



FEATURE: PHILANTHROPY

By **Kristen A. Curatolo**

Reimagining Succession Planning for Donor-Advised Funds

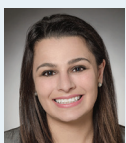
Create new opportunities with a charitable limited liability company

A **high-net-worth (HNW) individual** may use a donor-advised fund (DAF) as part of their philanthropy planning for many reasons, such as speed of creation, ease of administration and to maximize the allowable charitable deduction. Despite the ease of DAFs, the affluent often create a private non-operating foundation (PF) because they desire control over grantmaking and investment decisions (via a board of directors). Succession planning for PFs typically requires a lot of thought, with much consideration given to board composition, investment policies and sustainability. However, succession planning for DAFs is often overlooked aside from quietly adding a spouse and children to the class of advisors on the DAF account (usually effective on the donor's death). Estate planners and wealth advisors have an opportunity to add immense value to their clients by reopening the DAF succession conversation and suggesting a new structure: a charitable limited liability company (LLC) as the "donor" advising on distributions from the DAF. By incorporating a charitable LLC into the DAF structure, clients may combine the flexibility of the LLC with the many benefits of the DAF.

Here are the general benefits and drawbacks of the charitable LLC and DAF and an explanation of how a charitable LLC creates opportunities to customize DAF succession planning.

Charitable LLCs

About a decade ago, the Chan Zuckerberg Initiative



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raised awareness about the charitable LLC when Mark Zuckerberg and Priscilla Chan selected this structure for their philanthropic activities.¹ On its face, the decision was surprising because the LLC isn't tax-exempt, whereas DAFs and PFs are exempt from federal income tax. As a disregarded entity, any gains on the sale of assets held in the LLC flow through the LLC and are taxable to the LLC members unless the LLC elects to be classified as an association taxable as a corporation. And, perhaps most notably, no income tax deduction is available on the creation and funding of the LLC. But, if the LLC makes a grant to charity, a charitable income tax deduction, at that time, will flow through to the LLC's members (subject, however, to each member's applicable gross income limitation).²

Despite these drawbacks, the LLC structure has several upsides.³ First, there are no annual distribution requirements (unlike a PF, with a 5% mandatory annual distribution).⁴ Second, there are no special excise taxes that apply to LLCs (such as self-dealing, excess business holdings, jeopardy investments and taxable expenditures).⁵ Third, an LLC has no direct Attorney General oversight.⁶ Fourth, the LLC structure affords the donors privacy because LLC filings aren't public (unlike the PF, whose annual income tax return is publicly available).⁷ Finally, there's no limitation on the scope of the LLC's activities.⁸ For example, the LLC may invest in domestic and foreign for-profit opportunities without any issues.

DAFs

Generally, a DAF is a separately identified fund or account that's maintained and operated by an Internal Revenue Code Section 501(c)(3) organization, called a "sponsoring organization."⁹



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Each account is composed of contributions made by one or more individual donors.¹⁰ Once the donor makes the contribution, the sponsoring organization has legal control over the account, but 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.¹¹

DAFs have several positive attributes. First, unlike PFs, DAFs have no annual mandatory payout requirement.¹² This provides flexibility in determining how to expend the contributed funds over time (although most national DAFs self-impose a 5% mandatory annual distribution). Second, as it operates as part of a public charity (that is, the sponsoring organization), it isn't subject to the excise taxes applicable to PFs. Third, there's no Attorney General oversight. Fourth, the DAF can be created online in a matter of minutes. Compared with many PFs, there's minimal cost of administration.¹³ No separate corporation is necessary to direct the donor's charitable giving. Finally, there are few limitations on the identity of the charitable recipients.¹⁴

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While DAFs are user-friendly, they also have limitations. First, contributions to the DAF are irrevocable, and the donor relinquishes control on donation to the public charity sponsoring the DAF. Second, the donor (that is, the HNW individual or the charitable LLC) relinquishes control on donation to the DAF, and thereafter, the sponsoring organization obtains control over the ultimate disposition of the funds. The donor may make only non-binding recommendations to the DAF sponsor. Third, a DAF overseen by a public charity sponsor is often a less visible and public option for conducting charitable activities than a separate foundation

created by the donor. Finally, DAF sponsors may not accept recommendations for distributions to foreign charities unless the DAF sponsor deems the recipient organization is the equivalent of a U.S. public charity.

DAF Life Span

There's no statutory limitation on a DAF's duration. However, the DAF sponsor may have internal policies that limit the life span of a DAF account to a few generations or a term of years. In theory, a DAF could last in perpetuity so long as a successor advisor on the DAF account is named.

