**Work Group Recommendations to the Panel on the Nonprofit Sector**
**Posted for Public Comment January 24, 2005**

# #10: Donor-Advised Funds

***Background***

Over the past century, donor-advised funds have evolved as an important means of stimulating charitable contributions from a broad range of donors. Community foundations pioneered the development of donor-advised funds and such funds remain vital to their continued growth. More recently, other types of charitable organizations—including educational institutions, cultural organizations, federations and a new class of national charities that receive and distribute donor-advised funds—have begun to make extensive use of donor-advised funds.

There is currently no statutory definition of a donor-advised fund. However, a donor-advised fund is generally understood to be a fund maintained by a public charity,[1] typically as a separately identified fund or account, though in some cases as a separate trust. The donor-advised fund is owned, controlled, and administered by the public charity, subject to an agreement under which the donor (or an advisor designated by the donor) has the right to make recommendations with respect to the distributions and/or investments. As with its other assets, the administering public charity has a fiduciary obligation to ensure that donor-advised assets are used exclusively for charitable purposes.

For many donors, donor-advised funds are an attractive alternative to creating a private foundation. Because they are donations to a public charity, contributions to a donor-advised fund qualify for more favorable charitable deduction treatment than contributions to a private foundation. Because they are assets of a public charity, donor-advised funds are not subject to the self-dealing, payout, and taxable expenditure rules applicable to private foundations. Finally, because the public charity owns and administers the fund, the donor is freed of the administrative burden of creating and maintaining a private foundation and also benefits from the philanthropic and substantive expertise of the public charity.

Donor-advised funds are subject to a range of potential abuses if the administering public charity fails to exercise its fiduciary responsibility to ensure that donor-advised assets are used exclusively and appropriately to advance charitable purposes. One such abusive practice is known as "round-tripping" because it involves a private foundation meeting its annual payout obligation by making a grant to a donor-advised fund and the donor-advised fund then granting the assets back to the private foundation. Another abuse occurs when the public charity holding

[1] Although there is no known prohibition on private foundations administering donor-advised funds, virtually all donor-advised funds are and historically have been administered by public charities. Therefore, this description does not address the donor-advised funds, if any, that may be administered by private foundations.

a donor-advised fund approves grants from the fund that result in substantial private benefit to the donor/advisor or related parties, such as paying tuition or securing tickets to charity events. Yet another example involves public charities approving the use of donor-advised assets to reimburse donors/advisors for travel costs and other expenses purportedly related to the investigation of potential grantees.

The following recommendations provide a framework for addressing these abuses while preserving donor-advised funds as an effective fundraising vehicle for charitable organizations.

# 10a. Donor-Advised Fund Definition

## I. Legal Framework Work Group Recommendations

### A. Statement of Problem

There is currently no common definition of a "donor-advised fund," making it difficult to clearly discuss and remedy abuses in this area.

### B. Recommendations

The term "donor-advised fund" should be statutorily defined and the Work Group will recommend a statutory definition that will specify the essential attributes of a donor-advised fund. The definition will make clear, among other things, that a donor-advised fund is a separately identified fund or account consisting of assets owned by a charitable organization with respect to which there is an understanding between the donor and the charity that the charity will consider non-binding advice from the donor (or an advisor) regarding distributions of the amount held in the fund.

The Work Group's proposed definition will also explicitly exclude a number of arrangements in which advisory rights are substantially more limited than in the typical donor-advised fund. For example, funds for which a majority of the advisors are appointed by a public charity or by a governmental entity may be excluded from the definition of "donor-advised fund," as may funds designated at the time of the gift to support a specific charitable purpose if specified conditions regarding the fund advisors or the selection of grantees are met.

### C. Rationale

The proposed definition will provide a basis for imposing targeted anti-abuse rules addressing the potential abuses of donor-advised funds discussed in the background paper.

### D. Other Considerations

None.

## II. Expert Advisory Group Comments

The Expert Advisory Group supports the recommendation that the Internal Revenue Code be amended to add a statutory definition of donor-advised funds along the lines outlined above. In addition, the Expert Advisory Group suggests that in drafting the proposed definition the Work Group consider including a prohibition on the receipt of more than an insubstantial benefit by a donor, advisor or related persons either in return for or in recognition of a recommended distribution from a donor-advised fund.

