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June 4, 2007

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

Re: 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

Dear Commissioner Brown:

Enclosed are 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. 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
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**ABA SECTION OF TAXATION
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**

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”), and Frederick J. Gerhart, Vice Chair Law Development for the Committee. Substantive contributions were made by Lance W. Behnke, Victoria B. Bjorklund, Gregory L. Colvin, Brian W. Crozier, Alyssa DiRusso, Paul H. Feinberg, Lawrence Katzenstein, Raeburn Kennard, Jeanette Lodwig, Marion Ringel, Barbara Rosen, David A. Shevlin, and James L. Walker. The Comments were reviewed Carolyn M. Osteen of the Section’s Committee on Government Submissions and by Richard S. Gallagher, Council Director of 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.

Contact person:

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Date: June 4, 2007

Executive Summary

The Pension Protection Act of 2006¹ (“Pension Protection 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 to donor advised funds held by charitable organizations. Some provisions, particularly those regarding section 4958 “intermediate sanctions” and section 4943 “excess business holdings,” affect both donor advised funds and SOs. Other provisions affect private foundations and donor advised funds that make grants to SOs, which must be able to ascertain the tax status of a potential grantee in order to identify the procedures required for making a grant and the tax consequences of making the grant.

On December 4, 2006 the Internal Revenue Service (the “Service”) issued Notice 2006-109³ providing interim guidance concerning several of the provisions affecting donor advised funds and SOs, and private foundations that make grants to SOs. Notice 2006-109 also requested comments regarding the Notice and suggestions for future guidance with respect to changes regarding donor advised funds and SOs.

Notice 2006-109 provided useful interim guidance to help private foundations and donor advised funds determine the status of potential grantees. Additional guidance is needed in this area, however, to provide streamlined and practical procedures for private foundations and donor advised funds to determine when a potential grantee is an SO and how the SO will be classified.

Guidance is needed in other areas as well to provide clear definitions and to resolve ambiguity. With respect to the new provisions concerning donor advised funds, guidance is needed regarding the definition of a donor advised fund, and regarding the circumstances under which excise taxes will be imposed under new sections 4966 and 4967 on tax-exempt sponsoring organizations (and in some cases their foundation managers) that operate donor advised funds. With respect to the new provisions concerning SOs, guidance is needed regarding the factors that indicate that a person directly or indirectly controls a supported organization, the definition of a Type III functionally integrated SO, the circumstances under which a charitable trust may qualify as a Type III SO under the “responsiveness test,” and the application of the Pension Protection Act to SOs in existence before the Tax Reform Act of 1969. In addition, guidance is needed concerning the application of new excise taxes under section 4958 and the application of the excess business holdings rules under section 4943 to both donor advised funds and SOs.

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 2006-1009, 2006-51 I.R.B. 1121.

Recommendations Regarding Provisions Affecting Donor Advised Funds

1. We recommend that in interpreting the statement in section 4966(d)(2)(A)(i) that a donor advised fund “is separately identified by reference to contributions of a donor or donors,” guidance provide that (a) the balance in a donor advised fund must be tracked by both additions to and subtractions from the fund; (b) contributions by related donors are treated as made by one donor; and (c) a fund having at least three unrelated donors and meeting certain other requirements is not a donor advised fund.

2. We recommend that in determining whether a donor or donor advisor has a reasonable expectation of advisory privileges with respect to the distribution or investment of a fund by reason of the donor’s status as a donor within the meaning of section 4966(d)(2)(A)(iii), guidance provide that (a) advisory privileges do not include legal rights that are limited to enforcing the charitable use or purpose of a fund; (b) in the absence of written evidence, advisory privileges will not be inferred unless there are at least three separate, successive occasions where the charity accepts the donor’s advice; and (c) a donor’s service as an officer, director or employee of a charity will not by itself give rise to advisory privileges.

3. We recommend that in interpreting the exception from donor advised fund status in section 4966(d)(2)(B)(i) for a fund that makes distributions to a single organization or government entity, guidance provide that such a fund (a) can benefit any activity of the single entity including grants to natural persons; (b) can engage in a direct charitable activity; (c) can benefit a single organization that is external to the organization holding the fund; (d) can benefit a single organization that is not described in section 501(c)(3), and (e) includes a fund where the donor is an organization described in section 4966(c)(2)(A).

4. We recommend that in interpreting the exception from donor advised fund status in section 4966(d)(2)(B)(ii) for a fund where the donor advises as a member of a selection committee with respect to “grants for travel, study or other similar purposes,” guidance (a) allow a donor to recommend persons for appointment to the selection committee; (b) treat any person the donor recommends for appointment to the selection committee as a donor advisor unless the recommendation is based on objective criteria related to the person’s expertise; (c) count any member of a selection committee with certain current fiduciary duties to the donor against the donor in determining control of the selection committee; (d) adopt certain factors to ensure that the role of a donor or donor advisor as a member of a selection committee is equivalent and parallel to the role of other committee members; (e) allow charities to set uniform procedures for selection committees; and (f) adapt existing guidance in Regulation § 53.4945-4 for this purpose.

5. We recommend that in implementing the Department of the Treasury’s (“Treasury”) authority to exempt committee advised funds and single purpose funds under section 4966(d)(2)(C)(i) and (ii), guidance (a) allow an exempt employer-sponsored disaster relief fund to provide the broader scope of relief that Publication 3833 permits for public charity programs; (b) exempt disaster relief funds outside the

employment context; (c) allow an exempt fund to make any type of grant to a natural person that a private foundation can make; and (d) exempt a fund that benefits a commonly controlled group of organizations pursuing a common charitable purpose.

6. We recommend that in interpreting the definition of “taxable distribution” in section 4966(c), guidance provide that the word “distribution” has the same meaning as the word “grant” in section 4945(h), and does not include payments to vendors for goods or services.

7. We make numerous recommendations for adapting the existing private foundation Regulations governing expenditure responsibility under section 4945 as guidance for the exercise of expenditure responsibility by donor advised funds under section 4966(c)(1).

8. We recommend that guidance expressly provide that donor advised funds can make grants to foreign organizations based on the same equivalency determinations that private foundations are allowed to use.

9. We recommend that in interpreting the excise tax on a “more than incidental benefit” under section 4967, guidance (a) provide examples confirming that the token benefit rule applicable for charitable deduction purposes also applies in determining whether there is a more than incidental benefit under section 4967; (b) clarify how section 4967 applies to bifurcated payments; (c) confirm that a distribution from a donor advised fund to an organization that employs or contracts with a donor or related party will not result in a more than incidental benefit; and (d) provide that fund managers can rely in good faith on a certificate of the donor or donor advisor.

Recommendations Regarding Provisions Affecting Supporting Organizations

1. We recommend that guidance (a) clarify what factors will and will not indicate that a person directly or indirectly controls a supported organization for purposes of sections 509(f)(2) and 4943(f)(3)(B); (b) provide safe harbors for private foundations and donor advised funds that make grants to SOs if certain due diligence procedures are followed; (c) allow for a remedy when an SO inadvertently receives a contribution from a person who is deemed to control a supported organization; and (d) for SOs that name many supported organizations and for Type I SOs that support a class of organizations, limit the application of these sections to donations from persons who control the particular supported organization with respect to which the SO meets the “relationship test.”

2. We recommend that guidance apply a facts and circumstances analysis to determine whether a Type III SO is functionally integrated, in which the existence or absence of continuing donor involvement is a significant factor. We further recommend that guidance recognize limited categories of Type III SOs as *per se* functionally integrated.

3. We recommend (a) modifications to the guidance provided in Notice 2006-109 to simplify the procedure for determining whether an organization is a section

509(a)(1), (2) or (3) public charity and its status as a Type I, II or functionally integrated Type III SO; (b) that new determination letters specify an SO's status; (c) a procedure for an existing SO to obtain a new determination letter confirming its status and that, in the interim, grantors be permitted to rely on a grantee's status reported on the Form 990; (d) providing a simpler, streamlined process for small grants; and (e) allowing private foundations to rely on an SO's signed, written representation as to the identity of its supported organization(s).

4. We recommend that Regulations establish additional requirements for charitable trusts established (a) before the date of enactment of the Pension Protection Act; and (b) on or after the enactment of the Pension Protection Act, to satisfy the responsiveness test in order to qualify as a Type III SO that is "operated in connection with" a supported organization.

5. We suggest that Treasury consider providing special treatment to "grandfathered" SOs that were in existence before 1969.

Recommendations Regarding Section 4958 Intermediate Sanctions

1. With respect to section 4958 issues affecting both donor advised funds and SOs, we recommend that guidance confirm that (a) sales and leases of property are excluded from the automatic excess benefit provisions of section 4958(c)(2) and (3); (b) this exclusion applies to all forms of property and property transactions; and (c) loans, compensation and similar payments from a donor or related person to a donor advised fund or SO are not subject to the automatic excess benefit provisions.

2. With respect to section 4958 issues affecting only donor advised funds, we recommend that guidance confirm that the automatic excess benefit rules of section 4958(c)(2) do not apply where the sponsoring organization retains a donor, donor advisor or related person with respect to one of its donor advised funds to provide investment or other services to the sponsoring organization or its donor advised funds and the amount charged to any donor advised fund in connection with such services is pursuant to a uniform and ratable allocation across all of the donor advised funds that are eligible to benefit and receive such service.

3. With respect to section 4958 issues affecting only SOs, we recommend that guidance confirm that the automatic excess benefit rules of section 4958(c)(3) do not apply to transfers of assets or cost sharing between a SO and a supported organization described in section 501(c)(4), (5) or (6), or another SO within a group of entities under common control.

Recommendations Regarding Section 4943 Excess Business Holdings

1. With respect to the provisions at section 4943(e) that apply the excess business holdings rules to donor advised funds, we recommend that guidance confirm and clarify that (a) only the assets of a donor advised fund, and not all assets of the sponsoring organization, are liable for any excise tax imposed on the donor advised fund under section 4943(a); (b) the limits on holdings in a business enterprise generally apply

to each donor advised fund on a separate fund basis and do not apply to a sponsoring organization's holdings outside its donor advised funds; (c) the two percent *de minimis* rule under section 4943(c)(2) generally applies to each donor advised fund on a separate basis; and that guidance (d) address the circumstances under which related donor advised funds may be aggregated for purposes of applying the excess business holdings rules.

2. With respect to the provisions at section 4943(f) that apply the excess business holdings rules to SOs, we recommend that guidance clarify the meaning of "disqualified person" and "organization" and create a bright-line rule for determining common control.

Comments

A. Provisions Affecting Donor Advised Funds

- **Section 4966(d)(2)(A)(i): First Prong of Definition of Donor Advised Fund.**

- a. **Background.**

Section 4966(d)(2) defines a “donor advised fund” for purposes of the new excise taxes under sections 4966 and 4967, as well as for purposes of sections 4943 and 4958 and several other provisions of the Code. The term “donor advised fund” was previously used somewhat loosely to refer to a variety of arrangements. A precise definition of a donor advised fund is essential in order to ensure that the new excise taxes apply only in situations that present the potential for abuse that Congress intended to address.

In addition to the traditional use of the term, the donor advised fund label was previously used for convenience for many types of special funds, such as giving circles of unrelated donors sharing a charitable interest, new charities incubating under the wing of an existing charity, emergency and short-term funds needing a temporary host, coalitions and collaborative funding arrangements, and a vast array of specific projects (from documentary films to public health research) that have a fiscal sponsorship arrangement with a public charity. Other special funds and accounts that pose little or no potential for abuse include pooled scholarship funds, field of interest funds, agency funds, and programs bearing the name of a prominent donor or founder.

Section 4966(d)(2)(A) provides a three-part definition of a donor advised fund. The first prong of the definition states that a donor advised fund “is separately identified by reference to contributions of a donor or donors.”⁴ The second prong of the definition states that a donor advised fund “is owned and controlled by a sponsoring organization.”⁵ The third prong of the definition provides that a donor advised fund is a fund or account “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.”⁶

Below we address the first and third prongs of the definition of a donor advised fund. We have no comments on the second prong of the definition.

