



## Donor-Advised Funds: Maintaining Control and Doing it My Way

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## More to the Story: History and the Basics

Longfellow's poem *The Midnight Ride of Paul Revere* memorialized Revere's legendary role in the early part of the Revolutionary War. Yet, there was much more to Paul Revere than his famous ride. He served as an officer in the Massachusetts artillery brigade, was a renowned craftsman of gold and silver, and worked as a courier for the Boston Committee of Correspondence.<sup>2</sup> In his post-war life, Revere opened the first successful copper rolling mill in the U.S. and his factory produced the copper hull for the USS *Constitution*. While he always worked hard and excelled, what he did changed over time.

Donor-advised funds have also changed quite a bit over time. In the 1930s, the New York Community Trust established the first donor-advised fund and structured it to help the local community.<sup>3</sup> Now, almost 100 years later, donor-advised funds are valued in the billions and are found in both community foundations and commercial brokerages that have created a charitable arm to sponsor and maintain these funds. According to the National Philanthropic Trust, there are now over 1,000 sponsoring organizations and more than 460,000 individual donor-advised funds.<sup>4</sup> No longer solely focused on the local community, DAFs remain firmly committed to noble endeavors, and today touch nearly every corner of the charitable giving landscape. Considering their continued expansion, it is important to understand exactly what a donor-advised fund is.

### Defining a Donor-Advised Fund

A donor-advised fund is a contractual relationship between the donor and a sponsoring organization. The donor makes a charitable contribution to the sponsoring organization, which then owns the assets and administers the fund. The donor retains advisory privileges over the charitable funds distributed from the account. This arrangement lets the donor qualify for an immediate income tax deduction for the amount of the contribution even though funds won't be distributed until later, at which time the donor can influence distributions to support a chosen charity. A donor-advised fund offers unique versatility in allowing a donor to give what is most favorable at the time that works best for the donor. employees a bonus as a result of the lower tax rate.<sup>4</sup>

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### FORBES MAGAZINE COMPARED DONOR-ADVISED FUNDS TO A TRADITIONAL BROKERAGE

Think of a donor-advised fund (DAF) account as kind of a tax-advantaged charity brokerage account. The sponsoring organization is a charity that holds and manages donors' contributions—cash, stocks, bonds, real estate, even business ownership—for the purpose of making grants to other charities, once (or if) the donors tell them to do so.<sup>5</sup>

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### Requirements

IRC §4966 describes a donor-advised fund by documenting three important requirements:

1. **Separate identification.** The first requirement, that the fund be “separately identified by reference to contributions of a donor or donors,” means the fund must be sequestered from the sponsor's general fund and specifically identified by reference to a particular donor (or group of donors) in that all contributions must be attributable to the named donor (or group). The IRS clarifies: “A distinct fund or account of a sponsoring organization does not meet this prong of the definition unless the fund or account refers to contributions of a donor or donors, such as by naming the fund after a donor, or by treating a fund on the books of the sponsoring organization as attributable to funds contributed by a specific donor or donors.”<sup>6</sup>
2. **Ownership and control.** The second requirement states that the fund or account must be “owned and controlled by a sponsoring organization.”<sup>7</sup> Under this section of the Code, “sponsoring organization” is defined as a public charity (not a private foundation) that has one or more donor-advised funds.<sup>8</sup> Typically, a sponsoring organization will either be a community foundation, a single-issue organization, or a national organization.<sup>9</sup>
3. **Advisory privileges.** The third requirement states that the “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.”<sup>10</sup> These advisory privileges may be (but are not required to be) evidenced through

a written document executed by the donor and the sponsoring organization.<sup>11</sup> If the sponsoring organization and the donor both conduct themselves as if the donor has advisory privileges, this may be enough to establish the privilege.

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## MORE ON ADVISORY PRIVILEGES

The Joint Committee on Taxation stated:

For example, even in the absence of a writing, if a donor regularly provides advice to a sponsoring organization and the sponsoring organization regularly considers such advice, the donor has advisory privileges under the provision. Even if advisory privileges do not exist at the time of a contribution, later acts by the donor (through the provision of advice) and by the sponsoring organization (through the regular consideration of advice) may establish advisory privileges subsequent to the time of the contribution. For example, if a past donor of \$100,000 telephones a sponsoring organization and states that he would like the sponsoring organization to distribute \$10,000 to an organization described in section 170(b)(1)(A), although the mere act of providing advice does not establish an advisory privilege, if the sponsoring organization distributed the \$10,000 to the organization specified by the donor in consideration of the donor's advice, and reinforced the donor in some manner that future advice similarly would be considered, advisory privileges (or the reasonable expectation thereof) might be established.<sup>12</sup>

The Committee also noted that a donor's expectation of advisory privileges would not be reasonable if the sponsoring organization never reinforced that expectation. If the donor made the donation but the sponsoring organization had no understanding that the donor expected to have advisory privileges, and the sponsoring organization had "no intention of considering any advice provided by the donor, then the donor does not have a reasonable expectation of advisory privileges."<sup>13</sup> As with many tax issues, the question of whether advisory privileges were established comes down to the facts and circumstances of the individual situation.