# 10b. Disclosure of Donor-Advised Fund Information

## I. Legal Framework Work Group Recommendations

### A. Statement of Problem

There is concern that current reporting obligations for charities owning donor-advised funds are inadequate to allow the IRS, the media or the general public to determine whether donor-advised funds are being administered properly.

### B. Recommendations

In addition to the current requirement that charities with donor-advised funds identify themselves as owners of such funds on the Form 990,[2] some financial information relating to such charities' donor-advised funds in the aggregate (e.g., the fair market value of all assets held in donor-advised funds at the charity) should also be disclosed on the Form 990. There should not, however, be any reporting obligation at the individual account level. Specific financial information to be recommended for disclosure on the Form 990 will be discussed further in Phase II of the work of the Panel on the Nonprofit Sector.

[2] Beginning in 2003, charities were required to disclose whether they maintained separate accounts for donors who have the right to provide advice regarding the use or distribution of funds in such accounts. *See* Form 990, Schedule A, Part III, Question 4a.

### C. Rationale

Although the Work Group believes that enhanced public disclosure of information in the aggregate about the donor-advised funds a public charity owns would be helpful in addressing abuses, the Work Group opposes disclosure of individual fund information as administratively burdensome and fundamentally inconsistent with the level of reporting required with respect to other types of assets held by public charities. In addition, Work Group members were concerned that public disclosure of individual fund-level information could compromise donor anonymity. Because anonymous giving is considered by some to be the most honorable form of philanthropy and is desired by others for reasons including their prominent positions in community, the loss of donor anonymity could result in a reduction in funds given to charity.

### D. Other Considerations

As the burden imposed by additional reporting requirements would fall most heavily on smaller organizations (which may not have software that would facilitate reporting), the Work Group recommended that the IRS should be granted the discretion to exempt smaller organizations from the reporting requirement.

## II. Expert Advisory Group Comments

The Expert Advisory Group agreed with the Work Group's recommendation and noted that although the Form 990 currently requires charitable organizations with donor-advised funds to disclose such facts, such questions (and any related questions) should be more prominent.

# 10c. Donor-Advised Fund "Asset Parking" and "Round-Tripping"

## I. Legal Framework Work Group Recommendations

### A. Statement of Problem

Concern has been expressed that assets contributed by individuals to donor-advised funds, for which the donors received a current income tax deduction, may not be used for charitable purposes for quite a long time, either because the assets are "parked" in the donor-advised fund indefinitely or because the assets are paid out to a private foundation, which then grants the assets back to a donor-advised fund, counting such distribution toward satisfaction of the foundation's minimum payout requirement ("round-tripping").

## B. Recommendations

Anti-abuse rules should be adopted which target the potential for "asset parking" and "round-tripping." Specifically:

1. Grants from donor-advised funds to private non-operating foundations should be prohibited (thus breaking the circulation loop).
2. Charitable organizations holding donor-advised funds should be subject to minimum activity rules to ensure that funds are not permitted to sit in inactive donor-advised fund accounts indefinitely.
   a. The Work Group favors minimum activity rules requiring charitable organizations to contact the donors/advisors of funds that have been inactive for a period of years to request advice and to distribute the funds' assets or revoke advisory privileges if there has been no activity in a donor-advised fund account for a specified time period. A more detailed minimum activity rule recommendation will be forthcoming in Phase II of the Panel on the Nonprofit Sector process.
   b. The Work Group does *not* recommend a minimum payout rule for donor-advised funds such as that proposed by the Senate Finance Committee staff. However, if a minimum payout rule is to be imposed, the Work Group strongly believes that any such rule should be applied to the aggregate asset balance held by a charity in donor-advised fund accounts—and *not* to the individual donor-advised fund accounts.

## C. Rationale

The majority of Work Group members concluded that because there are few legitimate cases in which grants from donor-advised funds to private non-operating foundations are desirable, attempts to draft a rule to allow these few instances while prohibiting other such distributions would be very difficult, and ultimately may not succeed. The Work Group also felt that a flat prohibition on grants to private non-operating foundations would be much easier to enforce.

Minimum activity rules are recommended to ensure that assets contributed to a charitable organization's donor-advised funds do not sit idle in the funds indefinitely.