- b. **Recommendations – First Prong of Definition.**

- (i) We recommend that guidance confirm that neither of the following factors by themselves will result in a fund or account being considered a donor advised fund:

⁴ Section 4966(d)(2)(A)(i).

⁵ Section 2966(d)(2)(A)(ii).

⁶ Section 4966(d)(2)(A)(iii).

- Referring to a fund or account as a donor advised fund.
- Naming a fund or account after a donor.

It may be advisable to treat one or both of these factors as creating a presumption that the fund or account meets the definition, but that presumption should be rebuttable by a showing that the fund does not satisfy one or more of the three prongs of the statutory definition.

(ii) We recommend that to meet the first prong of the definition of donor advised fund, the sponsoring organization must track a “separate donor balance” by not only adding a specific donor’s contributions (and income earned on the fund) but also subtracting distributions (and administrative costs, *etc.*) charged against the fund.

(iii) We recommend that in applying the first prong of the definition, all contributions made to a fund by a group of related donors be consolidated and treated as having been made by one donor. To be consistent with the defined group of persons subject to taxes on prohibited benefits set forth in new section 4967(d), the definition of “related person” for this purpose should be controlled by section 4958(f)(7), section 4958(f)(3) and (4), and section 4946(d). Thus, if a fund or account receives contributions from two or more persons in the following group, and shows one consolidated fund balance for all of them, it meets the first prong of the donor advised fund definition:

- A donor and any advisors appointed or designated by a donor.
- Their spouses and ancestors.
- Their children, grandchildren, great grandchildren, and their respective spouses.
- Their brothers and sisters, including half-siblings, and their respective spouses.
- Entities, thirty five percent controlled by any combination of those described above.

(iv) We recommend that a multiple donor fund (“MDF”) with multiple unrelated donors be excluded from the definition of donor advised fund if it meets the following requirements, which would prevent the vast majority of potential abuses of MDF status, and yet allow the large variety of giving circles and giving pools currently

maintained at many public charities to avoid donor advised fund status:

- Three or more unrelated donors or groups of unrelated donors.
- All donations aggregated together with a single consolidated account balance tracked in the fund.
- No separate balance tracking for specific donors or groups of related donors to the fund.
- No written or oral understanding among the donors to the MDF that any advisory privileges they have correspond to the amounts they donated to the fund.
- No single donor or group of related donors, since inception of the fund, has given more than thirty five percent of all donations.

These requirements would be met where a fund receives donations from a number of unrelated individuals who are affiliated with each other only as members of an alumni, professional or similar society, even if the society or a committee of the society has the right to advise on awards from the fund. If, however, the society itself is the sole or dominant donor to the fund, the society should be treated as a single donor so that MDF status would not be available.

In addition, we recommend that the charity be expressly permitted to rely on written representations of the donors that all of these requirements are met, and that the multiple donors be allowed to adopt any process they wish for exercising advisory privileges regarding distributions from the fund, including collective or individual advice.

c. Explanation – First Prong of Definition.

(i) Labels and Names Are Not Enough.

Prior to the enactment of the Pension Protection Act the term “donor advised fund” was not formally defined and community foundations and other charities were known to use the term loosely as a matter of convenience. Charities should not be penalized for an inadvertent use of the term that does not fit the statutory definition.

The Staff of the Joint Committee on Taxation⁷ suggests that “naming the fund after a donor”⁸ would cause the fund to satisfy the first prong of the definition. It is not

⁷ 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”).

uncommon, however, for a fund to have multiple donors but be named after the first or most prominent donor, or after a deceased relative of a donor. Moreover, the Joint Committee Report, as discussed below, anticipates that certain multiple donor funds fall outside the first prong of the definition. Therefore, the use of a donor's name in the name of the fund should not be taken as conclusive evidence that the first prong of the definition is met.

(ii) Tracking a Separate Donor Balance with Both Additions to and Subtractions from Account.

The Joint Committee Report states that the first prong of the definition can be met “by treating a fund on the books of the sponsoring organization as attributable to funds contributed by a specific donor or donors.”⁹ Public charities may have a number of reasons to track and identify funds contributed by donors, often unrelated to maintenance of any donor advised fund. Charities maintain fundraising records showing repeat gifts in order to solicit donors and to provide them with recognition when they reach prescribed levels. Public support tests under sections 170(b)(1)(A)(vi) and 509(a)(2) require charities to track donor gifts over multiple years in order to complete Schedule A to Form 990. The charity can perform such tracking by adding the same donor's contributions (and perhaps those of related persons) to a cumulative list maintained over a certain time span.

This type of tracking of contributions should not be enough by itself to meet the first prong of the definition of donor advised fund. The charity must in addition track distributions from the fund as subtractions from the donor's contributions. The remaining balance after distributions are subtracted is the amount available from time to time for donor advice with respect to either distribution or investment. Only by keeping track of the balance after distribution can the amount still subject to advice be known.

(iii) Multiple Donors Who Are Related.

The statute and the Joint Committee Report are not entirely clear about when multiple donor funds meet the first prong of the definition of a donor advised fund. Section 4966(d)(2)(A)(i) refers to “a donor or donors,” but this apparently is not meant to sweep in every fund with multiple donors. The Joint Committee Report states that a fund “that pools contributions of multiple donors generally will not meet the first prong of the definition unless the contributions of specific donors are in some manner tracked and accounted for within the fund.” This possible ambiguity can be explained by distinguishing among multiple donor situations on the basis of whether the donors are related. For example, the Joint Committee Report suggests that its reference to “specific donors” is met “if the reference is to persons related to a donor.”¹⁰ The Joint Committee Report cites the example of a husband donating to a fund named after his wife. Other related persons who should be aggregated for this purpose are suggested by the statutory

⁸ Joint Committee Report at 342

⁹ *Id.* at 342-43.

¹⁰ *Id.* at 343.

provisions cited in the recommendation above. The recommendation pulls together these provisions in attempting to define the category of related persons who should be treated as one donor for the purpose of satisfying the first prong of the definition of donor advised fund.

(iv) Multiple Donors Who Are Unrelated.

The Joint Committee Report addresses the situation where multiple donors to a fund or account are unrelated by stating that a fund “that pools contributions of multiple donors generally will not meet the first prong of the definition unless the contributions of specific donors are in some manner tracked and accounted for within the fund.”¹¹ If a fund or account receives contributions from multiple unrelated donors, or unrelated groups of donors, and aggregates them into one “separate donor balance,” it should not meet the first prong of the definition. To prevent abuse, however, it is necessary to define carefully a multiple donor fund (“MDF”), *i.e.*, a fund with multiple donors that is treated as not meeting the first prong of the definition of donor advised fund. A definition of an MDF as any fund or account receiving assets from two or more unrelated donors or unrelated groups of donors may permit abuses. Examples:

- If two unrelated donors agree to set up a fund at a public charity, each contributes fifty percent of the fund, and they agree (a) to a consolidated balance and (b) that either of them may advise on distributions, such an arrangement is close in practice to a donor advised fund. They could have an informal understanding between them (not communicated to the charity) that each will advise no more than half the assets for distribution. Similarly, the arrangement bears an implicit assumption that each donor has designated the other to be a donor advisor. The pooling effect of a group of only two seems insufficient to create the sense that “separate identification” has been given up in the amalgamation of the donors’ interests. Allowing an MDF with only two unrelated donors could be an invitation to those who wish to work around and avoid the new donor advised fund rules.
- Likewise, if one donor provides the dominant portion of contributions to a fund, and he or she tries to make it an MDF by inviting one or more unrelated persons to make nominal donations to the fund, this also would circumvent donor advised fund status.

The conditions recommended above for excluding MDFs from meeting the first prong of the definition should avoid these and other potential abuses of MDFs.

It is common for a number of unrelated individuals who are affiliated with each other only as members of an alumni or professional society to contribute to a single fund. As recommended above, if the members are otherwise unrelated and are the source of

¹¹ *Id.*

multiple contributions to a fund that otherwise meets the conditions of MDF status, the fund should be regarded as an MDF.

We also recommend that a charity be allowed to rely on a certification of the donors that all of the conditions of MDF status are satisfied. It would be very difficult and burdensome for the charity to investigate all of the relationships and other factors necessary to ensure that the conditions are met. Requiring the unrelated donors to certify that all of the conditions are satisfied places the burden where it belongs, on the persons who have the knowledge and who stand to benefit.

- **Section 4966(d)(2)(B)(iii): Third Prong of Definition of Donor Advised Fund.**

- d. Background.**

- The third prong of the definition of donor advised fund in section 4966(d)(2)(B)(iii) applies to a fund or account:

- 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.

This third prong has several elements.

Specific Recipient and Amount. Advisory privileges can be with respect to either the distribution or investment of a donor advised fund. Where the advice pertains to distributions, the traditional practice of donor advised funds has been to allow donors to advise with respect to both the identity of the recipient and the amount that the recipient will receive.

Distributions Suggested by Sponsoring Organization. Sponsoring organizations often take the initiative to suggest grantees to a donor and ask for the donor's response. This happens because the sponsoring charity knows that many donors may be interested in a cause (such as Hurricane Katrina relief) or because the charity knows that certain donors have special interests in the environment, the arts, or other areas. In these cases, the donors are not initiating the giving of advice, but are responding affirmatively or negatively to suggestions made by the sponsoring organization.

Excluding Legal Rights or Obligations from Advisory Privileges. The Joint Committee Report distinguishes advisory privileges from donor-restricted gifts as follows:

- Advisory privileges are distinct from a legal right or obligation. For example, if a donor executes a gift agreement with a sponsoring organization that specifies certain enforceable rights of the donor with respect to a gift, the donor will not be

treated as having ‘advisory privileges’ due to such enforceable rights for purposes of the donor advised fund definition.¹²

The Joint Committee Report is distinguishing a donor restricted fund (“DRF”) from a donor advised fund. A DRF is traditionally regarded as a fund held by the charity that is restricted as to use or purpose of the assets in the fund. It generally arises under a written understanding at the time of the gift. The written understanding can be evidenced by a formal pledge or gift agreement executed by both parties. A DRF can also be created by the charity’s solicitation of funds for a limited purpose, or result from a statement made by the donor in a letter accompanying the donation or a phrase written on the face of the donation check. If the charity does not inform the donor that it retains variance power over the gift, or does not return the gift, it is deemed to have accepted the gift on the restricted terms communicated between the donor and the charity and a DRF results, for legal and accounting purposes.

A DRF may give the donor legal standing to petition a court to enforce the donor’s rights. Where the donor lacks standing to sue for breach of a DRF, the attorney general can sue a charity on behalf of the public to prevent or redress a diversion of funds from a restricted purpose.

Evidence of Advisory Conduct. In most cases a donor advised fund is created under a written agreement that defines the donor’s advisory privileges. The Joint Committee Report describes conduct indicating the presence of a donor’s reasonable expectation of having advisory privileges in the absence of a written agreement. Such conduct includes a donor who “regularly provides advice to a sponsoring organization and the sponsoring organization regularly considers such advice”¹³ Also, even if advisory privileges do not exist at the time of a contribution, “later acts” by the donor and by the charity “subsequent to the time of the contribution” may establish advisory privileges.¹⁴ However, the “mere act of providing advice” or the “donor’s singular belief that he or she has advisory privileges” does not establish the existence of such privileges.¹⁵

The Joint Committee Report states that “there must be some reciprocity on the part of the sponsoring organization.”¹⁶ One act of advice followed by a distribution in compliance with the advice is not enough; the donor must be “reinforced...in some manner that future advice similarly would be considered”¹⁷ to create a reasonable expectation of advisory privileges. “Ultimately,” states the Joint Committee Report, the presence or absence of advisory privileges “depends upon the facts and circumstances.”¹⁸

¹² Joint Committee Report at 343.

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *Id.* at 343-344.

¹⁶ *Id.* at 344.

¹⁷ *Id.* at 343-344.

¹⁸ *Id.* at 344.

