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Avoiding Misuse of Donor Advised Funds

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AVOIDING MISUSE OF DONOR ADVISED FUNDS

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I. INTRODUCTION

Donor advised funds allow taxpayers to get the most favorable tax treatment for a charitable contribution with no requirement that any of the contribution be put to active charitable use. In a time of economic crisis, tax benefits are flowing out to taxpayers but with no guarantee that any benefit will flow to charities for their active charitable purposes.

At its core, a donor advised fund is a contractual relationship between the donor and a public charity.[1] The donor contributes money or other property to the charity, which then holds the money in a separate bookkeeping account. The donor retains the right to advise the public charity as to when, to whom, and in what amount distributions should be made from the account. The donor does not retain any legal control over the contributions. The final decision-making authority rests with the public charity.

For example, Jack has had a successful year and earned significant income. He also has done well with his investments and has several investments with sizeable capital gains. Jack holds his marketable securities in a brokerage account at Fidelity Investments. In late December, Jack decides that he would like to make a large charitable contribution to reduce his income tax liability. Jack would like to make a $50,000 charitable contribution. In the past, Jack has thought on and off about charitable giving but he does not have a particular charity in mind. Jack decides that a donor advised fund is his best option. It is inexpensive to create, and he can reap the tax benefits in the current taxable year. Jack creates a donor advised fund with Fidelity Charitable Gift Fund (Fidelity Gift) and transfers $50,000 of his appreciated marketable securities to the account. Because Fidelity Gift is a § 501(c)(3) organization, Jack will receive the most favorable tax treatment for his gift.[2]

[1] At the outset, this Article uses "public charity" to name the organization holding the donor advised fund. The Pension Protection Act of 2006, as discussed later, defines the organization holding the donor advised fund as a "sponsoring organization." I.R.C. § 4966(d)(1) (2009). A sponsoring organization is a publicly-supported charity or a charity that is exempt by operation of law and does not have to meet the public support tests. A sponsoring organization cannot be a private foundation. I.R.C. § 4966(d)(1)(B). A "publicly supported charity" is one that receives a set percentage or more of its support from the public and does not receive more than a set percentage of its support from gross investment income or unrelated taxable business income. I.R.C. § 509(a)(2) (2009).

[2] Fidelity Charitable Gift Fund is an entity separate from Fidelity Investments. Although created by Fidelity Investments, the Fidelity Charitable Gift Fund is not owned or controlled by Fidelity Investments. The Fidelity Charitable Gift Fund has a self-perpetuating board of trustees. *See* Fidelity Charitable Gift Fund, About the Charity, http://www.charitablegift.org/learn-about-charity/board.shtml (last visited Mar. 23, 2010).

Additionally, Jack does not have to select a charitable recipient now. In fact, under the terms of Jack's donor advised fund agreement with Fidelity Gift, Jack only must make $250 in grants every seven years.

From time to time, donor advised funds have attracted attention as needing some regulation.[3] The concerns involved both the private benefits that might be received by a donor and the delay in making payments for active charitable purposes.[4] Until 2006, any proposals to regulate or reform donor advised funds had gone nowhere.[5]

The Pension Protection Act of 2006 (PPA) for the first time defined a donor advised fund and imposed excise taxes to prevent some abuses. Some taxpayers were directing that grants be made to individuals related to the taxpayer or to organizations that the taxpayer or related persons controlled.[6] In a letter to the Senate Finance Committee, then I.R.S. Commissioner Mark Everson wrote that:

> [the Service had] found that certain promoters encourage individuals to establish purported donor-advised fund arrangements that are used for a taxpayer's personal benefit, and some of the charities that sponsor these funds may be complicit in the abuse. The promoters inappropriately claim that payments to these organizations are deductible under section 170 of the Code. Also, they often claim that the assets transferred to the funds may grow tax free and later be used to benefit the donor in the form of compensation for purported charitable projects, to reimburse them for their expenses, or to fund their children's educations.[7]

In addition to defining donor advised funds and imposing excise taxes, in PPA Congress also identified several areas of concern and directed the Treasury Department to study donor advised funds and report back on any further needed action.[8] Congress's concerns might be summarized in one question: Is the current deduction allowable for contributions to a donor advised fund appropriate given both the lack of a required minimum payout and the donor's retained advisory privilege?

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[3] U.S. DEP'T OF TREAS., GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2001 REVENUE PROPOSALS 105-07 (2000).

[4] *Charities and Charitable Giving: Hearing Before the S. Comm. on Finance on Proposals for Reform*, 109th Cong. 3 (2005) [hereinafter Gravelle] (prepared statement of Jane G. Gravelle, Senior Specialist in Economic Policy, Congressional Research Service).

[5] Gravelle, *supra* note 4; U.S. DEP'T OF TREAS., GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2001 REVENUE PROPOSALS (2000).

[6] *See* New Dynamics Found. v. United States, 70 Fed. Cl. 782 (2006) (denying organization's tax-exempt status because of personal benefits flowing to donor through purported donor advised funds).

[7] *Enforcement Problems, Accomplishments, and Future Direction: Hearing Before the S. Comm. on Finance on Exempt Organizations*, 109th Cong. 5-6 (2005) (written statement of Mark W. Everson, Commissioner, Internal Revenue Service).

[8] Pension Protection Act of 2006, Pub. L. No. 109-280, § 1226, 120 Stat. 780, 1226 (2006).

Most of the articles written on donor advised funds have focused on their place among other charitable giving options. In response to Notice 2007-21,[9] many interested parties discussed the operation and future of donor advised funds, but none suggested a new model for them.

This Article presents a proposal for further modifying donor advised funds to retain most of their hallmark flexibility and ease of use while drawing them into line with other charitable giving vehicles that put contributed funds to use for active charitable purposes.[10]

This Article argues that using individual retirement accounts as an underlying legal model for donor advised funds will address Congress's concerns regarding the appropriateness of the income tax deductions for contributions to donor advised funds while allowing donor advised funds to retain much of their hallmark flexibility and ease of operation. In Part II, this Article discusses the exponential growth of donor advised funds and recent changes to them as mandated by the Pension Protection Act of 2006. In Part III, this Article discusses various charitable giving vehicles, including private foundations, supporting organizations, and split interest trusts. This section details why each of these charitable giving vehicles falls short in offering the ease in planned charitable giving offered by donor advised funds. In Section IV, this Article sets forth a proposal for reforming donor advised funds using individual retirement accounts as an underlying theoretical model.

II. DONOR ADVISED FUNDS

A. Exponential Growth of Donor Advised Funds

Although donor advised funds have been on the charitable giving scene since the 1930s,[11] their popularity has exploded in recent years.[12] This period has seen exponential growth in the creation and funding of donor advised funds.[13] They have gained popularity in large part due to their easy creation and advantageous income tax deduction limitations. The rapid growth of donor advised funds in the 1990s

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[9] In the Pension Protection Act of 2006, Congress directed the Treasury Department to prepare a study on donor advised funds. As part of that study, in Notice 2007-21, the Treasury Department and the Internal Revenue Service requested comments on whether donor advised funds should be further regulated. *See infra* Part I.B.3.

[10] This Article focuses on donor advised funds created by individuals. A donor advised fund may also be created by a partnership, corporation, or a trust (singularly, a corporate donor or entity, or collectively, corporate donors or entities). Because sponsoring organizations generally require larger minimums for a corporate entity to open a donor advised fund, donor advised funds do not occupy as unique of a place in corporate charitable giving as they do in individual charitable giving. For example, Fidelity Charitable Gift Fund requires a $5,000 minimum for an individual donor but $100,000 for a corporate donor. A corporate donor with $100,000 or more to contribute to charity might be in a position to consider a private foundation or supporting organization.

[11] Gravelle, *supra* note 4, at 2-3.

[12] EMANUEL J. KALLINA II ET AL., PLANNED GIVING DESIGN CENTER, CHARITABLE GIVING WITH DONOR ADVISED FUNDS – PART I (2000), http://www.pgdc.com/pgdc/article/2000/04/charitable-giving-donor-advised-funds-part-i.

[13] Gravelle, *supra* note 4, at 3-4.

began with the creation of "commercial" donor advised funds. In 1991, Fidelity Investments created the first "commercial" donor advised funds.[14] It was followed by Vanguard Charitable Endowment Program (1997), Schwab Charitable Fund (1999), Oppenheimer Funds Legacy Program (2000), and Eaton Vance U.S. Charitable Gift Trust, J.P. Morgan Chase (2000).[15]

The exponential growth of donor advised funds has continued into this century.[16] Each year, the Chronicle of Philanthropy ranks the largest 400 charities in the United States. In 2005-2008, Fidelity Gift, ranked 9th, 6th, 4th, and 3rd respectively. In 2008, only the United Way of America and the Salvation Army topped Fidelity Gift. Fidelity Gift was closely followed by Schwab Fund for Charitable Giving and Vanguard Charitable Endowment Program at 9th and 16th, respectively.[17]

A look at Fidelity Gift shows the rapid growth of "commercial" donor advised funds. The largest "commercial" sponsoring organization is Fidelity Gift.[18] As of June 30, 2008, Fidelity Gift held $4.7 billion in assets.[19] It made charitable contributions in the amount of $1.16 billion while attracting $1.59 billion in new contributions.[20] These numbers make Fidelity Gift the fourth largest public charity in the United States.[21] To say the least, this is solid growth for a sponsoring organization that had about $1.5 billion assets total just ten years ago.[22]

In an effort to engage more donors, Fidelity Gift has reduced the minimum grant amount,[23] reduced the minimum contribution to open an account,[24] and made

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[14] Fidelity Charitable Gift Fund, http://www.charitablegift.org/learn-about-charity/verview.shtml (last visited Mar. 23, 2010).

[15] William H. Hewitt, Kintera Inc., *Are We There Yet . . . Is The Financial Services Industry Finally Ready for Donor Advised Funds?* 3 (2005) http://www.kintera.org/atf/cf/%7B168B193F-C7D9-4A4D-85D8-E97CAA9AC3A3%7D/DAFWHITEPAPER.PDF (referencing creation of Vanguard Charitable Endowment Program, Oppenheimer Funds Legacy Program, and Eaton Vance U.S. Charitable Gift Trust); Schwab Charitable, *Our History & Evolution*, http://www.schwabcharitable.org/about/history.html (last visited Mar. 23, 2010) (referencing Schwab's creation of commercial donor advised fund).

[16] As outlined by the Congressional Research Service, donor advised funds experienced 31% annual growth from 1994 to 2001. Over $12.3 billion was held in donor advised funds in 2001. *See* Gravelle, *supra* note 4, at 3.

[17] Schwab's Charitable Fund ranked 86th, 47th, 13th, and 9th over the 2005-2008 period. Vanguard's sponsoring organization ranked 28th, 24th, 22nd, and 16th over the 2005-2008 period. *The Philanthropy 400*, CHRON. OF PHILANTHROPY, Oct. 27, 2005.

[18] Fidelity Charitable Gift Fund, Fidelity Charitable Gift Fund Reports Record Giving Year, http://www.charitablegift.org/learn-about-charity/news/02-06-2008.shtml (last visited Mar. 23, 2010).

[19] FIDELITY CHARITABLE GIFT FUND, 2009 ANNUAL REPORT (2009).

[20] *Id.*

[21] *The Philanthropy 400*, *supra* note 17.

[22] Victoria B. Bjorklund, *The Emergence of the Donor-Advised Fund*, 3 PAUL STRECKUS' EO TAX J. 15, 15 (1998).

[23] In 2007, the minimum grant amount was $100. *See* http://content.members.fidelity.com/ Inside_Fidelity/fullStory/1,7668,00.html (last visited Mar. 23, 2010). In 2009, the minimum grant amount had fallen to $50. Fidelity Charitable Gift Fund,

enhancements to its website that were "aimed at making giving simpler and more efficient for the donor."[25] Fidelity Gift also notes the efficiency that can come with donations of marketable securities when using the Fidelity Gift.

Each of these reasons offers insight into not only the popularity of donor advised funds but why they are a valuable charitable giving tool. Each reason is ultimately about accessibility. By lowering the minimums, enhancing the website, and more easily facilitating the donation of marketable securities, Fidelity Gift has made itself more accessible to donors seeking to create a donor advised fund. This access also furthers the concept that although legal title might rest with Fidelity Gift, implicit control over the contributed funds rests with the donors.

