

# THE Good Advisor

## Donor Advised Funds

Donor Advised Funds (or DAFs) have emerged as an important feature of the charitable giving landscape. Community foundations were naturally the first to offer DAFs. In the 1990s, mutual fund companies and brokerage houses such as Vanguard and Fidelity began to form charitable units to administer DAFs. Since that time, individual charities have also established DAFs. According to the annual survey conducted by The Chronicle of Philanthropy, “assets of 103 of the nation’s biggest donor-advised funds grew 25 percent in 2007, reaching \$23.3 billion.”\* The popularity of DAFs deserves attention as evidence of a trend towards greater donor control in charitable giving.

In this issue, we put the spotlight on DAFs. The points of discussion include:

- Exactly what is a DAF?
- How does a DAF work?
- Why have DAFs become so popular?
- How does giving to a DAF differ from other types of planned giving?

Plus, we will discuss advantages and disadvantages, as well as current issues and prospective legislation concerning DAFs.

### THE DONOR ADVISED FUND – NUTS AND BOLTS

Generally speaking, donor advised funds are segregated funds maintained by a donee charitable organization also known as a sponsoring organization. The sponsoring organization administers the DAF, including investment management. Strictly speaking a donor cannot choose how his contribution in the DAF is invested. However, some sponsoring organizations offer investment categories that may appeal to different donor investment styles. Many DAFs have certain policies regarding the types of property that can be donated (e.g. prohibiting restricted stock).

The donor makes an irrevocable contribution to the fund. Because the DAF is considered a public charity, the donor receives an income tax deduction. The donor has the ability to make recommendations on distributions from the fund for charitable purposes. The donor may take an income tax deduction for the contribution to a DAF subject to the rules that limit the deduction to a percentage of adjusted gross income. As a public charity, the DAF is a fifty percent (50%) organization which means a donor can deduct up to 50% of adjusted gross income (AGI) for a cash contribution to a DAF in the year of the gift and up to 30% of AGI for a non-cash contribution.

The donor can recommend charitable distributions to the sponsor organization. However, the donor cannot satisfy a legally binding pledge with a DAF distribution. Nor can the donor direct distributions from a DAF to a private foundation. Most importantly, the DAF sponsoring organization must retain the right to control the donated property, (including the right to sell and invest fund assets) and retain the right to reject the donor’s advice concerning the timing or propriety of a distribution from the DAF.

### Legal Definition of a Donor Advised Fund

Prior to the Pension Protection Act of 2006 (PPA), there was no statutory definition of a donor advised fund. Section 1231 of the PPA set forth three defining characteristics of a DAF. The pertinent statute - IRC Sec. 4966(d)(2)(A) - now states:

- 1) The DAF must be solely owned and controlled by the sponsoring organization;
- 2) The DAF must be sequestered and separated from the sponsor’s general fund and identified with reference to the contribution of a donor (or donors); and
- 3) The donor or donor advisor appointed or designated by a donor must have, or reasonably expect to have, advisory

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privilege with respect to the distribution or investment of accounts held in the fund or account.

Furthermore, IRC Sec. 4966(d)(2)(B) explicitly excludes the following types of gift funds from the DAF definition:

- A fund or account that makes distributions only to a single identified organization or government entity.
- A fund or account for which a donor provides advice as to which individuals receive grants for travel, study, or other similar purposes, though only under certain conditions:
  - The donor (or donor advisor) is part of a committee appointed by the sponsor;
  - The donor does not control the committee (whether it is the donor alone or in concert with related persons); and
  - Grants are awarded on an objective basis.
- A committee-advised fund, i.e. a fund established exclusively for disaster relief or to benefit a single identified charitable purpose as established by Treasury regulations.

### WHY DONORS ARE ATTRACTED TO DONOR ADVISED FUNDS

There are many advantages that a donor advised fund offers over a traditional charitable donation:

- **An immediate tax deduction:** Upon making a donation to a DAF (which is a public charity), the donor may claim an immediate tax deduction for the contribution. The deduction does not depend on the distribution from the DAF to a particular charity.
- **Flexibility in choosing beneficiaries:** A donor makes an irrevocable gift when contributing to a DAF, but does not need to name charitable beneficiaries for grants at that time. Later, the donor can choose a wide variety of charitable beneficiaries for a distribution. Of course, the sponsoring organization may have rules concerning a minimum amount for the distribution. And, the sponsoring organization also retains the right to reject a donor's suggestion if the proposed distribution would not be beneficial.
- **Relief from administrative burdens:** After funding the DAF, the donor is relieved of the time consuming administrative burdens associated with the donated assets, such as recordkeeping, tax returns, investment strategies, etc.