Donor's Service as Officer or Director of Sponsoring Organization. The statute and the Joint Committee Report state that the donor's advisory privileges must be "by reason of the donor's status as a donor."¹⁹ The Joint Committee Report states that if the expectation of advisory privileges "is due solely to the donor's service to the organization, for example, by reason of the donor's position as an officer, employee, or director, then the third prong is not satisfied."²⁰ The Joint Committee Report also states that "in general, a donor that is a member of the board of directors of the sponsoring organization may provide advice in his or her capacity as a board member with respect to the distribution or investment of amounts in a fund to which the board member contributed"²¹ without having advisory privileges.

e. Recommendations – Third Prong of Definition.

- (i) We recommend that advisory privileges "with respect to the distribution" under the third prong require both (a) naming a specific recipient and (b) setting the amount the recipient should receive. Advice lacking either of those details is not advice "with respect to the distribution."
- (ii) We recommend that where a donor has advisory privileges, the sponsoring organization's proposal of a distribution of a certain amount to a certain distributee, or its request that the donor approve such a distribution, be viewed as the donor's exercise of the advisory privilege if the donor approves the proposal or request.
- (iii) We recommend that guidance confirm that (a) the legal rights of a donor that are excluded from the definition of advisory privileges are limited to those restricting the charity's purpose or use of the funds contributed; (b) such rights include both those enforceable by the donor and those enforceable by an attorney general or other official representing the public interest; and (c) if such rights are combined with advisory privileges the resulting fund will nonetheless be considered a donor advised fund.
- (iv) We recommend that, where there is no written evidence of advisory privileges, guidance should require the transmission of advice from a donor to the charity, and the charity's acceptance of that advice, on at least three separate, successive occasions before an inference can be drawn that the donor has a reasonable expectation of advisory privileges.

¹⁹ Section 4966(d)(2)(A)(iii); Joint Committee Report at 344.

²⁰ Joint Committee Report at 344.

²¹ *Id.*

- (v) We recommend that guidance state (a) that a donor’s service as an officer, director or employee of a public charity does not by itself give rise to advisory privileges, but that such a donor will be treated like any other donor in determining whether he or she has advisory privileges by virtue of a donation; and (b) that a similar principle applies to independent contractors who advise the sponsoring organization generally about distributions or investments.
- (vi) We recommend that guidance confirm that there is no limit on the number of successive donor advisors, so that a donor advised fund could last in perpetuity.

f. Explanation.

(i) Specific Recipient and Amount of Distribution.

To constitute advice with respect to a distribution, the donor’s recommendation should address both a specific grantee and a specific amount of money. The Joint Committee Report is silent on this question, except for one example of an “act of providing advice” where the donor “states that he would like the sponsoring organization to distribute \$10,000 to an organization described in section 170(b)(1)(A)”²² Presumably, in this example the donor named the grantee organization, rather than telling the sponsoring organization that it could choose any organization described in section 170(b)(1)(A).

Traditional donor advised funds have provided advisory privileges that involve both the identity of the grant recipient and the amount the recipient will receive. This is presumably what Congress had in mind when it used the term “advisory privileges” in section 4966(d)(2)(B)(iii).

Requiring that advice include both a specific grantee and a specific amount will also make clear to charities and their donors that they need not fear donor advised fund status merely because they communicate in general terms about potential grantees and the magnitude of funding efforts, as well as specific grant purposes and the performance of grantees. Such communications often occur with respect to “field-of-interest” funds and “fiscal sponsorship projects” where the donors do not advise specific amounts to specific grantees, but leave those details to the charity.

(ii) Distributions Suggested by Sponsoring Organization.

Whether a recommendation for a distribution from a donor advised fund originates with the donor, the sponsoring organization or some third party is largely a matter of form. The charity’s suggestion of a distribution from a donor advised fund

²² Joint Committee Report at 343.

should be viewed as the charity seeking the donor's advice, so that if the donor responds affirmatively, that is the exercise of an advisory privilege.

(iii) Excluding a Legal Right or Obligation.

The donor's legal rights over the "use or purpose" of a DRF distinguish it from a donor advised fund, where the donor can only recommend how the funds will be used. Other legal rights of the donor, such as the right to a periodic accounting, the right to confidentiality, or rights pertaining to the timing and exercise of the advisory privileges, are rights that a donor of a donor advised fund would have, and do not distinguish a DRF from a donor advised fund. Accordingly, only rights as to the use or purpose of a DRF should distinguish it from a donor advised fund.

Any right the donor may have over the use or purpose of a fund is not exclusive of advisory privileges. The language quoted above on this point from the Joint Committee Report states that a donor "will not be treated as having 'advisory privileges' due to such enforceable rights" ²³ Thus, the enforceable rights standing alone do not result in advisory privileges. If the donor separately retains advisory privileges over the use of the fund, then those advisory privileges would have to be tested in applying the definition of donor advised fund without regard to the enforceable rights.

(iv) Evidence of Advisory Conduct.

In most cases advisory privileges will be evidenced in writing. Written evidence of advisory privileges could take the form of an initial written agreement between the donor and the charity defining the advisory privileges or other written communications between the charity and the donor, including financial reports showing a balance in a fund or account with a written indication that further distributions will not be made without advice from the donor. Any such written evidence of advisory privileges should be clear and unambiguous to establish the existence of advisory privileges.

In the absence of clear and unambiguous written evidence of advisory privileges, requiring a minimum number of occasions when a donor offers advice and a charity accepts it before advisory privileges are inferred is advisable to avoid an overbroad rule. There are many situations where communications between a charity and a donor could mistakenly lead to an inference of advisory privileges. Requiring that there be at least three separate, successive occasions before an inference can be drawn that there is a reasonable expectation of advisory privileges is a reasonable safe harbor.

(v) Donor's Status as a Donor.

As noted above, both the statute and the Joint Committee Report state that the donor's advisory privileges must be "by reason of the donor's status as a donor."²⁴ The Joint Committee Report goes on to make a somewhat ambiguous observation that

²³ *Id.*

²⁴ Section 4966(d)(2)(A)(iii); Joint Committee Report at 344.

if by reason of such donor's contribution to such fund, the donor secured an appointment on a committee of the sponsoring organization that advises how to distribute or invest amounts in such fund, the donor may have a reasonable expectation of advisory privileges, notwithstanding that the donor is an officer, employee, or director of the sponsoring organization.²⁵

This statement appears to mean only that a donor's status as an officer, director or employee of the sponsoring organization does not insulate the donor from having advisory privileges. This meaning is supported by the use of "notwithstanding," which suggests that even if the donor is an officer or director, the donor can still have advisory privileges on the same basis as any other donor. The use of the word "committee" presumably refers to a committee with advisory privileges as discussed elsewhere in the Joint Committee Report, rather than a committee of the board. In other words, a donor who by virtue of a donation secures a position on a committee that provides advice with respect to a particular fund of the sponsoring organization that otherwise satisfies the definition of donor advised fund will be treated like any other donor for purposes of determining whether he or she has advisory privileges with respect to that fund.

If that is not the intended meaning, then the statement is puzzling because it could negate the prior statement in the Joint Committee Report that service as an officer, director or employee does not result in a donor's having advisory privileges. It seems unlikely that the Joint Committee intended such inconsistency. Moreover, such a meaning would be troubling because it is commonplace for significant donors to be added to a charity's board and committees of the board in recognition of their support and interest in the charity, and as an encouragement of their continued support and interest. If such a situation could result in donor advised fund status and exposure to punitive excise taxes, that could have a chilling effect on established and nonabusive practices in the charitable sector. If the statement from the Joint Committee Report quoted in the preceding paragraph is interpreted more broadly, guidance should require an express statement, orally or in writing, by the donor or by an agent of the organization indicating that the sole consideration causing the donor to seek the position, or causing the organization to offer the position to the donor, was the person's status as a donor.

(vi) Successive Donor Advisors.

The Joint Committee Report states that "a person appointed or designated by a donor advisor is treated as being appointed or designated by a donor"²⁶ There is no reason to limit the number of times a successor can be named and still traced back to the original donor. Sponsoring organizations may allow an indefinite succession of advisors that continues into later generations without limitation, so it should be recognized that a donor advised fund can last in perpetuity.

²⁵ Joint Committee Report at 344.

²⁶ *Id.*

- **Section 4966(d)(2)(B)(i): First Exception to Definition of Donor Advised Fund.**

- g. Background.**

Section 4966(d)(2)(B) provides two exceptions to the definition of “donor advised fund.” These exceptions allow common and nonabusive charitable giving practices to avoid being subject to the donor advised fund penalties even if the fund is named after a donor, a separate donor balance is kept, and the donor can advise on the fund’s distributions and investments. This Section 3 discusses the first exception. The second exception is discussed in Section 4 below.

Single Entity Beneficiary Fund (“SEBF”). The first exception from donor advised fund treatment is described in section 4966(d)(2)(B)(i) as a fund or account that “makes distributions only to a single identified organization or governmental entity.” We will refer to this fund or account as a Single Entity Beneficiary Fund (“SEBF”).

Type of Activities an SEBF Can Conduct. The scope of the SEBF exception depends on the types of activities that guidance will allow an SEBF to conduct. The Joint Committee Report provides two examples of an SEBF. One speaks of an “endowment fund ... held exclusively for the benefit of” the sponsoring organization and the other speaks of a fund created by a donor to a university that “supports the activities of the university”²⁷ Neither example gives any indication that there is a limit on the types of activities an SEBF can conduct.

Types of Organizations an SEBF Can Serve. Neither the statute nor the Joint Committee Report indicates that there is any limit on the types of organizations that could receive distributions from an SEBF. It is important to know whether an SEBF can benefit a single entity that is external to the organization holding the SEBF, and whether the single entity receiving funds from the SEBF must be described in section 501(c)(3).

- h. Recommendations.**

- (i)** We recommend that guidance confirm that there is no limitation on the types of activities an SEBF can fund at the single entity it benefits, including grants to natural persons. An SEBF should be able to provide scholarships, research awards and other grants benefiting individuals who participate in the single entity’s programs, so long as eligible individuals are limited to students or other participants in that entity’s programs. For example, a student selected to receive a scholarship from an SEBF at a university should be allowed to use the scholarship while studying abroad so long as that study is pursuant to a university program. Similarly, a donor should be able to establish an SEBF at a homeless shelter, or at a hospital to augment medical benefits to individual patients

²⁷ Joint Committee Report at 345.

served at that institution. Guidance should be broad enough to allow an SEBF to engage in any form of charitable activity, including grants to natural persons, so long as distributions are limited to those within the charitable class served by that single entity.

- (ii) We recommend that guidance confirm that an SEBF can engage in a direct charitable activity by receiving, holding and disbursing funds for a specific project or program conducted by the single entity it benefits, including making payments for staff, goods, services, and incidental grantmaking limited to that project or program.
- (iii) We recommend that guidance confirm that the SEBF exception applies where the fund makes distributions to a single identified external organization. For example, an SEBF may be held by a community foundation and make distributions solely to a single identified external organization such as a university or hospital.
- (iv) We recommend that guidance confirm that the single identified beneficiary organization of an SEBF can be a non-charity (such as a section 501(c)(4) or (c)(6) organization) or even a for-profit business, and could be a foreign private or public entity as well, so long as the distribution is made for a proper charitable purpose under section 501(c)(3) as interpreted by existing law.
- (v) We recommend that guidance confirm that where a fund or account meets the donor advised fund definition, but the donor is itself an organization described in section 4966(c)(2)(A), the fund be treated as an SEBF.

i. Explanation.

(i) Types of Activities an SEBF Can Conduct.

The second example from the Joint Committee Report referenced in Section 3(a) above speaks of an SEBF that “supports the activities of the university”²⁸ There is no apparent reason to limit the scope of the university’s activities that the SEBF can support. For example, a donor may create a scholarship fund at a university and ask to have some role in selecting the recipients of the scholarships. So long as scholarships from the fund are awarded only to students of that university, the fund would be held exclusively for the university’s benefit and distributions from the fund would benefit the university’s activities within the meaning of this example in the Joint Committee Report. Likewise, the first example in the Joint Committee Report refers to an endowment fund held for the benefit of the sponsoring organization without mentioning any limit on how

²⁸ Joint Committee Report at 345.

the endowment might be expended. This also indicates that an SEBF is permitted to fund any charitable use at a single entity, including grants to its program participants.