B. Pension Protection Act of 2006

After several high profile bankruptcies due in part to underfunded pension liabilities that required the government to assume these obligations, Congress enacted the Pension Protection Act of 2006. PPA provides more security for pension plans by imposing stricter funding requirements and shoring up the Pension Benefit Guaranty Corporation.[26] PPA also contains several tax provisions. For the first time, donor advised funds were defined in the Internal Revenue Code.[27] Additionally, PPA made a number of excise taxes applicable to these funds and directed the Treasury Department to undertake a study of donor advised funds.

1. Defining Donor Advised Funds

For seventy-five years, the term "donor advised fund" referred broadly to a contractual relationship between a donor and a public charity.[28] The donor and the public charity, most often a community foundation,[29] would enter into a short contract wherein the donor would make a charitable contribution to a public charity and retain the right to advise the charity how the donated funds would be distributed. The donor's privilege was merely advisory and in no manner legally binding upon the public charity. The public charity had legal control over the contributed

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http://www.charitablegift.org/ harity-giving-programs/daf/fees.shtml (last visited Mar. 23, 2010).

[24] The minimum amount to open is $5,000 for individuals and $100,000 for a corporate account. Fidelity Charitable Gift Fund, http://www.charitablegift.org/charity-giving-programs/daf/fees.shtml (last visited Mar. 23, 2010).

[25] Fidelity Charitable Gift Fund, Fidelity, *supra* note 18.

[26] *See generally* Mary Williams Walsh, *Trying to Clear Fog From Pension Plans*, N.Y. TIMES, Feb. 3, 2008, http://www.nytimes.com/2008/02/03/business/03pension.html.

[27] Joint Comm. on Taxation, JCX-38-06, 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, at 331 (2006), *available at* http://www.house.gov/jct/x-38-06.pdf [hereinafter Technical Explanation of H.R. 4].

[28] Gravelle, *supra* note 4, at 2.

[29] *Id.* Despite the use of "foundation" in its description, a community foundation is usually a publicly-supported charity. As such, donors receive the most favorable tax treatment for contributions and the community foundation is not subject to the excise taxes applicable to private foundations.

charitable assets. As a result, the donor received the most favorable income tax deduction treatment permissible under the Internal Revenue Code.[30]

The enactment of PPA provided the first statutory definition of a donor advised fund.[31] A donor advised fund is defined as:

> [A] fund or account (i) which is separately identified by reference to contributions of a donor or donors, (ii) which is owned and controlled by a sponsoring organization, and (iii) with respect to which a donor (or any person appointed or designated by such donor) has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in such fund or account by reason of the donor's status as a donor.[32]

As such, the key elements of the donor advised fund are the transfer of the legal ownership of the contributed assets to a public charity and the retention of advisory rights with respect to the charitably contributed property. The retention of the advisory rights can be explicit or implicit. The test is whether there is a reasonable expectation of such advisory rights.[33] If the retention of advisory rights is not explicit, then some acknowledgement of the advisory rights by the sponsoring organization is necessary to make the fund at issue a donor advised fund.[34] The sponsoring organization must indicate that it will consider any advice offered by the donor in making a charitable grant from the donor advised fund.[35] Likewise, the donor's giving of advice is not necessarily conclusive of a fund being a donor advised fund if the sponsoring organization has not indicated it will consider such advice regarding the fund.[36] The definition of a donor advised fund is important

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[30] Because the contribution was to a public charity, the donor received the highest possible AGI limitations for the charitable contribution. Generally the donor is able to deduct the charitable contribution up to 50% of his or her AGI. For capital gain property, the general rule is that the AGI limitation is 30%. For contributions to private foundations, these limitations are 30% and 20% respectively. I.R.C. § 170(c) (2009). *See generally* Thomas J. Ellwanger & Alan S. Gassman, *Don't Overlook the Benefits—Tax and Otherwise—of Private Operating Foundations*, 34 TAX MGMT. ESTATES, GIFTS, AND TRUSTS J., 250 (2009).

[31] There also was no regulatory definition of a donor advised fund. *See* TECHNICAL EXPLANATION OF H.R.4, *supra* note 27, at 331.

[32] I.R.C. § 4966(d)(2)(A).

[33] I.R.C. § 4966(d)(2)(A)(iii).

[34] Technical Explanation of H.R. 4, *supra* note 27, at 343.

[35] *Id.* at 344. A sponsoring organization is a charity, other than a government or a private foundation, that holds one or more donor advised funds. I.R.C. § 4966(d)(1). Specifically, a sponsoring organization is "any organization which (A) is described in section 170(c) (other than in paragraph (1) thereof, and without regard to paragraph 2(A) thereof, (B) is not a private foundation (as defined in section 509(a)), and (C) maintains 1 or more donor advised funds." *Id.* The charity must be one described in I.R.C. § 170(c) but may be created or organized outside of the United States. Charitable contributions to foreign-based charities are permissible for estate and gift charitable deduction purposes but not for income tax charitable deduction purposes. *See* I.R.C. § 2055 (2009), I.R.C. § 2522 (2009).

[36] Technical Explanation of H.R. 4, *supra* note 27, at 344. As the legislative history notes, "[u]ltimately, the presence or absence of advisory privileges (or a reasonable expectation

because Congress extended several excise taxes and imposed new excise taxes on donor advised funds.[37]

In the initial example, Jack created the donor advised fund at Fidelity Gift, a public charity. Jack transferred marketable securities to Fidelity Gift, which are owned and controlled now by Fidelity Gift, the sponsoring organization. The contributed assets are held in a separate account, whose name is selected by Jack.[38] Jack expressly retained the right to advise Fidelity Gift on when, to whom, and in what amount to make charitable grants from the fund. Other than the donor advised fund agreement with Fidelity Gift, nothing requires Jack to recommend charitable grants be made from his donor advised fund nor is Fidelity Gift required to make any distributions.

Although the statutory definition is very broad, it also includes two useful exclusions that provide some boundaries and guidance on whether the new excise taxes might be applicable to a fund.[39] Moreover, PPA gives the Secretary of the Treasury authority to exclude other funds if certain requirements are met.[40]

The first type of fund excluded is a fund for the benefit of a single charitable organization.[41] For example, Jack creates a fund at a university and names the

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thereof) depends upon the facts and circumstances, which in turn depend upon the conduct . . . of both the donor or the donor advisor and the sponsoring organization with respect to the making and consideration of advice." *Id.*

[37] *See infra* Part I.B.2 discussing I.R.C. §§ 4966, 4967, 4943, 4958 (2009).

[38] Depending upon the sponsoring organization, Jack's selection of a name for his donor advised fund may have minimal limitations. For example, Vanguard's donor advised fund agreement Policies and Procedures provides that each donor advised fund "must begin with 'The' and end with 'Fund,' and [it] may not contain the words 'Trust,' 'Foundation,' or 'Endowment.'" https://a248.e.akamai.net/f/248/21630/7d/im.uprinv.com/rc/sr2/vcep/PoliciesandGuidelines07.pdf (last visited Mar. 23, 2010).

[39] I.R.C. § 4966(d)(2)(B) excludes:

> Any fund or account (i) which makes distributions only to a single identified organization or governmental entity, or (ii) with respect to which a person described in subparagraph (A)(iii) advises as to which individuals receive grants for travel, study, or other similar purposes, if (I) such person's advisory privileges are performed exclusively by such person in the person's capacity as a member of a committee all of the members of which are appointed by the sponsoring organization, (II) no combination of persons described in subparagraph (A)(iii) (or persons related to such persons) control, directly or indirectly, such committee, and (III) all grants from such fund or account are awarded on an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the board of directors of the sponsoring organization, and such procedure is designed to ensure that all such grants meet the requirements of paragraphs (1), (2) , or (3) of section 4945(g).

[40] I.R.C. § 4966(d)(2)(C) provides:

> The Secretary may exempt a fund or account not described in subparagraph (B) from treatment as a donor advised fund . . . (i) if such fund or account is advised by a committee not directly or indirectly controlled by the donor or any person appointed or designated by the donor for the purpose of advising with respect to distributions from such fund (and any related parties), or (ii) if such fund benefits a single identified charitable purpose.

[41] I.R.C. § 4966(d)(2)(B)(i).

university as the only permissible beneficiary of the fund.[42] Jack retains the right to advise the university on how the contributed assets might be used to further the university's mission. Jack might advise that some of the fund be used to build a new chemistry lab and some be used to expand the library. Such a fund is not a donor advised fund as defined in I.R.C. § 4966 even though Jack has retained advisory privileges.

The second type of fund excluded is one in which "individuals receive grants for travel, study, or other similar purposes" but only if certain requirements are met.[43] The requirements are designed to ensure that the donor cannot directly or indirectly control the selection of the individual recipient. First, the donor can only exercise his or her advisory privileges "in such person's capacity as a member of a committee all of the members of which are appointed by the sponsoring organization."[44] Secondly, the donor and any persons related to the donor cannot directly or indirectly control the committee.[45] Finally, "all grants . . . [must be] awarded on an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the board of directors of the sponsoring organization."[46] The procedure must also meet the grant accountability requirements of I.R.C. § 4945(g).[47]

For example, the legislative history to PPA excludes from the definition of donor advised fund a scholarship fund whose recipients are determined by a committee, if the committee members are appointed based upon objective standards.[48] Thus, "if a donor recommends that a committee of a sponsoring organization that will provide advice regarding scholarship grants for the advancement of science at local secondary schools should consist of persons who are the heads of the science departments of such schools," then such persons are not likely donor advisors[49] and as a result, the scholarship fund fails to meet the definition of a donor advised fund. Since the fund is not a donor advised fund, the distribution to individual recipients is not a taxable distribution. On the other hand, if the scholarship fund were determined to be a donor advised fund, then the scholarship grants to the individual students would be taxable distributions subject to an excise tax.[50]

Lastly, the Secretary may also exclude from treatment as a donor advised fund a fund that fails to meet the requirements of the second statutory exclusion if the fund is advised by a committee that is not controlled directly or indirectly by the donor.[51]

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[42] For the purpose of this example, the university is presumed to be an organization described in I.R.C. § 170(b)(1)(A)(ii).

[43] Technical Explanation of H.R. 4, *supra* note 27, at 345.

[44] *Id*.

[45] *Id.*

[46] *Id.*

[47] I.R.C. § 4966(d)(2)(B)(ii)(III).

[48] Technical Explanation of H.R. 4, *supra* note 27, at 344-45.

[49] *Id.*

[50] I.R.C. § 4966(c).

[51] I.R.C. § 4966(d)(2)(C).

For example, in Notice 2006-109,[52] the Service excludes from the definition of a donor advised fund a disaster relief fund established by an employer with a sponsoring organization provided certain requirements are met.[53] If the disaster relief fund was a donor advised fund, then distributions to an employee or a member of the employee's family would be a taxable distribution subject to an excise tax payable by the sponsoring organization and possibly fund management.[54] For the disaster relief fund not to be a donor advised fund, an independent committee must be selecting grant recipients from a "large or indefinite class . . . based on objective determinations of need" with "any benefit to the employer [being] incidental and tenuous."[55]

2. Imposing New Excise Taxes

PPA imposes two new excise taxes on donor advised funds.[56] PPA also expands two existing excise taxes on private foundations to cover donor advised funds.[57]

First, PPA imposes a 20% excise tax if a donor advised fund makes a "taxable distribution."[58] A taxable distribution occurs when one of three things happens. First, the distribution is made to a natural person.[59] Donor advised funds are not permitted to make distributions to individuals. Second, the distribution is made to a person who is not a natural person and does not use the distribution for charitable purposes.[60] Third, a taxable distribution occurs when the organization holding the donor advised fund does not exercise expenditure responsibility with respect to the distribution.[61]

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[52] I.R.S. Notice 2006-109, 2006-2 C.B. 1121.

[53] *Id.*; Notice 2006-109, Section 5.01.

[54] I.R.C. § 4966(a), (c). Notice 2006-109 does not opine on whether the grant to the individual employee is gross income to the employee.

[55] Notice 2006-109, *supra* note 52, Section 5.01. Additional requirements are that the "fund serves a single identified charitable purpose, which is to provide relief from one or more qualified disasters," (ii) the "selection committee is independent if a majority of the members of the committee consists of persons who are not in a position to exercise substantial influence over the affairs of the employer," (iii) no "director, officer, or trustee of the sponsoring organization of the fund or members of the fund's selection committee" receives grants, and (iv) "adequate records" are maintained documenting the recipients' needs. *Id.*

[56] I.R.C. § 4966 (excise tax on taxable distributions); I.R.C. § 4967 (2009) (excise tax on prohibited benefits).

