

TRUSTS ESTATES

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How DAFs Can Support Nonprofits Through Nontraditional Means

Help donors have a greater impact

While not subject to the same distribution requirements as private foundations (PFs), donor-advised funds (DAFs) consistently punch above their weight when it comes to grantmaking. For instance, researchers have noted that despite holding just one-sixth of the aggregate assets held by all DAFs and PFs, DAFs were responsible for roughly a third of such charitable entities' grants in 2022.¹

How do DAFs compare to PFs in terms of less traditional means of support? And when should DAF donors weigh alternate strategies? Consider that many nonprofits consistently raise *just enough* revenue from fees for service, government and private fundraising to meet their immediate needs and must turn to other forms of financing to achieve certain long-term goals. And while PFs have a long history of providing such financing through program-related investments (PRIs), the ability of DAFs to engage in these strategies is slightly murkier. We'll cover the ground rules for DAFs in supporting nonprofits beyond grantmaking. We'll also examine how donors might weave together traditional and nontraditional strategies to achieve greater impact.

DAF Basics

Although DAFs have been part of the philanthropic landscape for almost a century, it wasn't until the

enactment of the Pension Protection Act of 2006 that they were formally recognized. Internal Revenue Code Section 4966(d)(2) defines a DAF as a separate fund or account owned and controlled by a public charity (a "sponsoring organization") and funded with contributions from one or more donors who retain advisory privileges—but not ultimate control—over the distribution or investment of DAF assets. Because the sponsoring organization remains the DAF's final decisionmaker, contributions to a DAF receive the same treatment as those made to a public charity under most circumstances. Additionally, DAFs aren't subjected to required distribution rules and certain other restrictions applicable to PFs. But with this added flexibility comes some heightened complexity in providing philanthropic support outside of grantmaking, as outlined below.

Mission-Driven Investing

Donors looking to provide additional capital to nonprofits without overly depleting a DAF's funds may consider exploring concessionary investments. Rather than simply distributing cash, a DAF could leverage its balance sheet to deliver benefits to a nonprofit at below-market terms if permitted by the DAF's sponsoring organization. Such investments may include:

- Direct loans to a nonprofit at below-market interest rates or with other borrower-favorable repayment terms;
- Credit enhancement arrangements, such as loan guarantees, to bolster a nonprofit's ability to secure competitive lending; or
- Equity investments in capital assets for nonprofit use with expectations of below-market returns.

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We'll refer to these strategies as "mission-driven investments." Importantly, due to the additional legal and administrative requirements associated with such non-grant strategies, sponsoring organizations vary in their ability to support them.

In structuring this type of investment, donors first must consider certain tax and fiduciary restrictions—paying close attention to prevailing uncertainty around their specific application to DAFs. For example, consider the tax penalties applied to both PFs and DAFs to ensure such entities' pursuit of charitable, rather than unrelated business, purposes. IRC Section 4943 imposes an excess business holdings tax when a PF or DAF and its disqualified persons² own more than 20% (or, in some cases, 35%) of the voting or profits interests in a business not functionally related to the entity's charitable purpose. Additionally, IRC Section 511 levies an unrelated business income (UBI) tax on the gross income generated by a PF or DAF's investment in such unrelated business. IRC Sections 4945 and 4966 also institute an excise tax on a PF or a DAF's sponsoring organization, respectively, for certain distributions that fail to further the entity's charitable purpose and are made without appropriate financial oversight. *Thus, aligning any mission-driven investment with its investing entity's charitable purpose is key to avoiding such taxes.*

When does an investment serve a legitimate charitable purpose? The IRC sections and Treasury regulations pertaining to PFs provide some guidance. IRC Section 4944 defines PRIs as investments:

the primary purpose of which is to accomplish one or more of [the foundation's exempt activities], and no significant purpose of which is the production of income or the appreciation of property.

In practice, for an investment to qualify as a PRI, a PF must demonstrate that it significantly furthers the PF's exempt activities and is unlikely to be made by a third-party investor without such charitable goals.³ Consider a PF providing a below-market loan to a mission-aligned nonprofit.