(ii) SEBF Supporting Projects.

The scope of activities that an SEBF can fund should also include specific charitable projects, sometimes called “fiscal sponsorship” projects, created to serve one of a wide variety of charitable needs and goals that may be administered under a single charity’s umbrella. Separate accounts may be established for human service projects devoted to certain populations such as foster children, pilot programs, artistic and cultural productions, environmental efforts focused on specific locations, documentary films, construction projects, funding collaboratives, short-term emergency funds, incubation of new charitable programs, and foreign development or relief campaigns. The charity typically conducts its fiscal sponsorship projects directly as part of its program work, with some donor advice and involvement. So long as a fund or account created by a donor is limited to a specific project or program of a single entity, it should qualify as an SEBF.

(iii) SEBF Benefiting an External Entity.

In both of the examples of an SEBF from the Joint Committee Report referenced in Section 3(a) above, the sponsoring organization itself is the only beneficiary. The language of the SEBF exception in section 4966(d)(2)(B)(i) (“distributions to . . . a single identified organization or government entity”) contemplates going further and making distributions to an external organization.

For example, a community foundation may hold a fund created by a donor that is intended to benefit only one university. A donor may prefer such an arrangement to creating the fund at the university to have increased leverage to ensure that the university honors any restrictions on the use or purpose of the distributions it receives from the fund. The donor of such an SEBF should be allowed to recommend to the charity holding the SEBF a change of the single entity receiving distributions from the SEBF. So long as there is only one such external entity at any one time, such a fund should qualify as an SEBF.

(iv) Tax Status of Entity Served by the SEBF.

Neither the statute nor the Joint Committee Report suggests a limitation on the tax status of an SEBF’s single beneficiary entity. If the drafters had wished to limit the tax status of possible distributees, the statute could have followed the lead of section 4966(c)(2)(A), which specifically limits distributees in that context to organizations described in section 170(b)(1)(A) other than disqualified SOs. Allowing an SEBF’s single beneficiary organization to have some other tax status is consistent with the SEBF requirement of having only a single grantee organization. The donor is still not using the fund to retain a choice of grantee. The donor’s advisory privileges are limited to suggesting the amounts, timing, purposes, and restricted uses of distributions by a single grantee.

This approach would apply to many existing charitable programs and relationships. One example is the U.S.-based “friends of” charity that allows donors to create donor advised funds that support the programs of a single foreign organization. Another example is a section 501(c)(3) organization operating in tandem with a section 501(c)(4) organization, where the charity has accounts set up by certain donors in which the donor has the ability to advise on grants made by the (c)(3) only to the (c)(4) for defined charitable programs. These are also known as “pre-approved grant relationships” or “re-grant” funds, which is a form of fiscal sponsorship, sometimes operated with donor advice, in which the charity receives grants and donations and transfers the proceeds to a single sub-grantee to conduct a specific charitable project.

(v) Public Charity as Donor to SEBF.

An SEBF could be an “agency fund,” where the donor is actually a public charity that places certain assets under the ownership and control of another public charity for investment, liability protection or other reasons. Donor advised distributions, when they are made, are advised by the donor public charity and often go back to that public charity. Many of these exist at community foundations and other institutions. The fund may be advised by the donor charity to make grants of any kind, to any individual or entity, for appropriate charitable purposes. Because the donor is the type of charity deemed unobjectionable by section 4966(c)(2)(A), distributions benefiting the donor pose no problem of private inurement, should not be taxable distributions, and should not be excess benefit transactions.

• **Section 4966(d)(2)(B)(ii): Second Exception to Definition of Donor Advised Fund.**

j. Background.

Section 4966(d)(2)(B)(ii) creates the second exception for a fund or account that otherwise meets the three-prong definition of a donor advised fund. This second exception applies where the donor advises “as to which individuals receive grants for travel, study, or other similar purposes” if three requirements are met. We will refer to a fund or account falling within this exception as an Individual Grant Fund (“IGF”). Unlike the SEBF discussed above, the recipients of scholarships and other travel or study grants from an IGF are not limited to students at a single institution.

The First Requirement of an IGF. The first requirement of an IGF is stated in section 4966(d)(2)(B)(ii)(I) as follows: “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”

The Second Requirement of an IGF. Section 4966(d)(2)(B)(ii)(II) states the second requirement of an IGF as follows: “no combination of [donors or donor advisors] (or persons related to such persons) control, directly or indirectly, such committee”

The Third Requirement of an IGF. Section 4966(d)(2)(B)(ii)(III) states the third requirement of an IGF as follows:

all grants . . . are awarded on an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the board of directors of the sponsoring organization, . . . designed to ensure that all such grants meet the requirements of paragraphs (1), (2), or (3) of section 4945(g).

The reference to section 4945(g) ties the IGF exception closely to the private foundation rules on grants for “travel, study or other similar purposes.” The IGF exception is limited to the same type of travel and study grants and does not, for example, extend to grants for the relief of poverty, disaster assistance, or medical needs. As discussed below, those other types of grants should be permitted under the Treasury’s exemption authority in section 4966(d)(2)(C). This policy of distinguishing between grants for travel, study or other similar purposes and other types of grants is consistent with the policy reflected in the private foundation provisions.²⁹

k. Recommendations.

- (i) We recommend that guidance provide that the role of a donor or donor advisor who is a member of an IGF committee must be equivalent and parallel to the roles of other committee members. The committee need not review and choose applicants solely as a group at in-person meetings, but they should:
 - Have the right to participate equally in any outreach or interview phases of the process;
 - Have equal access to applications and equal opportunity to review them;
 - Propose finalists and awardees in the same manner; and
 - Operate by majority vote; *i.e.*, the donor or donor advisor should not have veto power over selections.
- (ii) We recommend that guidance state that appointments to the committee need not be made by the board of directors and may be made using any reasonable procedure, considering the size of the organization, the number of IGFs, and other relevant facts and circumstances.
- (iii) We recommend that guidance confirm that (a) donors are permitted to recommend persons (including the donors) for the sponsoring organization to appoint to an IGF selection committee

²⁹ *E.g.*, Reg. § 53.4945-4(a)(3)(i) (grants to indigent individuals are not subject to the requirements of section 4945(g)).

and (b) members recommended by the donor will be considered donor advisors in determining control of the committee unless the recommendations are based on “objective criteria related to the expertise of the member.”

- (iv) We recommend that in determining whether the donor or donor advisor controls an IGF committee, any person currently engaged by the donor or donor advisor, whether as an employee or independent contractor, in any professional or fiduciary relationship related to the committee’s work, should be treated as a person through whom a donor or donor advisor can exercise indirect control over a committee, if he or she is part of the majority of the committee together with similar individuals, with the donor, donor advisor, and persons related to them. That would include the donor’s current lawyer, accountant, personal assistant, and his or her current business employees and agents, if their fiduciary duties to the donor include matters pertaining to the work of the committee.
- (v) We recommend that guidance confirm that if a fund or account is not a donor advised fund because it is a multiple donor fund of unrelated donors or because it qualifies as an SEBF or any other exception or exemption from donor advised fund treatment, it need not also meet the requirements of an IGF.
- (vi) We recommend that guidance allow the charity to set uniform procedures with flexibility in the selection criteria that each of its IGFs may use, subject to the overall requirement of objectivity and nondiscrimination.
- (vii) We recommend that guidance provide that incidental donations made by an IGF committee member to pay for a ticket to attend a fundraising event supporting the IGF on the same basis as other attendees should not cause that person to be a donor for purposes of section 4966(d)(2)(B)(ii)(II).
- (viii) We recommend that guidance implementing the reference to section 4945(g) in the third requirement of an IGF be adapted from existing guidance for private foundations in Reg. § 53.4945-4 and other applicable authorities, and that such guidance confirm that the advance approval of the Service required in section 4945(g) does not apply to an IGF.

I. Explanation.

(i) Donor’s Role on Committee under First Requirement.

Prior to the Pension Protection Act donors often played a role in the selection of scholarship recipients and other individual grantees. They encouraged people to apply. They might have been the first to see the applications or nominations and sift through them to pick the winners or to narrow the group to top candidates. Or they might not have been involved in the initial screening of applications at all, but served in the last step, influencing or even vetoing the final selection.

Our recommendations would limit all such practices. To comply with the first requirement of an IGF, *i.e.*, that the donor’s advisory privileges must be exercised “exclusively . . . as a member of a committee,” the donor’s rights should be no different from those of the other members of the committee. At the same time our recommendations are also intended to permit sufficient flexibility so that the committee is not unduly burdened with cumbersome requirements on how the donor can and cannot act.

(ii) Appointments to an IGF Committee.

The statute requires that all the members of the committee (which would include any donor or donor advisor) be “appointed by the sponsoring organization,” but is silent (compare the third requirement in section 4966(d)(2)(B)(ii)(III)) as to whether the board of directors must make the appointments. For a large organization with many IGF committees, it would be burdensome to require the board of directors to appoint the members of every committee. The board should be permitted to delegate the appointment power to an executive or administrative committee, or to the executive director or other senior officer of the organization, subject to the ultimate authority of the board.

The board should also be permitted flexibility in creating guidelines for the membership of an IGF committee. In a small organization or for a small program, the board could stipulate that only one donor or donor advisor will be appointed to each committee and that the same two other people (not related to any donor or advisor) will sit on every committee. For larger organizations or programs, the board may prefer to allow larger committees that would accommodate more than one donor or donor advisor.

(iii) Donor Recommendations of Committee Members.

Section 4966(d)(2)(B)(ii)(I) states as the first IGF requirement that the sponsoring organization must appoint all of the members of the IGF committee. The statute does not prohibit a donor or donor advisor from serving on or recommending members of the IGF committee. The second IGF requirement, *i.e.*, that the committee cannot be controlled by the donor, donor advisor or related persons, is also silent on whether the donor or donor advisor can serve on or recommend members of the IGF committee. The Joint Committee Report provides the following interpretation and example, however:

to the extent a donor recommends to a sponsoring organization the selection of members of a committee that will advise as to distributions . . . , such members are not treated as appointed or designated by the donor if the recommendation of such members by such donor is based on objective criteria related to the expertise of the member. For example, if a donor recommends that a committee of a sponsoring organization that will provide advice regarding scholarship grants for the advancement of science at local secondary schools should consist of persons who are the heads of the science departments of such schools, then the donor generally would not be considered to have appointed or designated such persons, *i.e.*, they would not be treated as donor advisors.³⁰

This language is at first a bit confusing because at the beginning it speaks of when a donor is treated as “appointing or designating” a member of a committee, which could affect the first IGF requirement, but the final clause speaks of whether the affected appointees would be considered donor advisors, which affects only the second IGF requirement.

We do not view the example in the Joint Committee Report as affecting the first IGF requirement, which states that the sponsoring organization must “appoint” all of the members of the IGF committee. The words “appointed or designated” are used in section 4966(d)(2)(A)(iii) to define a donor advisor. The first IGF requirement refers only to the “appointment” of members of the committee, not “appointment or designation.” The quoted language from the Joint Committee Report consistently uses “appointed or designated” three times, and then at the end of the paragraph equates that with a reference to a donor advisor. The choice of “appointed or designated” in the example, together with the repetition of those words and the reference to donor advisors at the end of the paragraph, indicates that the quoted language affects only whether a member of an IGF committee will be treated as a donor advisor, not whether the individual will be considered as appointed by the donor instead of by the sponsoring organization.

Under this reading, the donor is free to recommend persons for membership on the IGF committee. This allows the donor to recommend himself or herself as a member of the committee without regard to whether the recommendation is based on objective criteria relating to expertise. To bar the donor from making such recommendations would be unrealistic because the sponsoring organization cannot be expected to refuse to listen to the donor. Moreover, where the donor is appointed to the committee, a question will inevitably arise whether that appointment was in response to the donor’s recommendation, which would cast doubt on the committee’s status if donors are not allowed to recommend appointments.