### THE DONOR ADVISED FUND AS COMPARED TO PRIVATE FOUNDATIONS

The donor advised fund resembles a private foundation in that a DAF permits a donor to contribute now but distribute later – a charitable holding company of sorts. However, DAFs bear notable differences to private foundations. The following is a list of advantages that a DAF holds over a private foundation.

- A donor can deduct the fair market value of appreciated property contributed to a DAF.
- A donor can deduct a larger percentage of adjusted gross income as compared to a private foundation.
- There is no need for the donor to seek an IRS ruling on tax-exempt status of a DAF.
- The set-up and administrative costs of a DAF are typically lower.
- The DAF may realize better investment returns because of the consolidated investment management over different funds.
- The DAF is not required to report its contributors.
- The donor may remain anonymous while making grants.
- The DAF is not required by law to make distributions.

### SOME CONCERNS ABOUT DONOR ADVISED FUNDS

Despite the many advantages that donor advised funds provide, there are some general concerns about this way of giving. Here are a few of the general issues:

- **DAFs may require larger administrative and investment fees:** Critics argue that DAFs require relatively higher administrative and investment fees than other arrangements, which means a reduction in what the charity ultimately gets.
- **DAFs act much like a private foundation, without the government-imposed safeguards:** Other critics contend that the donor holds too much control over the funds, much like a private foundation, without the government-imposed restrictions applicable to private foundations. Consequently, critics contend that DAFs might not be used for the charitable purposes for which the donor received a charitable deduction.
- **Donors do not truly have control over how contributions are ultimately distributed:** Although the donor

may make recommendations on distributions, and such recommendations are often followed, the donor does not "call the shots." Final discretion rests with the organization that controls the fund. This may be unappealing to some donors.

One reason that Congress decided to amend IRC Sec. 4944(d)(2) to include a definition of a DAF for tax purposes was to define the thing it wanted to regulate. Note that the IRS issued its first private letter ruling acknowledging DAFs in the early eighties. And, in recent years, the IRS became more attentive to the potential abuse of the DAF form and even added DAFs to its annual "Dirty Dozen" list of tax scams (DAFs have now been removed from this list).

Here is a list of measures included in the Pension Protection Act of 2006 meant to curb DAF abuses.

### **Excise Taxes**

Excise taxes are imposed on a distribution from a DAF to any person for a purpose not specified under IRC Sec. 170(c)(2)(B). The DAF sponsoring organization is taxed 20% on any improper distribution. An additional 5% tax (not to exceed \$10,000 per distribution) can be imposed on any fund manager who knowingly permits an improper distribution.

### **More Than Incidental Benefit**

More than incidental benefit occurs when the donor, donor advisor or related party gains a benefit which would have reduced or eliminated a deduction for a charitable gift if such benefit was received as an incident of the distribution. If a donor, donor advisor or related party provides advice on distributions that result (directly or indirectly) in a more than incidental benefit to that person or party, a 125% tax on the benefit inured is imposed both on the advisor and the recipient. Any fund manager that knowingly approves a distribution that creates the benefit can be taxed up to 10% (not to exceed \$10,000 per distribution).

### **Excess Business Holdings**

The excessive business holdings rules outlined under IRC Sec. 4943 apply to DAFs. A DAF may not own more than 20% of equity ownership in a business entity as defined by its voting stock. If a DAF owns more than the threshold amount, the DAF risks a 5% tax on the excessive holdings.

### **Automatic Excess-Benefit Transactions**

Any grant, loan, compensation, or similar payment from DAFs to donors, advisors, and related parties is considered an

excess benefit transaction subject to the penalty taxes under IRC Sec. 4958. The person who received the excess benefit must pay a 25% tax on the value of the benefit. And a manager of the sponsoring organization that knowingly permits the transaction shall pay a 10% penalty as based on the value of the benefit. Note that if the excess-benefit tax applies, the more than an incidental benefit tax does not.

