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PROPOSED GUIDANCE FOR DONOR ADVISED FUNDS

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[1] The comments contained in the paper are the individual views of the authors who prepared them, and do not represent the position of the State Bar of California or of the Los Angeles County Bar Association.
[2] Although the authors and/or presenters of this paper might have clients affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law, no such participant has been specifically engaged by a client to participate on this project.

EXECUTIVE SUMMARY[3]

Donor Advised Funds, in various forms, have been in existence for almost a century, and are among the most widely used charitable giving vehicles in philanthropy today. On August 17, 2006, President George W. Bush signed the Pension Protection Act of 2006, which included, for the first time, a definition of Donor Advised Funds, and placed new rules on their use. Many of the provisions affecting Donor Advised Funds were extensions of the rules already applicable to private foundations, with little or no guidance explaining how to apply these rules to Donor Advised Funds.

Thus, practitioners generally look to guidance in the private foundation context to elucidate issues affecting Donor Advised Funds. However, the authors believe that the rules and guidance applicable to private foundations do not seamlessly apply to Donor Advised Funds because there are significant differences between Donor Advised Funds and private foundations. In addition, the lack of guidance creates confusion among practitioners and sponsoring organizations and limits the flexibility and functionality of Donor Advised Funds. Accordingly, this paper attempts to highlight a few key issues raised by the rules implemented under the Pension Protection Act, and provides recommendations on how these issues can be resolved through U.S. Treasury Regulations.

The authors have focused on issues of primary concern or common confusion among practitioners, sponsoring organizations, and donors. Specifically, this paper addresses: (1) questions concerning the application of the definition of Donor Advised Funds; (2) excise taxes with respect to receiving, directly or indirectly, a "more than incidental benefit" in the Donor Advised Funds context; (3) excise taxes related to distributions to disqualified supporting organizations; and (4) excise taxes in connection with excess business holdings.

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[3]Courtney Gardner and Jorge Lopez are associates of Farella Braun + Martel LLP and Adler & Colvin, respectively. The views expressed herein are those of the authors and do not necessarily reflect the views of Farella Braun + Martel LLP and Adler & Colvin. The information contained herein is general in nature and is not intended, and should not be construed, as legal, accounting, or tax advice or as an opinion by Farella Braun + Martel LLP and Adler & Colvin to the reader. The reader is also cautioned that the material may not be applicable to, or suitable for, the reader's specific circumstances or needs, and may require considerations of non-tax and other factors if any action is to be contemplated. The reader should contact his or her tax advisor prior to taking any action based on this information. Farella Braun + Martel LLP and Adler & Colvin assume no obligation to inform the reader of any changes in tax laws or other factors that could affect the information contained herein.

DISCUSSION

I. BACKGROUND

A. History of Donor Advised Funds

Donor-advised funds ("DAF") have been utilized as a charitable giving vehicle since the 1930s, when the New York Community Trust and the Winston-Salem Foundation created segregated funds for individual donors, who provided some direction with respect to the charitable use of the funds. In the decades that followed, community foundations have been established throughout the United States, allowing donors to create individual or family funds, from which distributions are generally made in furtherance of local charitable organizations or programs.

The tax-exempt status of organizations that "sponsor" DAFs was not supported by legal authority until 1987.[4] National Foundation, Inc. ("NFI") allowed donors to establish an "account" with NFI and recommend charitable projects or charitable organizations to be supported with funds from their account.[5] The U.S. Court of Federal Claims determined that NFI was operated for exempt purposes within the meaning of section 501(c)(3) of the Code,[6] relying largely on the fact that the donors did not retain control over the funds that were contributed to NFI, and NFI exercised discretion over the final distribution of funds.[7]

Not long after this judicial support in favor of DAFs, in 1991, Fidelity Charitable Gift Fund, managed by Fidelity Investments, became the first nationally known DAF sponsoring organization to obtain tax-exempt status. From that point forward, the popularity of DAFs has grown on an exponential scale. With this growth came perceived abuses, which Congress sought to curtail through a new set of restrictions applicable to DAFs, enacted by the Pension Protection Act of 2006.

B. Pension Protection Act of 2006

[4] Nat'l Found., Inc. v. United States, 13 Ct. Cl. 486 (1987).
[5] *Id*. at 488-89.
[6] All references to "Code" herein refer to the Internal Revenue Code of 1986, as amended, unless otherwise noted.
[7] *Nat'l Found.*, at 492-93.

The Pension Protection Act of 2006 ("PPA"), enacted on August 17, 2006, contains a number of provisions applicable to DAFs. Remarkably, despite their 85-year history, DAFs were not defined by statute prior to PPA's enactment of Code section 4966 (discussed in more detail below). Once defined, Congress could then attempt to eliminate the perceived abuses of DAFs, such as donors using DAF assets to compensate their family members, or pay for family members' tuition. To prevent donors from using DAF funds for the benefit of the donor or the donor's family, the PPA applied restrictions on the investments and activities of this newly defined charitable vehicle.