If the donor advisor is no longer available to advise the DAF sponsor on grantmaking, and no successor advisor has been appointed, the DAF becomes an "orphan."¹⁵ An orphaned DAF's funds become unrestricted assets of the DAF sponsoring organization.¹⁶ While the DAF sponsor must use it for charitable purposes, the DAF sponsor takes control over the disposition of the DAF account. The treatment of orphaned DAFs depends on the DAF sponsor's policies. A board of advisors at the DAF sponsor might take over grantmaking responsibilities. Or, the DAF sponsor might direct funds to a list of preselected charities (either chosen by the DAF creator or the DAF sponsor). Much like how state law governs intestacy for those who die without a will, if the donor advisor doesn't take the time to create a succession plan, the DAF sponsor creates one for them.

Adding a Charitable LLC to a DAF

A DAF account has one or more "advisors" who, acting unanimously, advise the DAF sponsor on the amount and timing of grants to charitable recipients (which may not include PFs). The DAF sponsor usually honors these recommendations so long as the grant complies with its standards and guidelines.

Despite the staggering size of a client's DAF, many times, the extent of the client's succession planning for the DAF is to add a spouse and/or children to the class of donor advisors (which can be effective on the client's death). However, this arrangement often doesn't achieve the client's goals. For example, if the client's spouse predeceases the client, this designation often isn't readdressed. Or, perhaps one or more of the client's children have no experience in charitable giving and grantmaking. Or, worst of all, the client's

children have no interest in being involved. To avoid hurting the feelings of an unqualified family member, the client may err on the side of including all children as successor advisors on the DAF account, even if the client feels that only one child understands the client's objectives and is suited for the role.

A more nuanced approach may be appropriate for large DAF succession planning. By adding a charitable LLC to the DAF structure, clients may ensure the right individuals are in the right positions with the right responsibilities. Here's how it works: A charitable LLC can control a DAF account. Under the terms of the LLC's operating agreement, the client can lay out a detailed plan for making grant recommendations from the DAF account, including how to appoint and remove the advisor on the DAF account. Specifically, the functions of an advisory committee, management committee and DAF representative may be baked into the LLC's operating agreement as provided below:

Structuring the charitable LLC.

- *Name.* The LLC may be named anything, but it typically must contain the abbreviation LLC, L.L.C. or the words "Limited Liability Company."
- *Governing law.* A flexible jurisdiction, such as Delaware, allows for the expedited creation of the LLC while disclosing minimal information about the donor.
- *Initial capital contributions and ownership.* Initially, the donor contributes cash to the LLC in exchange for a percentage interest as sole member. Additional members may be added if desired.
- *Tax returns.* The income and gains will pass through to the member(s), who will report the profits or losses on their respective tax returns. Each year, the LLC will file an income tax return (Form 1065) and issue a Schedule K-1 to each member.¹⁷
- *Advisory committee.* The Advisory committee for the LLC may include anyone, including leaders or consultants in the charitable community. The committee may: (1) propose and recommend grants from the LLC to the management committee; and (2) propose and recommend any other charitable or non-charitable activities conducted by the LLC.

- *Management committee.* The management committee determines when and in what amount distributions will be made from the LLC (including contributions to the DAF accounts). The management committee is also responsible for the day-to-day management and administration of the LLC. However, the management committee will only manage the LLC's assets if no investment committee member is serving. A majority vote of the management committee may designate additional and successor management committee members. A majority vote of the management committee may remove management committee members.

The investment committee
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responsibility to manage the
LLC's assets/investments.

- *Investment committee.* The investment committee has the power, right and responsibility to manage the LLC's assets/investments. The management committee may designate additional and successor investment committee members and may remove investment committee members.
- *Distributions.* Distributions may be made to the DAF account or directly to charities and other entities selected by the management committee at such times and in such amounts as the management committee determines.
- *Profits/losses.* Profits and losses will be allocated among the capital accounts of the members of the LLC based on each member's percentage interest in the LLC.

Setting up the DAF account.

- *Creation.* The charitable LLC creates a DAF account online at a DAF sponsoring organization. The DAF account may be named anything and will take only minutes to create.



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- *Funding.* The charitable LLC contributes cash to the DAF.¹⁸
- *Grant-making process.* First, the charitable LLC's advisory committee makes a recommendation to the management committee on proposed grants to public charities from the DAF account. Next, the charitable LLC's management committee votes on and approves the amount of each grant and the charity receiving the grant. Finally, once the grant is approved, the charitable LLC's management committee makes a written direction to the "DAF representative" (see below).

DAF succession planning deserves as much attention afforded to succession planning for PFs.