The objective criteria standard in the Joint Committee Report example does affect the second IGF requirement. The quoted language suggests that any members of an IGF committee that are recommended by the donor will be treated as donor advisors in determining whether the donor controls the committee in violation of the second IGF requirement, unless the recommendation is based on objective criteria relating to their

³⁰ Joint Committee Report at 344-345.

expertise. This allows the donor to recommend a minority of members of the committee without regard to the objective criteria standard.

(iv) Other Persons Considered Donors or Donor Advisors.

In a discussion of the Treasury's separate authority under section 4966(d)(2)(C)(i) to exempt certain committees from donor advised fund status if the committee is not controlled, directly or indirectly, by the donor or a donor advisor (discussed below), the Joint Committee Report makes the following statement:

indirect control includes the ability to exercise effective control. For example, if a donor, a donor advisor, and an attorney hired by the donor to provide advice regarding the donor's contributions constitute three of the five members of such a committee, the committee would be treated as being controlled indirectly by the donor³¹

Presumably this same principle of going beyond related persons and aggregating an unrelated attorney in determining whether the donor or donor advisor has majority control of the committee should also apply to IGFs. Our recommendation is intended to describe those situations where this broader aggregation is appropriate, but at the same time to define and limit the scope of permissible aggregation so that charities and donors will have some certainty about the types of relationships that can lead to aggregation. It seems reasonable, for example, to limit the scope to persons who have a current relationship with the donor or donor advisor, and to limit the type of relationship to one involving fiduciary responsibilities to the donor or donor advisor relating to the IGF committee. Without those limitations, the aggregation would be overbroad and would leave uncertainty as to how the rule should be applied.

(v) IGF Requirements Not Applicable Elsewhere.

The IGF exception contains several conditions that do not apply to other funds that avoid donor advised fund status. This is consistent with the approach under the private foundation rules to grants to individuals for "travel, study or other similar purposes." These conditions need not be imposed on funds that avoid donor advised fund status on some other basis. For example, a fund that makes scholarship grants to students of one university qualifies as an SEBF. Congress decided that limiting scholarships to the students of one university was sufficient protection from abuse to allow an SEBF to avoid donor advised fund status. The fact that Congress thought it necessary to require additional protections against abuse where an IGF can award scholarships to students of multiple institutions does not affect the principle that an SEBF is not a donor advised fund due to its limitation to one institution. The same is true of other exceptions and limitations, each of which has its own independent protections against abuse that should stand separate and apart from the IGF exemption.

(vi) Creating Standard Procedures for Multiple IGFs.

³¹ Joint Committee Report at 345.

A public charity may have a multitude of IGFs. To require its board of directors to approve the details of every IGF would be burdensome. The charity's board should be able to issue policy statements or a handbook governing generally applicable issues affecting IGFs, such as outreach to applicants, conduct of selection committee proceedings, how to set eligibility criteria, how to avoid bias, follow up and enforcement mechanisms, and the records to be kept. The board should also be allowed to delegate authority to a lower body or senior official to approve the specific criteria, calendar, and other details pertaining to each IGF. Board level approval, confirmation, or ratification for each grant should not be required. The board should be allowed to delegate that authority to a subordinate official or IGF selection committee, subject to the board's ultimate authority.

- **Secretarial Authority to Exempt Funds.**

- m. Background.**

In addition to the “exceptions” to donor advised fund treatment in section 4966(d)(2)(B) discussed immediately above in Sections 3 and 4, section 4966(d)(2)(C) gives the Treasury the authority to “exempt” two types of funds or accounts from treatment as donor advised funds. This exemption authority does not extend to a fund or account already described in one of the exceptions in section 4966(d)(2)(B).

Committee Advised Funds (“CAFs”). The first type of fund that the Treasury has authority to exempt from donor advised fund status is described in section 4966(d)(2)(C)(i) as a fund or account that “is advised by a committee not directly or indirectly controlled by the donor [or donor advisor] . . . (and any related parties).” The Joint Committee Report refers to these as “committee advised funds”³² and we will refer to them as CAFs.

Neither the statute nor the Joint Committee Report indicates any limit on CAFs as an alternative to donor advised funds so long as the donor is willing to accept a minority position on the committee that selects grant recipients. The Joint Committee Report refers expansively to this exemption authority as follows:

In general, under this authority, the Secretary may establish rules regarding committee advised funds generally that, if followed, would result in the fund not being treated as a donor advised fund. The Secretary also may establish rules excepting certain types of committee-advised funds, such as a fund established exclusively for disaster relief, from the donor advised fund definition.³³

The Joint Committee Report addresses the scope of indirect control by the donor or donor advisor in the following language, which is also quoted above in the discussion of IGFs:

³² Joint Committee Report at 345

³³ *Id.*

indirect control includes the ability to exercise effective control. For example, if a donor, a donor advisor, and an attorney hired by the donor to provide advice regarding the donor's contributions constitute three of the five members of such a committee, the committee would be treated as being controlled indirectly by the donor³⁴

The only statutory requirement for a CAF is that it not be controlled by the donor or donor advisor and their related parties. A CAF does not have the additional requirements imposed on IGFs under section 4966(d)(2)(B)(ii), such as the requirement that all members of an IGF committee be appointed by the charity and the requirement that the selection committee use only board-approved objective and nondiscriminatory selection criteria.

Single Purpose Funds (“SPFs”). Section 4966(d)(2)(C)(ii) gives the Treasury broad authority to exempt other funds or accounts that benefit “a single identified charitable purpose.” We will refer to these funds as “SPFs.” The Joint Committee Report adds nothing to the statutory language.

Notice 2006-109 on Disaster Relief. Recognizing that the prohibition in section 4966(c)(1)(A) against grants to natural persons would eliminate many programs at community foundations and other public charities that provide disaster relief to individuals, the Service in Notice 2006-109 invoked the Treasury's authority under section 4966(d)(2)(C) to exempt certain employer-sponsored disaster relief programs from the definition of donor advised fund. Notice 2006-109 draws upon IRS Publication 3833³⁵ in prescribing the requirements for the disaster relief exemption. Publication 3833 was issued in reaction to the events of September 11, 2001, and sets forth the Service's general views on disaster relief programs.

Notice 2006-109 does not specify whether it is relying on the CAF exemption authority or the SPF exemption authority to exempt employer-sponsored disaster relief funds. The Joint Committee Report anticipates that a CAF could provide disaster relief to natural persons.³⁶ The exemption for disaster relief funds in Notice 2006-109 may be consistent with CAF status because it involves an independent selection committee, but that requirement may also be derived from Publication 3833 rather than CAF status. The Notice also allows selections to be made using “adequate substitute procedures,” so perhaps the presence of a committee is not essential. The SPF exemption could also apply to providing disaster relief to natural persons so long as disaster relief is the fund's single identified charitable purpose. The distinction is that an SPF would not be required to have a selection committee; the donor or donor advisor alone could provide advice to the public charity.

³⁴ *Id.*

³⁵ *Disaster Relief: Providing Assistance through Charitable Organizations*, I.R.S. Pub. No. 3833, (“Publication 3833”).

³⁶ See Joint Committee Report at 345.

Notice 2006-109 exempts only employer-sponsored disaster relief programs from treatment as donor advised funds. It does not address other disaster relief programs outside the employment context.

Publication 3833 allows both employer-sponsored private foundations and employer-sponsored public charities to provide disaster relief to employees of the sponsoring employer if (1) the number of employees eligible for disaster relief is sufficiently large or indefinite to constitute a charitable class; (2) the recipients of relief are selected based on an objective determination of need; (3) the selection is made using either an independent selection committee (including one consisting of persons who are not in a position to exercise substantial influence over the affairs of the employer) or adequate substitute procedures to ensure that any benefit to the employer is incidental and tenuous; and (4) adequate documentation is kept.³⁷ Employer-sponsored private foundations are subject to an additional self-dealing limitation.³⁸ There is a key difference between the disaster relief programs that Publication 3833 allows to be conducted by employer-sponsored private foundations and employer-sponsored public charities. Publication 3833 allows employer-sponsored private foundations to provide relief only with respect to “qualified disasters” defined in section 139.³⁹ Publication 3833 allows employer-sponsored public charities to provide much broader disaster relief programs that may “respond to any disaster or employee emergency hardship situations.”⁴⁰ Notice 2006-109 exempts from the definition of donor advised fund only those disaster relief programs that Publication 3833 allows employer sponsored private foundations to conduct, not the broader disaster relief programs that Publication 3833 allows employer-sponsored public charities to conduct.

Publication 3833 provides guidelines for disaster relief programs that do not involve an employment relationship as well as the guidance for employer-sponsored programs.⁴¹ The Joint Committee Report includes a broad reference to disaster relief programs in its discussion of CAFs.⁴²

Individual Grants for Relief of Poverty. Private foundations are allowed to make grants to indigent individuals to relieve poverty without having to follow the special rules relating to grants for travel, study or other similar purposes.⁴³ Thus, under the private foundation rules poverty grants to individuals are subject to fewer restrictions than travel and study grants. On the face of section 4966, the reverse is true. Section 4966(d)(2)(B)(ii) provides an exception for travel and study grants corresponding to the private foundation rules, but the statute says nothing about poverty grants to individuals.

n. Recommendations.

³⁷ Publication 3833 at 15-19.

³⁸ *Id.* at 16.

³⁹ *Id.* at 15.

⁴⁰ *Id.* at 18.

⁴¹ Publication 3833 at 4-15, 20-23.

⁴² Joint Committee Report at 345.

⁴³ *E.g.*, Reg. § 53.4945-4(a)(3)(i).

- (i) We recommend that guidance implement the requirement that a donor cannot control a CAF directly or indirectly by requiring the CAF committee to operate as follows:
- The CAF committee should operate by majority vote; *i.e.*, the donor or donor advisor should not have veto power over decisions.
 - A majority of the appointments to the CAF committee should be made by the board of directors of the public charity or by exercise of a power delegated to a lower body or to a senior official of the organization, and the donor or donor advisor should be allowed to appoint a minority of the selection committee.
 - The donor should be allowed to recommend persons to be appointed to the CAF committee, but a member recommended by the donor will be considered a donor advisor in determining control of the committee unless the recommendation is based on “objective criteria related to the expertise of the member.”
 - In determining whether the donor or donor advisor has majority control of the committee, those family members and business associates within the defined group of “related” persons subject to taxes on prohibited benefits set forth in section 4967(d) and section 4958(f)(7) should be included with the donor and donor advisor.
 - To implement the example of indirect control cited in the Joint Committee Report, any person currently engaged by the donor or donor advisor, whether as an employee or independent contractor, in any professional or other fiduciary relationship with respect to the committee, should be counted with the donor, donor advisor, and those related to them in determining majority control.
- (ii) We recommend that guidance specify which exemption provision, CAF or SPF, is being relied upon to exempt disaster relief programs.
- (iii) We recommend that the exemption from the definition of donor advised fund for employer-sponsored disaster relief programs should have the broader scope allowed in Publication 3633 for public charity programs.

- (iv) We recommend that guidance allow exempt disaster relief programs outside the employment context based on Publication 3833.
- (v) We recommend that guidance take advantage of the broad exemption authority under section 4966(d)(2)(C)(ii) to allow a fund to make any type of grant to an individual that a private foundation can make if the fund is dedicated to making those grants as its single identified charitable purpose.
- (vi) We recommend that guidance exempt from the definition of donor advised fund any fund or account that benefits a commonly controlled group of organizations pursuing a common charitable purpose. For example, guidance could state that the SPF exemption includes those funds and accounts established to benefit a single set of entities that (a) have a common charitable purpose and (b) are subject to common control under some arrangement recognized as appropriate under a provision of federal tax law such as the rules on controlled organizations under section 512(b)(13), affiliated organizations under the lobbying rules of section 4911(f), or group exemptions.

o. Explanation.

