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August 1, 2007

Mr. Kevin Brown
Acting Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments in Response to IRS Notice 2007-21 on Treasury Study on Donor Advised Funds and Supporting Organizations.

Dear Acting Commissioner Brown:

Enclosed are comments in response to IRS Notice 2007-21 on Treasury Study on donor advised funds and supporting organizations. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Susan P. Serota
Chair, Section of Taxation

Enclosure

cc: Donald L. Korb, Chief Counsel, Internal Revenue Service
Eric Solomon, Assistant Secretary (Tax Policy), Department of the Treasury
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**ABA SECTION OF TAXATION
COMMENTS IN RESPONSE TO IRS NOTICE 2007-21
ON TREASURY STUDY ON
DONOR ADVISED FUNDS AND SUPPORTING ORGANIZATIONS**

The following comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, the Comments should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by LaVerne Woods, Chair of the Exempt Organizations Committee (“Committee”). Substantive contributions were made by Brian Crozier. The Comments were reviewed Carolyn M. Osteen of the Section’s Committee on Government Submissions and by Richard S. Gallagher, Council Director for the Committee.

Although members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal income tax principles addressed by these Comments, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: August 1, 2007

Executive Summary

The Pension Protection Act of 2006,¹ (“Act”), enacted on August 17, 2006, contained a number of provisions relating to charitable organizations classified as section 509(a)(3)² supporting organizations (“SOs”), and donor advised funds held by charitable organizations. Section 1226 of the Act requires the Department of the Treasury (“Treasury”) and the Internal Revenue Service (the “Service”) to conduct a study on the operations of donor advised funds and SOs. On February 2, 2007, the Service issued Notice 2007-21,³ which invites public comment in connection with that study on a number of issues relating to donor advised funds and SOs.

Our specific recommendations are as follows:

1. With respect to donor advised funds, we recommend that Treasury not impose any distribution requirement, either on an aggregate basis or on a fund-by-fund basis, on sponsoring organizations that hold donor advised funds. If any distribution requirement is deemed necessary, however, we recommend that it be imposed on an aggregate, rather than on a fund-by-fund basis. We further recommend that to the extent that any distribution requirement is based on the value of assets within a donor advised fund or funds, the requirement should include rules similar to those applicable to private foundations with respect to the distribution requirements under section 4942.
2. With respect to SOs, we recommend that Treasury consider applying a distribution requirement for non-functionally integrated Type III SOs similar to that under current law for private operating foundations, *i.e.*, the lesser of 85% of net income or 85% of the fair market value of assets (*i.e.*, 4¼% of asset value), with a minimum distribution requirement of 3⅓% of asset value. We further recommend that any such distribution requirement be phased in over a period of years, and that Treasury provide special transition rules for charitable trusts that must institute judicial or other proceedings under state law in order to comply with new federal tax law distribution requirements. Finally, we recommend that Treasury provide rules similar to those applicable to private foundations with respect to the distribution requirements under section 4942.

¹ Pub. L. No. 109-280, 120 Stat. 780 (2006).

² All references to sections herein are references to sections of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise expressly stated herein, and references to Regulations are to the Treasury Regulations issued under the Code.

³ Notice 2007-21, 2007-9 I.R.B. 611.

Comments

Notice 2007-21 poses a number of questions relating to donor advised funds and SOs for public comment. Many of those questions were addressed in our comments⁴ in response to Notice 2006-109,⁵ submitted on June 4, 2007. These Comments accordingly address only two of the questions posed in Notice 2007-21: what would be appropriate payout requirements for donor advised funds, and for Type III SOs that are not “functionally integrated.”

I. What Would be Appropriate Payout Requirements for Donor Advised Funds?

A. Background.

Section 1226 of the Act directs the Treasury to undertake a study on the organization and operation of donor advised funds, and to consider specifically whether donor advised funds should be required to distribute for charitable purposes a specified amount (whether based on the income or assets of the fund) in order to ensure that the sponsoring organization with respect to the fund is operating in a manner consistent with the purposes or functions constituting the basis for its exemption under section 501 or its status as an organization described in section 509(a).

