donors or managers of donor advised funds; and/or (d) deny or revoke the charity's 501(c)(3) exemption. The excise taxes referred to in (b) are the "Taxes on Taxable Distributions."

Excise Taxes, Donor Advised Funds and the Pension Protection Act of 2006

Donor Advised Funds became the target of Congressional scrutiny as a result of actual and potential abuses by funds and fund managers, resulting in excise taxes being imposed on Donor Advised Funds and their fund managers. These excise taxes came about as part of the provisions enacted under the 2006 Pension Protection Act ("PPA"), due to Congressional concern about potential abuses associated with the use of donor advised funds. Specifically, the 2006 PPA introduced the terms "donor advised fund" and "sponsoring organization" and enacted or amended various excise taxes designed to penalize improper acts of donor advised funds and their sponsoring organizations, donors, and advisors. For example, the taxes under §4943 on excess business holdings, which primarily apply to private foundations, were extended to cover donor advised funds. The taxes under §4958 on excess benefit transactions, which primarily

apply to disqualified persons with respect to public charities, were extended to cover donors of donor advised funds and investment advisers of sponsoring organizations. Likewise, with regard to prohibited distributions. The definition of the term “taxable distribution,” and the exceptions to such term, are the key concepts in applying the taxes under §4966. Depending on the particular provisions, the excise taxes involving donor advised funds became effective for transactions occurring after August 17, 2006, or for tax years beginning after August 17, 2006.

Taxable Distributions

IRC Sec. 4966, with respect to Taxable Distributions provides:

4966(c) Taxable Distribution

4966(c) (1) In General-The term “taxable distribution” means any distribution from a donor advised fund—-

4966(c) (1) (A) to any natural person, or

4966(c) (1) (B) to any other person if—-

4966(c) (1) (B) (i) such distribution is for any purpose other than one specified in section 170(c) (2) (B), or

4966(c)(1)(B)(ii) the sponsoring organization does not exercise expenditure responsibility with respect to such distribution in accordance with section 4945(h)- Emphasis added. (AS NOTED: Section 4966 was enacted by the 2006 PPA, P.L. 109-280, §1231(a)).

Stated another way, a distribution from a donor advised fund to any person other than a natural person (i.e., like an L^3C) which is organized for any of the purposes specified under IRC Sec. 170(c)(2)(B) is NOT a taxable distribution (Recall that an L^3C under the Vermont statute must be organized to: “(i)significantly furthers the accomplishment of one or more charitable or educational purposes within the meaning of Section 170(c)(2)(B) of the IRS Code of 1986, 26 U.S.C. Section 170 (c)(2)(B); and (ii) would not have been formed but for the company’s relationship to the accomplishment of charitable or educational purposes”). IRC Sec. 170(c)(2)(B) specifically sets out those purposes as: “organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or

equipment), or for the prevention of cruelty to children or animals". So a distribution to an L^{3}C, properly organized, clearly "flunks" as a taxable distribution on the first prong. However, the Sponsoring Organization MUST "exercise expenditure responsibility with respect to such distribution in accordance with section 4945(h)"with respect to such distribution, to clear the second prong. Accordingly, in construing the definition of a taxable distribution, the purposes specified in §170(c) (2) (B) are generally charitable purposes, such as religious, scientific, literary, educational, or other charitable purposes (See §170(c) (2) (B)). Thus, a distribution to a corporation for a non-charitable purpose would be a taxable distribution subject to tax under §4966. Even if a distribution is for a charitable purposes described in §170(c) (2) (B), such distribution is a taxable distribution unless the sponsoring organization exercises expenditure responsibility with respect to it (See §4966(c) (1) (B) (ii); and Staff of J. Comm. on Tax'n, 109th Cong).

Donor Advised Funds Must Exercise Expenditure Responsibility

The "expenditure responsibility with respect to such distribution in accordance with section 4945(h)" referred to above in IRC Sec. 4966, is set out in IRC Sec. 4945, Taxes on Taxable Expenditures, which comes under Subchapter A — Private Foundations (Sections 4940 to 4948), more commonly known as the "Private Foundation Excise Tax Rules". This section provides:

4945. Taxes on Taxable Expenditures

4945(h) Expenditure Responsibility The expenditure responsibility referred to in subsection (d) (4) means *that the private foundation (here in our example, the Donor Advised Fund) is responsible to exert all reasonable efforts and to establish adequate procedures—*

4945(h) (1) to see that the grant is spent solely for the purpose for which made,

4945(h) (2) to obtain full and complete reports from the grantee on how the funds are spent, and

4945(h) (3) to make full and detailed reports with respect to such expenditures to the Secretary-Emphasis added, mine.