[57] I.R.C. § 4943 (2009) (excise tax on excess business holdings); I.R.C. § 4958 (2009) (excise tax on excess benefit transactions).

[58] I.R.C. § 4966(a).

[59] I.R.C. § 4966(c)(1). A "natural" person is an individual. A "natural" person is not a corporation, trust, or other entity.

[60] I.R.C. § 4966(c)(1)(B)(i).

[61] I.R.C. § 4966(c)(1)(B)(ii). Expenditure responsibility is defined in I.R.C. § 4945(h) (2009). The sponsoring organization must "exert all reasonable efforts and . . . establish adequate procedures" to ensure that the grantee spends the distribution for the intended charitable purpose. I.R.C. § 4945(h) (2009).

Second, PPA imposes an excise tax on prohibited benefits. If a donor or a donor advisor recommends a grant from a donor advised fund that results in such person "receiving, directly or indirectly, a more than incidental benefit," then a 125% excise tax is imposed upon the donor or donor advisor.[62] A 10% excise tax is imposed upon any fund manager who knowingly makes such a prohibited distribution.[63] This excise tax is not imposed if the excess benefit excise tax applies.[64]

Third, PPA makes the excise taxes on private foundations with excess business holdings applicable to donor advised funds by providing that donor advised funds shall be treated as private foundations for this purpose.[65] The excess business holdings excise tax provides that a private foundation or a donor advised fund must pay a 10% excise tax on the excess business holdings.[66] Donor advised funds are permitted to hold 20% of voting stock or profit interests of a business reduced by the amount owned by all disqualified persons.[67] Special transitional rules apply to donor advised funds to divest themselves of any excess business holdings held by the donor advised fund on August 17, 2006.[68] Donor advised funds receiving an ownership interest that would otherwise be considered an excess business holding have five years from the date of receipt to divest the ownership interest.[69]

Fourth, PPA makes the private foundation excise tax on excess benefit transactions applicable to donor advised funds. Generally, an excess benefit transaction is one in which an economic benefit is provided by a charitable organization to a disqualified person in excess of any consideration paid or services performed.[70] For both private foundations and donor advised funds, I.R.C. § 4958

[62] I.R.C. § 4967(a)(1). A "donor advisor" is a person appointed or designated by the donor to give advice to the sponsoring organization regarding distributions from the donor advised fund. *See* I.R.C. § 4966(d)(2)(iii). It may be that the donor does not wish to retain personally the right to advise the sponsoring organization. Including donor advisors also eliminates easy avoidance of being classified as a donor advised fund. For example, A and B are married. A creates a donor advised fund with Z sponsoring organization. A directs that Z should consider B's advice. Here, B is a donor advisor. As such, the fund created by A is a donor advised fund, and B is subject to an excise tax for taxable distributions.

[63] I.R.C. § 4967(a)(2).

[64] I.R.C. §§ 4967(b), 4958.

[65] I.R.C. § 4943(e) added by Pension Protection Act § 1233(a).

[66] I.R.C. § 4943(a).

[67] I.R.C. §§ 4943(c)(2), 4943(c)(3).

[68] I.R.C. § 4943(e)(3).

[69] I.R.C. § 4943(c)(6). This divesture provision is available only if the interest was not acquired by purchase by the donor advised fund. The interest must be acquired by gift or bequest. With the approval of the secretary, donor advised funds can obtain an additional five year period to divest ownership. I.R.C. § 4943(c)(7).

[70] I.R.C. § 4958(c)(1) provides:

> The term "excess benefit transaction" means any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit.

imposes a 25% excise tax upon the disqualified individual and a 10% excise tax upon the "organization manager . . . unless such participation was not willful and is due to reasonable cause."[71] If the excess benefit transaction "is not corrected within the taxable period,"[72] a 200% excise tax is imposed on the disqualified person.[73] Further, when the excess benefit is repaid, it may not be held in any donor advised fund.[74]

Additionally, PPA expands the definition of an excess benefit transaction when a donor advised fund is involved. For donor advised funds, the definition of excess benefit transaction additionally includes "any grant, loan, compensation, or other similar payment" to a disqualified individual.[75]

A disqualified individual for donor advised fund purposes is a person who falls into one of three categories. First, a disqualified individual is the donor or the donor's appointee if the donor or appointee has advisory privileges, or a reasonable expectation of advisory privileges, over the fund.[76]

Second, a disqualified individual is also a family member of an individual described in the preceding sentence.[77] I.R.C. § 4967 provides that its excise tax is applicable to persons named in § 4958(f)(7). I.R.C. § 4958 turns to § 4946(d) for its definition of family member but also expands § 4946's definition to include siblings and their spouses. I.R.C. § 4946(d) defines "members of family" to include a donor's spouse, three generations of lineal descendants and spouses of those lineal descendants, and the donor's ancestors.[78] I.R.C. § 4958, as noted above, adds the donor's siblings and their spouses to the definition of a person to whom distributions from a donor advised fund are not permitted.

Third, a disqualified individual is also a corporation, a partnership, or a trust if more than 35% of the total combined voting power, profits interests, or beneficial interest, respectively, is owned by any combination of the donor, the donor's appointee, or family members of either.[79]

3. Treasury Study and Notice 2007-21

In PPA, Congress identified three areas of concern and directed the Treasury Department to study donor advised funds and report back on any further needed

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[71] I.R.C. § 4958(a).

[72] The "taxable period" begins on the day of the excess benefit transaction and ends on the earlier of the mailing of a notice of deficiency or the assessment of the excise tax itself. *See* I.R.C. § 4958(f)(5).

[73] I.R.C. § 4958(b). Generally, the 200% excise tax can be avoided if the disqualified person corrects the excess benefit transaction before it is discovered by the Internal Revenue Service. *Id.*

[74] I.R.C. § 4958(f)(6).

[75] I.R.C. § 4958(c)(2).

[76] I.R.C. §§ 4958(f)(1)(E), 4958(f)(7)(A), 4966(d)(2)(A)(iii).

[77] I.R.C. § 4958(f)(7)(B).

[78] I.R.C. § 4946(d).

[79] I.R.C. §§ 4958(f)(7)(C), 4958(f)(3).

action.[80] First, Congress is concerned whether the deductions allowable for contributions to sponsoring organizations "are appropriate in consideration of the use of contributed assets (including the type, extent, and timing of such use)."[81] Second, Congress wants further information on "whether donor advised funds should be required to distribute for charitable purposes a specified amount"[82] so that the sponsoring organization is "operating consistent with the purposes or functions constituting the basis for" its tax exempt status.[83] Lastly, Congress wishes to know whether the advisory privileges retained by donors are consistent with the requirement that the transfer be a completed gift in order for the taxpayer to be entitled to a deduction for income, gift, and estate tax purposes.[84]

In Notice 2007-21, the Internal Revenue Service requested comments on donor advised funds and supporting organizations. The notice requested comments regarding the advantages and disadvantages of donor advised funds as compared to other charitable giving vehicles.[85] It also asked for comments regarding the appropriate tax treatment of contributions given that investment control and advisory privileges over charitable grants are often retained by the donor.[86] Further, the notice asked for comments on what the appropriate payouts should be for donor advised funds.[87] The notice also asked for comments regarding the perpetual existence of donor advised funds.[88] The notice echoes Congress's concern regarding the appropriateness of the income tax treatment of donors and donor advised funds given the control retained by the donor through investment direction and advisory privileges.

Largely, the submitted comments express the view that the regulation of donor advised funds should remain unchanged. The commentators generally argued that no minimum payout should be required of donor advised funds because, in the aggregate, sponsoring organizations already are distributing 5% or more as would be required by imposing the § 4942 excise tax on a private foundation's failure to distribute income.[89] If there must be a change, then the commentators suggested that the private foundation rules should apply.

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[80] Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780, § 1226 (2006).

[81] Pension Protection Act § 1226(a)(1).

[82] Pension Protection Act § 1226(a)(2).

[83] *Id.*

[84] Pension Protection Act § 1226(a)(3).

[85] I.R.S. Notice 2007-21, 2007-9 I.R.B. 611.

[86] *Id.*

[87] *Id.*

[88] *Id.*

[89] Council on Foundations, Comments in Response to IRS Notice 2007-21, 2007-9 I.R.B. 611 (April 9, 2007), http://www.cof.org/files/Documents/Government/Charitable%20Reform%20Resource%20Center/CommentsIRSNotice200721.pdf (last visited Mar. 24, 2010); ABA Task Force, Comments of Individual Members of the American Bar Association, Section of Real Property, Probate and Trust Law, Charitable Planning and Organizations Group, Concerning Internal Revenue Code Sections 170, 4966, 4967, and 4958, In Response to IRS

The American Bar Association's Section of Taxation recommended that no distribution requirements be imposed on donor advised funds. The section went on to recommend, though, that if a distribution requirement must be imposed, such a requirement should be imposed on an aggregate basis rather than on a fund-by-fund basis. Lastly, the section recommended that if a distribution requirement is based upon the value of the fund, rules similar to those applied to private foundations under I.R.C. § 4942 should be applied to donor advised funds.

Citing the testimony of Jane Gravelle, the ABA argues that no distribution requirement is needed because sponsoring organizations are already making greater than 5% distributions from donor advised funds.[90] The ABA argues that because sponsoring organizations hold hundreds, if not thousands, of donor advised funds, a distribution requirement should be based upon an aggregate basis as opposed to a fund-by-fund basis.[91] The ABA thinks the administrative burden would be staggering on a sponsoring organization if the 5% distribution requirement had to be calculated on a fund-by-fund basis.[92]

C. Why Use a Donor Advised Fund?

The reasons for charitable giving are many and varied.[93] Some people give for the public recognition that comes from making the gift while others give because of a fond experience they have had with the charitable organization. As one might expect, donors seek flexibility in making their charitable contributions while maximizing the tax benefits.

If the taxpayer has sufficient time to identify a particular charity, the taxpayer can make an outright contribution to the charity. Often, though, a taxpayer might not have the time before the end of the tax year to identify a charity.[94] One advantage of a donor advised fund is the ease with which it may be established. For donors who are considering a charitable contribution at the end of the taxable year, donor advised funds are an attractive option because they are a simple contractual arrangement and are usually quicker to create than a charitable trust or a private foundation. Further, a donor, often rushed at year end, does not need to select the recipient charity but can defer that decision. Still, because the contribution will be to a sponsoring

Notice 2007-21, (2007), http://meetings.abanet.org/webupload/commupload/RP529000/otherlinks_files/Notice-2007-21-ABA-RPPT-COMMENTS.pdf (last visited Dec. 23, 2009).

[90] ABA Task Force, *supra* note 89, at 9.

[91] *Id.*

[92] *Id.*

[93] *See* Mark P. Gergen, *The Case for a Charitable Contributions Deduction*, 74 VA. L. REV. 1393, 1429-30 (1988) (discussing empirical evidence studying why donors give to charity). *See also*, Ellen P. Aprill, *Churches, Politics, and the Charitable Contribution Deduction*, 42 B.C. L. REV. 843, 872 (2001) (concluding that "organizations and activities for which the tax laws permit a charitable contribution deduction have never been a neat set necessarily capable of one clear-cut set of justifications.").

[94] More precisely, the taxpayer might not have the time to sort through many charities and select the one that best matches the taxpayer's goals. A taxpayer might want to make a contribution to "further education" but does not know to which educational institution to give and what might be funded with the contribution.

organization that itself is a public charity, the donor will receive the tax benefits in the year of the contribution while being able to delay the decision on the ultimate recipients.[95]

In other cases, a taxpayer might not presently have the resources to make a sizeable contribution to a charitable organization to accomplish a particular purpose or goal. For example, Sally might decide that she would like to make a charitable gift to her alma mater. One option for Sally is to contribute $10,000 a year. Sally, though, might prefer to do something that has more name recognition and makes a bigger impact at the school. One day, Sally would like to be able to make a $100,000 contribution for some project. Let us assume that the dean would be dutifully grateful for Sally's annual contribution but unlikely to rename the computer lab after Sally for $10,000. Sally is reluctant to approach the dean about pledging $10,000 a year for ten years because Sally fears that her circumstances could change and she might be unable to complete the pledge. A donor advised fund presents an elegant solution to this dilemma.