Section 4966(d)(2) defines a donor advised fund as a fund or account that is (1) separately identified by reference to contributions of a donor or donors; (2) owned and controlled by a “sponsoring organization”; and (3) 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. Section 4966(d)(2)(B) sets out certain exceptions. A “sponsoring organization” is defined at section 4966(d)(1)(A) as an organization described in section 170(c) (*i.e.*, an organization eligible to receive tax-deductible charitable contributions), other than a governmental entity, which is not a private foundation (as defined in section 509(a)), and which maintains one or more donor advised funds. All sponsoring organizations that are qualified under section 501(c)(3) are accordingly public charities, and not private foundations, and therefore are not subject to any distribution requirements under current law.

Private non-operating foundations must generally make “qualifying distributions” in an amount equal to five percent of their annual net asset value, under section 4942. Reasonable and necessary administrative expenses, in addition to grants to other organizations for charitable purposes, are taken into account as qualifying distributions, under section 4942(g)(1)(A). Among other special rules and exceptions under section 4942 are provisions for (1) the carryover of excess distributions made in a given year, (2) the possibility of “set-asides” allowing postponement of otherwise required distributions until a future year where this best accomplishes charitable purposes, (3) the exclusion for computation purposes of assets used or held for use directly in carrying out exempt purposes (*e.g.*, real estate or the portion thereof used in exempt activities, program-related investments, interests in a functionally-related business, reasonable

⁴ Comm. on IRS Notice 2006-109, ABA Tax Sec. *Comments in response to IRS Notice 2006-109 on the application of the Pension Protection Act of 2006 to donor advised funds and supporting organizations*, (June 4, 2007).

⁵ Notice 2006-109, 2006-51 I.R.B. 1121.

cash balances to cover current administrative expenses, etc.), (4) periodic valuation of real estate, and (5) “pass-through” requirements for distributions to certain controlled organizations.

B. Recommendations.

- (1) We recommend that Treasury not impose any distribution requirement, either on an aggregate basis or on a fund-by-fund basis, on sponsoring organizations that hold donor advised funds.
- (2) To the extent that any distribution requirement is deemed necessary, we recommend that it be applied to the aggregate of all donor advised funds held by a sponsoring organization, rather than on a fund-by-fund basis.
- (3) We further recommend that to the extent any distribution requirement is deemed necessary, and to the extent that any such requirement is based on the value of assets within a donor advised fund or funds, any distribution requirement should include provisions similar to those applicable to private foundations under section 4942 (*e.g.*, confirmation that ordinary and necessary administrative expenses are counted as qualifying distributions; carryover of excess distributions in a given year; exclusion for assets used or held for use directly in carrying out exempt purposes; and allowance for “set-asides” where the postponement of otherwise required distributions until a future year is done for a specific purpose).

C. Discussion.

Section 4942 requires private non-operating foundations to distribute a minimum of five percent of their annual net asset value. Looking to this five percent distribution requirement as a benchmark, the available evidence with respect to distributions from donor advised funds suggests that as a group such funds distribute a comparatively high percentage of their asset values. Recent statistics indicate that grants from donor advised funds at community foundations average 17% of assets, while grants from commercial gift funds holding donor advised funds average in excess of 22%.⁶ Similarly, a recent survey conducted by the Council on Foundations to which 85 community foundations responded supports the proposition that donor advised funds annually distribute amounts that are substantially in excess of five percent of aggregate assets.⁷ There accordingly does not appear to be any compelling need to mandate distributions from donor advised funds in order to ensure that assets in donor advised funds result in current funding of charitable operations.

Nonetheless, to the extent that any distribution requirement is deemed necessary, we recommend that it be imposed on an aggregate basis to a sponsoring organization’s donor advised funds, and not on a fund-by-fund basis. Many sponsoring organizations, such as community foundations and commercial gift funds holding donor advised funds, have hundreds

⁶ Statement of Jane G. Gravelle of the Congressional Research Service, Senate Finance Committee Hearings on Charities and Charitable Giving: Proposals for Reform (April 5, 2005), p. 4, available at <http://www.senate.gov/~finance/hearing/testimony/2005test/jgtest040505.pdf>.