- *DAF representative.* The DAF representative will be an individual designated under the charitable LLC's operating agreement. The management committee of the charitable LLC will have authority over the appointment, removal and replacement of the DAF representative and will update the DAF sponsor on any changes in DAF representatives. For administrative ease, the DAF representative will have sole signing authority over the DAF account. Only the DAF representative can advise (not direct) the DAF sponsor on all grantmaking from the DAF account. Ultimate discretionary authority over distributions from the DAF is in the hands of the DAF sponsor.
- *Viewing ability.* The charitable LLC's management and advisory committees may maintain viewing ability over the DAF account. "Viewing ability" means the ability to access the DAF account's investments, statements and grant-making activity. This would ensure checks and balances on the DAF representative's signing authority over the account.
- *Investments.* The charitable LLC's management committee or investment committee will direct

the DAF account's investments. Typically, the DAF sponsor has several funds as part of its standard investment offering. Any exchange-traded fund can be selected, but individual bonds or publicly traded stock positions typically aren't permitted investments.

- *Transferability.* If a different DAF sponsor is desired in the future, the DAF account may be transferred to another DAF sponsor.
- *Fees.* The DAF sponsor's fee schedule for administering the DAF account is typically based on its size. For example, account balances between \$10 million and \$20 million may warrant 17 basis points, while an account balance of \$250 million or more may warrant 5.5 basis points.

Three Examples

Here are three examples of how charitable LLCs can be used with DAFs in succession planning:

The diligent daughter. Dad built a successful empire in the financial industry. Along the way, Dad married Mom, had three children and created a DAF. As Dad built his career, he regularly made contributions to his DAF (which has grown substantially). As Dad retires, he takes stock of where his children are in life: Daughter is heavily involved in charitable work around the world, Son 1 has thrown himself into the family business and Son 2 was so successful in his cryptocurrency endeavors that he took up surfing in Hawaii and is nearly impossible to reach. Traditionally, Dad might have approached DAF succession planning by adding Mom as a co-advisor and then his three children as successor advisors after Mom dies. Because advisors on a DAF account must act unanimously, imagine Daughter's frustration carrying out Dad's charitable legacy by trying to get the attention of Son 1 and fruitlessly trying to get ahold of Son 2. Instead, Dad could set up a charitable LLC that: (1) places Daughter on the management committee; (2) places his three children on the advisory committee to recommend grants; (3) places Dad's long-time business partner on the investment committee; and (4) designates Daughter as the DAF representative. This way, Son 1 and Son 2 may remain involved by recommending grants, but Daughter can handle management responsibilities

and effectively carry out Dad's charitable intentions.


The disinterested descendants. Assume the same facts described in "The diligent daughter," except all three children were successful in the cryptocurrency endeavor and now operate a surfing school in Hawaii together. They live and breathe surfing and have minimal interest in much else. Dad panics because he can't think of anyone to designate as an advisor on the DAF account after Mom dies. To solve this, Dad could set up a charitable LLC that: (1) places a handful of prominent charitable experts who understand Dad's charitable goals on the management committee; (2) places his three children, some close friends and the charitable experts on the advisory committee to recommend grants; (3) places Dad's financial advisor on the investment committee; and (4) designates three of the charitable experts as the DAF representatives. This way, the children may remain involved by recommending grants, but a team of engaged charitable experts who are familiar with Dad's mission can handle management and grant-making responsibilities.

By incorporating a charitable LLC into the DAF structure, the client may find the tools to harmoniously balance tricky family relationships and philanthropic objectives.

Keeping options open. Assume the same facts described in "The diligent daughter," except Dad's philanthropic vision includes more than simply cutting checks to existing charities. Dad wants to organize free financial literacy classes for high school students. A DAF account (and its sponsoring organization) is purely for grantmaking and not for conducting charitable activities. Dad doesn't want to add complexity to his philanthropy structure by

creating a PF or entering into a joint venture with an existing charity. Dad can achieve his objectives of keeping things simple and consolidated by setting up a charitable LLC that looks like the one in "The diligent daughter" but also by creating a charitable programming committee that's populated by his children and leaders in the financial industry and local communities to develop and conduct financial literacy classes and plan other charitable activities.

A Balancing Act

DAF succession planning deserves as much attention afforded to succession planning for PFs. Today, grants from DAFs account for more than 10% of all giving in the United States.¹⁹ As DAFs are now sizable line items on clients' balance sheets, estate planners and advisors can seize the opportunity to reopen the DAF succession conversation. By incorporating a charitable LLC into the DAF structure, the client may find the tools to harmoniously balance tricky family relationships and philanthropic objectives. 