## Exceptions

In addition to the three requirements set out in the IRC, the Code also notes a series of exceptions that would exclude a fund from being a donor-advised fund. Excepted is 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 paragraph (1), (2), or (3) of section 4945(g).<sup>14</sup>

## Restrictions on Donor-Advised Funds

For New York workers traveling home on November 15, 2018, the commute was a bit different due to events far from the commuter's control. An intense, early-season snowstorm caught officials off-guard, crippled public transportation, and brought the roadways to a standstill.<sup>15</sup> This situation is not unlike a donor-advised fund when an unanticipated restriction on some aspect of the charitable distribution means the fund is "stuck in traffic with nowhere to go." While the IRS is still considering donor-advised fund rules, there are already a number of restrictions professional advisors should understand and consider. We will look at a few of those here (although this is by no means a comprehensive list).

### Restriction on Distributions

While the donor has advisory privileges, the IRC is clear that the sponsoring organization holds ownership of the donated assets.<sup>16</sup> The donor may provide advice, but may not place any material restrictions on the fund's distribution, as such restrictions would cause the gift to be incomplete<sup>17</sup> and therefore not deductible.

What constitutes a material restriction? This must be determined by looking at all the facts and circumstances, including answers to the following questions:<sup>18</sup>

- Who owns the assets received from the donor?
- Are the assets held and administered by the charitable organization for the purposes of furthering the charitable organization's exempt purposes?
- Does the donee charitable organization's governing body have ultimate control over the assets?
- Is the charitable organization's governing body organized and operated independently from the donor?

Factors used to identify an independent governing body include the selection of the governing body, the terms of service for governing board members, and the terms of renewal of service time for governing board members.<sup>19</sup>

### Restrictions Due to Excise Tax

**Taxable Distributions.** The IRC levies a 20% tax on each taxable distribution made from a donor-advised fund.<sup>20</sup> According to the IRC, a distribution is considered taxable if:

- (1) the distribution is made to a natural person<sup>21</sup>
- (2) the distribution is made "to any other person" (i.e., not a "natural person") and the distribution is not used for charitable purposes, and
- (3) the sponsoring organization did not exercise expenditure responsibility for the distribution.<sup>22</sup>

However, the IRC carves out nontaxable exceptions for distributions to other DAFs or other charities (other than disqualifying supporting organizations).

In addition, the IRC imposes a 5% excise tax on a fund manager who knowingly makes a taxable distribution.<sup>23</sup>

**Taxable Incidental Benefits.** The IRS also imposes an excise tax on any distribution to a person who receives an incidental benefit as a result of the distribution. The tax is equal to 125% of any such benefit received.<sup>24</sup> For this IRC section, a "person" is the donor to the fund with an expectation of advisory privileges (or a person appointed by that person), a family member of that described person, or a 35%-controlled entity (which means a corporation, partnership, trust or estate in which the donor owns more than 35% of the entity).

The restriction on incidental benefits can cause problems for donors. A charitable recipient who receives a distribution from a donor-advised fund after the recommendation of the donor may want to provide a token of appreciation. That token, whether a good or service, is acceptable only if it is de minimus in value.

**Taxation of Excess Business Holdings.** A DAF with excess business holdings is subject to a 10% tax on those excess holdings.<sup>25</sup> IRC §4943 "applies the taxes on excess business holdings applicable to private foundations to donor-advised funds."<sup>26</sup> If the excess business holdings are not disposed of within a specified time period, an additional tax of 200% of the excess holdings is imposed.<sup>27</sup>

## No Onions, Extra Mustard: The Benefits of Donor-Advised Funds

For much of the past forty years, fast-food chain Burger King has employed the slogan “Have It Your Way.”<sup>28</sup> Their ads—immortalized by the jingle “hold the pickles, hold the lettuce, special orders don’t upset us”—declare that sandwiches can be tailored to appeal to individual tastes. This was a direct challenge to fast-food behemoth McDonald’s, a company that emphasized “sameness” and consistency of the sandwiches served at every location. With their commitment to customized sandwiches, Burger King tapped into our innate desire to exercise control.