(i) Defining Donor Control of a CAF.

The measures recommended above are reasonable steps to insure that a CAF operates in a manner that does not allow a donor or donor advisor to control the committee directly or indirectly. The Joint Committee Report references “an attorney hired by the donor to provide advice regarding the donor’s contributions . . . ”⁴⁴ as a person who must be attributed to the donor in determining control goes beyond normal rules that would treat employees or fellow employees as subordinate to the donor. However, the reference is limited to an attorney who is both currently employed by the donor and is providing advice with respect to the donor’s contributions to the fund. Hence, our recommendation is that only a person who is currently engaged in a professional or other fiduciary relationship with the donor should be attributed to the donor in determining control. This test requires that the person have some fiduciary relationship with the donor that involves the committee before that person would be considered to represent the donor. This test should avoid sweeping in persons whose contractual relationship to the donor has nothing to do with the committee, such as the president of a landscaping company that the donor employs or the president of the donor’s bank.

The CAF rules should be consistent with the IGF rules discussed above. These principles of committee control could be applied in that context as well. Moreover, the

⁴⁴ Joint Committee Report’s reference at 345.

explanation above in Section 4(b)(iii) concerning donor recommendations of IGF committee members could also be applied in the CAF context.

(ii) Identifying Applicable Exemption.

The Treasury's authority under the two exemption provisions of section 4966(d)(2)(C) is very broad. It would be helpful for practitioners to understand how the Treasury interprets this authority if each exemption is specifically tied to one or the other of the exemption provisions.

(iii) Allow Broader Employer-Sponsored Disaster Relief Programs.

By prescribing that employer-sponsored disaster relief programs must be based on those allowed for private foundations under Publication 3833, Notice 2006-109 limits the usefulness of these disaster relief programs because employer-sponsored private foundations can only provide assistance in the event of a qualified disaster described in section 139. Qualified disasters are limited to Presidentially declared disasters, disasters resulting from terroristic or military action, and disasters related to common carrier accidents or other accidents determined by the Secretary to be of a catastrophic nature. Section 139(c)(1), (2) and (3). Any fire, storm or other disaster affecting a single employee or a small group of employees at a particular location is not covered, and even a significant disaster involving many employees would likely not be eligible for relief unless the Secretary affirmatively determined that it was catastrophic.

If instead the model is the type of disaster relief programs that an employer-sponsored public charity can conduct under Publication 3833, the fund could provide relief for virtually any disaster or employee emergency hardship. Our recommendation that a fund be allowed to provide the broader relief allowed for employer-sponsored public charities is based on several points. First, sponsoring organizations are public charities and, absent some overriding consideration, would be eligible as such to conduct the broader type of disaster relief allowed for public charities under Publication 3833.

Second, an employer could often create its own separate public charity to conduct a disaster relief program by encouraging employees to contribute to the program. That separate public charity would be eligible to adopt the broader form of disaster relief program allowed under Publication 3833 without regard to section 4966, but establishing a new public charity and complying with all of the charitable solicitation and other regulatory requirements would be much more costly than having the disaster relief program operated by a community foundation or other sponsoring organization.

Third, any fear of abuse if the broader form of employer-sponsored disaster relief is allowed could be addressed by adding further conditions or requirements without disallowing the greater flexibility afforded employer-sponsored public charity disaster relief programs. For example, Notice 2006-109 already adapts the additional protections against self-dealing applicable to disaster relief programs of private foundations in Publication 3833 by requiring an exempted disaster relief program to prohibit relief payments to officers and directors of the sponsoring organization and members of the

selection committee. That additional protection against abuse could be retained even if the scope of the exemption for employer-sponsored disaster relief programs were broadened to the type allowed under Publication 3833 for public charities. Other conditions could be added to target potential abuses without denying the flexibility necessary for an effective employer-sponsored disaster relief program.

(iv) Other Disaster Relief Programs.

As noted above, Publication 3833 provides guidelines for disaster relief programs generally as well as employer-sponsored disaster relief programs. In addition, the Joint Committee Report contains a broad reference to disaster relief programs. Thus, there is no apparent reason not to use the Treasury's exemption authority to create a broad category of disaster relief programs that a fund can operate outside the employment context. The Treasury could create such an exemption under either the CAF provision, which would require a selection committee not controlled by the donor, or under the SPF provisions, which would not require a selection committee.

(v) Other Individual Grants for the Relief of Poverty, Etc.

Congress created an exception for travel and study grants under section 4966(d)(2)(B)(ii) that parallels the private foundation rules for such grants. There is no specific statutory exception for other types of individual grants. Under the private foundation rules other types of grants, such as grants to relieve poverty or for disaster relief, are subject to fewer restrictions than travel and study grants. One could expect, therefore, that the rules for sponsoring organizations and their funds would also allow such other types of grants on a less restrictive basis than travel and study grants.

The Service started the process of creating broader exemptions for other types of grants when it created the targeted exemption for employer-sponsored disaster relief programs in Notice 2006-109. Treasury should complete the process by using its broad authority to create exemptions from the donor advised fund rules for grants to individuals to relieve poverty and other charitable purposes. Such an exemption should be at least as broad as the private foundation rules, so that any grant that would not be a taxable expenditure under section 4945(d) and the Regulations thereunder should be permitted under the exemption from the donor advised fund rules.

(vi) Commonly-Controlled Organizations.

On its face the SEBF exception discussed above applies only to a fund benefiting a single organization or government entity. Those charitable enterprises that are organized into multiple entities for limited liability or other good reasons could qualify only if each entity had its own SEBF, which would be burdensome. Examples include a religious denomination, a national charity with chapters under a group exemption, a hospital or health system organized into various commonly controlled entities, and an affiliated university structure. Exempting a fund or account that benefits only an affiliated group under common control and serving a common purpose as recommended

above is consistent with the SEBF exception, would simplify administration of such funds, and should not lend itself to abuse.

- **Scope of Taxable Distributions under 4966.**

- p. Background.**

Section 4966 imposes its excise taxes on a “taxable distribution” by a donor advised fund. The incidence of the excise taxes falls on the sponsoring organization of the donor advised fund that makes the taxable distribution and on any fund manager who knowingly agrees to the taxable distribution. The term “taxable distribution” is defined in section 4966(c) to mean any distribution (i) to any natural person or (ii) to any other person if (a) the distribution is for a purpose other than a tax-exempt purpose described in section 170(c)(2)(B) or (b) the sponsoring organization does not exercise expenditure responsibility in accordance with section 4945(h). Section 4966(c)(2) excepts from the definition of “taxable distribution” any distribution (i) to any organization described in section 170(b)(1)(A) other than disqualified SOs, (ii) to the sponsoring organization, or (iii) to any other donor advised fund.

Defining the word “distribution” is critical in determining the scope of a “taxable distribution” subject to section 4966. If “distribution” encompasses only grants or awards, then the scope of section 4966 is limited to a donor advised fund’s grantmaking activities. If instead “distribution” is more broadly defined to include payments to vendors for goods or services, then a donor advised fund cannot engage in any direct charitable activity without following the expenditure responsibility rules for virtually every payment it makes, unless the vendor is a tax-exempt organization described in section 4966(c)(2).

- q. Recommendation.**

The term “distribution” in section 4966 should have the same meaning as “grant” for purposes of section 4945(h), and should not include payments to vendors for goods or services.

- r. Explanation.**

The best guide to the meaning of “distribution” for this purpose is the incorporation into section 4966(c)(1)(B)(ii) of the expenditure responsibility rules of section 4945(h). Because the expenditure responsibility rules are thus an integral part of the application of section 4966, the two provisions should be interpreted consistently.

Section 4945(h) applies only to grants.⁴⁵ The Regulations under section 4945(h) state specifically that the definition of “grant” for purposes of the expenditure

⁴⁵ *E.g.*, Reg. § 53.4945-5(b)

responsibility rules excludes employee compensation and other payments for personal services.⁴⁶

In describing the expenditure responsibility rules under section 4966, the Joint Committee Report repeats the language of section 4945(h) except for substituting the word “distribution” for the word “grant.” The Joint Committee thus uses the terms interchangeably. This lends further support to treating distributions as having the same meaning as grants for purposes of section 4966, especially in the absence of any support in the Joint Committee Report or other commentary for a broader interpretation.

The word “distribution” is also used in applying the excise taxes on more-than-incidental benefits under section 4967. Two references in the Joint Committee Report support treating “distribution” as meaning “grant” for purposes of section 4967. First, the Joint Committee Report uses a reference to the deductibility of a charitable contribution in describing “incidental benefit.”⁴⁷ Second, the Joint Committee Report goes on to describe incidental benefit by reference to a contribution to the Girl Scouts of America.⁴⁸ The use of charitable contribution illustrations and terminology in the Joint Committee Report is consistent with treating a “distribution” under section 4967 as having the same meaning as “grant.” Consistency in the administration of sections 4966 and 4967 also supports interpreting the common term “distribution” as having the same meaning of “grant” in both sections.

- **Adapting the Section 4945 Expenditure Responsibility Rules to Section 4966.**

- s. **Background.**

Section 4966(c)(1) requires a donor advised fund to exercise expenditure responsibility within the meaning of section 4945(h) of the private foundation rules for distributions to all organizations except:

- public charities described in section 170(b)(1)(A)(i) through (vi),
- public charities described in section 509(a)(2) and (a)(3) other than disqualified SOs (defined in section 4966(d)(4)), and
- private foundations described in section 170(b)(1)(F) (private operating, pass-through, and common fund foundations).

Section 4945(h) states that expenditure responsibility “means that the private foundation is responsible to exert all reasonable efforts and to establish adequate procedures (1) to see that the grant is spent solely for the purpose for which made, (2) to obtain full and complete reports from the grantee on how the funds are spent, and (3) to make full and detailed reports with respect to such expenditures to the Secretary.” The

⁴⁶ Reg. § 53.4945-4(a)(2).

⁴⁷ Joint Committee Report at 350.

⁴⁸ *Id.*

Joint Committee Report repeats this language, substituting the word “distribution” for the word “grant.”

The expenditure responsibility rules of section 4945(h) are interpreted in Regulation § 53.4945-5. Some, but not all of the detailed Regulations under section 4945(h) can be adapted and used in interpreting and applying the taxable distribution rules of section 4966.

t. Recommendations and Explanation.

- (i) We recommend that those private foundation expenditure responsibility rules that pertain to the process of supervising and reporting distributions be applied largely without change to section 4966, but those rules reflecting matters that are peculiar to private foundations, such as permissible grantees and permissible uses of funds, not be used for guidance under section 4966. The following material surveys the relevant paragraphs of Regulation § 53.4945-5 and recommends which of them should and should not apply under section 4966(c)(1)(B)(ii).

(a) Grants to nonpublic organizations, paragraphs (1) through (4). SHOULD NOT APPLY. These provisions define the expenditure responsibility grantee class as those not within section 509(a)(1), (2), and (3), which includes disqualified SOs and does not include the types of private foundations listed in section 170(b)(1)(F). This differs from the expenditure responsibility grantee class for donor advised funds. Many of the clauses found in Regulation § 53.4945-5 contain differential treatment for private foundation grantees that would be difficult to translate to the context of donor advised funds.

(a)(5) Certain foreign organizations. SHOULD APPLY, with some modification. This is the one paragraph from the Regulations at § 53.4945-5 cited in the Joint Committee Report to support the principle that a donor advised fund may make grants, without expenditure responsibility, to foreign public charity equivalents.⁴⁹ However, the scope of grantees for which an equivalency determination can be made should be adjusted to include, for instance, foreign equivalents of private operating foundations eligible to receive donor advised fund grants without expenditure responsibility.

(a)(6) Certain earmarked grants. SHOULD APPLY. The general rule for earmarked grants determines when the grantor must look through a grantee to a secondary grantee and exercise expenditure responsibility on the secondary grant. This same rule is suitable for donor advised funds.

(b) Expenditure responsibility. (1) In general. SHOULD APPLY. This paragraph states general principles that can apply as well to donor advised funds.

