Grantmaking Best Practices & Emerging Trends

Greg Larson & Sarah Duniway
Partners

March 14, 2023

AGENDA

- BASICS: Legal requirements applicable to grantmaking
  - When making grants to public charities
  - When making grants to non-charities
  - When making grants to fiscal sponsors
  - When making grants to individuals
- DISCUSSION: Trends in grantmaking & legal implications

The Basics

- Granted funds must always be used for a charitable purpose
- Recipients may include:
  - Public charities—without restrictions
  - Private foundations—with expenditure responsibility (PFs)
  - Governmental entities—for exclusively public purposes (PFs)
  - Foreign nonprofits—with expenditure responsibility or equivalency determination (PFs)
  - For-profit organizations—with expenditure responsibility (PFs)
  - Individuals—under various circumstances

Grantmaking to Public Charities

Public Charity Classification in Grantmaking

- Important to understand public charity status of both the grantor and the grantee in the grantmaking relationship
  - Public charity vs private foundation
  - Type of public charity
- Primary Considerations
  - Ensuring charitable use / Expenditure Responsibility (PFs)
  - "Tipping" Risk
- Review public charity status as part of due diligence
  - Determination letter, IRS exempt orgs site, Form 990 Schedule A

Public Support Test and Avoiding "Tipping" of Grantees

- Some grantees must meet an ongoing **public support test** to qualify as a public charity
- Important for **private foundation grantors** to be generally aware of how the public support test works because of potential for tipping a **public charity grantee** into private foundation status
- Two different public support tests –
  - 170(b)(1)(A)(vi) (donative public charities)
  - 509(a)(2) (service providers)

Grantees Subject to Public Support Test

501(c)(3) Organizations

Public charities

Supported by donations 170(b)(1)(A)(vi)

Supported by fees 509(a)(2)

Churches, hospitals, schools 509(a)(1)

Supporting Organizations 509(a)(3) [3 Types]

Private (non-operating) Foundations

Private Operating Foundations

Avoiding Tipping—Consequences

- Impact of Tipping on **Grantee**
  - Becomes subject to more onerous rules applicable to private foundations
  - May disqualify grantee from receiving certain grants (some grantors will not make expenditure responsibility grants)
  - Less favorable charitable deduction limits for donors
- Impact of Tipping on **Grantor**
  - May result in taxable expenditure (to which penalties apply) if the PF grantor knew or should have known that its grant would tip the grantee

Avoiding Tipping—Due Diligence

Support Test for Donative Public Charities

- **Normally** receives at least **1/3 of its total support** from a governmental unit or direct or indirect contributions or grants from the public
  - "Normally" means over a rolling **5-year measurement period**
- Contributions from a single source (e.g., individual, private foundation) are counted as "good support" only to the extent they do not exceed **2%** of the grantee's total support over the 5-year measurement period
  - Grants from government or other public charities are 100% good support
- If fail 1/3 support test, can retain public charity status by receiving **at least 10% "good support" <u>and</u> meeting a facts-and-circumstances test** demonstrating potential for attracting public support
- May exclude **"unusual grants"** from public support test calculation

Avoiding Tipping—Due Diligence

Support Test for Service-Provider Charities

- **Normally** receives at **least 1/3 of its total support** from combination of contributions, grants, membership fees, and gross receipts from mission-related services
- Normally receives **no more than 1/3 of its total support** from gross investment income and UBTI
- Same rolling 5-year measurement period
- May exclude **"unusual grants"** from public support test calculation
  - But NOT the investment income generated by the unusual grant funds

Avoiding Tipping—Unusual Grants

- The exclusion for **unusual grants** is generally intended to apply to contributions or bequests from **disinterested parties** where the contributions or bequests:

  (1) are attracted by reason of the organization's publicly supported nature,

  (2) are **unusual or unexpected with regard to amount**, and

  (3) would, by reason of their size, **adversely affect the organization's status** as normally being publicly supported.

