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

After dominating American popular music in the 40s and early 50s, Frank Sinatra faced a number of down years during the onset of the rock and roll era. Even though he recorded various hits, in 1969, "My Way" became one of his most enduring and popular recordings. As a song that exemplifies individuality and aspiration, "My Way" has triggered a strong emotional response in popular music and culture for almost 50 years.

This aspiration is much like donors who are motivated to give but want to "do it their way" by maintaining control of the assets they intend to donate. These donors place a high value on philanthropy but simply haven't worked out all of the details. Who should receive the gift? What is the best timing for the donation? How should the gift be structured?

For such donors, a donor-advised fund (DAF) may be the best solution. While not a new charitable giving tool, donor-advised funds have become one of the most popular giving techniques in recent years. Contributions as a percentage of total individual giving have more than doubled between 2010 and 2017,[1] probably because these funds offer a variety of donor benefits, including anonymity, potential tax savings, and ease of giving.

In this issue of ***The Good Advisor***, we take a closer look at donor-advised funds:

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.[2] 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.[3] 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.[4] 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.

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 advise them to do so.[5]

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.

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."[6]
2. **Ownership and control.** The second requirement states that the fund or account must be "owned and controlled by a sponsoring organization."[7] 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.[8] Typically, a sponsoring organization will either be a community foundation, a single-issue organization, or a national organization.[9]
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."[10] These advisory privileges may be (but are not required to be) evidenced through a written document executed by the donor and the sponsoring organization.[11] 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.

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).[12]

The first exception relates to distributions from the donor-advised fund to a single entity. If a donor-advised fund only makes distributions to a single charity, this would likely violate the first exception. However, the key is for the sponsoring organization to avoid having an obligation to make payments. If the sponsoring organization maintains the right to distribute the assets to any qualified charity, the donor-advised fund should comply with this requirement.

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

For much of the past forty years, fast-food chain Burger King has employed the slogan "Have It Your Way."13 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."

Advantages

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 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 1: 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 2: 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.

Disadvantages

While donor-advised funds offer immediate tax benefits and flexibility, there are challenges as well:

- DAFs may require larger administrative fees and investment fees than other arrangements.
- Some critics contend that the donor actually holds too much control over DAFs—much like a private foundation, but without the government-imposed restrictions that apply to private foundations. Consequently, they argue that donor-advised funds may not be used for the charitable purposes for which the donor received a charitable deduction.

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, benefits and shortcomings) will allow you to effectively counsel clients. Ideally, informed advice will lead clients away from inflexible gifts to informed transactions that are financially successful and personally satisfying to donors.

ENDNOTES

1 2018 Donor-Advised Fund Report, National Philanthropic Trust.
2 Paul Revere Biography. https://www.paulreverehouse.org/biography/
3 A History of Modern Philanthropy, National Philanthropic Trust. www.historyofgiving.org
4 2018 Donor-Advised Fund Report, National Philanthropic Trust.
5 Richard Eisenberg, "There's a Target on Charity's Booming Donor-Advised Funds," Forbes, August 2, 2018.
6 Donor-Advised Funds Guide Sheet Explanation, July 31, 2008. https://www.irs.gov/pub/irs-tege/donor_advised_explanation_073108.pdf
7 26 U.S.C. 4966(d)(2)(A)(ii).
8 26 U.S.C. 4966(d)(1).
9 Rebecca Moffett, "Partners in Philanthropy: How to Work with Donor-Advised Funds," Guidestar Blog, September 19, 2018.
10 26 U.S.C. 4966(d)(2)(A)(iii).
11 Joint Committee on Taxation General Explanation of Tax Legislation Enacted in the 109th Congress, JCS-1-07—Part 2 of 2, Congress (United States).
12 26 U.S.C. 4966(d)(2)(B).
13 As with all things, even the successful "Have it Your Way" campaign finally came to an end in 2014 after a 40-year run. However, Burger King maintained the concept of control when they switched to "Be Your Way." https://www.cnbc.com/2014/05/19/burger-king-scrapping-have-it-your-way-slogan.html

Access more information now!

An electronic copy of our campanion booklet with a more detailed discussion of donor-advised funds including an explanation of restrictions, particular cases involving donor-advised funds, and a future forecast for this giving tool may be accessed in the Professional Advisor section of our webite at **www.catholicfoundation.com.**

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