Specifically, Code section 4966 imposes excise taxes on the sponsoring organization and fund management for distributions that require the exercise of "expenditure responsibility" or that do not accomplish a charitable purpose. In addition, Code section 4967 imposes excise taxes on donors, donor advisors, and related persons if they receive more than an "incidental benefit" from a DAF. The PPA amended Code section 4958 to apply "intermediate sanctions" on "excess benefit transactions" entered into by DAF donors and sponsoring organization investment advisers. Finally, the PPA amended Code section 4943 to apply the excess business holdings rules to DAFs.

C. Current State of the Law

1. *Statutory Definitions*

Code section 4966(d)(2) defines a "donor-advised fund" as (1) a fund or account owned and controlled by a sponsoring organization, (2) which is separately identified by reference to contributions of the donor or donors, and (3) where the donor (or a person appointed or designated by the donor) has or reasonably expects to have advisory privileges over the distribution or investments of the assets.

Statutorily excluded from the definition of a DAF are: (1) funds or accounts that make distributions only to a single identified organization or government entity;[8] and (2) funds or accounts for which a donor provides advice regarding grants to individuals for travel, study, or other similar purposes, provided:

[8] I.R.C. § 4966(d)(2)(B)(i).

> (a) the donors' or the donor advisor's advisory privileges are performed in his or her capacity as a member of a committee, all the members of which are appointed by the sponsoring organization,
>
> (b) no combination of donors or donor advisors (or related persons) directly or indirectly control the committee; and
>
> (c) all grants are awarded on an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the board of directors of the sponsoring organization that meets the requirements of Code section 4945(g)(1), (2), or (3).[9]

Code section 4966(d)(1) defines a "sponsoring organization" as an organization that (1) is described in Code section 170(c) (other than a governmental entity described in Code section 170(c)(1), and without regard to any requirement that the organization be organized in the United States); (2) is not a private foundation (as defined in Code section 509(a)); and (3) maintains one or more DAFs.

Code section 4966(d)(3) defines a "fund manager" with respect to a sponsoring organization as an officer, director, or trustee of such sponsoring organization (or an individual having powers or responsibilities similar to those of officers, directors, or trustees of the sponsoring organizations).

Disqualified persons with respect to a DAF include: (1) a donor or any person appointed or designated by a donor who has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in a DAF, by reason of the donor's status as a donor[10] (a "donor advisor"); (2) a member of the family of a donor advisor;[11] and (3) an entity in which a donor advisor or donor advisor's family has more than a 35% interest (voting control, profits interest, or beneficial interest).[12]

Disqualified persons with respect to a sponsoring organization include: (1) an "investment advisor," which is any person other than an employee of the sponsoring organization that is compensated by the sponsoring organization for managing the investment of, or providing

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[9] I.R.C. § 4966(d)(2)(B)(ii).
[10] I.R.C. § 4966(d)(2)(A)(iii) and 4958(f)(7)(A).
[11] I.R.C. § 4958(f)(7)(B).
[12] I.R.C. § 4958(f)(7)(C) and (f)(3).

investment advice with respect to, assets maintained in DAFs;[13] (2) a member of the family of an investment advisor;[14] and (3) an entity in which an investment advisor or investment advisor's family has more than a 35% interest.[15]

Code section 508(f) provides that a sponsoring organization must notify the Internal Revenue Service ("IRS") if it maintains or intends to maintain DAFs, including the manner in which the sponsoring organization plans to operate such DAFs.

2. *Excise Taxes*

Code section 4966 imposes a 20% excise tax on "taxable distributions" made by a sponsoring organizations. In addition, a 5% excise tax is imposed on a fund manager who makes a taxable distribution with knowledge that it is a taxable distribution.[16] "Taxable distributions" include any distribution from a DAF if the distribution is (1) to any individual or (2) to any other person (e.g., corporation, partnership, estate) if the distribution is not for charitable purposes, or if the sponsoring organization does not exercise required expenditure responsibility in accordance with Code section 4945(h).[17]

Exceptions from this general rule include: (1) distributions to organizations defined in Code section 170(b)(1)(A) that are not "disqualifying supporting organizations";[18] and (2) distributions from a DAF to the sponsoring organization of such DAF, or to any other DAF.[19] "Disqualifying supporting organizations" are Type III non-functionally integrated supporting organizations and Type I, Type II, and functionally integrated Type III supporting organizations where the donor or donor advisor directly or indirectly controls the supported organization.[20]

Code section 4967 applies a 125% excise tax on a donor, donor advisor, or related person who advises a sponsoring organization to make a distribution from a DAF which results in such person receiving, directly or