- Grantee may seek an advance ruling from IRS that a proposed grant will constitute an unusual grant

Avoiding Tipping—Other Strategies

- **PF grantors can be good partners to their grantees by**:
- **Educating grantees** on the tipping issue
- **Encouraging grantees to seek legal and accounting advice** on the issue (and perhaps funding the expense of doing so)
- **Being flexible** in structuring grant terms (might need to grant a smaller amount now and consider another grant in the future—note that installment payments will not help if the grantee uses accrual method of accounting)
- **Considering grant alternatives** such as loans (not counted in support calculation until/unless forgiven)
- Considering paying some of the grant from a DAF (but CAUTION! This is a loophole that is likely to close)

Grantmaking to Non-Charities

Fiscally Sponsored Grantees

- **Fiscal sponsorship**
  - **Public charity provides oversight, management, and administrative services** to a project that is not itself a public charity
  - Public charity acting as the “fiscal sponsor” determines that the project is a charitable activity, and that fundraising to support the project furthers its own charitable purposes
  - Governed by a fiscal sponsorship agreement
    - Note that there is **more than one way to structure a fiscal sponsorship**
    - Always ask for a **written fiscal sponsorship agreement** and **ask questions about relationship**

Fiscally Sponsored Grantees

- **Done right**: Allows a PF to make a grant to a public charity to support charitable activity of a grantee that is not itself a public charity without having to exercise expenditure responsibility
  - **Ensure written fiscal sponsorship agreement is in place**
  - **All parties treat the grant as made directly from the PF to the public charity**
  - **Fiscal sponsor retains “variance power”**
- **Done wrong**: Results in a taxable expenditure for PF (to which penalties apply) because the IRS will treat the grant as being made to a grantee that is not itself a public charity; also a problem for public charity grantmakers if funds may be used for non-charitable purposes
  - **Grant is earmarked for the ultimate grantee**
  - **Fiscal sponsor and grantee act as if grant is a “pass through” to the grantee**

Grants to Businesses and Other Non-Charities

- **Whether or not a grant is charitable depends on its purpose**, not solely who the recipient is
- Businesses and other non-charities can be conduits through which charitable purposes are accomplished and charitable classes are served
- Additional oversight responsibilities apply

Expenditure Responsibility

- **Purpose**: Ensure sufficient oversight that charitable grants are used to further exempt purposes
- **If grantor is a private foundation,** it must perform expenditure responsibility for grants to grantees that are not public charities or government entities
  - For example:
    - Private foundations, foreign charities, for-profits, other exempt entities such as 501(c)(4) or 501(c)(6)
    - And Type III supporting orgs that are "not functionally integrated"
- **If grantor is a public charity** making grants to non-charitable grantees, **follow ER "light"**

Expenditure Responsibility

- Requirements:
  - Conduct **pre-grant inquiry**
  - Enter into **written grant agreement**
  - Receive and review **grantee reports**
  - **Annual report** to IRS on Form 990-PF
  - Retain **records**
  - Investigate any **diversion** of funds

Grantmaking to Individuals

Grants to Individuals—Common Purposes

- Scholarships and fellowships
- Prizes and awards
- To achieve a specific objective, produce a report or similar product, or improve or enhance a literary, artistic, musical, scientific, or other capacity, skill, or talent of the grantee
  - The objective is the *grantee's* objective
  - When the purpose is to achieve the *grantor's* objective, likely a payment for services, not a grant
- Demonstrated need (aid to poor or distressed)
  - Disaster relief
  - Employer-sponsored assistance programs

Grants to Individuals—Special Rules for Private Foundations

- A grant from a private foundation to an individual for **“travel, study, or other similar purposes”** is a taxable expenditure (i.e., prohibited) unless:
  - It is awarded on an objective and nondiscriminatory basis;
  - It is awarded pursuant to a **procedure approved in advance** by the IRS; and
  - It is demonstrated that the grant is—
    - A **scholarship or fellowship**
    - A **prize or award** excluded from gross income
    - For the purpose of **achieving a specific objective or improving of a skill/talent of grantee**