⁷ Comments of the Council on Foundations in Response to Notice 2007-21, April 9, 2007, at 19.

of donor advised funds under their control. Any distribution requirement that applied on a fund-by-fund basis would add tremendously to the administrative burden on such sponsoring organizations – a burden that has already been significantly increased under the Act by the addition of requirements under sections 4966 (taxes on taxable distributions), 4967 (taxes on prohibited benefits) and 4958 (taxes on excess benefit transactions). It is not evident what public benefit would be achieved by a fund-by-fund distribution requirement as a justification for increasing this burden further. In addition, the application under the Act of the excess business holdings rules of section 4943 to donor advised funds addresses the potential for abuse concerning distributions from donor advised funds that have as their principal asset illiquid, closely-held stock.

To the extent that any asset-based distribution requirement is deemed appropriate, any such requirement should include rules similar to those in section 4942 and the regulations thereunder, which apply to private foundations. Those rules take into account a variety of situations in which an asset-based distribution requirement must be tempered in order to promote appropriate charitable expenditures and to avoid unintended results. The policy underlying those rules is no less applicable to public charities that sponsor donor advised funds than to private foundations. Indeed, it would be contrary to historic tax policy to impose a harsher rule on a public charity than on a private foundation, which would occur if any distribution requirement failed to include such rules.

II. What Would be An Appropriate Payout Requirements for Supporting Organizations?

A. Background.

Section 1241(d)(1) of the Act directs the Treasury to promulgate regulations requiring Type III SOs (other than functionally integrated Type III SOs) to distribute “a percentage of either income or assets to supported organizations . . . in order to ensure that a significant amount is paid to such organizations.” For these purposes, a “functionally-integrated Type III supporting organization” has the meaning given such term under section 4943(f)(5)(B).

The Staff of the Joint Committee on Taxation⁸ indicates that the concern with respect to the existing payout requirements that apply to non-functionally integrated Type III SOs is that “

the current income-based payout does not result in a significant amount being paid to the charity if assets held by a supporting organization produce little or no income, especially in relation to the value of the assets held by the organization, and as compared to amounts paid out by nonoperating private foundations.⁹

The “integral part test” under the existing regulations generally requires payment of substantially all “income” to or for the use of the supported organizations. Reg. § 1.509(a)-4(i)(3)(iii). The existing payout requirement, based as it is solely on income, has been

⁸ 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 (“Joint Committee Report”).

⁹ *Id.* at 360, n.571.

criticized because it can result in there being little or no current payout required. This would occur, for example, where endowment assets are invested heavily or solely in growth stocks or other non-income generating assets.

It appears from the language of the Act that Congress expected regulations would be promulgated which would change the existing distribution requirement based solely on “income” in a manner that would also take into account the value of the assets held by a Type III SO and which ensures that these organizations will actually be distributing a significant amount to the supported organization(s). In this regard, the Joint Committee Report refers to a comparison with the payout rules for non-operating private foundations.¹⁰ Private foundations must generally make “qualifying distributions” in an amount equal to five percent of annual net asset value, under section 4942. Reasonable and necessary administrative expenses, in addition to grants to other organizations for charitable purposes, are taken into account as qualifying distributions. As noted above, among the special rules and exceptions are provisions for (1) the carryover of excess distributions made in a given year, (2) the possibility of “set-asides” allowing postponement of otherwise required distributions until a future year where this best accomplishes charitable purposes, (3) the exclusion for computation purposes of assets used or held for use directly in carrying out exempt purposes (*e.g.*, real estate or the portion thereof used in exempt activities, program-related investments, interests in a functionally-related business, reasonable cash balances to cover current administrative expenses, etc.), (4) periodic valuation of real estate, and (5) “pass-through” requirements for distributions to certain controlled organizations.