Like Burger King, the innate flexibility in donor-advised funds provides donors options that allow for some level of control, and arguably provides customized charitable giving options that let donors “donate their way.”

For the donor, there are many benefits to donor-advised funds:

- Income tax deductions are allowed in the year of the contribution, even if no distribution is made from the DAF.
- A DAF offers a more generous income tax deductibility percentage limitation than is available for private foundations, assuming the donor itemizes. The deduction limit for a cash gift is equal to 60% of a donor’s adjusted gross income (pursuant to the 2017 Tax Cuts and Jobs Act).
- If privacy is a concern, a DAF may allow the donor to maintain anonymity (or at least minimize publicity).
- A DAF’s advisory privilege offers donors a great deal of flexibility and control over fund distributions.

For certain donors, the flexible nature of a donor-advised fund may be almost as important as the tax deduction. Consider a typical charitable donation—let’s say a donor writes a check to a charity, the charity accepts the donation, and the donor qualifies for an income tax deduction in the year of the gift. The gift is complete and the donor and charity each go their merry way. With a donor-advised fund, however, the donor has more options. Let’s look at two examples:

**EXAMPLE:** Brian took a gamble on an initial public offering of a new stock, and it paid off. He is going to owe significant income taxes this year and would like to use the stock to make a charitable donation so that he can make use of the charitable income tax deduction. However, he does not have a particular charity in mind yet. He has no time to research worthy charities and doesn’t want to rush into a decision. For Brian, a donor-advised fund provides a way to make a donation, take the income tax deduction now, and then later recommend distributions to particular charities.

**EXAMPLE:** Erin is a successful software engineer who will be receiving a series of substantial payments over the next 20 years as a result of her work being licensed. Erin wants to make a charitable contribution to her graduate school, but also wants the contribution to be large enough to allow the school to do something significant. Rather than contribute \$10,000 or \$20,000 per year, Erin instead contributes the annual cash into a donor-advised fund. In 10 years, enough has accumulated that she can make a significant contribution.

## Packing an Umbrella: Cases, Criticisms and the DAF Forecast

The movies use umbrellas as a theatrical device—Gene Kelly in *Singing in the Rain*, Julie Andrews in *Mary Poppins*, the villainous Penguin in *Batman*. Practically speaking, the umbrella is both fashionable and utilitarian, showing that its user had the foresight to bring along protection from rain or sun.

### Cases

Court cases can also provide foresight (and therefore protection) by allowing donors to benefit from the successes and mistakes of others. Let’s look at one case that covers a broad spectrum of problems from which donors should be protected—the U.S. Court of Federal Claims case of *National Dynamics Foundation vs. U.S.*<sup>29</sup>

National Dynamics Foundation (NDF) was incorporated as a public benefit corporation in California by Robert Henkell and several of Henkell’s business associates, who served with him on the NDF board of directors. NDF used a number of

marketing materials that described the NDF fund as a typical donor-advised fund, with a separate account established for each donor's contribution. An advisory committee would be established for the account (under the control of the NDF board of directors) to make recommendations to the board for the charitable use of the funds in the account. However, upon filing their application for tax-exempt status, NDF encountered challenges from the IRS based on a number of questionable NDF practices:

1. **Apparent self-dealing for Henkell:** The NDF incorporator/president/chairman founded a marketing firm called Estate Preservation Services (EPS) that had an oral agreement with NDF to pay EPS a solicitation commission out of contributions made to NDF.
2. **Apparent benefits to donors and their families:** NDF materials indicated that "it is just as important to realize that charitable use, which is normally non-taxable, can also benefit the Donor or the Donor's family." Under this concept, NDF promoted that the account could be used to pay a reasonable wage to a donor's child who engaged in volunteer work.
3. **Broadly defined administrative expenses:** NDF promoted a broad view of administrative expenses under which donors could justify spending the charitable funds. For example, a donor could seek reimbursement of expenses ranging from office supplies for foundation operation to gas mileage costs for travel in support of foundation goals or activities. Requests could be made in advance to "fund" a foundation meeting, including airfare and lodging, or to simply repair or improve a foundation-held asset.
4. **Use of the charity as an apparent personal investment tool:** NDF marketing materials touted the use of the NDF accounts to "warehouse income for long-range planning and wealth accumulation," to avoid capital gain, for Medicaid paydown relief, and to protect assets from creditors.<sup>30</sup>
5. **Questionable investments for the benefit of donors:** Despite publicly stating that all NDF assets should be income producing, the NDF board agreed to a number of donor requests for non-income producing assets, including collectible coins, a Mexican vacation timeshare, and the purchase of life insurance and annuity contracts

that did not produce income.