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[13] I.R.C. § 4958(f)(8)(B).
[14] I.R.C. § 4958(f)(8)(A)(ii).
[15] I.R.C. § 4958(f)(8)(A)(iii) and (f)(3).
[16] I.R.C. § 4966(a)(1) and (2).
[17] I.R.C. § 4966(c)(1).
[18] I.R.C. § 4966(c)(2)(A).
[19] I.R.C. § 4966(c)(2)(B) and (C).
[20] I.R.C. § 4966(d)(4).

indirectly, a more than incidental benefit as a result of such distribution.[21] This tax does not apply if tax has already been imposed under the Code section 4958 excess benefit rules.[22] In addition, a 10% excise tax is imposed on a fund manager who makes a distribution knowing it will confer a more than incidental benefit on the donor, donor advisor, or family member.[23]

Code section 4943(e) extends the application of excise taxes on excess business holdings to DAFs.[24] For purposes of determining whether the DAF has excess holdings, disqualified persons with respect to a DAF include a donor or donor advisor, a family member of a donor or donor advisor, or an entity in which such persons own more than 35% interest.[25] The tax is equal to 10% of the value of the excess holdings,[26] and increases to 200% if the excess holdings are not disposed of prior to notice from the IRS that excise tax is being imposed on such excess.[27]

Code section 4958 applies a 25% excise tax on a disqualified person with respect to an excess benefit transaction.[28] In addition, a 10% excise tax is imposed on a manager who participated in the excess benefit transaction while knowing that it caused an excess benefit.[29] If the excess benefit transaction is not corrected, an additional 200% excise tax is imposed on the disqualified person.[30]

Any grant, loan, compensation, or other similar payment from a DAF to a donor, donor advisor, or person related to a donor or donor advisor is automatically treated as an excess benefit transaction.[31] The entire amount paid is treated as the amount of the "excess" benefit.[32]

3. *Published Guidance*

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[21] I.R.C. § 4967(a)(1).
[22] I.R.C. § 4967(b).
[23] I.R.C. § 4967(a)(2).
[24] I.R.C. § 4943(e)(1).
[25] I.R.C. § 4943(e)(2).
[26] I.R.C. § 4943(a)(1).
[27] I.R.C. § 4945(b).
[28] I.R.C. § 4958(a)(1).
[29] I.R.C. § 4958(a)(2).
[30] I.R.C. § 4958(b).
[31] I.R.C. § 4958(c)(2).
[32] I.R.C. § 4958(c)(2)(B).

Notice 2006-109[33] provides interim guidance that excludes employer-sponsored disaster relief funds from the definition of DAFs and clarifies the application of the new Code section 4966(a) excise tax on educational grant payments made from DAFs with respect to educational grants awarded prior to the enactment of Code section 4966. Additionally, it provides that, for purposes of determining whether a donor or donor advisor or related person controls a supported organization of the grantee, the control standards established in U.S. Treasury Regulations ("Regulations") section 53.4942(a)-3(a)(3) will apply.

Notice 2014-4[34] provides interim guidance for sponsoring organizations making distributions from DAFs to supporting organizations. This Notice provides that a sponsoring organization can rely on the Type I, Type II, Type III, or Type III functionally integrated supporting organization classifications reported on the IRS Business Master File, or on written representations made by the grantee supporting organization, accompanied by documentation to demonstrate the organizational structure and functional integration, if applicable.

The Joint Committee on Taxation has published Technical Explanations which suggest generally that a fund created by multiple, unrelated donors will not constitute a DAF.[35] In addition, the Technical Explanations clarify that, for purposes of Code section 4967, a benefit is "more than incidental" if the benefit received by the donor, donor advisor, or related person would have reduced or eliminated a charitable contribution deduction if the benefit were received as part of an ordinary quid pro quo charitable contribution transaction.[36] Finally, the Technical Explanations also clarify that payments pursuant to bona fide sales or leases of property are not "other similar payments" for purposes of Code section 4958 excess benefit transactions, where any grant, loan, or "other similar payment" from a DAF to a donor, donor advisor, or related person is treated as an excess benefit transaction.[37]

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[33] 2006-51 C.B. 1121.
[34] 2014-2 I.R.B. 274.
[35] Staff of the Joint Committee on Taxation, 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 (JCX-38-06) at 342.
[36] *See* Staff of the Joint Committee on Taxation, 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 (JCX-38-06) at 350.
[37] *Id*. At 347.