Sally can create a donor advised fund with a sponsoring organization. Sally then makes a donation to a donor advised fund in the current year and subsequent years. Sally is entitled to a $10,000 charitable contribution in each year.[96] Because the amount of the charitable contribution is smaller in any given year than the lump sum contribution in the current year, the taxpayer is less likely to bump up against the Adjusted Gross Income (AGI) limitations and thus less likely to have the current deduction limited. When Sally is ready to make a distribution to her alma mater, she can recommend to the sponsoring organization that the donor advised fund make a distribution to the university to renovate the computer lab.[97] If Sally changes her mind, then she can recommend distributions to other charities. Even though Sally has the intention of eventually distributing the entire amount to the university, the fund does not meet the exclusion of I.R.C. § 4966(d)(2)(B)(i) as being for the benefit of a single charitable organization because Sally is not obligated to recommend any grant to the university. Further, under existing law, Sally is not required to recommend any distributions be made to any charity from the donor advised fund. Nor is the sponsoring organization required to make any distributions.

Sally obtains a current income tax deduction, up to 50% of her AGI depending upon the property contributed, for the charitable contribution but retains the right to advise the sponsoring organization maintaining the donor advised fund as to which charities should receive grants from the donor advised fund. Sally obtains all of the benefits of an outright charitable contribution without a charity ever having to put her contribution into its operating funds.

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[95] Of course, technically the ultimate decision rests with the sponsoring organization as the donor's privilege to recommend charitable grants is merely advisory.

[96] Subject to the AGI limitations of I.R.C. § 170(b).

[97] In order to avoid being treated as a taxable distribution, Sally cannot be under any obligation to make the charitable contribution. If in Year 1, Sally pledged to donate $100,000 in Year 10, then requesting a distribution from the donor advised fund is impermissible because the distribution would be used to satisfy an obligation of Sally. Many sponsoring organizations require donors to certify that the recommended grant does not satisfy any obligation of the donor.

D. The Problem

Even with the application of some excise taxes to donor advised funds, abuses still exist. The imposition of some excise taxes upon donor advised funds has addressed the abuse of private benefits flowing to a donor or members of a donor's family.[98] Still unaddressed is a lack of a minimum payout. As a result, there is no requirement that any grant ever be made for use in an active charitable purpose, even though the donor has taken a current income tax deduction for the contribution to the donor advised fund.

In its comments in response to Notice 2007-21, the New York State Bar Association voiced the concern that donor advised funds are no longer a charitable giving vehicle but rather have become an income tax avoidance vehicle. The NYSBA wrote that:

> We believe that [donor advised funds] . . . exhibit many of the characteristics of private foundations. These entities afford opportunities for abuse of their tax-exempt status that are similar to the concerns that led to the enactment of the private foundation provisions in the Tax Reform Act of 1969.
>
> We are concerned about the rapid growth of DAF assets over the last two decades and the expansion of DAF sponsorship to entities formed by financial institutions. Increasingly, it appears that DAFs are considered more as tax-planning vehicles than as charitable resources. We believe that the benefits of tax deductions realized by donors and the cost to the fisc should be balanced by commensurate resources going to charitable purposes.[99]

Nothing in current law requires a sponsoring organization to make a charitable grant from a donor advised fund. This is not to say that no grants are being made from donor advised funds. Even for donor advised funds held at Fidelity Gift, Fidelity Gift imposes some minimal limitations. Under the terms of the Fidelity Gift's standard donor advised fund contract, every seven years, the donor must recommend at least $250 in charitable grants.[100]

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[98] *See* I.R.C. §§ 4966-67.

[99] N.Y. St. Bar Assoc., Report Responding to Notice 2007-21 Concerning Donor-Advised Funds and Supporting Organizations, 2 (June 6, 2007), *available at* http://www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1129Letter.pdf (last visited Mar. 23, 2010).

[100] Fidelity Charitable Gift Fund, *Gift Fund Policy Guidelines: Program Circular*, at 19, http://www.charitablegift.org/docs/Gift-Fund-Policy-Guidelines.pdf (last visited Mar. 23, 2010). Under the terms of the Fidelity's 2007 standard donor advised fund contract, every seven years the donor had to make at least one $100 recommendation for a charitable grant. Under the terms of the Vanguard Charitable Endowment Program as of December 2009, the donor must at least make one grant of $500 or more every seven years. Vanguard Charitable Endowment Program, Policies and Guidelines, at 30, *available at* https://a248.e.akamai.net/f/248/21630/7d/im.uprinv.com/rc/sr2/vcep/PoliciesandGuidelines07.pdf (last visited Mar. 23, 2010). Vanguard has a $500 minimum grant, so one grant every seven years will satisfy the minimum requirement. *Id.*

At issue is whether the minimums established by sponsoring organizations is enough or whether there should be some minimum established by law for all donor advised funds.[101] If the goal is to encourage charitable giving so that the donated funds, for which the donor has likely taken a charitable contribution deduction, are put to use for charitable purposes, then a minimum of $250 every five years actually distributed for charitable purposes is paltry. Under existing law, Fidelity Gift is not required to even have a minimum recommendation requirement.

If the charitably contributed funds are not being put to use for active charitable purposes, who is benefiting from this arrangement? Clearly, the sponsoring organization itself is benefitting.[102] Fidelity Gift charges a minimum account fee of the greater of 0.6% (60 basis points) or $100 per year.[103] For larger accounts, a reduced fee schedule is available.[104] Thus, while only $250 every five years needs to be recommended for distribution for active charitable use, Fidelity Gift is making at least $100 a year from each donor advised fund it sponsors, not to mention any investment fees it is generating from managing the underlying assets in which the donor advised fund is invested.[105]

Concern over not requiring distributions from donor advised funds stems from the mismatching that occurs when the use of the donated funds or property for a charitable purpose is delayed.[106] Generally, mismatching is disfavored under the Internal Revenue Code and exceptions to mismatching are statutorily created and narrowly defined.[107] For example, with a § 401(k) plan, an employee can defer

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[101] *See* Pension Protection Act § 1226(a)(2).

[102] Gravelle, *supra* note 4, at 11

[103] Fidelity Charitable Gift Fund, http://www.charitablegift.org/charity-giving-programs/daf/fees.shtml (lasted visited Mar. 23, 2010).

[104] *Id.*

[105] *See generally* Fidelity Charitable Gift Fund, http://www.charitablegift.org/charity-giving-programs/daf/investments.shtml (which has links to particular investment options) (last visited Mar. 23, 2010); Fidelity Charitable Gift Fund, http://www.charitablegift.org/charity-giving-programs/daf/investments/individual.shtml (for information about investing in individual investment pools; some offer both Fidelity funds and outside funds, others offer only Fidelity funds) (last visited Mar. 23, 2010); https://www.vanguardcharitable.org/content/investmentpools.html?c=1 (for investment options for all donor advised funds held by Vanguard) (last visited Mar. 23, 2010).

[106] *See* U.S. DEP'T. OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2001 REVENUE PROPOSALS 106 (2000), http://www.treas.gov/offices/tax-policy/library/grnbk00.pdf (last visited Mar. 23, 2010. Also, donor advised funds provide the benefit of accruing income tax-free on the contributed property. Suppose that a donor contributes $10,000 to a donor advised fund. The $10,000 is invested for a year at 5%. The donor now has $10,500 that may be recommended for distribution to a charity for active charitable uses, less any fees charged by the sponsoring organization. This delay has the effect of depriving the charity of determining whether to spend the $10,000 currently or invest it and earn the 5% income, which will be "tax-free" to the charity just as if held by the sponsoring organization in the donor advised fund.

[107] *See, e.g.*, I.R.C. § 404(a) (allowing an employer to deduct an employee's contribution to a qualified retirement plan even though the employee does not presently include the compensation in income).

recognizing income on amounts contributed to a qualified retirement plan even though the employer remains entitled to a deduction in the current year. With a donor advised fund, the donor is entitled to a current income tax deduction even though no part of the contribution is guaranteed to be put to use for an active charitable purpose in the current taxable year.

III. OTHER CHARITABLE GIVING VEHICLES

Federal income tax law permitting charitable deductions contains a myriad of rules and regulations with differing results depending on what is given to whom and when it is given.[108] Among charitable giving vehicles, donor advised funds are known for their flexibility, ease of administration, and favorable tax treatment.[109] As a result, donor advised funds provide access to planned charitable giving that other charitable giving vehicles do not.

In order to understand what changes might be appropriate for donor advised funds, it is helpful to understand common charitable giving options that are available to donors. Donor advised funds occupy a unique place in charitable giving because of the flexibility that they provide to donors. Donor advised funds allow donors to have input over the distribution of funds for charitable uses but free donors from the administrative requirements that come with other forms of charitable giving. This section explores five other charitable giving alternatives, explaining each one and why it does not fill the unique place held by donor advised funds.

A. Outright Gifts

The simplest and best known way to give to charity is an outright contribution to a public charity.[110] The donor writes a check to the charity. The charity cashes the donor's check. The donor is entitled to an income tax deduction limited to 50% of the donor's AGI for the taxable year.[111] If the contribution exceeds 50% of the

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[108] If a taxpayer who itemizes his or her deductions gives marketable securities valued at $10,000 to a publicly-supported charity, the taxpayer will receive a charitable contribution deduction of $10,000 if the taxpayer has held the securities for more than a year. If not, the taxpayer's charitable contribution deduction will be limited to the taxpayer's basis. Suppose instead that the taxpayer contributes a painting valued at $10,000 to an art museum. Assuming that the painting will be used by the museum in furtherance of its exempt purpose, the taxpayer will receive a $10,000 charitable contribution deduction. If the taxpayer were to give the same painting to a local food pantry that intends to sell the painting for $10,000 and use the proceeds to buy food for the poor, even though the food pantry is a publicly-supported charity, the taxpayer's charitable contribution deduction will be limited to the taxpayer's basis.

[109] KALLINA II, *supra* note 12.

[110] As used here, a public charity refers to any organization that is not a private foundation as defined in I.R.C. § 509(a).

[111] President Obama's proposed budget would further reduce the charitable contribution available to taxpayers with adjusted gross incomes over $250,000 by imposing a 28% limitation rather than allowing a taxpayer the deduction at the taxpayer's marginal rate, which may be greater than 28%. For example, suppose a taxpayer has an adjusted gross income greater than $250,000 and a 35% marginal tax rate. Under existing law, if the taxpayer makes a $100,000 charitable contribution, in cash, the taxpayer will receive a $35,000 charitable contribution deduction. Under President Obama's plan, the same taxpayer would only receive a $28,000 charitable contribution deduction. *See* OFFICE OF MGMT. & BUDGET, EXECUTIVE

donor's AGI, then the donor may carry forward the "excess" contribution for five years.[112]

While an outright cash contribution has the advantage of simplicity, it may not produce the best overall tax result for a donor. For example, if a donor has appreciated marketable securities to donate instead of cash, the donor will be able to deduct the fair market value of the appreciated securities provided that the marketable securities have been held by the donor for more than one year.[113] The donor will not have to recognize the capital gain that would otherwise be due if the grantor sold the appreciated securities.[114]

Outright gifts to public charities come with a perceived downside for the donor in that the donor has parted with all dominion and control over the contributed property. The donor has written his or her check, the charity has cashed it, and now the charity is spending the donor's charitable contribution as the charity sees fit. If the donor is displeased with the way in which the charity is spending the contribution, there is little the donor can do. The donor is largely limited to voicing his or her displeasure to the charity and then declining to make any future contributions.[115]

An outright gift to a public charity has the advantage of being easy to accomplish and often provides the maximum possible charitable deduction, but it comes with a loss of influence over the donated funds and the loss of the ability to save on a tax favored basis for a larger charitable contribution.

B. I.R.C. § 408(d)(8)

The Pension Protection Act of 2006 also provided for distributions from individual retirement accounts (IRAs) directly to charitable organizations without

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OFFICE OF THE PRESIDENT, A NEW ERA OF RESPONSIBILITY RENEWING AMERICA'S PROMISE: FISCAL YEAR 2010 BUDGET PROPOSAL, 29 (2009) *available at* http://www.whitehouse.gov/omb/assets/fy2010_new_era/A_New_Era_of_Responsibility2.pdf (last visited Mar. 23, 2010).