6. **Distributions for a donor's personal expenses:** The Court indicated that NDF had a pattern of paying for a donor's request for personal expenses, with examples ranging from a donor's luxury motor home to advisory committee members' expenses for attending a religious retreat and a conference on evangelism and marriage. NDF even covered the costs of donors attending Henkell's own seminars and related training classes.
7. **Use of donor funds for college expenses:** The Court also noted that Henkell promoted the NDF donor-advised fund as a way to pay for educational expenses when he talked in one lecture about taking money for "an emergency in your life," to educate someone, and to fund a scientific study by the donor, such as "studying the canal systems of Peru." In another such lecture, he suggested that donors could go to a college financial aid office and ask whether the college would assist the donor's child if a donation were made to the college, noting that NDF would take a "don't ask, don't tell" approach to such requests. In addition, an NDF newsletter said the "warehoused wealth" with NDF could also be used to provide scholarships and grants.

The consistent theme throughout NDF operations was the idea of using charitable funds for apparently non-charitable purposes and failing to maintain any documentation of these transactions. Needless to say, the Court of Claims took issue with NDF's operations, and after detailing a litany of facts in opposition to NDF claims, the Court denied NDF's petition.

## Criticism

Even the staunchest advocate for donor-advised funds would agree that NDF's issues were unacceptable, but other criticisms go more to the nature of donor-advised funds, their operation, and the purported effect the rise of donor-advised funds has had on charitable giving:

- There is no required minimum payout. Donors get an immediate tax benefit, money managers earn immediate fees, but those who would ultimately benefit from the donation have to wait (perhaps even years) to see the money they sometimes urgently need.

- DAFs are not subject to requirements for transparency, as private foundations are.
- Commercially based DAFs are merely instruments of the investment houses which run the funds and are therefore not really charities.
- The significant growth in DAFs presents a challenge to other charitable entities (if the charitable giving environment is a zero-sum game, the dramatic growth in DAFs by definition takes dollars away from other charities).
- Nonprofits cannot criticize DAFs (including DAF donors or sponsors) without fear of losing donations.

### Forecast

The charitable giving community is still awaiting a set of Treasury regulations for donor-advised funds. In 2011, a Department of the Treasury report to Congress on donor-advised funds and supporting organizations was not entirely well received.<sup>31</sup> In 2015, former Ways and Means Chair David Camp (since retired) proposed the imposition of taxes on donor-advised fund monies that were not distributed to charity within five years.<sup>32</sup>

While Congress did not act, the IRS is now considering regulations. On December 4, 2017, the IRS issued Notice 2017-73 Request for Comments on Application of Excise Taxes with Respect to Donor-Advised Funds in Certain Situations.<sup>33</sup> This Notice proposed three new rules that would:

1. Treat DAF distributions that pay for tickets to charity-sponsored events (for a donor, donor advisor or related person) as more-than-incidental benefits under IRC Section 4967 (and thus subject to penalties).
2. Set conditions on DAF distributions made for the purpose of fulfilling a charitable pledge (made by a donor, donor advisor or related person) so that, if requirements are met, such distributions are not treated as more-than-incidental benefits under IRC Section 4967.
3. Revise the public support computation to prevent donor-advised funds from circumventing the excise tax rules applicable to private foundations.

The notice provides that taxpayers may rely on the guidance from this notice until further guidance is released.

## Maintaining Control and Avoiding Problems

Donor-advised funds offer a level of control that is often lacking with other charitable giving strategies. For donors who prefer flexibility in their giving but still want an immediate income tax deduction, a DAF may be the answer. As a professional advisor, understanding the basics of donor-advised funds (including requirements, restrictions, benefits and shortcomings) will allow you to effectively counsel clients. Ideally, informed advice will lead clients away from inflexible gifts to transactions that are financially successful and personally satisfying to donors.

## ENDNOTES

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- 12 *Id.*
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- 16 26 U.S.C. 4966(d)(2)(A)(ii).
- 17 26 U.S.C. 170(f)(18)(B).
- 18 Treas. Reg. Sec. 1.507-2(a)(7)(i).
- 19 Treas. Reg. Sec. 1.507-2(a)(7)(ii).
- 20 26 U.S.C. 4966(a)(1).
- 21 The term “natural person” refers to an individual and does not include a corporation, LLC, trust or any other business entity.
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- 23 26 U.S.C. 4966(a)(2).
- 24 26 U.S.C. 4967(a)(1).
- 25 26 U.S.C. 4943(a)(1).
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- 27 U.S.C. 4943(b).
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