II. NEED FOR GUIDANCE

A. Donor Advised Fund Growth

DAFs are among the most popular giving vehicles in philanthropy. In 2011, the total number of individual DAF accounts reached 177,357, representing a growth of 17% from 2007.[38] By comparison, the combined total of other gift planning vehicles -- namely, charitable remainder and charitable lead unitrusts and annuity trusts, and pooled income funds, was 117,307 in 2011.[39]

Similarly, assets under management grew steadily over that same time period. In 2011, assets in DAFs grew by $5.5 billion and total assets under management were $37.43 billion.[40] In 2012, assets in DAFs grew by $7.21 billion and total assets were an estimated $45.35 billion. [41] Contributions (i.e., amounts deposited into DAFs to establish the fund or add money to it) in 2012 increased from $10.19 billion in 2011 to $13.71 billion (an increase of 34.6%).[42] Further, grantmaking (i.e., payouts) through DAFs in 2012 reached $8.62 billion compared with $8.08 billion in 2011 (an increase of 6.7%).[43]

From 2007 through 2012, the average distributions from DAFs annually exceeded 16% of total DAF assets.[44] For 2012, the payout rate slowed slightly to 16.0% from 17.5% the previous year.[45] In comparison, the payout rates at a typical private foundation are around 5%, which payout amount includes private foundation operational costs. Reported DAF payout rates, on the other hand, do not include overhead costs.[46]

In 2012, Fidelity Charitable (an independent public charity that sponsors the nation's largest DAF program) collected $3.6 billion in contributions to DAFs, which is more than the American Cancer Society, the

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[38] Nat'l Philanthropic Trust 2012 Donor-Advised Report *available at* http://www.nptrust.org/daf-report/pdfs/donor-advised-fund-report-2012.pdf.
[39] *Id.*
[40] *Id.*
[41] *Id.* Assets under management generally means the total amount a charitable sponsor holds and manages in a donor-advised fund account.
[42] Nat'l Philanthropic Trust 2013 Donor-Advised Report *available at* http://www.nptrust.org/daf-report/pdfs/donor-advised-fund-report-2013.pdf.
[43] *Id.*
[44] *Id.*
[45] *Id.*
[46] *Id.*

Boys & Girls Club, or the American Red Cross (some of the most well-known and broadly supported public charities) received in donations.[47] The extraordinary amounts held in DAF accounts underscore the widespread use of DAFs in the charitable sector and, perhaps more importantly, the need for clear guidance on the rules that apply to their operation.

B. Reasons for Increased Use of Donor Advised Funds

There are several reasons why DAFs historically have been, and continue to be attractive charitable giving vehicles for philanthropists. Among the reasons generally cited for the growth in DAF popularity are: (i) the immediate fair market value tax deduction, (ii) avoidance of capital gains tax for gifts of appreciated capital assets, (iii) the ability to donate different types of assets with greater ease, (iv) low-cost professional investment management, and (v) the ability to name successors to continue family involvement.[48]

As a practical matter, DAFs are affordable and relatively easy to set up. Generally, donors only need a minimum amount, as determined by the sponsoring organization, to set up a DAF. Some community foundations have minimums as low as $10,000 and many also offer "acorn" funds, allowing donors to build up to the minimum.[49] Moreover, a donor can easily establish a fund without incurring legal or accounting fees. Instead, the sponsoring organization charges an administration fee that depends in part on the size of the account.[50]

Due to the above-described tax incentives and general ease of set up, DAFs are the fastest growing vehicles for charitable giving. Indeed, the number of gifts from DAFs has grown every year and tripled over the past decade.[51] With so many philanthropists turning to DAFs to accomplish their philanthropic goals, the need for clear guidance has become crucial not

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[47] Leon Neyfakh, *Donor-advised funds*: *Where Charity Goes to Wait, The Boston Globe*, Dec. 1, 2013, *available at* http://www.bostonglobe.com/ideas/2013/12/01/donor-advised-funds-where-charity-goes-wait/tYa8P5trm6av9BnXPhyQTM/story.html

[48] Fidelity Charitable, Giving Strategies, Donor-Advised Funds, http://www.fidelitycharitable.org/giving-strategies/give/donor-advised.shtml (last visited Feb 20. 2014).

[49] Council on Foundations, Donor Advised Funds: A Face of American Philanthropy (2007) *available at* http://www.cof.org/sites/default/files/documents/files/DonorAdvFunds.pdf.

[50] Elfrena Foor, *Philanthropy 101: Donor-Advised Funds*, Journal of Financial Planning (2003) *available at* http://www.aefonline.org/Philanthropy_101.pdf

[51] Fidelity Charitable, *2013 Fidelity Charitable Giving Report available at* http://www.fidelitycharitable.org/docs/giving-report-2013.pdf

just for donors and sponsoring organizations, but the nonprofit sector as a whole.

III. ISSUES REQUIRING CLARITY AND PROPOSED GUIDANCE

A. Statutory Definition of Donor Advised Fund

1. *Issue*

As discussed, Code section 4966(d)(2)(A) provides a three-part definition for DAFs. We will focus on the first and third parts of the definition, as those parts raise questions of particular importance. The first part of the DAF definition provides that a DAF "is separately identified by reference to contributions of a donor or donors."[52] The Joint Committee Report provides that this prong of the definition will not be met unless "the fund or account refers to contributions of a donor or donors, such as by naming the fund after a donor . . . ."[53]

Although it is common practice for sponsoring organizations to name a fund after the initial donor, the statute does not, on its face, contemplate a situation where a fund or account, which otherwise meets the definition of a DAF, is named by reference to something other than the donor or donors. For example, a fund or account may be named after a preferred charitable cause or interest, or named in honor or memory of someone other than the donor. To ensure consistent application of the rules applicable to DAFs, donors should arguably not be able to escape characterization as a DAF on the basis of name alone.