### **A Common Misunderstanding Regarding Donor Advised Funds**

As noted, one advantage offered by donor advised funds is ease of use. The donor can simply send instructions to the sponsoring charity as to where a distribution should be sent. However, the donor might invite confusion if the distribution is part of a quid pro quo with the charity.

As noted above, a distribution from a DAF cannot be used to satisfy a legally binding pledge. Also, a donor cannot use a distribution from a DAF to pay for tickets to a fundraiser or to purchase raffle tickets. Another potential mistake is for an instruction to make a distribution to an organization or entity that is not a qualified charity under Sec. 170.

By making such mistakes, donors risk incurring penalty and excise taxes. Because there are many available DAFs, donors should research which sponsoring organizations offer assistance regarding proper and improper distributions from the DAF, and, if desired, advice about philanthropic choices.

### **MORE ABOUT THE DONOR ADVISED FUND**

In the same important Pension Protection Act of 2006 legislation, Congress included a directive to the Treasury to conduct a survey of donor advised funds. Many commentators have suggested that this survey might provide the basis for further regulations or rules concerning DAFs. It seems that the very attributes that make a DAF so attractive to the donor also attract the attention of the IRS to potential abuses. However, the good efforts of reputable sponsoring organizations should win out and the DAF will likely remain a viable and increasingly popular way for Americans to give.

# New Tax Developments

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## *The ACGA Lowers Immediate and Deferred Gift Annuity Rates*

The American Council on Gift Annuities (ACGA) is a nonprofit organization that publishes suggested charitable gift annuity rates (both immediate and deferred) for use by charities and their donors. According to its website, [www.acga-web.org](http://www.acga-web.org), the ACGA retains the services of an actuarial firm to advise and consult on matters pertaining to life expectancies and related matters in determining the appropriate rates.

The suggested rates are commonly recognized by charities and donors, as well as state insurance departments and the IRS, as actuarially sound and beneficial for the promotion of gift annuities. However, each individual charity may choose to adopt a different set of rates than those suggested by the ACGA for its particular gift annuity program.

At its meeting prior to the 2008 ACGA Conference, the ACGA board approved a set of new, lower immediate gift annuity rates. And, for deferred payment gift annuities, the compounding rate will decrease, resulting in lower deferred annuity rates as well. The new rates take effect July 1, 2008.

## *Contribution of Closely Held Stock to a DAF Not Deemed a Sale*

In Private Letter Ruling 200821024, the IRS determined that contribution of corporate stock to a donor advised fund is not a sale.

The donor owned shares of closely held company stock both as an individual and through a grantor trust (Trust A). The donor also acted as trustee of a separate trust that currently benefits his spouse and, if his wife predeceases him, benefits him (Trust B). Donor proposes to contribute his shares of the closely held company to a DAF sponsored by a qualified charitable organization. Under the terms of the DAF, the donor will make successive gifts – at first, his individually held shares, and, within two years, his remaining shares held in Trust A. The DAF sponsoring organization requires investments to be diversified. The sponsoring organization indicated that it will seek buyers for the shares donated to the DAF. The donor indicated that, as the trustee of Trust B, he may seek to purchase those shares. The sponsoring organization was not legally bound to sell the shares to Trust B, nor could the sponsoring organization be compelled to surrender the shares for redemption; rather, the charity has every right to decide whether and when to sell the shares.

The IRS cited *Palmer v. Commissioner*, 62 T.C. 684 (1974) aff'd on other grounds, 523 F.2d 1308 (8th Cir. 1975) and Rev. Rul. 78-197, 1978-1 C.B. 83 to support its holding that for federal income tax purposes the donor will not be treated as selling to Trust B the shares of closely held stock contributed to the DAF as individually held and through Trust A.

This newsletter is only for professional advisors and only for their information and discussion. It is intended only to provide general information about charitable gifts and charitable-gift planning. This newsletter is not (1) legal, tax, accounting, or financial advice, (2) any solicitation of legal, tax, accounting, or financial services, (3) any securities or investment advice, or (4) any solicitation of securities or investment advisory services. Each professional must evaluate the tax and financial consequences of each individual situation.

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