The low borrowing costs would likely support the nonprofit's ability to provide services furthering the PF's mission. Moreover, a third-party investor would be unlikely to lend at a submarket return. Hence, whatever interest such a loan generates is unlikely to have been a significant driver in the PF's decision to lend.

If an investment qualifies as a PRI, it's excluded from the excess business holdings tax as a program-related activity.⁴ Similarly, PRIs are seldom subjected to the UBI tax due to their relationship to the PF's exempt purpose.⁵ And, they aren't treated as taxable expenditures if the PF exercises the required financial oversight.⁶

DAF donors should also weigh the impact of state fiduciary standards.

Notably, the concept of a PRI applies solely to PFs. The IRC sections applicable to DAFs don't expressly adopt this term. That said, since public charities (including the sponsoring organizations for DAFs) are typically subject to less regulatory scrutiny than PFs, it stands to reason that an activity deemed to serve a charitable purpose when conducted by a PF would similarly support a charitable purpose if done by a public charity or DAF. As such, to avoid undesirable tax ramifications, DAF donors and sponsoring organizations frequently rely on the PRI guidelines when structuring mission-driven investments.

DAF donors should also weigh the impact of state fiduciary standards. Most U.S. states have adopted some form of the Uniform Prudent Management of Institutional Funds Act (UPMIFA), which governs the investment and management of institutional funds, including DAFs.⁷ The UPMIFA requires that DAF administrators invest DAF funds "in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances."⁸ However, this analysis may take into consideration "an

asset's special relationship or special value, if any, to the charitable purposes of the institution.⁹⁹ Thus, a DAF's mission-driven investment may satisfy UPMIFA's prudent investor standard by its impact on the DAF's charitable purpose, even if it fails to secure the same return or other financial benefit of an unrelated investment.

Recoverable grants can be an effective means for DAFs to provide a nonprofit with needed capital apart from its traditional grantmaking but without the additional restrictions of a PRI.

Splitting the Difference

Can a DAF provide a nonprofit with needed capital apart from its traditional grantmaking but without the additional restrictions of a PRI? Indeed, it can! Enter the recoverable grant. This type of grant is made to a qualifying charitable organization subject to terms allowing for the DAF's recovery of capital based on certain pre-set objectives. For example, recapture or forgiveness may hinge on the charitable organization achieving certain fundraising or programmatic targets. The nonbinding agreement typically sets out all agreed-on trigger events, along with the timing of recovery and any applicable interest rate. A recoverable grant's structure may appeal to a DAF donor as it allows the recycling of grant dollars to support multiple nonprofits or charitable projects. It also can serve as a means of influencing the nonprofit's operations and goals. Meanwhile, the lower cost of capital and friendlier terms may make such grants an attractive funding source for nonprofit borrowers.

Importantly, recoverable grants are just that—grants, not loans. Repayments hinge on the nonprofit's performance in connection with identified targets rather than a set schedule like

a traditional loan. Their classification as grants allows the receiving nonprofit to book such funds as receivables without negatively impacting the organization's creditworthiness or violating the terms of any existing financing. Additionally, the issuing DAF can treat such grants as expenses on its statement of activities without the additional tax and regulatory hurdles associated with PRIs.

Case Study

Now that we've identified different means of leveraging a DAF's charitable assets outside of traditional grantmaking, let's consider how a DAF donor might piece together such strategies to address the needs of a local nonprofit.

Meet Sophia, an entrepreneur who contributed \$5 million to a DAF following the sale of her business. Sophia's primary concern is the development of quality affordable housing for low income families in her local community. Through her yearly \$500,000 donations and volunteer work, Sophia developed strong ties to a local nonprofit, Getty Housing Partnership (GHP), which hoped to expand its services to a neighboring community. However, this plan would require the purchase of a new building and revamping of its current infrastructure.

When she learned of GHP's plans, Sophia asked her advisor to assist GHP's board of directors in determining whether the organization had sufficient revenue to support its ongoing activities and the expansion. The advisor reviewed GHP's balance sheet, typical revenue streams, ability to borrow and spending needs—including those necessary for the upcoming project. Based on this information, GHP had \$5 million in liquid assets, including \$3 million in cash and \$2 million in long-term investments. While they could withdraw the \$4 million needed to fund the proposed expansion, that would eliminate their long-term portfolio and significantly reduce their cash reserves, leaving them in a precarious financial position. How could they remain invested while supporting the new operating budget?