If a sponsoring organization names a fund or account after a donor or donors, then the statute provides, and the Joint Committee Report confirms, that the account will be treated as meeting this first part of the definition. It is possible, however, for multiple unrelated donors to contribute to a single account with a sponsoring organization and name the account after the initial contributor. In these instances, the account should not be treated as meeting this first prong of the definition, as the same concerns related to control that are present when there is only one donor (or, potentially, a few related donors) is not present when there are multiple, unrelated donors. This highlights that the first part of the definition also

[52] I.R.C. § 4966(d)(2)(A)(i).
[53] Joint Committee Report *supra* note 34 at 342.

requires clarification with respect to number of donors: at what point is the number of donors too large or too diverse to constitute a DAF? Although the Joint Committee Report suggests that a fund created by multiple, unrelated donors will not constitute a DAF,[54] the Regulations should provide guidance elucidating this issue.

The third part of the DAF definition raises additional questions requiring clarification. The following is the third prong of the definition:

> "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."[55]

This last prong of the definition is concerned with advisory privileges as they relate to distributions and investment of amounts held in a donor's account. However, it is not clear whether this definition encompasses a donor's ability to recommend a charitable recipient or a particular investment, or to recommend a specific amount to be either distributed or invested.

For example, if a donor can identify certain charitable recipients to receive distributions, or certain investment funds in which to invest the DAF assets, but does not have any advisory privileges with respect to the actual amount so distributed or so invested, this should not meet the third prong under a plain reading of the statute because the donor would not have advisory privileges "with respect to the distribution or investment of amounts" held in a fund. The Joint Committee Report provides that "the mere provision of advice by a donor or donor advisor does not mean the donor or donor advisor has advisory privileges."[56] Accordingly, the Regulations should clarify the meaning of advisory privileges for purposes of meeting this third prong of the definition.

2. *Proposed Guidance*

[54] *Id.*
[55] I.R.C. § 4966(d)(2)(A)(iii).
[56] Joint Committee Report *supra* note 34 at 344.

With respect to the first part of the DAF definition, we recommend that the Regulations provide that an account named after a donor (or donors) but funded by contributions of multiple, unrelated donors will not meet the first prong of the definition under Code section 4966(d)(2)(A). The Regulations should provide that a fund established by more than two unrelated donors, where amounts are consolidated in one account and no donor has sole advisory privileges with respect to that account, will not meet the first part of the DAF definition. The U.S. Department of Treasury has indicated its concern that multiple donor funds may still be controlled through one primary donor or the formation of informal sub-funds. For this reason, we recommend that in a fund with more than two unrelated donors, there should be a limit to the amount any one donor can contribute. The Regulations should provide that no one donor can give more than 33-1/3% of the total amount held in one account, so that each unrelated donor contributes a substantial portion of the fund and advisory privileges should be held jointly, not on a pro-rata basis.

Further, the Regulations should clarify that "reference to contributions of a donor or donors" means maintaining a separate account balance (measured by contributions and distributions) for a particular donor or related donors (for these purposes the term "related" should have the same meaning as it does for purposes of section 4958 of the Code). By focusing the definition on the activities within the account that can be traced to one donor (or related donors), this eliminates confusion caused by simple naming conventions. Further, the Regulations should clarify that amounts given by a group of related donors will be aggregated and treated as one account for purposes of applying the three-part DAF definition.

The above suggested guidance is consistent with the Joint Committee Report's statement that a fund that pools contributions from multiple donors is generally not a DAF. In addition to the specific guidance suggested above, the Regulations should provide examples of group contributions that are considered a DAF because of the relation among the donors, as well as examples of group contributions that do not constitute a DAF, such as the formation of a company fund that holds employee contributions, or a fund established to support a particular local cause that receives contributions from the community.

In regard to "advisory privileges," we recommend that the Regulations provide that advisory privileges with respect to distributions include both an identification component and an amount component. Thus, in order to meet the third prong a donor must have (or have the reasonable expectation to have) advisory privileges allowing them to: (a) identify a recipient; and (b) advise on the amount of the distribution to the identified recipient.

Further, in order to meet this third prong, a donor should be able to demonstrate that an account is not a DAF if there is written evidence that the donor does not have the authority to advise the sponsoring organization as to both the recipient of funds and the amount distributed, because under such circumstances the donor does not have sufficient control or authority over the fund to engage in improper use of the fund assets. For these purposes, the written evidence may be in the form of a gift agreement between the donor and sponsoring organization that clearly outlines the donor's advisory privileges (or lack thereof). In the absence of written evidence, advisory privileges should only be found where there is evidence of more than one instance of a sponsoring organization making a distribution based on a donor's advice. Moreover, the Regulations should exclude donor restrictions on a gift (i.e., the creation of a restricted gift through a donor's specified charitable intentions set forth in a gift instrument) from the definition of "advisory privileges" for these purposes, because such restrictions generally do not create ongoing donor advisory privileges with respect to the recipient's use of the gift.