Minimum activity rules requiring the charity to contact advisors on a periodic basis will ensure that donors do not forget about their advisory privileges and will provide a mechanism for distribution of such funds when the donor/advisor cannot be located.

In general, the Work Group believes that a minimum payout requirement for donor-advised funds is not necessary because research has shown that annual distributions from donor-advised funds vastly exceed the proposed 5 percent minimum (in the aggregate). A payout requirement similar to that imposed on private foundations would likely involve similarly complex rules and compliance would impose additional costs on charities without any corresponding public benefit. The Work Group believes any minimum payout rules should be applied in the aggregate because (a) the funds are owned by the

charity, not the individual donors, and (b) it would be administratively burdensome (and very costly) for the charity to track activity at the fund level.

### D. Other Considerations

Some Work Group members suggested additional disclosure requirements for grants from (a) private foundations and (b) all 501(c)(3) organizations to donor-advised funds. The Work Group will consider these suggestions further in Phase II of the work of the Panel on the Nonprofit Sector.

## II. Expert Advisory Group Comments

The Expert Advisory Group agrees with recommendations 1 and 2.a of the Work Group. It however, was not opposed to a minimum payout rule, such as the one proposed by the Senate Finance Committee staff, which would require public charities to pay out annually from their donor-advised funds a minimum of 5 percent of the aggregate assets held in donor-advised funds by the charity. By design, such a rule would not impose a minimum payout on individual funds, but would ensure that public charities with multiple donor-advised funds maintain an aggregate payout requirement at least comparable to that imposed on private foundations under Internal Revenue Code section 4942. In this regard, the Expert Advisory Group acknowledged that, in fact, the aggregate payout rate from donor-advised funds for most public charities is substantially higher than 5 percent. In addition, if an aggregate payout rule were adopted, the Expert Advisory Group recommends that a transition rule for new donor-advised funds be included in such rule.

# 10d. Enrichment of Donors to Donor-Advised Funds

## I. Legal Framework Work Group Recommendations

### A. Statement of Problem

There is concern that donor-advised fund assets may be used to inappropriately benefit the donor, the advisor and/or related parties. Examples of such benefits include grants to individuals related to donors/advisors and expenditures for donors/advisors and their families to “investigate” grantees in desirable vacation locations.

## B. Recommendations

Targeted anti-abuse provisions should be adopted including:

1. Inclusion of a donor certification on the donor advice forms used by donors/advisors to recommend grantees to charitable organizations with donor-advised funds certifying that the recommended grant would not provide any benefit to, or relieve any obligation (other than a charitable pledge) of, the donor/advisor or any related party.
2. Prohibition of the use of a charitable organization's donor-advised funds to (a) reimburse donors/advisors or related parties for expenses incurred by them in an advisory capacity for the selection of grantees; (b) compensate donors/advisors or related parties for services rendered, if all or substantially all of such compensation is paid from the relevant donor-advised fund; or (c) make grants to donors/advisors or related parties.

## C. Rationale

Distributions made from donor-advised funds generally should not benefit (or reduce the obligations of) the donor, the advisor or related parties. The recommended donor certification on the donor advice form would put donors and advisors on notice that grants from donor-advised funds cannot benefit themselves or their family members. The recommended narrowly targeted prohibition on certain uses of donor-advised fund assets is an easily administrable standard that would prevent identified abuses. To the degree that donors or advisors choose to incur legitimate expenses associated with the work of the charity that owns the donor-advised fund, they would still generally be able to deduct such expenses on their personal tax returns.

## D. Other Considerations

The Work Group recommends against the Senate Finance Committee staff proposal that grantee organizations be required to provide affirmative acknowledgement that grants received will not benefit the donor because (a) such a requirement would be unduly burdensome to administer and (b) it would be difficult to meaningfully implement without compromising donor anonymity. If such a requirement were instituted, charities with donor-advised funds who write many thousands of grant checks a year, often to small organizations that may not have paid staff, will face a huge and expensive paperwork burden. This may result in increasing minimum grant amounts in order to reduce the number of grants, and an erosion of the flexibility and utility of donor-advised giving.