Section 4942(j)(3) provides a different payout requirement for private operating foundations. A private operating foundation must make qualifying distributions directly for the active conduct of the activities constituting the purpose or function for which it is organized equal to the lesser of (1) 85% of its adjusted net income for the prior year; or (2) 85% of the minimum investment return as defined in section 4942(e) (calculated as five percent of the net fair value of the organization’s assets, excluding assets used or held for use directly in carrying out exempt purposes), *i.e.*, 4¼% of asset value.¹¹ A private operating foundation must in addition meet one of three alternative tests, one of which is an “endowment test,” under which a private operating foundation must make qualifying distributions equal to at least 3⅓% of the fair market value of its assets (excluding assets used or held for use directly in carrying out exempt purposes).¹² For private operating foundations that rely on satisfaction of the endowment test, the statute effectively imposes a floor on distributions of 3⅓% of asset value.

The payout provision for Type III SOs as approved by the Senate in the Tax Relief Act of 2005¹³ (“S. 2020”) would have required “qualifying distributions” at the greater of (1) 85% of net income for the preceding tax year, or (2) the “applicable percentage” (three percent for the year after enactment, four percent for second year, thereafter five percent) of the fair market

¹⁰ *Id.*

¹¹ See sections 4942(e), 4942(j)(3)(A); Reg. § 53.4942(b)-1(c).

¹² See sections 4942(j)(3)(B)(ii); Reg. § 53.4942(b)-2(b).

¹³ Tax Relief Act of 2005, S. 2020, 109th Cong. (2005).

value of assets (excluding assets used to perform functions or carry out purposes of a supported organization) on the last day of the preceding tax year.¹⁴

B. Recommendations.

- (1) We recommend that a Type III SO that is not functionally integrated be required to make distributions under rules similar to those required under current law for private operating foundations: the lesser of 85% of net income or 4¼% of the fair market value of assets (excluding assets used to perform functions or carry out purposes of a supported organization) on the last day of the preceding tax year, with a minimum distribution requirement of 3⅓% of the fair market value of assets (subject to phase-in and transition rules, as described below).
- (2) We further recommend that Treasury provide for a multi-year phase-in period for any annual asset-based distribution requirement, along the lines of that provided in S. 2020, described above.
- (3) We further recommend that Treasury provide transition rules for Type III SOs formed as charitable trusts that do not have authority under their trust instruments to distribute principal and must institute a judicial proceeding (or other proceeding required under state law) to reform, or excuse compliance with the trust instrument, in order to comply with an asset-based distribution requirement under the federal tax law.
- (4) In addition, we recommend that any regulations that provide for an asset-based distribution requirement also include provisions similar to those under section 4942 for the definition of income; confirmation that reasonable and necessary administrative expenses are counted as qualifying distributions; carryover of excess distributions made by a Type III SO in a given year; exclusion for assets used or held for use directly in carrying out exempt purposes; and allowance for “set-asides” where the postponement of otherwise required distributions until a future year is done for a specific purpose for the benefit of a supported organization (*e.g.*, to hold, invest and grow contributions raised from donors over time for the construction of a new building for the supported organization).

¹⁴ S. 2020 § 342.

To implement these recommendations, we suggest that Treasury replace the first sentence of Reg. § 1.509(a)-4(i)(3)(iii)(a)¹⁵ with the following:

The supporting organization makes payments of an amount equal to the lesser of 85% of its adjusted net income, as defined in section 4942(f) (the “required income distribution”) or 85% of the fair market value of its assets (excluding assets used to perform functions or carry out purposes of a supported organization) on the last day of the preceding taxable year (the “distributable amount”), to or for the use of one or more supported organizations, by the last day of the succeeding taxable year; provided, however, that for any taxable year in which the required income distribution is less than the distributable amount, the supporting organization shall pay out an amount equal to the excess of the “minimum distributable amount,” as defined below, over the required income distribution to or for the use of the supported organization(s) as an additional required distribution by the last day of the succeeding taxable year. For this purpose, the “minimum distributable amount” for a taxable year shall be determined by multiplying the “applicable distribution percentage” (two percent for tax years beginning after [*the date of promulgation of regulations*], three percent for the following taxable year, and 3½% for subsequent years) of the fair market value of assets (excluding assets used to perform functions or carry out purposes of a supported organization) on the last day of the preceding taxable year. Any distributions to or for the use of the supported organization(s) for a taxable year in excess of the distribution required for such taxable year may be carried over to one or more of the succeeding five taxable years and treated as distributions made during such succeeding taxable year(s). The amount of support received by one or more of the publicly supported organizations must be sufficient to insure the attentiveness of such organizations to the operations of the supporting organization.