[112] I.R.C. § 170(b)(1)(B). *See also* I.R.C. § 170(b)(1)(C)(ii); I.R.C. § 170(b)(1)(D)(ii).

[113] Suppose a donor has $10,000 cash and marketable securities worth $10,000 with an adjusted basis of $2,000. If the donor gives the charity the $10,000 in cash, the donor still has the securities along with $8,000 of inherent gain. If the donor gives the appreciated securities to the charity, the donor will have the $10,000 in cash, which the donor could use to purchase new securities. The donor will also have a $10,000 charitable contribution deduction. If the charity sells the donated securities, it will have $10,000 in cash and no gain to recognize because it is a tax-exempt organization.

[114] If the donor has held the securities for one year or less, then the donor's charitable deduction will be limited to the donor's basis. I.R.C. § 170(e)(1)(A). If the donor has tangible property to donate to the charity, then the donor will be able to deduct the fair market value of the donated property provided that the tangible personal property is used by the charity for its exempt purpose or function. *See* I.R.C. § 170(e)(1)(B)(i)(I). If not, then the donor's charitable deduction will be limited to the donor's basis. *Id*.

[115] Although state law is moving toward giving a donor standing to enforce the terms of a charitable gift, the movement is slow. Generally, it is the sole responsibility of the state attorney general to ensure that charities spend contributed funds as promised. Smithers v. St. Luke's-Roosevelt Hospital, 723 N.Y.S.2d 426, 426 (N.Y. App. Div. 2001); *see also* Iris J. Goodwin, *Donor Standing to Enforce Charitable Gifts: Civil Society vs. Donor Empowerment*, 58 VAN. L. REV. 1093, 1094 (2005).

any income tax consequences to the donor. I.R.C. § 408(d)(8) provides that an individual may make distributions directly from an IRA to charities if certain requirements are met.[116] A taxpayer's contribution is limited to $100,000 cumulative from all IRAs owned by the taxpayer.[117] Also, the distribution must have been made after the taxpayer achieved age 70½.[118] The distribution must have otherwise been includable in the taxpayer's gross income for the current taxable year.[119] The distribution must be made directly to a qualifying charity and cannot be made to a donor advised fund or a supporting organization described in § 509(a)(3).[120]

While I.R.C. § 408(d)(8) evidences a Congressional intent to facilitate charitable giving, it is not an adequate substitute for donor advised funds. First, I.R.C. § 408(d)(8) is not a permanent part of the Internal Revenue Code. It is slated to sunset on December 31, 2009.[121] Second, only taxpayers who have reached age 70½ may take advantage of this provision.

C. Private Foundations

1. Overview

A charitable donor may also consider creating a private foundation to receive and administer his or her charitable contribution. Donors find private foundations appealing because they provide a permanent vehicle through which the donor can coordinate and carry out the donor's charitable giving.[122] Private foundations are tax-exempt entities, but because they are not publicly-supported charities, contributions to private foundations are subject to more restrictive rules regarding the deduction allowable to the taxpayer.[123] Providing the proper safeguards are in place, the donor can still exert influence over the ultimate disposition of the charitable funds.

Often the private foundation is a non-operating private foundation, meaning that it does not carry on any active charitable activities. Non-operating private foundations are those foundations that are not actively engaged in charitable work

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[116] I.R.C. § 408(d)(8) was enacted in the Pension Protection Act of 2006. Originally, it was applicable to distributions made after December 31, 2005 and on or before December 31, 2007. Pension Protection Act § 1201(a). The sunset date was extended to December 31, 2009. Tax Extenders and Alternative Minimum Tax Relief Act of 2008, Pub. L. No. 110-343, Div. C. § 205(a), 122 Stat. 3865 (2008).

[117] I.R.C. § 408(d)(8)(A).

[118] I.R.C. § 408(d)(8)(B)(ii). If an individual is retired, he or she must begin taking required minimum distributions from qualified retirement plans in the year in which he or she attains age 70½. I.R.C. § 401(a)(9)(A); I.R.C. § 401(a)(9)(C).

[119] I.R.C. § 408(d)(8)(A).

[120] I.R.C. § 408(d)(8)(B)(i).

[121] I.R.C. § 408(d)(8)(F).

[122] *See generally* Ellwanger & Gassman, *supra* note 30.

[123] Generally, the charitable deduction for contributions to a private foundation is limited to 30% of the donor's adjusted gross income. I.R.C. § 170(b)(1)(B)(i).

but are instead grant-making entities.[124] Rather, the private foundation makes grants to other charitable organizations. Because the private foundation is usually closely identified with the donor, Congress has enacted a number of excise taxes to ensure that the contributed funds are being properly used.

2. Excise Taxes

Leading up to the Tax Reform Act of 1969, two large areas of abuse in the operation of private foundations had been identified. First, was self-dealing by the founder[125] or members of the founder's family. Second, was a failure to distribute the private foundation's assets in furtherance of active charitable purposes.[126] The excise tax rules adopted by Congress in 1969 are intended to address and remedy these abuses.[127]

a. Self-Dealing

Since many private foundations are family affairs, one of the abuses addressed by the private foundation rules is self-dealing by the donor or members of the donor's family. Self-dealing between a disqualified person and a private foundation is prohibited.[128] A disqualified individual is one who is a "substantial contributor to the foundation," is an "owner of more than 20 percent of" various business entities who are themselves substantial contributors to the foundation, or "a member of the family of any individual described [above]."[129] A "substantial contributor" is "any person who contributed or bequeathed an aggregate amount of more than $5,000 to the private foundation, if such amount is more than two percent of the total contributions and bequests received by the private foundation before the close of [its] taxable year."[130] If self-dealing occurs, the Code imposes a 10% excise tax on the self-dealer and a 5% excise tax on the foundation manager.[131] If the self-dealing goes uncorrected, excise taxes of 200% and 50% are imposed upon the self-dealer and the foundation manager, respectively.[132]

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[124] I.R.C. § 4942(j)(3) defines an operating foundation. Any foundation that does not meet the requirements of I.R.C. § 4942(j)(3) to be an operating foundation is a non-operating foundation. Most often, operating foundations are engaged in active charitable activities but fail to meet the public support test and therefore cannot be classified as a publicly-supported charity.

[125] COMM. ON WAYS & MEANS, TAX REFORM ACT OF 1969, H.R. REP. NO. 91-413, at 20-21 (1969).

[126] *Id.* at 25.

[127] *Id.* at 4.

[128] I.R.C. § 4941.

[129] I.R.C. § 4940(d)(3)(B).

[130] I.R.C. § 507(d)(2).

[131] I.R.C. § 4941(a).

[132] I.R.C. § 4941(b).

b. Failure to Distribute Income

If a private foundation fails to make certain minimum qualifying distributions, then a 30% excise tax is imposed.[133] A private foundation must distribute all of its income for the taxable year.[134] A private foundation's minimum investment return is defined to be 5% of the foundation's net aggregate fair market value of its assets.[135] Thus, a minimum 5% distribution is required each year.

For private foundations, detailed rules address which distributions count toward satisfying the minimum required distributions.[136] Various administrative expenses count toward the 5% distribution minimum, so it is unlikely that a private foundation in fact distributes 5% for active charitable purposes. Also, some of a private foundation's assets may be excluded from the base amount used to determine the 5% minimum investment return.[137] The percentage amount and what expenditures are included as qualifying distributions are often debated by interest groups. The excise tax on a private foundation's failure to distribute its income prevents a taxpayer from being able to claim a charitable contribution deduction without ever putting any money toward active charitable use.[138]

c. Net Investment Income

Private foundations are subject to a 2% excise tax on their net investment income each year.[139] The excise tax is only applicable to private foundations that are tax exempt and that are not operating foundations.[140] Net investment income is defined as gross investment income less deductions.[141] Gross investment income includes interest, dividends, royalties, and capital gains, but excludes unrelated trade or business income.[142] Taxpayers may deduct expenses attributable to producing the gross investment income to arrive at net investment income.[143] Treating donor advised funds as private foundations would subject donor advised funds to this additional tax.

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[133] I.R.C. § 4942(a).

[134] *Id.*

[135] I.R.C. § 4942(e).

[136] I.R.C. § 4942(g); Treas. Reg. § 53.4942(a)-3 (as amended in 1986).

[137] Treas. Reg. § 53.4942(a)-2(c)(2)-(3) (as amended in 1983).

[138] This 5% distribution requirement is not applicable to public charities. I.R.C. § 4942(j)(3)(B)(iii). Presumably a public charity (as well as an operating foundation) is using its donated funds to further its charitable purposes.

[139] I.R.C. § 4940.

[140] *Id.*

[141] I.R.C. § 4940(c)(1).

[142] I.R.C. § 4940(c)(2).

[143] I.R.C. § 4940(c)(3).

3. Dissolving a Private Foundation

If it is decided that a private foundation should be dissolved because it no longer is the right vehicle for the donor's charitable giving, a number of federal tax law and state law issues are raised. Very detailed procedures must be followed to avoid adverse tax consequences when terminating the foundation.

A termination tax is imposed when an organization terminates its private foundation status.[144] This tax is imposed even if the organization continues to exist under state law, and conversely may not be imposed even if the organization is dissolved under state law.[145] If the organization decides to completely dissolve, the termination tax can be avoided provided that all of the foundation's assets are transferred to public charities in existence at least sixty months or to another private foundation.[146] The private foundation should make the transfer before terminating its private foundation status to avoid the termination tax. Depending upon the structure of the winding down, notice to the Secretary of the Treasury may be required.[147] Lastly, a final tax return, Form 990-PF, is needed. In addition to the federal tax requirements, state law must be followed with respect to dissolving the private foundation.[148]

4. Private Foundations Not Feasible for Most Taxpayers

Private foundations impose a heavy administrative burden upon the founder and his or her family, mostly through the prohibitions on self-dealing, the limitations on the deductibility of contributions to the private foundation, and annual tax returns. In exchange, though, the donor is able to maintain significant control over where the charitable contributions are distributed. The founder is able to appoint the initial board of directors if the foundation is a corporation, or the initial trustees if the private foundation is a trust.

It is the role of the board or trustees to meet regularly to determine to which § 501(c)(3) organizations grants will be made. If the founder is engaged in charitable giving and has clear philanthropic goals in mind, a private foundation may be the right choice. The foundation will also be incurring legal and accounting costs each year to ensure proper tax compliance. To be something more than an employment opportunity for lawyers and accountants, the private foundation must have substantial enough resources to generate income beyond what is needed to pay the

[144] I.R.C. § 507.

[145] *See* Rev. Rul. 2002-28, 2002-1 C.B. 941.

[146] I.R.C. § 507(b).

[147] The Service has issued two revenue rulings that detail the notice requirements for terminating a private foundation. Rev. Rul. 2002-28 addresses the termination of a private foundation when the foundation transfers its assets to another private foundation or foundations. Rev. Rul. 2002-28, 2002-1 C.B. 941. Rev. Rul. 2003-13 addresses the termination of a private foundation when the foundation transfers its assets to public charities. Rev. Rul. 2003-13, 2003-1 C.B. 305.

[148]. For example, notice to the state attorney general may be required. *See, e.g.*, CAL. CORP. CODE §§ 6615, 6716. (West 2010). *See also* Nonprofit Transactions Requiring Notice or Attorney General Approval, Op. Cal. Att'y Gen., *available at* http://ag.ca.gov/charities/publications/charities_nonprofit_transactions.pdf.

legal and accounting fees. As a result, private foundations are not the right planned charitable giving vehicle for many taxpayers.

If the taxpayer decides that a donor advised fund is no longer the right vehicle for his or her charitable giving, the donor can simply direct the sponsoring organization to make a full distribution of the remaining funds, and the donor advised fund will come to an end. There are no federal tax consequences to consider and no state law requirements with which to comply. In fact, many smaller private foundations consider creating a donor advised fund to receive distributions and relieve the private foundation of many legal and administrative burdens.[149]

D. Supporting Organizations

The donor might also choose to create a supporting organization. A supporting organization is one that supports another charitable organization. A supporting organization is not a public charity in its own right because it lacks the public support necessary to be a public charity, but because of the relationship between the supporting organization and the supported organization, which is a public charity, the supporting organization is treated as a public charity and thus is not subject to the excise taxes applicable to private foundations.