⁴⁹ *Id.* at 349 note 526.

(b)(2) Pre-grant inquiry. SHOULD APPLY. This states useful guidance for evaluating potential grantees, including the examples. The adaptation to donor advised funds should require the sponsoring organization to consolidate its records regarding expenditure responsibility grantee history for all donor advised funds, because a grantee's failure to file proper reports on a previous grant from one donor advised fund should be noted in the pre-grant inquiry performed for a grant from another donor advised fund.

(b)(3) Terms of grants. SHOULD APPLY, except subparagraphs *(iv)(a)*, *(b)*, and *(c)*. This paragraph requires a written commitment signed by the grantee, agreeing to repay any portion of the grant not used for proper purposes, to submit annual reports, and to maintain books and records available to the grantor. Subparagraphs *(iv)(a)*, *(b)*, and *(c)* flow not from the expenditure responsibility process requirement of section 4945(h), but from substantive prohibitions on the use of grant funds that appear elsewhere, in section 4945(d).

Subparagraph *(iv)(a)* refers to attempts to influence legislation, which are taxable expenditures for a private foundation under section 4945(d)(1) but are permitted, within the limits of the section 501(c)(3) "insubstantial part" test or the section 501(h) test, for a public charity that sponsors donor advised funds. There is nothing in the legislative history to suggest that section 4966 was intended to penalize lobbying expenditures made by public charities from donor advised funds. Guidance should clarify this point, because many public charities are presently refraining, due to uncertainty about the application of section 4966(c)(1)(B)(ii), from making donor advised fund grants to organizations described in section 501(c)(4) and other groups for lobbying programs that they are legally entitled to conduct and support.

Subparagraph *(iv)(b)* states the section 501(c)(3) prohibition on election campaign intervention, but goes further and prohibits expenditures for voter registration drives as defined under section 4945(d)(2), which allows voter registration drives only if they are conducted in five or more states and meet other requirements stated in section 4945(f). Public charities, including their donor advised funds, may conduct any kind of local or multi-state nonpartisan voter registration drives, so the section 4945(d)(2) limitation is inappropriate for donor advised funds and sponsoring organizations. Again, nothing in the legislative history indicates that section 4966 was intended to prevent donor advised funds from supporting voter registration.

Subparagraph *(iv)(c)* prevents the grantee from making sub-grants that do not comply with section 4945(d)(3) (to individuals for travel, study, or other similar purposes) or (4) (to non-public charities without expenditure responsibility). This is another feature of grantmaking unique to the private foundation regime. There is nothing in the legislative history suggesting that the restrictions of section 4966(c)(1) were intended to apply at the secondary or sub-grant level, to organizations receiving grants from donor advised funds. The limitations on grants from donor advised funds to natural persons are even more restrictive than the section 4945(d) rules for private foundations, so that extending those limitations to the sub-grant level for donor advised funds would be even more burdensome. And, as noted before, the grantee class subject to expenditure responsibility under section 4945(d)(4) differs markedly from the class defined in section 4966(c)(1).

Subparagraph *(iv)(d)* prohibits use of grant funds for any purpose outside section 170(c)(2)(B), which is congruent with the section 4966(c)(1)(B)(i) requirement, and is appropriate for donor advised funds.

(b)(4) Terms of program-related investments. SHOULD APPLY IN PART. Although program-related investments are within the definition of grants to which the term “distributions” under section 4966 would refer, some of the detail of this paragraph flows from the specific private foundation requirements of sections 4944 and 4945(d) and should not be extended to guidance under section 4966. Public charities making donor advised fund grants for program-related investments should otherwise be subject to the procedural requirements for expenditure responsibility applicable to other types of grants.

(b)(5), (6), (7), and (8). SHOULD NOT APPLY. These provisions are pertinent to private foundation grants. They are derived from section 4945(d) and other detailed requirements that are not appropriate in the donor advised fund context.

(c) Reports from grantees. (1) In general. SHOULD APPLY. The general rules for annual financial, compliance, and progress reports from grantees are well-known and would provide good guidance for donor advised funds and their grantees.

(c)(2) Capital or Endowment Grants. SHOULD APPLY. The principle that capital or endowment grants to private foundations can be made should be carried over to donor advised funds, including the authority to limit reporting to the year of the grant and two succeeding years.

(c)(3) Grantee’s accounting and recordkeeping. SHOULD NOT APPLY. These complex rules seem closely tied to private foundation status and issues and need not be carried over to donor advised funds.

(c)(4) Reliance on information supplied by grantee. SHOULD APPLY. Like a private foundation, a sponsoring organization should be able to rely upon records and other evidence supplied by the grantee.

(d) Reporting to Internal Revenue Service by grantor. SHOULD APPLY. These reporting rules can readily be carried over to donor advised funds. So far the instructions to the new Form 990 and Schedule A for sponsoring organizations with donor advised funds do not inform filers about the reports required for donor advised fund grants made with expenditure responsibility. At the very least, the following instruction for Line 25 on the Form 990-PF should be used with Form 990:

Organizations sponsoring donor advised funds may include, as a single entry on the schedule, the total of amounts paid as grants for which the organization exercised expenditure responsibility. Attach a separate report for each grant.

(e) Violations. SHOULD APPLY. The enforcement provisions, although they are lengthy, should work reasonably well for donor advised fund grants.

- **Treatment of Grants to Foreign Organizations.**

- u. **Background.**

Although most foreign charities do not have a determination letter from the Service recognizing their tax-exempt status, a donor advised fund can make grants to them if it exercises expenditure responsibility under section 4966(c)(1)(B)(ii). The Joint Committee Report states that an alternative approach that is available to private foundations for making grants to foreign organizations will also be available to donor advised funds, which is the so-called equivalency determination made pursuant to Regulation § 53.4945-5(a)(5).⁵⁰

- v. **Recommendation.**

We recommend that guidance expressly provide that donor advised funds can make grants to foreign organizations based on equivalency determinations on the same basis as private foundations.

- w. **Explanation.**

Donor advised funds should not be treated more harshly than private foundations without a specific statutory provision directing such treatment. Because private foundations are allowed to rely on equivalency determinations, donor advised funds should also be allowed to rely on them. The Joint Committee Report expressly acknowledges this in the footnote cited above.

- **Prohibited Benefits under Code Section 4967.**

- x. **Background.**

Meaning of Permissible “Incidental Benefit.” Section 4967(a)(1) imposes an excise tax if a donor or donor advisor of a donor advised fund or a person related to the donor or donor advisor (as described in sections 4967(d) and 4958(f)(7)) advises the making of a distribution that results in any such person receiving, directly or indirectly, a “more than incidental benefit.” The excise tax is imposed on the person or persons who advise as to the distribution and on the person or persons who receive the benefit. In addition, section 4967(a)(2) imposes a separate excise tax on a fund manager who agreed to making the distribution, knowing that the distribution would result in a more than incidental benefit. By negative implication, an “incidental benefit” is permissible.

Reference to Charitable Income Tax Deduction Rule. The Joint Committee Report states that there is a more than incidental benefit if, as a result of a distribution from a donor advised fund, a donor, donor advisor, or related person receives a benefit that would have reduced (or eliminated) a charitable contribution deduction if the benefit

⁵⁰ Joint Committee Report at 349 note 526.

was received as part of the contribution to the sponsoring organization.⁵¹ The Joint Committee Report provides the following example:

If, for example, a donor advises that a distribution from the donor's donor advised fund be made to the Girl Scouts of America, and the donor's daughter is a member of a local unit of the Girl Scouts of America, the indirect benefit the donor receives as a result of such contribution is considered incidental under the provision, as it generally would not have reduced or eliminated the donor's deduction if it had been received as part of a contribution by donor to the sponsoring organization.⁵²

Bifurcated Payments. The "more than incidental benefit" language of section 4967 also raises the issue of "bifurcation": whether it is a "more than incidental benefit" for a donor, donor advisor or related party of either to split the purchase of a ticket to a fundraising event or purchase of a membership in a public charity with a donor advised fund. In this situation, the fund would pay the portion of the ticket or membership cost that would be deductible under section 170, and the donor, donor advisor or related party would pay the portion that would be non-deductible under section 170.

One view, supported by the Joint Committee Report's explicit reference to the charitable deduction rules, is that the donor advised fund's payment of the deductible portion alone of the ticket or membership cost does not result in the donor receiving any benefit. That is, the donor advised fund's payment of the deductible portion of the ticket or membership cost leaves the donor in the exact same position she would have been in had she paid the full cost of the ticket herself. As an example, assume that the cost of a ticket to a fundraising event is \$500, with the non-deductible portion of the dinner valued at \$100, and the deductible portion the remaining \$400. If the donor pays the full \$500 cost of the ticket herself, she would claim a charitable contribution deduction of \$400 – the \$500 cost of the ticket minus the \$100 value of the dinner received. Under one view there would not be a more than incidental benefit because the donor would claim the same \$400 deduction for a gift to the donor advised fund. She would advise a gift of \$400, representing the deductible gift portion of the payment, and she would separately pay \$100 to cover the value of the dinner, which would not be deductible by her. Under this view, the distribution from the donor advised fund is for the fully deductible portion of the ticket price, and if the donor had made that payment alone, the deduction for the \$400 payment would not be reduced.

The alternative view is that bifurcation results in a "more than incidental" benefit because, but for the \$400 distribution from the donor advised fund, the donor, donor advisor or related party would not have received the benefits that the ticket or membership provides. This was the theory espoused in the one piece of guidance the Service has issued on this topic.⁵³ That guidance, however, was issued in the company

⁵¹ Joint Committee Report at 350.

⁵² *Id.*

⁵³ See PLR 9021066 (March 1, 1990).

foundation context where the self-dealing rules, which do not apply to donor advised funds, were applied. There, the Service found that the foundation's proposal to pay the deductible portion of a ticket to a fundraising event while the company paid the non-deductible portion would result in self-dealing under section 4941. The reasoning behind the position appears to be that the company, a disqualified person as to the foundation, would not have been in a position to pay only the nondeductible portion of the cost of the ticket to the event unless the foundation had paid the deductible portion. The foundation's payment, therefore, freed the disqualified person from a financial obligation that it would otherwise incur, resulting in a benefit to the disqualified person. This position, however, is understood to apply because of the relationship between the company and its foundation. In other contexts – family foundations and donor advised funds – the sector is uncertain what to do.

Grant to Organization that Employs or Contracts with Donor or Related Party. Concern can arise about incidental benefit where a donor advised fund makes a distribution to a charity that employs or contracts with the donor or a family member.

Reliance on Certificate Provided by Donor. Recognizing the risk faced by private foundations, donor advised funds and other grantors in determining the “type” of supporting organization to which they propose to distribute funds, Notice 2006-109 allows a grantor, acting in good faith, to rely on a certificate of a grantee as to its “type.” Similar risks are presented where fund managers of donor advised funds make distributions to perfectly reputable grantee charities. This risk could be managed if fund managers are allowed to rely on a certificate from the donor or donor advisor that no benefits other than those incidental benefits disclosed on the certificate will be provided to the donor, donor advisor or related parties by reason of a recommended grant.

y. Recommendations.

- (i) We recommend that guidance elaborate on the example quoted above from the Joint Committee Report to indicate the nature of the incidental benefit the donor might receive. For example, as a result of the donor advised gift, the local Girl Scout unit in the Joint Committee Report example may be able to charge participating families lower dues, reduce what families pay for patches, pins, activities, or reimburse unit leaders for their out-of-pocket costs. As one of the parents, the donor may thereby benefit indirectly from the advised gift. However, if she had made the same gift to the local unit personally, the benefits she may receive as a parent of a member of the youth group would not reduce her deduction and guidance should confirm that these benefits do not constitute a more than incidental benefit for purposes of section 4967. In addition, an example should be provided with an incidental benefit of tangible personal property or membership services that are disregarded as incidental. We recommend an example like the following:

Example: A, a donor advisor, recommends a distribution of \$1,000 from the fund he advises to the school that his daughter attends. In return for the fund's distribution, the school provides A with the school's donor advised fund incidental benefits package, which includes a hat bearing the school's logo and a monthly calendar of events. Under the reasoning set forth in the Joint Committee Report, A's receipt of the hat and the events calendar will not be considered a "more than incidental benefit" since, if A had contributed the \$1,000 to the school directly and received the hat and calendar in return, the value of the hat and calendar would not have reduced his charitable contribution deduction below \$1,000.