We further recommend that Treasury include in the Regulations a provision allowing “set asides” along the following lines:

An amount set aside for a specific project which meets the following requirements may be treated as a qualifying distribution for purposes of the distribution requirements applicable to type III supporting organizations: (a) the project directly benefits a supported organization; (b) the project can better be accomplished by such set-aside than by immediate payment of funds; and (c) the type III supporting organization attaches a statement to its annual Form 990 for the year of the set-aside and each subsequent year until the set-aside amounts are expended describing the nature and purpose of the project, the amount of the set-aside, the amounts and approximate dates of planned additions to the set-aside funds, a statement of the reasons why the project can better be accomplished by a set-aside than by immediate payment, a detailed description of the project (including estimated costs, sources of any future funds expected to be used for completion of the project, and the location or locations of any physical facilities to be acquired or constructed as part of the project), and a statement as

¹⁵ The existing first sentence is as follows: “The supporting organization makes payments of substantially all of its income to or for the use of one or more publicly supported organizations, and the amount of support received by one or more of such publicly supported organizations is sufficient to insure the attentiveness of such organizations to the operations of the supporting organization.”

to the expected date by which the set-aside funds will be expended for the project. Absent advance approval from the Commissioner, the set-aside period for any specific project cannot extend beyond the end of the five taxable years following the taxable year in which the amount is set aside.

- (5) Finally, we recommend that Treasury *not* promulgate rules that require a functionally integrated Type III SO to make annual minimum distributions.

C. Explanation.

(1) Asset-Based Payout Rate.

Our recommendation is similar to the provision passed by the Senate in S. 2020, but differs from that provision in certain key respects. First, we recommend a minimum asset-based payout of 3½ rather than five percent. Second, we recommend that the payout requirement be the *lesser* of 85% of net income or a percentage of asset value, rather than the *greater* of the two measures.

(a) Percentage of Asset Value.

A threshold issue is whether any asset-based minimum distribution requirement for Type III SOs should be computed using the five percent rate applicable to private foundations.

As an initial matter, a Type III SO is qualitatively different from a private foundation. A private foundation may permissibly be controlled, managed and governed exclusively by disqualified persons with no level of nexus to any public charity or governmental entity. In contrast, a Type III SO cannot be controlled by disqualified persons, and must establish and maintain a level of nexus with one or more supported organizations sufficient to establish an “operated in connection with” relationship under section 509(a)(3)(iii). We suggest that these significant differences warrant consideration of a lower payout rate than that required for private non-operating foundations. (As addressed in detail below, we suggest instead applying the payout rate currently required for private operating foundations.)

In addition, current economic analysis, as explained below, suggests that a spending rate of five percent under current conditions can be too high to sustain the real value of an endowment fund on a long-term basis.

By way of background, the distinction between income and corpus for payout purposes is derived from historical trust accounting concepts, the objective of which was to provide a balance between current and future spending. A requirement to keep the principal of charitable assets intact allows for the preservation and investment of such assets in perpetuity so the resulting income therefrom is available to provide benefits to all future generations. Many charitable donors desire to create or contribute to a permanent endowment.

A study commissioned by the Michigan Council on Foundations in 2000¹⁶ concludes that a five percent spending rate is slightly too high to maintain purchasing power in perpetuity, and that payout rates in excess of 5% almost guarantee the depletion of the real value of a foundation over the long term, resulting in it being unable to maintain its spending in constant dollar terms without liquidating.