Generally three tests must be met for an organization to be treated as a supporting organization under I.R.C. § 509 and not as a private foundation. First is the organizational and operational test asking whether the supporting organization is "organized, and at all times thereafter is operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more" supported organizations.[150] Second is the relationship test.[151] The supporting organization must meet one of several possible relationships with its supported organization. It is this test that commonly gives definition to the various types of supporting organizations. The final test, the disqualified person control test, ensures that the supporting organization "is not controlled directly or indirectly by one or more disqualified persons."[152]

The Pension Protection Act of 2006 also brought changes for supporting organizations. The various types of supporting organizations were defined for the first time in the Internal Revenue Code.[153] PPA also introduced the terminology of a "functionally integrated" Type III supporting organization[154] and a "non-functionally

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[149] In Private Letter Ruling 9807030, the Service approved a private foundation creating a donor advised fund at a community foundation and with a committee at the private foundation making recommendations to the community foundation on distributions from the donor advised fund. I.R.S. Priv. Ltr. Rul. 9807030 (Feb. 13, 1998).

[150] I.R.C. § 509(a)(3)(A).

[151] I.R.C. § 509(a)(3)(B).

[152] I.R.C. § 509(a)(3)(C).

[153] *See* I.R.C. § 4966(d)(4)(B) (defining Type I and Type II supporting organizations). *See* I.R.C. § 4943(f)(5) (defining Type III supporting organization and functionally integrated Type III supporting organization). The Code adopted the terminology commonly used by those involved with charitable giving. *See* Notice 2006-109, § 2.01, 2006-2 C.B. 1121 (Dec. 4, 2006).

[154] I.R.C. § 4943(f)(5)(B).

integrated" Type III supporting organization. Additionally, PPA directed the Department of Treasury to issue regulations regarding minimum payouts required of non-functionally integrated Type III supporting organizations.[155]

In August 2007, the Department of Treasury issued proposed regulations requiring minimum payouts for Type III supporting organizations.[156] The minimum payouts apply the 5% minimum distribution rules for private foundations to Type III supporting organizations.[157] The Treasury has yet to issue final or temporary regulations. PPA also extended the excess benefit excise taxes of I.R.C. § 4958 to supporting organizations.[158]

Supporting organizations are divided into four broad categories—Type I, Type II, functionally integrated Type III, and non-functionally integrated Type III.

With a Type I supporting organization, the supporting organization is "operated, supervised, or controlled by" one or more supported organizations.[159] The relationship of a Type I supporting organization to its supported organization resembles a parent-subsidiary relationship.[160] Type I supporting organizations are attractive to public charities seeking to isolate activities in a separate entity or otherwise limit liability. For example, a university might create a Type I supporting organization to raise money for a research institute.[161] The supporting organization is operated and controlled by the university and is thus responsive to the university.

With a Type II supporting organization, the supporting organization is "supervised or controlled in connection with" one or more supported organizations.[162] There is common management or control of the two organizations. A Type II supporting organization operates in much the same way as a brother-sister relationship. Type II supporting organizations are attractive in situations where there is a strong connection and identification between the supporting organization and the supported organization.[163] For example, a university's alumni association is closely identified with the university and makes distributions for the benefit of the university. Assuming that there is some common control and management, the alumni association might be a Type II supporting organization.

[155] Pension Protection Act of 2006, Pub. L. No. 109-280, § 1241(d)(1), 120 Stat. 1103.

[156] Prop. Treas. Reg. § 155929-06, 72 Fed. Reg. 42335 (Aug. 2, 2007).

[157] *Id.*

[158] Pension Protection Act of 2006, Pub. L. No. 109-280, § 1242, 120 Stat. 1103.

[159] I.R.C. § 509(a)(3)(B)(i).

[160] Treas. Reg. §1.509(a)-4(g)(1)(i) (as amended in 1981).

[161] The Treasury Regulations give the example of a university press created by a university to perform its "publishing and printing." The university's board of trustees appoints the board of governors of the university press. The regulations conclude the university press is a Type I supporting organization because the university press is "operated, supervised, or controlled by" the university. Treas. Reg. § 1.509(a)-4(g)(2), Example (1) (as amended in 1981).

[162] I.R.C. § 509(a)(3)(B)(ii).

[163] *See generally* Treas. Reg. § 1.509(a)-4(h) (as amended in 1981).

With a Type III supporting organization, the supporting organization is "operated in connection with" one or more public charities.[164] A Type III supporting organization is not controlled by the supported organization. In its organizational documents, the Type III supporting organization must name the supported organization.[165]

A Type III supporting organization must meet two further tests to qualify.[166] First, the Type III supporting organization must meet the responsiveness test.[167] The responsiveness test asks whether the Type III supporting organization is responsive to the supported organization. Broadly, the responsiveness test ascertains whether the supported organization has input and influence over the decisions of the supporting organization.[168]

Second, a Type III supporting organization must meet the integral part test.[169] The integral part asks whether (i) the activities of the Type III supporting organization are activities that the supported organization would carry on itself if not for the supporting organization,[170] or (ii) the supporting organization distributes substantially all of its income to the supported organization and the amount of the support is "sufficient to insure the attentiveness of" the supported organization.[171] Broadly speaking, the integral part test ascertains whether the activities of the supporting organization are sufficiently important to the supported organization so as to attract the supported organization's attention giving the requisite oversight to the Type III supporting organization such that its treatment as a public charity is justified.

A Type III supporting organization has the most appeal to an individual charitable donor. A Type III supporting organization is treated as a publicly-supported charity giving donors the higher AGI limitations and freedom from many of the private foundation excise taxes.[172] Still, the donor has significant influence over the distribution of the funds.

As noted above, there are two types of Type III supporting organizations. First, there is the functionally integrated Type III supporting organization. It will be involved in active charitable activities and not be merely a passive actor involved

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[164] I.R.C. § 509(a)(3)(B)(iii).

[165] Treas. Reg. § 1.509(a)-4(d)(2) Example (1). Types I and II supporting organizations have more flexibility in naming the supported organizations and can identify beneficiaries by class or purpose.

[166] Treas. Reg. § 1.509(a)-4(i)(1)(i).

[167] Treas. Reg. § 1.509(a)-4(i)(2).

[168] *Id.*

[169] Treas. Reg. § 1.509(a)-4(i)(3).

[170] Treas. Reg. § 1.509(a)-4(i)(3)(ii).

[171] Treas. Reg. § 1.509(a)-4(i)(3)(iii)(a).

[172] The Pension Protection Act of 2006 did extend the excess business holdings and excess benefit transaction excise taxes to supporting organizations. *See* I.R.C. § 4943(f) (excess business holdings excise tax) enacted by PPA § 1243(a). *See* I.R.C. § 4958(c)(3) enacted by PPA § 1242(b).

primarily in grant making. Second, there is the non-functionally integrated Type III supporting organization. A non-functionally integrated Type III supporting organization is closest to a donor advised fund but carries with it significant administrative cost and complexity. The supporting organization must be created under state law and its tax-exempt status sought from the I.R.S. A public charity must agree to be supported. Also, the donor is limited to whom distributions may be directed because the distributions must go to the supported organizations. Non-functionally integrated Type III supporting organizations are now subject to the same rules as private foundations and have the same required annual distributions.[173]

Overall, supporting organizations have a limited appeal for many taxpayers. Because of the needed connection with the supported organization, a supporting organization is not a good substitute for a donor advised fund.

E. Split Interest Trusts

A philanthropically-minded individual might consider a split interest trust. A split interest trust is one which a charity and non-charitable individuals are both beneficiaries of a trust. A split-interest trust might be inter vivos or testamentary. With an inter vivos split-interest trust, the donor's charitable deduction will be based upon the amount of the gift, the length of the lead period, and the appropriate interest rate published by the Internal Revenue Service.[174]

Two broad types of split interest trusts exist.[175] First is the charitable lead trust. With a charitable lead trust, the charity enjoys the present income interest before the remainder passes to individual, non-charitable beneficiaries. The second type is the charitable remainder trust, where the non-charitable beneficiaries enjoy the present income interest with the remainder interest passing to the charity upon the expiration of the term. A testamentary split-interest trust might generate an estate tax deduction for the donor's estate.

A donor who creates a charitable lead trust splits the transfer to a trust between a charitable organization and individuals chosen by the grantor as remainder

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[173] I.R.C. § 4942.

[174] Each month, the Internal Revenue Service publishes the § 7520 rate for use in determining "the value of any annuity, any interest for life or a term of years, or any remainder or reversionary interest." I.R.C. § 7520(a). For any "income, estate, or gift tax charitable contribution" the taxpayer can use the rate for the month of the transfer or the rate of either or the two preceding months. I.R.C. § 7520(a).

[175] Each broad type is further divided into annuity trusts and unitrusts. For charitable split interest trusts, there are four popular trusts: Charitable Lead Annuity Trust (CLAT), Charitable Lead Unitrust (CLUT), Charitable Remainder Annuity Trust (CRAT), and Charitable Remainder Unitrust (CRUT). A variation of the CRUT also exists. It is the Net Income Make-up Charitable Remainder Trust (NIMCRUT). The I.R.S. has issued model trust forms for these charitable trusts. For annuity trusts, see Rev. Proc. 2003-53, 2003-2 C.B. 230 (*inter vivos* for one measuring life), Rev. Proc. 2003-54, 2003-2 C.B. 236 (*inter vivos* for term of years), Rev. Proc. 2003-55, 2003-2 C.B. 242 (*inter vivos* for two consecutive measuring lives), Rev. Proc. 2003-56, 2003-2 C.B. 249 (*inter vivos* with two concurrent and consecutive lives), Rev. Proc. 2003-57, 2003-2 C.B. 257 (testamentary with one measuring life), Rev. Proc. 2003-58, 2003-2 C.B. 262 (testamentary for a term of years), Rev. Proc. 2003-59, 2003-2 C.B. 268 (testamentary with consecutive interest for two measuring lives), Rev. Proc. 2003-60, 2003-2 C.B. 274 (testamentary with two concurrent and consecutive lives).

beneficiaries. The charitable lead trust will generate a charitable contribution deduction for the donor if certain provisions are included that cause the trust to be taxed to the donor for income tax purposes.[176] Any income, including capital gains, that is not needed to make the lead payment to the charity may be accumulated for distribution to the remainder beneficiaries. The charitable lead trust is not a tax-exempt entity and detailed rules apply regarding the taxation of the income and distributions to charity. In a charitable lead trust, the charitable beneficiary may be changed, but only if done by an independent party.[177] No deduction will be allowed if the donor retains the ability to change.[178]

The taxpayer may also create a charitable remainder trust. In order to be a charitable remainder trust, a trust must meet the requirements of I.R.C. § 664. The charitable remainder trust must have a remainder for the charity that has an actuarial value of 10% or more of the value of the property contributed to the trust upon its creation.[179]

Additionally, the payouts to the non-charitable lead beneficiaries must be "not less than 5 percent nor more than 50 percent of the . . . fair market value of all property placed in trust" and "paid, not less often than annually."[180]

Charitable remainder trusts are tax-exempt entities, but the distributions to the non-charitable lead beneficiaries do carry out income to the beneficiaries.[181] Charitable remainder trusts allow taxpayers flexibility to change the remainder beneficiaries of the charitable remainder trust. The donor can add or drop charitable beneficiaries or adjust the amount going to each charity at the termination of the lead interest.[182]

The charitable split-interest trust is not an adequate substitute for a donor advised fund. First, there are the administrative burdens. An attorney is required to draft the trust agreement. Annual tax returns are required. Also needed is a trustee who is willing and competent to serve. Second, the income tax consequences are not as favorable. With a charitable remainder trust, the lead payments to the non-charitable beneficiaries will carry out income. If the contributed property were held in a donor advised fund, the income would not be subject to income tax.

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[176] I.R.C. § 170(f)(2)(B).

[177] Rev. Rul. 77-275, 1977-2 C.B. 346.

[178] Rev. Rul. 78-101, 1978-1 C.B. 301.

[179] I.R.C. § 664(d)(1)(D) (2009).

[180] I.R.C. § 664(d)(1)(A), (d)(2)(A). For annuity trusts, the fair market value is the initial net value. I.R.C. § 664(d)(1)(A). For unitrusts, it is the fair market value determined annually. I.R.C. § 664(d)(2)(A).