Endnotes

1. Natasha Singer and Mike Isaac, "Mark Zuckerberg's Philanthropy Uses L.L.C. For More Control," *New York Times* (Dec. 2, 2015).
2. Internal Revenue Service, "Charitable Contribution Deductions," www.irs.gov/charities-non-profits/charitable-organizations/charitable-contribution-deductions.
3. For a terrific discussion about the pros and cons of the charitable limited liability company (LLC) structure, see Jennifer B. Goode, Jennifer R. Ostberg and Ashley E. Velategui, "From Grantmaking to Problem Solving: The Power of Charitable LLCs," *Trusts & Estates* (September 2023).
4. Internal Revenue Code Section 4942 provides that private foundations (PFs) must make "qualifying distributions" equal to 5% of their non-charitable assets annually. In general, a distribution to a public charity described in IRC Section 509(a)(1), (2) or (3) to accomplish a religious, charitable, scientific, literary, educational or other permitted public purpose is a qualifying distribution. See Internal Revenue Service, "Qualifying distributions: In general," www.irs.gov/charities-non-profits/private-foundations/qualifying-distributions-in-general.
5. See Lauren Watson Cesare, "Private Foundations and Public Charities—Definition and Classification," 456 *Tax Mgmt. Port.* (BNA), for a discussion of the advantages and disadvantages of PFs.
6. In many states, such as New York, the Office of the State Attorney General regulates non-profit organizations and fundraisers.



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7. The Corporate Transparency Act (CTA) has threatened to remove some of the privacy benefits by requiring all LLCs to file a beneficial ownership information report (BOIR). As of the date of this publication, given ongoing litigation as to the CTA's constitutionality, the Financial Crimes Enforcement Network (FinCEN) isn't requiring companies to file beneficial ownership information. However, reporting companies may continue to voluntarily submit BOIRs. See FinCEN, "Beneficial Ownership Information," <https://fincen.gov/boi>.
8. A PF must have a purpose that's charitable under IRC Section 501(c)(3) and, among other things, can't engage in political action or use their net earnings to benefit private shareholders.
9. For example, Fidelity Charitable, Schwab Charitable and National Philanthropic Trust are among the largest donor-advised fund (DAF) sponsors in the United States.

SPOTLIGHT



Flash a Smile

Flowers of Hope by Takashi Murakami sold for HK\$1,143,000 at Phillips New Now: Modern & Contemporary Art auction on Oct. 4, 2024 in Hong Kong. Murakami is known for exploring the kawaii aesthetic, a concept deeply rooted in Japanese culture that signifies cuteness and innocence.

10. "Donor-advised funds," www.irs.gov/charities-non-profits/charitable-organizations/donor-advised-funds.
11. *Ibid.*
12. While DAFs don't currently have a mandatory payout requirement, there's been extensive discussion and heightened scrutiny from lawmakers about regulating DAFs. For example, the IRS published proposed Treasury Regulations REG-142338-07 under IRC Section 4966 on Nov. 14, 2023 that would apply to DAFs. See "Taxes on Distributions From Donor Advised Funds Under Section 4966," www.federalregister.gov/documents/2023/11/14/2023-24982/taxes-on-taxable-distributions-from-donor-advised-funds-under-section-4966 and www.federalregister.gov/documents/2024/01/09/2024-00260/taxes-on-taxable-distributions-from-donor-advised-funds-under-section-4966. The IRS states that:
[t]he proposed regulations relate to excise taxes on taxable distributions made by a sponsoring organization from a donor advised fund, and on the agreement of certain fund managers to the making of such distributions.
Notably, it doesn't address a mandatory DAF payout requirement.
13. DAFs typically have administrative and investment management fees. These fees can vary depending on the fund sponsor and the amount of assets in the fund.
14. The charitable recipient from a DAF is typically another Section 501(c)(3) organization. The DAF can't make contributions to PFs and can't be used to personally benefit the donor (or their family members).
15. "Donor Advised Fund Succession Planning: What Happens Next?" Massachusetts General Hospital Giving (March 12, 2024), <https://giving.massgeneral.org/stories/donor-advised-fund-succession-planning-what-happens-next>.
16. *Ibid.*
17. The LLC isn't a tax-exempt entity. This means: (1) contributions to the LLC won't generate an immediate income tax deduction to the members; and (2) the LLC members must pay tax on the entity's income each year. While the members will receive income tax charitable deductions generated by the LLC's charitable contributions (that is, to the DAF account), the deduction will be limited. A corporation's charitable contribution deduction generally may not exceed 25% of its taxable income. A corporation may carry forward for five years any qualifying contribution that exceeds the 25% ceiling for the tax year of the contribution.
18. Cash is used as an example for ease of explanation. A DAF can receive many different types of assets, including publicly traded securities, real estate, cryptocurrency and restricted stock. Certain DAF sponsoring organizations also specialize in illiquid assets, such as wine collections, aircrafts and art.
19. National Philanthropic Trust, "The 2024 DAF Report," www.nptrust.org/reports/daf-report/.