Grants to Individuals—Special Rules for Private Foundations

- **Grants for travel, study, or other similar purposes—**
  - IRS advance approval of grant-making procedures may be obtained at the time of initial application for tax-exempt status, or through a separate application process
  - **Approval is of a set of procedures**, not a specific program
  - **No single set of procedures is required** (may vary with type of program)
  - In general, foundation is expected to exercise sufficient oversight over the grants to satisfy itself that the funds are used as intended

Trends in Grantmaking and Legal Implications

Criticisms of Traditional Philanthropy

The power dynamics are off—at its worst, it centers the desires of the grantor over the needs of the grantee and perpetuates existing inequities.

Criticisms of Traditional Philanthropy

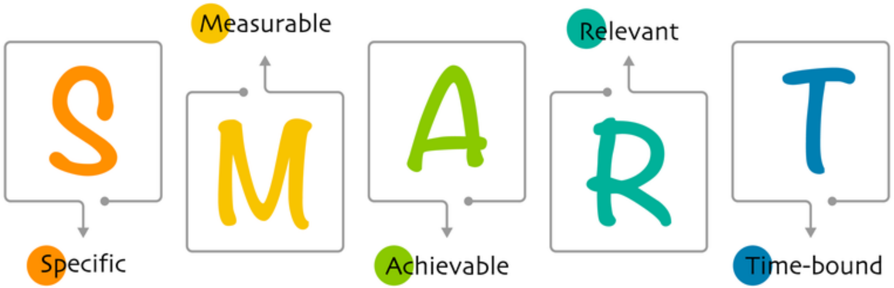
Endlessly seeking funds and reporting on their use is a distraction from mission activities.

Criticisms of Traditional Philanthropy

Project-based grants and narrow restrictions on use may be myopic.

Criticisms of Traditional Philanthropy

The insistence that hopeful grantees conduct specific goal-setting prior to applying for funds, measure everything, and aim for what's achievable in the short term might be SMART—but it might also discourage risk-taking, dampen creativity, and limit larger ambition.



Emerging Models: Trust-Based Philanthropy

- Trust-based philanthropy is principally about a redistribution of power in the grantor-grantee relationship.
- **The Trust-Based Philanthropy Project describes six practices of trust-based philanthropy.**

1. Give multi-year unrestricted grants
2. Funders do the homework
3. Simplify and streamline paperwork
4. Be transparent and responsive
5. Solicit and act on feedback
6. Offer support beyond the check

Emerging Models: Yield Giving (McKenzie Scott)

Our process to date:

- Conduct quiet research to identify candidate organizations working to advance the opportunities of people in underserved communities
- Evaluate organizations through careful analysis of criteria specific to their size, geography, and mission for indicators of high potential for sustained positive impact, including stable finances, multi-year track records, measurement and evidence of outcomes, and experienced leadership representative of the community served
- Complete these steps as privately and anonymously as we can in order to limit burden on non-profits and avoid diverting them from their work
- Reach out to selected organizations to tell them we admire what they are doing and would like to give them an immediate gift for use however they choose
- Incorporate experience and perspective of a diverse extended team: small internal giving and operations unit, large network of advisors (consultants, non-profit leaders, and other givers), and external operational support specialists (translation, international non-profit law, and high-volume investment and gift administration)

Emerging Models: Early Review of McKenzie Scott Giving

- The **Center for Effective Philanthropy** is conducting a three-year study* to examine the impacts on nonprofits who received surprise, unrestricted, very large grants. Some lessons so far—

1. Nonprofit leaders describe these large, unrestricted grants as **transformational for their organizations and their leadership,** allowing them to address longstanding needs, including **advancement of equity.**
2. The **health of nonprofit organizations matters**—strengthening institutions (as opposed to advancing a particular program) can create enduring impact.
3. Most organizations are using some of the money to **hire and fairly compensate and support staff** who are vital to the work (traditional philanthropy might view this negatively as "increased overhead" or "bloat").
4. No reports of unintended consequences such as declines in other funding.