[181] I.R.C. § 664(b) provides ordering rules for the distributions to the non-charitable lead beneficiaries. With the Tax Relief and Health Care Act of 2006 (P.L. 109-432, Division A, §424(a), enacting I.R.C. § 664(c)), Congress revised the treatment of a charitable remainder trust's unrelated trade or business income by imposing a 100% excise tax on it. For many charitable remainder trusts with unrelated trade or business income (UTBI), this excise tax actually resulted in less tax than the older rules and extremely streamlined the computational process. I.R.C. § 664(c)(2)(A).

[182] *See* I.R.S. Priv. Ltr. Rul. 95-04-012 (Jan. 27, 1995).

IV. A PROPOSAL FOR REFORMING DONOR ADVISED FUNDS

A. Recounting the Problem

The overarching perception of donor advised funds is that insufficient funds are being used for active charitable purposes because no minimum payouts are required. With the Pension Protection Act of 2006, Congress defined donor advised funds and addressed areas of abuse relating to self-dealing involved between the donor and the sponsoring organization.[183] As discussed above, interested parties overall have suggested, first, that no minimum payouts be required from donor advised funds. Second, if Congress is going to require donor advised funds to have a minimum payout, then the 5% distribution requirement applied to private foundations should be used. Further, the interested parties argue that the 5% requirement should be applied on an aggregate basis to all donor advised funds held by a sponsoring organization and not applied on a fund-by-fund basis.[184]

When looking to cure the defect that no distributions are required from a donor advised fund, the individual retirement account should be used as a model. Despite discussions that donor advised funds are an alternative to private foundations, treating donor advised funds as private foundations is not the proper model.[185] Donors creating donor advised funds are seeking a simple vehicle to obtain a charitable deduction while maintaining at least indirect control over the ultimate charitable recipients through exercise of advisory privileges regarding charitable grants. What current law lacks is a mechanism to compel the sponsoring organization to make annual distributions.

B. A Proposal

As noted above, the Pension Protection Act of 2006, for the first time in the Internal Revenue Code, provided a definition of donor advised funds.[186] PPA also provided that certain excise taxes applicable to private foundations are now applicable to donor advised funds.[187] The private foundation excise taxes on excess benefit transactions and excess business holdings are now applicable to donor advised funds.[188] Also, donor advised funds are now subject to an excise tax on taxable distributions.[189] The managers of a sponsoring organization are also subject

[183] P.L. 109-280, §§ 1231-1233 enacting I.R.C. §§ 4966, 4967 and amending I.R.C. §§ 4958, 4943.

[184] See generally the discussion of I.R.S. Notice 2007-21, 2007-1 C.B. 611, *supra* Part I.B.3.

[185] I.R.S. Notice 2007-21, 2007-1 C.B. 611, refers to donor advised funds as an alternative to private foundations.

[186] I.R.C. § 4966(d)(2).

[187] I.R.C. §§ 4958, 4943.

[188] See I.R.C. § 4958(f)(7) for the excise tax on excess benefit transactions. See I.R.C. § 4943(e) for the applicability of the excise tax on excess business holdings.

[189] I.R.C. § 4966.

to an excise tax if a taxable distribution is knowingly made.[190] The PPA also added an excise tax on prohibited benefits.[191]

Any further reform of donor advised funds should seek to do three things. First, it should address the concerns raised by Congress and the Treasury Department. As summarized above, those concerns largely involve the appropriateness of the charitable contribution deduction given the donor's retained advisory privilege and lack of minimum required payout. Notice 2007-21 also asked whether donor advised funds should enjoy perpetual existence. Second, the reform should maintain the simplicity and the flexibility of donor advised funds. Doing so will continue to facilitate charitable giving. Third, a reform of donor advised funds should draw upon the strengths of existing legal structures whenever possible.

My proposal is to use individual retirement accounts as the underlying model for donor advised funds because doing so will address Congress's concerns and keep the donor advised fund rules simple. It also allows for minimum required payouts that are easy to calculate while allowing donors to save within the donor advised fund for larger contributions. Lastly, using IRAs as a model draws upon existing legal structures so that donor advised funds are understandable to a broad range of taxpayers.

1. Use Individual Retirement Accounts as a Model

I propose that individual retirement accounts be the model underlying donor advised funds.[192] Using the IRA as the theoretical foundation for donor advised funds implements many of the remaining goals of reforming donor advised funds while preserving much of their hallmark flexibility. The model proposed here incorporates the best of donor advised funds while avoiding the strict and burdensome requirements of the private foundation and many of its excise tax rules.[193]

First, the IRA model builds upon an existing legal structure. To facilitate continued charitable giving, any reformed structure should be familiar to taxpayers. The IRA is a retirement savings vehicle familiar to many taxpayers. Taxpayers understand that, depending upon their income and other retirement savings, they may make income tax deductible contributions to an IRA.[194] Taxpayers also understand

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[190] *Id.*

[191] I.R.C. § 4967.

[192] Because of the differing goals of saving to fund retirement and planned charitable giving, it is too simplistic to label my proposal a call for the creation of a charitable IRA. The proposal draws upon IRAs but departs from their mechanics when the purposes differ.

[193] There are many excise taxes on private foundations designed to prevent the abuse of the private foundation structure. *See* I.R.C. § 4940 (Net Investment Income), I.R.C. § 4941 (Self-dealing), I.R.C. § 4942 (Failure to Distribute Income), I.R.C. §4943 (Taxes on Excess Business Holdings), I.R.C. § 4944 (Taxes on Investments Which Jeopardize Charitable Purpose), and I.R.C. § 4945 (Taxes on Taxable Expenditures such as lobbying).

[194] Alternatively, taxpayers will have made pre-tax contributions to § 401(k) plans that the taxpayers will have rolled over into IRAs upon separation from service with the employer. In either event, taxpayers are familiar with receiving an income tax benefit upon contribution and the corresponding obligation to include in income at some later date.

that at some future time, they must take distributions from the IRA or face penalties if they fail to do so.

Using IRAs as the underlying model allows the importation of a key concept that is able to address a central concern regarding the existing operation of donor advised funds, namely the lack of required distributions for active charitable purposes.[195]

2. Required Minimum Payouts

With an individual retirement account, generally after a certain age, minimum distributions are required to be taken.[196] Each year, the owner of the IRA must include some of the IRA in his or her gross income.[197] The owner is free to take larger distributions and include more of the IRA in income, but is only required to take the minimum.[198] In exchange for the income tax benefits received in prior years, the owner agrees to include some of the IRA in income in subsequent years.[199]

In my proposal, donor advised funds would be required to make a minimum payout each year. The required minimum payout would be based upon the donor's age using the distribution periods provided for individual retirement accounts. The distribution periods are based upon the joint life expectancy of the owner and a spouse who is ten years younger than the donor.[200] If used for donor advised funds, these distribution periods would need to be expanded to cover donors under age 70. Using the existing IRA distribution periods draws upon an existing legal structure that is familiar to taxpayers and their advisors. It also avoids having to create new tables.

My proposed minimum payout would operate similar to the minimum required distributions for an IRA. The required minimum payout would ensure that each year some of the charitably contributed money would be put to active use by a charitable organization. This payout requirement addresses the concern that contributors can park charitable dollars in a donor advised fund without directing that those dollars be used to carry out active charitable purposes.[201]

Additionally, having a required minimum payout will force the donor to focus each year on the charitable giving process because the donor will be expected to

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[195] *Charities and Charitable Giving: Hearing Before the S. Comm. on Finance on Proposals for Reform*, 109th Cong. 34-35 (2005) (live statement of Jane G. Gravelle, Senior Specialist in Economic Policy, Congressional Research Service).

[196] Steven R. Lifson, *Practical Planning Ideas for Distributions from IRAs and Qualified Plans*, 37 J. MARSHALL L. REV. 807, 817-19 (2004).

[197] *Id.* at 817-18.

[198] *Id.*

[199] *Id.* at 809.

[200] If the owner's spouse is the sole beneficiary and more than ten years younger than the owner, then different rules apply for determining the required minimum distribution.

[201] A 2003 study prepared by Foundation Strategy Group for the Council on Foundations found that 19% of donor advised funds made no distributions during the year. The study may be found at: Community Foundation Conjoint Study: Donor Advised Funds, at 42-43 (2003), http://www.cof.org/files/Documents/Community_Foundations/External_Reports/FSG2_Oct2003.pdf (last visited March 27, 2010).

make a recommendation to the sponsoring organization regarding to whom and in what amount a distribution from the donor advised fund should be made.

In my proposal, a minimum payout would be required in the year subsequent to the establishment of the donor advised fund. For example, a donor who establishes a donor advised fund in 2010 would be required to make a recommendation to the sponsoring organization in 2011 based upon the value of the donor advised fund on December 31, 2010.[202] Donors are still able to make charitable contributions at year end without the need to create a trust or corporation or have identified charities to receive grants.[203]

My proposal retains the donor's ability to "save" within the donor advised fund to fund a larger, focused charitable contribution. These distribution periods still allow the donor the ability to accumulate contributed funds inside of the donor advised fund without significant depletion by required minimum payouts. The required minimum payout amounts as a percentage of the donor advised fund would be quite small in my proposal. For example, until a donor reached age 79, the required distribution amount would be below 5% of the value of the donor advised fund.[204] Until a donor was in his or her mid 60's, the required minimum payout would be below 3%.[205]

Currently, donor advised funds are not required to distribute any of their assets for active charitable purposes. Advocates of keeping the existing rules for donor advised funds argue that requiring a percentage distribution from donor advised funds would significantly curtail the ability of donors to save for a larger charitable gift for an active charitable purpose.[206]

Some advocates have asserted that sponsoring organizations already distribute, on an aggregate basis, greater than 5% of the assets held in donor advised funds each year.[207] This assertion is made to further the argument that no formal distribution requirement is needed.

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[202] Although the donor would not have to have decided upon a charity or charities to receive the entire amount contributed, in the subsequent year, the donor would have to select a charity to receive the minimum required payout. For IRA minimum distribution rules, see Treas. Reg. § 1.408-8, Q&A (6) (as amended in 2004).

[203] If, as discussed *infra*, the agreement with the sponsoring organization has a "default" charity named to receive charitable grants, the donor would still need to have selected that charity.

[204] A donor advised fund holding $10,000 created by a donor who is currently 79 years old would be required to make a minimum payout of approximately $500. The distribution period for an individual aged 79 is 19.5. Dividing $10,000 by 19.5 results in a minimum required payout of $512.82.

[205] Since the IRA Distribution Periods do not go below age 70, this is an estimate based upon the table. At age 70, the distribution period is 27.4. Such a distribution period would result in a 3.65% minimum payout. The minimum payout requirement would not exceed 10% until age 93.

[206] Noelle Barton & Elizabeth Schwinn, *Growing Concerns and Assets*, THE CHRON. OF PHILANTHROPY, May 29, 2008, at 6.

[207] *See, e.g.*, ABA Task Force, *supra* note 89, at 9.

Unfortunately, this argument misses the mark as to the potential for abuse. A taxpayer who makes a contribution to his or her donor advised fund but never recommends to the sponsoring organization that a charitable grant be made should not benefit from the generosity of other taxpayers who are making larger recommendations for charitable grants from their donor advised funds.

My proposal for a required minimum payout from each donor advised fund held by a sponsoring organization ensures that for each taxpayer receiving a charitable income tax deduction, some of the contributed funds are being put to active charitable use. For smaller donor advised funds, it may be that a sponsoring organization's minimum grant amount covers the required minimum payout. For example, Vanguard requires a $500 minimum grant recommendation. If a donor advised fund has a 3% required minimum payout and a $16,000 account balance, one $500 grant covers the minimum required payout.

This minimum payout should increase the overall amount of money being put to active charitable use. Presumably those taxpayers who are recommending more than the minimum percentage already will continue to do so. Those who are not making any recommendations will now begin making recommendations.

As with individual retirement accounts, any fees charged to the donor advised fund by the sponsoring organization for managing the donor advised fund would not be credited against the minimum required payout amount.[208] Also, any fees charged by third parties, for example, mutual fund companies, would not be credited against the distribution amount. Even now, when no payout is required from a donor advised fund, these fees still reduce the amount that is available for distribution for active charitable use.