GHP's board of directors sought other sources of \$4 million in additional capital to solve this shortfall. In response, Sophia considered making a \$4 million grant from her DAF in lieu of the next eight years' worth of grants. However, her advisor noted that

an 80% drop in assets would significantly hinder the growth of her DAF's portfolio, undermining her long-term support for GHP.

To help Sophia make a decision, her advisor quantified the potential financial outcomes of making such a large gift. The analysis showed that if her DAF made an immediate \$4 million distribution and discontinued her annual \$500,000 gifts for the subsequent 8-year period, the DAF portfolio would grow to a median value of \$1.6 million by the end of Year 8, assuming a 60% stock and 40% bond allocation. As a result, the DAF would sustain only a few years of gifts before being depleted. Alternatively, if the DAF distributed \$2 million while discontinuing annual gifts in the subsequent four years, the DAF's value would be \$2.5 million by the end of Year 8, thereby

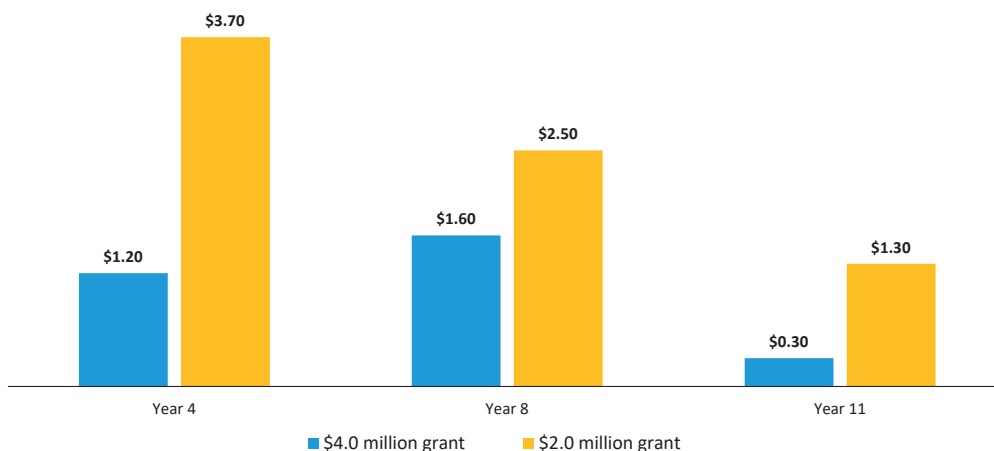
extending Sophia's giving potential by several additional years. See "DAF Portfolio Growth Over Time," this page.

While launching and expanding her own business, Sophia grew comfortable with taking measured risks and assuming strategic debt. So, her advisor raised the possibility of helping GHP improve its creditworthiness along with providing additional grant money. Specifically, her advisor suggested structuring the \$2 million grant as a recoverable grant and using the DAF's remaining \$3 million to guarantee GHP's loan for the \$2 million shortfall. This would bolster GHP's ability to secure a loan at a competitive interest rate while allowing the DAF to keep the extra \$3 million fully invested.

To protect the DAF from a "double whammy," GHP would enter into a reimbursement agreement

DAF Portfolio Growth Over Time

Giving potential is extended



- Assumptions: Asset allocation to 60% global stocks, 40% bonds. In the \$4 million scenario (blue columns), annual fixed distributions of \$500,000 begin in Year 9. In the \$2 million scenario (yellow columns), annual fixed distributions of \$500,000 begin in Year 5. Figures are in USD millions.
- Note: These figures are based on AllianceBernstein's estimates of the range of returns for the applicable capital market over the periods analyzed. Data doesn't represent past performance and isn't a promise of actual future results or a range of future results. Asset values represent the estimated market value; if the assets were liquidated, additional capital gains or losses would be realized that aren't reflected here.

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to repay any funds outlaid by the DAF under the guarantee. The recoverable grant could also allow for forgiveness as GHP builds sufficient reserves to eliminate the DAF's guarantee, as it secures \$2 million in savings. This plan would leave the DAF with an aggregate expense of \$2 million and a means of encouraging GHP to take the necessary steps to eliminate the DAF's exposure under the guarantee.