Exceptions A distribution to any of the following organizations is excepted from the scope of the term "taxable distribution": (i) a charitable organization described in §170(b) (1) (A) (other than a disqualified supporting organization); (ii) the sponsoring organization of the donor advised fund; or (iii) any other donor advised fund (See

IRC §4966(c) (2)). Accordingly, a distribution from a Donor Advised Fund must be a qualifying distribution and the Sponsoring Organization must exercise expenditure responsibility, unless one of the forgoing exceptions apply, i.e., a distribution to a public charity, the Sponsoring Organization, or another Donor Advised Fund, as provided in IRC §4966. To be clear then, distributions from Donor Advised must be qualifying distributions. Qualifying distributions are defined on IRC Sec. 4942 of the Code as:

4942(g) (1) In General, for purposes of this section, *the term "qualifying distribution" means—*

4942(g)(1)(A) *any amount (including that portion of reasonable and necessary administrative expenses) paid to accomplish one or more purposes described in section 170(c)(2)(B)*, other than any contribution to: (i) an organization controlled (directly or indirectly) by the foundation or one or more disqualified persons (as defined in IRC Sec. 4946) with respect to the foundation, except as provided in paragraph (3), *or (ii) a private foundation which is not an operating foundation (as defined in subsection (j)(3)), except as provided in paragraph (3), or 4942(g)(1)(B) any amount paid to acquire an asset used (or held for use) directly in carrying out one or more purposes described in section 170(c)(2)(B)*-Emphasis added, mine.

Qualifying Distributions A foundation's qualifying distributions generally are either amounts it expends directly for qualifying purposes or grants it makes to other organizations or individuals for qualifying purposes. The same is true for Donor Advised Funds. Qualifying distributions directly made by a foundation (and Donor Advised Fund) include amounts expended to accomplish §170(c)(1) or (2) (B) purposes or amounts paid to acquire assets used directly in carrying out one or more of such purposes (See §4942(g)(1)(A) and (B)). It also includes a portion of the foundation's (Donor Advised Fund's) reasonable and necessary administrative expenses incurred in carrying out its exempt functions (See §4942(g) (1) (A)). Most non-operating private foundations typically satisfy the minimum qualifying distribution requirement by making grants to other organizations, rather than making significant amounts of qualifying distributions in the form of exempt asset purchases or direct operating or administrative costs. Traditional Donor Advised Funds follow suit, taking their cue from the Donor in his advisory capacity. In either case, whether or not a grant is a qualifying distribution is determined by the purposes for which it is used, and not necessarily by the status of the individual or entity to which it is made. Whether or not a distribution is a qualifying distribution is, in every instance, a "facts and circumstances" analysis. However, the status of the grantee determines the degree of the foundation's diligence

necessary to ensure that its grant is being used for §170(c) (1) or (2) (B) purposes and determines whether expenditure responsibility under §4945 is required. This is also true with respect to a grant by a Donor Advised Fund to an L3C.

Qualifying Distributions to Non-charitable Organizations A private foundation can also make qualifying distributions to non-charitable organizations and to individuals if the distributions are for purposes described in §170(c) (1) or (2) (B). Since a "qualifying distribution" means "any amount paid to accomplish one or more purposes described in section 170(c)(2)(B)". Based on the foregoing, it seems clear that a Donor Advised Fund can not only make grants to L3Cs, they can likewise make a program related type investment as well, by following the rules discussed herein and exercising proper expenditure oversight.

Conclusion

So from our perspective, not only can an L3C come to a Donor Advised party, they should be able to dance together quite nicely, if they each follow the rules and behave themselves. With the possibility of forth coming regulations from the IRS, it is conceivable though, that the chaperone could shut down the party and dance early, and send everyone home. Stay tuned!

For More Information Regarding the L3C Visit Our Website:
americansforcommunitydevelopment.org

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