A donor that failed to recommend a payout from his or her donor advised fund and give the sponsoring organization sufficient time to make the payment by December 31st would "forfeit" the privilege of advising the sponsoring organization as to that payout. The donor advised fund agreement between the donor and the sponsoring organization could also recommend a specific charity to receive any required minimum payouts in the event the donor fails to make a recommendation. The sponsoring organization, as is the case now, would hold legal title to the contributed funds in the donor advised fund. The sponsoring organization would remain able and free to make charitable grants without a recommendation from the grantor. My proposal reflects the current reality that sponsoring organizations rarely act in contravention of a donor's recommendation, or lack of a recommendation.

An additional excise tax is needed to prevent non-compliance by sponsoring organizations. If an IRA owner fails to take the minimum required distribution, an excise tax is imposed.[209] I propose that if a sponsoring organization fails to make a minimum required payout, then an excise tax should be imposed. PPA amended the Code to provide that if a "taxable distribution" was made from a donor advised fund, then a 20% excise tax is imposed upon the sponsoring organization.[210] I propose that a 20% excise tax be imposed on the shortfall of any required minimum payout.

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[208] *See* Treas. Reg. § 1.401(a)(9)-5, Q&A(3) (as amended in 2007). For a more narrative reiteration, see I.R.S. Publication 590 (2008).

[209] I.R.C. § 4974(a) (1986) imposes a 50% excise tax on the failure to take a minimum required distribution.

[210] I.R.C. § 4966(a).

3. Required Payouts When Non-Individual Donor

To this point, my proposal has focused on individuals as the creators of donor advised funds. Given the still broad definition of a donor advised fund, nothing prevents a donor advised fund from being established by an entity. Donor advised funds created by corporate entities raise a problem with using IRAs as the underlying model because there is no donor age upon which to base the minimum required payouts and ultimate termination of the donor advised fund.

To remedy this problem, a set term must be established for each donor advised fund created by a corporate entity. Each year, a larger percentage would be distributed for active charitable use.

For example, assume that the four to five year window for termination after an individual donor's death is used. In 2009, Corp. creates a donor advised fund. By December 31, 2010, Corp. must recommend 1/4 of the balance be distributed. Each year, the percentage would increase so that 1/3 is distributed by December 31, 2011; 1/2 by December 31, 2012; and the remainder by December 31, 2013. Because nothing prevents Corp. from setting up a series of "rolling" donor advised funds,[211] a shorter time frame seems preferred.[212]

4. Termination

Continuing to use the individual retirement account as the model underlying donor advised funds would provide for the eventual termination of a donor advised fund. With an IRA, there are several events that will cause an IRA to terminate.

First, the owner of the IRA might withdraw all of the funds. The owner includes the IRA assets in his or her gross income, pays any tax,[213] and the IRA is closed.

Second, an IRA might also terminate when the owner dies. The timing of the inclusion of the remaining IRA assets in income depends, generally, on who is the beneficiary and whether the owner-decedent was taking required minimum distributions.[214] If the owner's spouse is the named beneficiary, then the surviving spouse can elect to treat the owner's individual retirement account as his or her own and delay taking distributions until April 1st of the year after the year in which the spouse reaches age 70½. The minimum required distribution rules apply as if the surviving spouse was the owner the entire time.

If someone other than the surviving spouse is named as a beneficiary, then, generally, the IRA assets are included in income over either the beneficiary's life span as determined on the date of the owner's death, or the IRA assets are included

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[211] For example, in 2009, Corp. creates the Corp. 2009 Donor Advised Fund. In 2010, Corp. creates the Corp. 2010 Donor Advised Fund.

[212] The 15 year period for amortization of goodwill or the 20 year term of charitable lead or remainder trusts are also options. The 20 year term of a charitable trust has the advantage of beginning with a 5% minimum required payout that is similar to the requirement for private foundations.

[213] If the owner is under age 59½ and no exception applies, the owner will be subject to a 10% penalty. *See* I.R.C. § 72(t)(2)(A)(i) (2008).

[214] Note the requirement for greater than 5% shareholders to take even if not retired. I.R.C. § 72(m)(5)(B).

in income no later than five years after the owner's death if no designated beneficiary is named.

In my proposal, first, a donor advised fund would terminate if the donor recommended to the sponsoring organization that the entire remaining account balance be distributed for active charitable purposes.

Second, each donor advised fund would have a termination date of not later than December 31st of the fourth year following the death of the donor. For example, Jack dies on May 1, Year 1. The remainder of Jack's donor advised fund must be distributed by December 31, Year 5. This gives Jack's named successor, or his personal representative, at least four years to make recommendations regarding the distribution of Jack's donor advised fund.

This termination date is intended to echo the five year period for individual retirement accounts that do not have a properly designated beneficiary who is able to spread the IRA distributions over a longer period.[215] If the donor is married when the donor advised fund is created and the donor's spouse is also an initial donor to the donor advised fund,[216] then in my proposal the older spouse would be treated as the primary donor for purposes of determining the minimum payouts. The termination date of the donor advised fund would be December 31st of the fourth year following the death of the surviving spouse.

This four to five year window allows the donor's family to continue its involvement using the donor advised fund to further its charitable giving but would provide a date certain for the termination of the donor advised fund. Importantly, a certain termination date ensures that at some point the charitably contributed funds will be put to active use by a qualified charity.

Bringing donor advised funds to an end after several years also removes the necessity of having a family that is committed to charitable giving for an extended period of time. With a private foundation or a supporting organization, often the donor desires that it will become the family vehicle for charitable giving.

If a donor makes a testamentary bequest to his or her donor advised fund, then the successor advisor named in the donor advised fund agreement will have until December 31st of the fourth year following the donor's death to make recommendations regarding the distribution of the assets of the donor advised fund.[217] As with all donor advised funds, the sponsoring organization would have the ultimate responsibility for making the charitable grants within the allowable period.

5. Illiquid Assets

[215] For example, a spouse might elect to treat the individual retirement account as his or her own and defer taking any distributions until the spouse would be required to do so as if the IRA had been owned by the spouse the entire time. Also, an individual beneficiary might elect to take the IRA over his or her life expectancy. The detailed rules about the post-mortem "cleaning up" of an IRA beneficiary designation are beyond the scope of this Article. I.R.C. § 401(a)(9)(B)(ii) (2008).

[216] Whether expressly stated in the agreement with the sponsoring organization or if the charitable contribution deduction was taken on a jointly filed federal income tax return.

[217] Fidelity Gift already provides an option for a donor to name a successor charitable organization that is to be the beneficiary of the donor advised fund upon the donor's death. *Gift Fund Policy Guidelines*, *supra* note 100, at 24.

Using individual retirement accounts as a model for donor advised funds works well for donor advised funds that hold exclusively cash or marketable securities. A sponsoring organization could easily value the donor advised fund as of December 31st and notify the donor of the required minimum payout for the year. To make charitable grants, the sponsoring organization needs to have liquid assets in the donor advised fund.

Fidelity Gift, the largest sponsoring organization, accepts assets other than cash or marketable securities (non-conforming assets) only on a case-by-case basis.[218] Because the sponsoring organization often lacks the personnel resources to manage the non-conforming assets, it will not make economic sense for it to accept the assets.

When a donor advised fund owns illiquid assets, several additional issues arise that are not necessarily present when a donor advised fund only holds cash and marketable securities. The first issue is the sponsoring organization's expertise to manage the illiquid assets. A sponsoring organization holding donor advised funds that consist of cash and marketable securities likely has the expertise to manage those assets. If a donor advised fund is holding real property or an interest in a closely-held business, then the sponsoring organization likely needs to take a more active role in managing the asset.[219] For example, if a donor contributes a parcel of rental real estate to a donor advised fund, the sponsoring organization becomes the owner and landlord of the rental property. A sponsoring organization likely has no desire to be a landlord.

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[218] *Id.* at 5.

[219] In Private Letter Ruling 200821024, the Service approved a series of transactions where a taxpayer who owned shares of a closely-held holding company proposed to gift the shares to a donor advised fund created by the taxpayer and held by a public charity. The charity's policies required it to have a diversified portfolio. Thus, it was unlikely that the charity would be interested in retaining the stock of the closely-held holding company.

The charity wants to sell the stock to an irrevocable trust of which the taxpayer is the trustee. The terms of the trust provide that the trust assets are to be held for the benefit of the taxpayer's spouse for her life. If she predeceases the taxpayer, the trust assets are to be used to benefit the taxpayer for his life. Upon the taxpayer's death, or upon his spouse's death if he predeceases her, the remaining trust assets are to be distributed to the children of the taxpayer and his spouse.

The question presented is whether the contribution by the taxpayer to the donor advised fund and the charity's subsequent sale to the irrevocable trust would be considered a sale by the taxpayer to the trust.

The Service ruled that because the charity is not under any legal obligation and cannot be compelled by any party to sell the shares, the contribution by the taxpayer of the closely-held stock to the charity and the charity's subsequent sale to the irrevocable trust will not be deemed a sale by the taxpayer to the trust.

The ruling shows the respect given to the independent decision making ability of the charity. Clearly, the parties contemplated that the donor, his family, and his attorney would advise the charity on when and to whom distributions would be made from the donor advised fund. Because the charity was free to accept or reject the advice, in its absolute discretion, the Service ruled that the taxpayer did not exercise control over the charity. The donor was able to avoid capital gain recognition. I.R.S. Priv. Ltr. Rul. 200821024 (May 23, 2008).

A collateral issue is whether the fee the sponsoring organization would charge to manage illiquid assets is economical given the value of the illiquid property contributed. As noted above, sponsoring organizations customarily charge a fee for managing a donor advised fund. Presumably, the fee for managing active assets would be greater than the fee for managing passive assets.

Donor advised funds holding assets other than cash and marketable securities present administrative problems, but not problems that are insurmountable. For example, a donor advised fund holding real estate poses problems regarding both valuation and liquidity with which to make distributions.

Real estate is not as readily subject to valuation as marketable securities. A qualified appraiser is needed to determine the value of real estate, unless a sale has recently occurred. Hiring an appraiser each year may be expensive and cumbersome when the value of the real estate might not significantly change from year to year.

For private foundations, excise tax rules address this concern by providing that real estate may be valued every five years.[220] A valuation every five years reduces the burden on the private foundation to obtain an appraisal every year.

For donor advised funds, an appraisal would be obtained upon the contribution of property to a donor advised fund. The donor will want an appraisal to substantiate his or her charitable contribution deduction. If the sponsoring organization is still holding the illiquid asset at the end of the fifth year, the sponsoring organization will be required to appraise the property again.

6. Preventing Further Abuse

To prevent abuse, I.R.C. § 4966(c)(2) must be amended to provide that a distribution from one donor advised fund to another donor advised fund does not satisfy the minimum payout requirement even though such a distribution is not a taxable distribution.

7. Simplicity Maintained

My proposal maintains, in large part, the simplicity that is associated with donor advised funds. The creation of a donor advised fund can still be a short contract between the donor and the sponsoring organization. In the contract itself, the only new provision might be the donor's insertion of a recommended charity in the event that the donor does not make a recommendation as to a payout.

No tax returns would be required for a donor advised fund. The sponsoring organization will hold legal title to the assets in the donor advised fund. Any income tax reportable transactions will continue to be reportable on the sponsoring organization's income tax return, which it is required to file.

To the extent that the sponsoring organization must value each donor advised fund account on an annual basis to determine the minimum payout required from each fund, my proposal does increase the administrative burden on the sponsoring organization. Since many sponsoring organizations only permit donor advised funds to hold cash and marketable securities, this should not be an onerous burden. The sponsoring organization must also ensure that the minimum required payout is made each year.

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[220] I.R.C. § 4942(e)(2), Treas. Reg. § 53.4942(a)-2(c)(4)(iv)(b) (as amended in 1983).

V. Conclusion

Congress identified the lack of a minimum payout as a concern given the favorable tax treatment afforded for contributions to donor advised funds. In Notice 2007-21, the Service asked for input regarding the perpetual existence of donor advised funds. This Article has addressed those concerns by providing a framework based upon individual retirement accounts that requires grants be made for active charitable use and that brings donor advised funds to an eventual end for each donor. The proposal brings the treatment of donor advised funds into line with the prevailing expectation of donors.

Donor advised funds are calling out for the creation of a new class of charitable giving rules. Throughout their rise, donor advised funds have managed to operate in the space between public charities and private foundations.

This is a perfect time to develop a new model for donor advised funds. Congress has taken the first step to remedy the private benefit abuses by imposing excise taxes upon donor advised funds. The next step should be to implement the proposal in this Article.