## II. Expert Advisory Group Comments

The Expert Advisory Group agrees with the recommendations of the Work Group. However, the Expert Advisory Group also recommends that charitable organizations making donor-advised fund distributions require each grantee public charity to acknowledge that the donor-advised grant will not result in any substantial benefit[3] to the donor (or donor advisor) that made the grant recommendation. This is similar to a proposal made by Senate Finance Committee staff. The Expert Advisory Group believes that a charitable organization with donor-advised funds has a fiduciary duty to protect such assets by ensuring that they are distributed to bona fide public charities and not used to benefit the donor. "Split gifts," wherein a donor gives a portion of a specified donation amount (often an amount which would entitle a contributor to a substantial "thank you gift" or to substantial membership benefits) and the remaining portion comes from a donor-advised fund that the donor advises, were seen as a potential abuse that could be detected through the use of grantee acknowledgements. The Expert Advisory Group thought some anonymity concerns could be addressed, while still protecting against benefits given in return for grants, by allowing donors to nominate a proxy to sign the donor advice form.

# 10e. Donor-Advised Fund Satisfaction of Donor Pledges

## I. Legal Framework Work Group Recommendations

### A. Statement of Problem

Charitable organizations currently cannot make grants from donor-advised funds in satisfaction of legally binding pledges of the relevant fund's donor, as the charity's use of such assets to relieve the donor of liability for the pledge would be a private benefit. The Senate Finance Committee staff has proposed allowing grants from donor-advised funds to satisfy both the binding and nonbinding pledges of a donor.

### B. Recommendations

The Work Group has no objection to the Senate Finance Committee staff proposal to allow grants from donor-advised funds to satisfy donors' binding and nonbinding pledges provided that the donor receives no substantial benefit (other than the satisfaction of the pledge) in return.

[3] Intangible religious benefits or naming opportunities would be considered insubstantial.

### C. Rationale

Under current law, well-advised tax payers often specify in pledge agreements that their pledges may be paid off either with personal contributions or with distributions from donor-advised funds. The Senate Finance Committee staff proposal allows all donors to achieve the same result. In addition, determining when a pledge is legally binding depends on state law and can be difficult to assess. Therefore, ease of enforcement may justify allowing all donor pledges to be fulfilled from a donor-advised fund to which the donor has contributed assets.

### D. Other Considerations

Some Work Group members felt that using a donor-advised fund distribution to satisfy a binding pledge of the donor is conferring a private benefit on the donor and should not be allowed.

## II. Expert Advisory Group Comments

The Expert Advisory Group agreed with the Work Group's recommendation provided that the donor receives no substantial benefit (other than the satisfaction of the pledge) in return.

# 10f. Rules for Valuation of Property Contributions and Grants to Foreign Grantees

### A. Statement of Problem

The Senate Finance Committee staff has recommended that contributions to donor-advised funds of assets other than cash or publicly traded securities be required to be sold within one year of the contribution (or that donor-advised funds be allowed to receive only contributions of cash or publicly traded securities). In addition, the Senate Finance Committee staff has recommended that no grants from donor-advised funds to foreign organizations be permitted unless the foreign organization is on a list specifically approved by the IRS.

### B. Recommendations

The Work Group recommends against creation of special rules addressing these issues specifically in the context of donor-advised funds. To the extent current law does not provide adequate safeguards against abuse in either of these areas—questions on which the Work Group has no view at this time—the Work Group recommends that abuses be specifically targeted through rules applicable to all charities. The issues of non-cash

contributions to charity and international charitable activity will be taken up in Phase II of the Panel on the Nonprofit Sector process.

### C. Rationale

The Work Group does not believe that donor-advised funds raise special concerns in relation to either the valuation of property contributions or grants to foreign grantees.[4]

### D. Other Considerations

None.

## II. Expert Advisory Group Comments

The Expert Advisory Group agrees with the Work Group recommendations.

[4] For example, Give2Asia, a U.S. nonprofit organization established by The Asia Foundation, aims to increase the quality and quantity of charitable investments in Asia by providing, among other things, donor-advised funds for individual donors. By using the Give2Asia donor-advised funds, individuals can participate in international philanthropy in an effective and accountable way, tapping into the experience and expertise of the Asia Foundation's 17 field offices and over 200 employees. The need for a large and rapid philanthropic response to the tsunami disaster in South East Asia underscores the importance of preserving the current ability of public charities to make foreign grants from their donor-advised fund assets.