B. Incidental Benefit

1. *Issues Requiring Clarity*

Code section 4967 applies a punitive excise tax on a donor, donor advisor, or related person who advises a sponsoring organization to make a distribution from a DAF which results in such person receiving, directly or indirectly, a more than incidental benefit as a result of such distribution.[57] Implicitly, Code section 4967 provides that an "incidental benefit" is permissible and will not give rise to an excise tax. The Joint Committee Report indicates that there is a more than incidental benefit if, as a result of a distribution from a DAF, a donor, donor advisor, or related person receives a benefit that would have reduced (or eliminated) a

[57] I.R.C. § 4967(a)(1).

charitable contribution deduction if the benefit were received as a quid pro quo component of the contribution to the sponsoring organization.[58]

Thus, presumably, DAF donors, donor advisors, and related persons should look to the provisions of Code section 170(a) and Regulations section 1.170A-1(h), which explain how to account for the value of goods and services received for purposes of determining the deductible amount of a charitable contribution. Goods and services received from the charitable organization and described in Regulations sections 1.170A-13(f)(8)(i) and 1.170A-13(f)(9)(i) are disregarded for purposes of determining any reduction in charitable contribution deduction as a result of a return benefit. These include goods of insubstantial value and certain member benefits. Presumably, since the receipt of such goods and services do not reduce a charitable contribution deduction, they are not "more than incidental" and are disregarded for purposes of Code section 4967.

While the Joint Committee Report purports to provide clarity by defining what constitutes a "more than incidental benefit" by implicit reference to the charitable deduction regulations promulgated under Code section 170, more explicit guidance would be helpful. Further, it is unclear how these rules should be applied in the DAF context.

For example, one common issue that arises is the purchase of tickets or tables at charitable events. Under the charitable deduction rules, when a donor buys a table at a charitable event, the portion of the amount paid that is attributable to the cost of the dinner is not deductible, and the balance of the amount paid is deductible.[59] Therefore, the portion attributable to the cost of the dinner is a more than incidental benefit, and if a sponsoring organization were to use DAF assets to acquire a table at a charitable dinner at which the DAF donor, donor advisor, or related person were in attendance, the Code section 4967 excise tax would apply. What is unclear is whether it is permissible to bifurcate the cost of the ticket or table: the DAF pays for the charitable portion, and the donor personally pays for the cost of the dinner. Such bifurcation is impermissible in the private foundation context with respect to self-dealing excise taxes,[60] but it is

[58] *See* Staff of the Joint Committee on Taxation, 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 (JCX-38-06) at 350.
[59] Regulations section 1.170A-1(h)(2).
[60] *See, e.g.,* Revenue Ruling 77-160; Private Letter Ruling 9021066. While Private Letter Rulings are not precedential authority, they nevertheless demonstrate the IRS' interpretation of the law as applied to specific factual scenarios.

unclear whether Congress intended Code section 4967 to be an extension of Code section 4941 self-dealing rules to DAFs.

Another common issue is the satisfaction of pledges. If a DAF donor, donor advisor, or related person makes a pledge to a charitable organization, such person may prefer to satisfy the pledge with a distribution from the DAF. It is often unclear whether a pledge is a legally binding obligation; however, there is a risk that if the pledge is legally binding, the DAF's satisfaction of such obligation would constitute a more than incidental benefit to the donor, donor advisor, or related person, as applicable. Again, in the private foundation context with respect to self-dealing, satisfaction of a legally binding pledge is clearly impermissible;[61] however, it is not at all clear whether Congress intended these private foundation limitations to apply to DAFs.

On the other hand, satisfaction of a donor's pledge would not reduce or eliminate the charitable deduction under the Code section 170 rules. This could indicate that satisfaction of a pledge is not an impermissible benefit to the donor, donor advisor, or related person. However, the lack of clear guidance on this issue has led sponsoring organizations to refuse to make DAF distributions in satisfaction of a donor or donor advisor's pledge, regardless of whether such pledge is legally binding.

2. *Proposed Guidance*

First, Regulations should define "more than incidental benefit" consistent with the Joint Committee Report. Then, Regulations should provide detailed discussion regarding what does, or does not, constitute a benefit that is more than incidental. The Regulations should provide examples of both tangible and intangible benefits that are incidental and therefore not impermissible under Code section 4967. The Regulations should also provide a clear example of the application of the Code section 170 charitable deduction rules to a DAF distribution, and clarify that the private foundation self-dealing rules are not applicable in the DAF context.