The distribution provisions of Uniform Management of Institutional Funds Act (“UMIFA”)¹⁷ address a similar concern; *i.e.*, determining endowment spending based on strict accounting concepts of income versus principal often results in insufficient current distributions where assets are prudently invested under modern investment portfolio theory. Among other things, UMIFA modifies the trust law rules applicable to the administration of charitable endowment funds by permitting application of a total return approach to investing and distributions.

UMIFA dates back to 1972 and has now been adopted in some form in almost every State. Based upon the work of a committee charged with determining whether and to what extent changes should be made to UMIFA, the National Conference of Commissioners on Uniform State Laws (“NCCUSL”) approved the Uniform Prudent Management of Institutional Funds Act (“UPMIFA”)¹⁸ in 2006. UPMIFA is intended to update and refine UMIFA.

With respect to the determination of an appropriate annual payout from endowment funds, the drafters of UMIFA and UPMIFA have devoted a great deal of time and thought to the issue. The following excerpt is from discussion in the 2006 comments of the NCCUSL to UPMIFA on the issue of whether to include a specific presumption that spending at or above a given percentage level is imprudent:

Perhaps the biggest problem with including a presumption in the statute is the difficulty of picking a number that will be appropriate given the range of institutions and charitable purposes and the fact that economic conditions will change over time. Under current economic conditions, a spending rate of seven percent is too high for most funds, but in a period of high inflation, seven percent might be too low. In making a prudent decision regarding how much to spend from an endowment fund, each institution must consider a variety of factors, including the particular purposes of the fund, the wishes of the donors, changing economic factors, and whether the fund will receive future donations.

...

The presumption of imprudence does not create an automatic safe harbor. Expenditures at six percent might well be imprudently high. [citation omitted] *Indeed, evidence discussed by the Drafting Committee suggests that few funds can sustain spending at a rate above five percent.* [citations omitted] *And under current conditions five percent may be too high.* [citation omitted] Further, spending at a lower rate, particularly in the early years of an endowment, may result in greater distributions over time. [citation omitted] A presumption of

¹⁶ Available at <http://www.cmif.org/documents/payout.pdf>.

¹⁷ Available at <http://www.law.upenn.edu/611/archives/ulc/fnact98/170s/umifa72.htm>.

¹⁸ Available at http://www.law.upenn.edu/611/archives/ulc/umoifa/2006final_act.htm.

imprudence can serve as a reminder that *spending at too high a rate will jeopardize the long-term nature of an endowment fund. If an endowment fund is intended to continue permanently, the institution should take special care to limit annual spending to a level that protects the purchasing power of the fund.*¹⁹

From a policy standpoint, we believe it would be a mistake to set a standard asset-based payout percentage at a rate that, based on current conditions and historical data, can be expected to result in erosion of the value over time (and a resulting decrease in the annual payout amounts in future years on an inflation-adjusted basis) of many Type III SOs. Note that the above discussion from the UPMIFA comments is focusing on a *maximum* prudent spending percentage, while the focus here is on a revised *minimum* distribution requirement for Type III SOs.

As a possible alternative to the five percent payout rate that generally applies to non-operating private foundations, the minimum payout rate for direct exempt function expenditures under the “endowment test” for private operating foundation status is set at two-thirds of the “minimum investment return” (*i.e.*, 5% of investment assets less any acquisition indebtedness). Section 4942(j)(3)(B)(ii); Reg. § 53.4942(b)-2(b)(1). This results in an annual minimum spending rate of 3⅓%. If such a spending rate is significant enough to support private operating foundation status, a similar percentage should be sufficient to demonstrate significant distributions by a Type III SO.

In our view, 3⅓% appears to be a payout rate that might appropriately balance the competing objectives of ensuring that a significant amount goes to the supported organizations and avoiding imposition of an excessive mandatory minimum distribution requirement that results in erosion of the real inflation-adjusted value of the permanent endowments of Type III SOs to the detriment of future generations.