*Giving Big: The Impact of Large, Unrestricted Gifts on Nonprofits

Emerging Models: Cash to Individuals

- Extension of trust-based philanthropy to individual recipients
- Unrestricted cash grants / guaranteed income
- Focus on outcomes over specific reporting on use of funds
- Examples:
  - **Youthprise**—unrestricted monthly cash for unsheltered youth over a 2-year period. Desired outcome is to achieve housing stability within 2 years.
  - **Frey Foundation**—piloting unrestricted cash grants to Black men exiting incarceration. Desired outcomes are dignified housing, quality of life, learning.
    - Prepaid credit cards generate data to analyze use of funds & trends on an aggregate basis
    - Reporting from individual participants is <u>not</u> about how dollars were spent but what outcomes were achieved

Emerging Models: Cash to Individuals—Is it Charitable?

Charitable is used in its generally accepted legal sense and includes:

- Relief of the poor and distressed or of the underprivileged
- Advancement of education
- Lessening the burdens of government
- Promotion of social welfare by organizations designed to—
  - Lessen neighborhood tensions
  - Eliminate prejudice and discrimination
  - Defend human and civil rights
  - Combat community deterioration
  - Combat juvenile delinquency
- **Does it benefit a charitable class of persons?**

Emerging Models: Race-Restricted Grantmaking

- Grants to BIPOC-serving organizations
- Grants to BIPOC-led organizations
- PRIs in BIPOC-owned companies
- Scholarships to BIPOC students

Emerging Models: Race-Restricted Grantmaking—Is it Charitable?

- A 501(c)(3) must be organized & operated exclusively (primarily) for charitable purposes
- Will not meet these tests unless organization serves public rather than private interests—sometimes this means the charity supports a **"charitable class"**
- Individuals and businesses may be conduits through which charitable purposes are pursued—*see* Rev. Rul. 74-587 (next slide)
- **All other laws still apply**, even if an activity is charitable under tax law (e.g., civil rights laws, employment laws)—and engaging in illegal activities is a basis for revocation

Emerging Models: Race-Restricted Grantmaking

Rev. Rul. 74-587 – organization provided loans and working capital to businesses as part of charitable activities

- Gave low-cost or long-term loans to minority-owned businesses and individuals who didn’t qualify for conventional financing
- Made investments in the businesses—typically would dispose of business interests as soon as it was demonstrated the business could survive
- IRS observed “these loans and purchases of equity interests are not undertaken for purpose of profit or gain but for the purpose of advancing the charitable goals of the organization and are not investments for profit in any conventional business sense.”
- Preference given to businesses that provided employment and training opportunities to the unemployed and under-employed

Emerging Models: Race-Restricted Grantmaking

Rev. Rul. 74-587 – Continued

IRS identified numerous charitable purposes—

- "Aiding minority-owned businesses **promotes the social welfare** of the community"
- Helps **eliminate prejudice and discrimination** by demonstrating that disadvantaged residents of an economically depressed area can successfully operate businesses when given the opportunity
- **Relieves poverty**
- **Lessens neighborhood tensions** arising from unemployment / lack of opportunity
- **Combats community deterioration**

Emerging Models: Race-Restricted Grantmaking

Rev. Rul. 74-587 – Application to support of BIPOC organizations and individuals

- **Be able to identify and articulate the charitable purpose of the support** (in terms described in Section 501(c)(3) and IRS rulings)
- **Be able to identify the charitable class of persons being served** (no guidance that says all BIPOC individuals or BIPOC-owned/managed businesses constitute a charitable class)
- **Again, it could be that individuals or businesses are conducting activities with a charitable purpose and serving a charitable class**
- **Consider the context and exercise caution** (application of other laws, political opponents, who's left out)

Questions??