For example, the Regulations should address a situation where a charitable organization provides "DAF membership" benefits to a donor, donor advisor, or related person, as a thank you for a distribution from a

[61] Regulations section 53.4941(d)-2(f)(1).

DAF. The Regulations should also address a situation where a DAF donor, donor advisor, or related person is invited to attend an event as a result of their relationship to a charitable organization through DAF donations. In these circumstances, the Regulations should state whether an incidental benefit occurs when the donor, donor advisor, or related person pays to attend such event.

Additionally, the Regulations should clearly state whether bifurcation of the purchase price/donation amount for charitable fundraising events, and satisfaction of pledges, result in a more than incidental benefit. Since DAFs differ fundamentally from private foundations in the sponsoring organization's control over DAF assets, we recommend that private foundation restrictions not be applied to DAFs through Regulatory interpretation of Code section 4967. We recommend that the Regulations provide that bifurcation and pledge satisfaction is permissible. We believe that this is consistent with the Joint Committee Report, which indicates Congressional intent that DAFs may make distributions that a donor, donor advisor, or related person would obtain a charitable deduction for if the donation were made individually.

We also suggest that the Regulations clarify where the application of the excess benefit provisions of Code section 4958 is appropriate, thereby superseding the application of Code section 4967. While this is not an area of common confusion among practitioners, the IRS has informally stated that it believes additional guidance is required for this issue.

Finally, we recommend that the Regulations provide that sponsoring organization fund managers may rely on a certificate from a donor or donor advisor that the donor, donor advisor, or related person did not and will not receive a more than incidental benefit as a result of a recommended distribution. Sponsoring organization fund managers are subject to potential excise taxes where they "knowingly" make a distribution that results in a more than incidental benefit; however, the donor or donor advisor is in the best position to know what benefits will be received. Thus, this recommendation does not come from a lack of clarity, but is intended to promote fairness and ease of administration for fund managers, as well as education and responsibility regarding Code section 4967 for donors and donor advisors when asked to certify whether a more than incidental benefit will be received.

C. Distributions to Supporting Organizations

1. *Issue*

Code section 4966 imposes an excise tax on distributions to "disqualifying supporting organizations", which are:

(a) Type III non-functionally integrated supporting organizations;[62] and

(b) Type I, Type II, and functionally integrated Type III supporting organizations where a DAF donor or donor advisor directly or indirectly controls the supported organization, or the IRS determines by Regulations that a distribution to a supporting organization is otherwise inappropriate.[63]

Notice 2014-4[64] provides that a sponsoring organization can rely on the Type I, Type II, Type III, or Type III functionally integrated supporting organization classifications reported on the IRS Business Master File, or on written representations made by the grantee supporting organization, accompanied by documentation to demonstrate the organizational structure and functional integration, if applicable. However, these provisions indicate that the IRS may disallow DAF distributions to Type I, Type II, and functionally integrated Type III supporting organizations under circumstances determined to be "otherwise inappropriate." There has been no guidance regarding what may constitute inappropriate circumstances.

More commonly problematic is the fact that "control" is not defined for purposes of determining whether a Type I, Type II, or functionally integrated Type III supporting organization is a "disqualifying supporting organization" for purposes of Code section 4966. There are several different control tests that could apply, such as 35% voting control, majority voting control, or appointment authority over the board of directors. Notice 2006-109 provides that, until further guidance is issued, DAFs can look to the definition of control under the private foundation Regulations.[65]

[62] I.R.C. § 4966(d)(4)(A)(i).
[63] I.R.C. § 4966(d)(4)(A)(ii).
[64] 2014-2 I.R.B. 274.
[65] Reg. § 53.4942(a)-3(a)(3).

The supporting organization regulations provide that a supporting organization will be considered "controlled" for purposes of section 509(a)(3)(C), if the disqualified persons, by aggregating their votes or positions of authority, may require such organization to perform any act which significantly affects its operations or may prevent such organization from performing such act.[66] This includes, but is not limited to, the right to designate the recipients from among the publicly supported organizations of the income attributable to his contribution to the supporting organization.[67] A supporting organization will be considered to be controlled directly or indirectly by one or more disqualified persons if the voting power of such persons is 50% or more of the total voting power of the organization's governing body or if one or more of such persons have the right to exercise veto power over the actions of the organization.[68] This definition of "control" is broader than the definition under the private foundation Regulations and more appropriate for application to DAFs because DAFs, like supporting organizations, are public charities and operate differently than private foundations.

This lack of clarity regarding what constitutes a "disqualifying supporting organization" makes it difficult for sponsoring organizations to administer DAF distributions to supporting organizations.

2. *Proposed Guidance*

We recommend that the Regulations clarify that control, for purposes of Code section 4966(d)(4)(A)(ii), is determined in accordance with Regulations section 1.509(a)-4(j) as described above, substituting disqualified persons as described in such Regulation, with the donor, donor advisor, and related persons as discussed above.