In addition, applying the private operating foundation standard in the context of an asset-based distribution would be consistent with the existing interpretation of the income-based rule under Reg. § 1.509(a)-4(i)(3)(iii)(a). That regulation requires a Type III SO to distribute “substantially all” of its income. The Service, in Rev. Rul. 76-208, 1976-1 C.B. 161, looked to the private operating foundation rules at Reg. § 4942(b)-1(c), which define “substantially all” as 85% for purposes of private operating foundation distributions, and applied the same standard in the Type III SO context.²⁰

Our recommendation adopts the provision in the distribution requirement passed by the Senate in S. 2020 under which asset value is calculated as of the last day of the preceding taxable year, rather than more complex asset value calculation rules that apply to private foundations under section 4942(e).

¹⁹ Drafting Committee on Uniform Prudent Management of Institutional Funds Act, 2006 Annual Meeting Draft Comment, July 7-14, 2006 (emphasis added). Available at <http://www.nccusl.org/Update/CommitteeSearchResults.aspx?committee=288>.

²⁰ See also PLR 9021060 (Feb. 28, 1990), PLR 9714006 (Dec. 18, 1996), and PLR 9730002 (Jan. 7, 1997) (all looking to the rules for private operating foundations for purposes of defining “income” for the Type III SO distribution rules).

(b) Lesser of 85% or a Percentage of Asset Value.

The provision passed by the Senate in S. 2020 would have required Type III SOs to make distributions equal to the *greater of* 85% of net income or five percent of asset value. We instead recommend that the required distribution follow the existing provisions under section 4942(j)(3) for those private operating foundations that rely on the endowment test at section 4942(j)(3)(ii), *i.e.*, the *lesser of* 85% of net income or 4¼% of asset value, plus a minimum distribution requirement of 3⅓% of asset value.

A requirement that an organization make distributions equal to the *greater of* a percentage of income or a percentage of asset value has the adverse effect of reducing the real value of the organization's assets in periods of high inflation. Prior to amendment by the Economic Recovery Act of 1981,²¹ section 4942(j)(3)(A) required private operating foundations to distribute substantially all of their income, with no asset-based alternative. Similarly, prior to amendment by the Economic Recovery Tax Act of 1981, section 4942(d) required private non-operating foundations to distribute the greater of their net income or five percent of net asset value.²² The Staff of the Joint Committee on Taxation explained the reason for the amendments as follows:

The rate of return that assets generally earn represents a real income portion and a portion to compensate for the effects of inflation. The minimum payout requirement of prior law required that a private foundation distribute the entire amount of its nominal income even though a portion of that income was to compensate the foundation for the effects of inflation. As a result, the effect of the minimum payout requirement of prior law was gradually to reduce the real value of a private foundation's investment assets.

The minimum payout requirement of prior law was adopted by the Congress when the rate of inflation was low compared to recent rates and, consequently, the effect of the minimum payout requirement was relatively minor. However, recent high rates in inflation have resulted in significant erosions of the real value of foundation endowments.

While the Congress believed that private foundations should only be required to distribute their real income for charitable purposes, the computation of such real income would be difficult. The Congress was also concerned that modification of the minimum payout rule to require payment of real income could have a substantial adverse effect upon the charitable recipients of grants from private foundations. Accordingly, the Congress concluded that private foundations need only be required to distribute their minimum investment return [five percent of asset value]. The Congress believed that the distribution rule will provide substantial relief to private foundations from the effects of inflation without, in

²¹ H.R. 4242, 97th Cong., Pub. Law 97-34, § 823.

²² *Id.*

the long term, adverse consequences to the charitable recipients of foundation grants.²³

We recognize that a distribution requirement equal to the lesser of 85% of net income or a percentage of net asset value could in fact result in some Type III SOs that have substantial income in relation to their asset value becoming subject to a *lower* distribution requirement than under current law. We understand, however, that the perceived abuses in this area have involved Type III SOs that have little or no income in relation to the value of their assets.²⁴ A minimum distribution requirement of 3⅓% of asset value would address this concern. At the same time, a requirement that looks to the lesser of 85% of income and a percentage of value satisfies the concerns regarding inflation and erosion of value that Congress sought to address in 1981 by eliminating a distribution requirement that was based on the higher of a percentage of income or asset value.