Overjoyed by Sophia's suggestion, GHP's board of directors began working with Sophia and her advisor to nail down the terms of both the recoverable grant and the guarantee. As a first step, Sophia's advisor performed a cash reserves analysis to help the GHP board size the amount that should be kept in cash and short-term bonds as an operating reserve (a rainy day fund to protect against shortfalls) after purchasing the building.

According to the analysis, GHP would need to keep a reserve of \$1,612,500 in cash and short-term bonds after the expansion, an equivalent to over four months of expenses. In deriving this figure, the advisor accounted for the organization's various risks—including variability in revenue and spending, the potential for timing mismatches between inflows and outflows and changes in borrowing capacity after accounting for the new \$2 million loan. The advisor also determined that the reserve would support increased programming expenses and building maintenance costs over the next several years until expected grants and increased revenue from the building expansion caught up with spending. Still, that would leave GHP with \$1.4 million of cash that could be redeployed for operating expenses or moved to the long-term investment portfolio.

In addition to their cash reserves, the advisor recommended an asset allocation of 80% stocks and 20% bonds for GHP's long-term portfolios. This allocation would allow GHP's portfolio to grow at a pace necessary to secure the required \$2 million of reserves to assume the DAF's obligations under the guarantee and achieve forgiveness under the recoverable grant. The advisor's wealth forecasting analysis projected a median annual return of 6% over the next 10 years in an 80/20 stock/bond portfolio. Further, it illustrated that the \$1.4 million

of cash would take six years to grow to the \$2 million savings target. See "Projected Range of Portfolio Values," last page.

Innovative Strategies

Recoverable grants can be an effective means for DAFs to provide a nonprofit with needed capital apart from its traditional grantmaking but without the additional restrictions of a PRI. Yet the most powerful combination might arise when a DAF donor pieces together disparate strategies to address a nonprofit's needs. Combining a recoverable grant and a guarantee, for example, may allow the DAF to keep excess funds fully invested—while extending the donor's long-term support. Critically, a cash reserves analysis can help nonprofits size the amount that's truly needed to support such an innovative and transformational gift. By leveraging these strategies in tandem, DAFs can provide additional capital to nonprofits and encourage them to strengthen their financial wherewithal to fulfill their mission. 

Endnotes

1. www.nptrust.org/reports/daf-report/#:~:text=DAF%20charitable%20assets%20amount%20to,of%20grants%20from%20private%20foundations.&text=In%202022%2C%20DAFs%20granted%2022.5,assets%20from%20the%20previous%20year. Researchers also noted that grants reported by donor-advised funds (DAFs) didn't reflect the same grant-related expenditures and administrative expenses incorporated into the private foundations' grant numbers.
2. As defined under Internal Revenue Code Section 4943(e)(2), a "disqualified person" with respect to a DAF includes a donor advisor, a donor advisor's family members and entities owned at least 35% or more by such individuals.
3. Additionally, a program-related investment can't serve the purpose of attempting to influence legislation or participating or intervening in a political campaign on behalf of or in opposition to a candidate. Treasury Regulations Section 53.4944-3(a)(1)(iii).
4. Treas. Regs. Section 53.4943-10(b).
5. IRC Section 513.
6. IRC Section 4945.
7. Uniform Prudent Management of Institutional Funds Act (Uniform Law Commission 2006).
8. *Ibid.*, at Section 3(b).
9. *Ibid.*, at Section 3(e)(1)(H).

Projected Range of Portfolio Values

Target reached in Year 6



- Assumptions: Asset allocation to 60% global stocks, 40% bonds. Figures are in \$USD millions.
- Beginning portfolio value is \$1.4 million and is projected to grow to \$1.5 million by the end of Year 1 in typical markets.
- Note that these figures are based on AllianceBernstein's estimates of the range of returns for the applicable capital markets over the periods analyzed. Data doesn't represent past performance and isn't a promise of actual future results or a range of future results. Asset values represent the estimated market value; if the assets were liquidated, additional capital gains or losses would be realized that aren't reflected here.

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