D. Excess Business Holdings

1. *Issue*

Code Section 4943 imposes a tax on the excess business holdings in a business enterprise held by a DAF.[69] Excess business holdings are those holdings which a DAF would have to transfer to a person other

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[66] Regulations section 1.509(a)-4(j)(1).
[67] *Id.*
[68] *Id.*
[69] I.R.C. § 4943(e).

than a disqualified person in order for the remaining holdings of the DAF to be permitted holdings.[70] The initial tax is 10% of the value of the excess business holdings.[71] If the excess holdings are not disposed of by the expiration of the correction period, an additional tax equal to 200% of the remaining excess business holdings is applied.[72]

Sections 4943(c)(2) and 4943(c)(4) of the Code provide the rules for determining the permitted holdings of a DAF in a business enterprise. These rules limit the combined holdings of a DAF (aggregated with all disqualified persons) to 20% of the voting stock (or profits interest in partnerships or joints ventures) in a business enterprise. Total holdings of 35% are allowed where one or more third persons – who are not disqualified persons – have effective control of the business enterprise.

Moreover, non-voting stock (or capital interest in the case of a partnership or joint venture) is a permitted holding of a DAF in any percentage when disqualified persons hold not more than 20% of the voting stock of the corporation (or profits interest in the partnership or joint venture).[73] Further, Code section 4943(c)(2)(C) provides that a DAF will not be treated as having excess business holdings in any corporation in which it owns not more than 2% of the voting stock (or profits interest) and not more than 2% in value of all outstanding shares of all classes of stock (or profits and capital interest).[74] This is commonly known as the 2 percent *de minimis* rule.

To avoid application of the excess business holding excise tax, it is necessary to accurately determine the applicable disqualified persons for purposes of aggregating the total business holdings. However, there is currently little guidance on how to aggregate disqualified persons for application of the excess business holdings rules to DAFs. For example, pursuant to Code section 4943(e)(ii)(A), all DAFs advised by the same donor or a related person may need to be aggregated for purposes of calculating business holdings.

It would be helpful to have guidance regarding whether the aggregation rules must be applied at the sponsoring organization level, and

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[70] I.R.C. § 4943(c)(1).
[71] I.R.C. § 4943(a)(1).
[72] I.R.C. § 4943(b).
[73] I.R.C. § 4943(c)(2)(A).
[74] Comparable rules apply to partnerships and joint ventures under I.R.C. § 4943(c)(2)(C).

whether the 2% de minimis rule should be applied on a DAF-by-DAF basis. Sponsoring organizations often have hundreds or thousands of DAFs to administer and maintain. Thus, the Regulations should address how a DAF's business holdings will be aggregated for purposes of Code section 4943.

2. *Proposed Guidance*

The Regulations should make clear that a sponsoring organization is not required to aggregate its holdings with those held in DAFs for purposes of applying Code section 4943. As discussed, a sponsoring organization can maintain hundreds or thousands of DAFs, and requiring the sponsoring organization to aggregate its own holdings with those held in DAFs it maintains would be both administratively burdensome and contrary to legislative intent. The rules surrounding Code section 4943 are intended to prevent donors from retaining control of a business enterprise through a DAF. This becomes less of a concern when a sponsoring organization holds shares in the same business enterprise, because typically the donor does not control the sponsoring organization.

We recommend the Regulations clarify that only assets held in a DAF will be subject to excise taxes under Code section 4943. Further, we recommend that the 20% and 35% limitations on holdings apply to each DAF account separately and provide that a sponsoring organization is not required to aggregate its own holdings for these purposes. Similarly, with respect to the 2% *de minimis* rule, we recommend that the Regulations provide that this determination be made on an individual account basis.

There are instances, however, when aggregation between DAFs is needed, as recognized by the statute. Again, the rules are generally concerned with a donor (or related donors) maintaining control of a business enterprise through a DAF. Therefore, we recommend that the Regulations clarify that "related DAFs" must be aggregated for purposes of Code section 4943. For these purposes, we recommend the term "related DAF" be defined as any DAF account established by the same donor or related persons within the meaning of Section 4958 of the Code.

To reduce the administrative burden on the sponsoring organization, we recommend that the Regulations provide that a sponsoring organization may rely on an affidavit signed by the donor advisor with respect to its business holdings.

IV. CONCLUSION

In conclusion, the IRS and U.S. Department of Treasury should address the lack of guidance regarding the application of the PPA's definition and regulation of DAFs. Following the historical trend, DAFs will continue to grow in both number and assets under management, and will continue to be an important charitable giving vehicle. However, due to the lack of guidance, sponsoring organizations, accountants and legal advisers are unclear on many issues surrounding DAFs, including issues not discussed in this paper. This lack of clarity unnecessarily limits the flexibility of DAFs and inhibits compliance with the PPA. The guidance we have proposed is line with the spirit and purpose of the statutory provisions applicable to DAFs and the Joint Committee's limited guidance.