B. Phase-In of Payout Requirement.

SOs that were organized under the existing income-based payout rules will need some reasonable transition period to adjust their investments to allow for sufficient liquidity to meet an payout requirement based in part on asset value. A three-year phase-in schedule similar to the one passed by the Senate in S. 2020 appears reasonable in this regard.

C. Transition Rule for Charitable Trusts.

Following the imposition of distribution requirements on private foundations under section 4942 by the Tax Reform Act of 1969, Treasury promulgated transition rules at Reg. § 53.4942(a)-2(e) for private foundations that were formed as charitable trusts prior to the effective date of the legislation, where it was necessary for the trust to institute a judicial proceeding to reform or excuse compliance with the trust instrument in order to comply with the asset-based distribution requirement under the federal tax law. Type III SOs formed as charitable trusts that were organized prior to the effective date of the Act will need similar transition rules in order to allow sufficient time to review trust documents in the context of any new asset-based distribution requirement and to take whatever action may be necessary under state law in order to enable the trust to make the required distributions.

D. Application of Rules Similar to Those Under Section 4942.

The Service has looked to the rules under section 4942 in applying the existing distribution requirements under the integral part test at Reg. § 1.509(a)-4(i)(3)(iii)(a). For example, in Private Letter Ruling 200045033,²⁵ the Service ruled that, under the rules set out in Reg. § 53.4942(a)-3(d), a Type III SO's distributions in one year would satisfy the "substantially all" requirement with respect to the prior year, and that, following the rule at Reg. § 4942(a)-3(e)(3), the Type III SO could carryover any excess distribution for five years following the year in which the excess distribution was made. It would be helpful for new

²³ Staff of the Joint Committee on Taxation, General Explanation of the Economic Recovery Tax Act of 1981 (H.R. 4242, 97th Cong., Pub. Law 97-34) (Dec. 29, 1981), at 366-67.

²⁴ See Joint Committee Report at 360, n.571.

²⁵ PLR 200045033 (Aug. 15, 2000).

Regulations concerning payout requirements for Type III SOs to formalize this guidance and generally to apply the rules for asset-based payouts under section 4942 to Type III SOs.

It would also be helpful in this regard for revised Regulations to include a provision to allow for “set-asides” by a Type III SO, similar to the rule for private non-operating foundations under section 4942(g)(2), where the postponement of otherwise required distributions until a future year is done for a specific purpose for the benefit of a supported organization. Examples of this type of project would include a specific plan to erect a building to house a new exempt activity of a supported organization (for example, a museum building, even though the location of the building and architectural plans have not been finalized), and a specific plan to purchase some particular item of expensive medical equipment for use by a supported organization that requires an expenditure of more than one year’s income.

F. No Authorization for Payout Requirement for Functionally Integrated Type III SOs.

Finally, we note that section 1241(d)(1) of the Act directs the Treasury to promulgate regulations “on payments required by type III supporting organizations *which are not functionally integrated type III supporting organizations*” (emphasis added). Notwithstanding the specific instruction in the language of the Act to exclude functionally-integrated Type III SOs from the new Type III payout requirement, the Joint Committee Report seems to suggest in a footnote that Treasury consider the possibility of adding a payout requirement for functionally integrated Type III SOs. In relevant part, footnote 571 of the Joint Committee Report reads as follows:

... There also is concern that the current regulatory standards for satisfying the integral part test not by reason of a payout are not sufficiently stringent to ensure that there is a sufficient nexus between the supporting and supported organizations. In revising the regulations, the Secretary has the discretion to determine whether it is appropriate to impose a pay out requirement on *any or all organizations not currently required to payout*. . . (emphasis added).

Notwithstanding the language quoted above, the legislative language of the Act does not appear to authorize a payout requirement for functionally integrated Type III SOs.