We further recommend that an example be provided to clarify that a more than incidental benefit will not result in the "pay as you go" context where, for example, a donor advisor who receives no more than an incidental "DAF membership" benefits in recognition of a gift from his donor advised fund to a public charity then pays personally for an event which he was invited to attend based on his status as a member of that charity. We recommend an example like the following:

Example: B, an individual, advises a gift from B's donor advised fund to an art museum (the "Museum"). The Museum gives B a "DAF membership" which carries no more than incidental benefits such as a recognition of the advised gift in the Museum's Annual Report to Donors, a monthly calendar of events, and a key chain with the Museum's logo, all of which benefits would have been disregarded in computing B's deduction had B made the contribution personally. Three months later, the Museum invites B to buy a ticket to a "Members Lunch with the Director" event at a cost of \$100, \$60 of which is tax deductible because \$40 represents the fair market value of the lunch. B pays the full \$100 personally and attends the lunch. B has not received a more than incidental benefit from the DAF membership fee paid by his DAF even if B is later invited to member events for which B has and exercises the option to pay personally for the full cost of the admission ticket and attends the event.

- (ii) We recommend that guidance clarify one way or the other whether bifurcation by a donor advised fund results in a "more than incidental benefit" under section 4967.
- (iii) We recommend that guidance confirm that a distribution from a donor advised fund to an organization that employs or contracts with a donor, donor advisor or a related party of either will not

result in a “more than incidental benefit.” We recommend the following example:

Example: C, a donor, recommends a distribution from her donor advised fund to the museum at which her spouse is employed as a curator. The distribution is for the museum’s general purposes, and the title and compensation of C’s spouse will not be affected by the distribution. The benefit to C’s spouse of this distribution is indirect and tenuous and does not result in a more than an incidental benefit.

- (iv) We recommend that guidance provide that a fund manager who relies in good faith on a certificate of the donor or donor advisor who recommends a distribution from a donor advised fund that the distribution will not result in a more than incidental benefit is not subject to excise tax under section 4967. We recommend the following example:

Example: D is a donor advisor. D provides the following certificate as to D’s grant advice: “I certify that, if the suggested grant is made, no goods or services will, as a result, be provided to or accepted by me, a member of my family, an entity we control, or any other person associated with the [NAME OF DONOR ADVISED FUND] [, other than goods or services resulting in a no more than incidental benefit to any of us]. I acknowledge that the suggested grant must receive the approval of [NAME OF DONOR ADVISED FUND].”

Guidance should also confirm that the absence of such a certificate does not create a presumption that the fund manager made the distribution “knowing” that it would result in a prohibited benefit.

z. Explanation.

(i) Application of Charitable Income Tax Rule.

An example should be provided that elaborates on the Joint Committee Report’s citation to the token benefit rules for charitable contributions, which permit a donor to receive tangible personal property, such as a logo-bearing coffee mug, as a token benefit in return for a charitable contribution without the benefit reducing the deductible amount of the contribution.⁵⁴ The example should confirm that for purposes of section 4967, a distribution from a donor advised fund will result in a “more than incidental benefit” only if the benefit is one that, if received in return for a charitable contribution to the sponsoring organization, would reduce the donor’s deduction.

⁵⁴ Joint Committee Report at 350 note 528.

It is important that the Joint Committee Report's reference to the charitable income tax deduction rules be adequately illustrated by examples. Otherwise, section 4967 might unintentionally discourage distributions to valuable organizations, such as the school or the museum, whose practices are to provide incidental benefits, like a hat and a calendar or a key chain and recognition in the annual report, in return for charitable contributions. In the alternative, if the Treasury intends there to be no benefit at all, that point must be made clear for practitioners, sponsoring organizations and public charities alike.

(ii) Bifurcated Payments.

We are not recommending whether bifurcated payments should or should not be treated as providing a more than incidental benefit to a donor or donor advisor. We ask only that guidance make the position of the Treasury and the Service clear. Given the uncertainty and differing practices of practitioners and charities in this area, there is a compelling need for this guidance.

(iii) Grants to Organizations that Employ or Contract with Donor.

The Regulations on indirect self-dealing by private foundations provide helpful guidance on situations where a grant is made to a grantee organization that has an employment or contractual relationship with the donor or related party.⁵⁵ Those Regulations permit such grants so long as the private foundation does not earmark the grant for an impermissible purpose or, by reason of section 4941(d)(2), could itself engage in the employment or contractual relationship. Section 4941(d)(2)(E), in turn, permits a private foundation to pay to a disqualified person, except a government official, reasonable compensation for personal services.⁵⁶ If grants like this were not allowed, section 4967 would discourage distributions to valuable organizations that employ or contract with related persons of donors or donor advisors. The argument in the recommended example is even stronger if C's spouse is not an employee of the museum, but the owner or an officer of a catering company that contracts to provide the refreshments for the museum's educational lecture series. Here, any benefit to C's spouse is even more indirect and attenuated.

(iv) Fund Managers' Reliance on Certification of Donor or Advisor.

It is entirely appropriate in the SO context to allow a grantee to the SO to rely on the type of certificate authorized by Notice 2006-109 because the SO is in the best position to identify its "type." It is equally important to issue guidance confirming that a fund manager of a sponsoring organization may rely on a certificate from a donor or donor advisor to avoid the section 4967 excise tax. Allowing a fund manager to rely on

⁵⁵ Reg. § 53.4941(d)-1(b)(2), (7), (8) Example (3).

⁵⁶ See Reg. § 53.4941(d)-3(c)(1); 53.4941(d)-1(b)(7). See also Reg. § 53.4941(d)-2(f)(2) (clarifying that a grant from a private foundation to a grantee organization will not be an act of self-dealing merely because the grant results in a disqualified person receiving an incidental or tenuous benefit, such as when one of the grantee's officers, directors or trustees is also a manager of or a substantial contributor to the foundation).

such a certificate will encourage responsible management of, and distribution from, donor advised funds by providing some degree of comfort to fund managers acting in good faith that their approval of distributions will not, absent actual knowledge that the distribution will result in a prohibited benefit, subject them to excise tax under section 4967(a)(2). It is appropriate that the donor or donor advisor who advises the distribution give the certificate as he or she is in the best position to know whether he, she or any related party will receive goods or services from an organization to which a distribution is made. Requiring donors and donor advisors to sign such a certificate also has the benefit of reminding and educating them about the issues involved. Because in our recommended example the fund manager has received D's certificate, the fund manager, absent actual knowledge that the certificate is false, should not be subject to the section 4967(a)(2) excise tax with respect to the distribution covered by the certificate.

On the other hand, a fund manager's decision not to take the extra precautionary step of requesting such a certificate should not create a presumption that the fund manager approved a distribution knowing that it would give rise to a more than incidental benefit.

B. Provisions Affecting Supporting Organizations

1. Sections 509(f)(2) and 4943(f)(3)(B): Contributions From Persons Who Control a Supported Organization.

a. Background.

Section 509(f)(2) provides that if a Type I or Type III SO accepts any gift or contribution from a person (other than a public charity, not including an SO) who (1) controls, directly or indirectly, either alone or together (with persons described below), the governing body of a supported organization of the SO; (2) is a member of the family of such a person; or (3) is a thirty five percent controlled entity, then the SO is treated as a private foundation for all purposes until such time as the organization can demonstrate to the satisfaction of the Secretary that it qualifies as a public charity other than as an SO. The person making the contribution to the SO need not be a substantial contributor to the SO or have any other relationship with the SO in order for the prohibition to apply.

Section 4943(f)(3)(B) provides a parallel rule for Type II SOs, but with a different penalty: a Type II SO that accepts such a gift or contribution becomes subject to the excess business holdings rules of section 4943.

The Joint Committee Report does not address the policy underlying these new provisions. A footnote in the discussion of section 4943(f)(3)(B) discusses the meaning of "indirect control," however:

For purposes of the provision, it is intended that indirect control includes the ability to exercise effective control. For example, if a person made a gift to a supporting organization and a combination of such person, a person related to such person, and such person's personal attorney were members of the

five-member board of a supported organization of the supporting organization, the organization would be treated as indirectly controlled by such person. Board membership alone does not establish direct or indirect control.⁵⁷

b. Recommendations.

(i) We recommend that guidance clarify that the following two factors do not, either by themselves or in combination with each other, without the presence of additional factors tending to indicate control, cause a person to “control” a supported organization for purposes of section 509(f)(2) or section 4943(f)(3)(B):

- Right to advise the supported organization concerning grantmaking, *e.g.*, as an advisor to a donor advised fund held by the supported organization.
- Service on the governing body of the supported organization where there are at least three members of the body. We recommend the following example:

Example: X is an organization described in section 501(c)(3) and is a Type III supporting organization described in section 4943(f)(5). Its purpose is to hold and invest an endowment fund for the benefit of Y, an organization described in sections 501(c)(3), 509(a)(1) and 170(b)(1)(A)(vi). Y has a governing body consisting of three directors, none of whom is related to the others. No director has veto power over decisions with respect to Y. A is a director of Y. A makes a contribution to X. Y will not be considered controlled directly or indirectly by A solely by reason of the fact that A is a director of Y. A’s contribution to X will not cause X to be treated as a private foundation.

(ii) We recommend that guidance address the types of relationships that will give rise to “indirect control,” such as the donor’s attorney-client relationship with another board member of the supported organization in the Joint Committee Report’s example. We suggest a rule under which any person currently engaged by the disqualified person, whether as an employee or independent contractor, in any professional or fiduciary relationship related to the SO’s work, would be treated as a person through whom a disqualified person can exercise indirect control over an SO. (This parallels our recommendation concerning control of an “Individual Grant Fund” committee in the donor advised fund context above at Section A.4.b.(iv) of these Comments.)

⁵⁷ Joint Committee Report at 361 note 573.

- (iii) We recommend that guidance provide that an SO that performs the following due diligence will qualify for a safe harbor from the application of sections 509(f)(2) and 4943(f)(3)(B):
- The SO identifies the members of the governing board of all relevant supported organizations through information either received directly from the supported organization(s) or information readily available to the public, such as IRS Forms 990 and filings with state regulators; and
 - The SO relies in good faith on an affidavit of the supported organization either certifying that no person controls it, directly or indirectly, or in combination with others, or identifying any controlling persons; or
 - The SO relies in good faith on an affidavit of the donor that the donor does not control a supported organization of the SO, directly or indirectly, or in combination with others.
- (iv) We further recommend that guidance provide that an SO is permitted to return, without loss of SO status or application of the rules under section 4943, a contribution from a person who is deemed to control a supported organization, if such contribution is received inadvertently, where the return is made within a reasonable period of time following the discovery of the donor's status.
- (v) Finally, we suggest that in the case of SOs whose organizing documents name more than a specific number of potential supported organizations (*e.g.*, five), and in the case of Type I SOs that identify supported organizations by class, only donations from persons who control the particular supported organization(s) with respect to which the SO meets the relationship test under section 509(a)(3)(A) should be counted in applying sections 509(f)(2) and 4943(f)(3)(B).

c. Explanation.

(i) Rights to Advise and Service on Board.

Control is a central concept in determining whether an organization qualifies under section 509(a)(3). Section 509(a)(3)(C) prohibits direct or indirect control of any SO by any disqualified person, within the definition of section 4946. Regulation § 1.509(a)-4(j)(1) provides that an SO will be considered controlled for purposes of section 509(a)(3)(C) “if the disqualified persons, by aggregating their votes or positions of authority, may require such organization to perform any act which significantly affects its operations or may prevent such organization from performing such act.”

The new provisions at sections 509(f)(2) and 4943(f)(3)(B) do not define “control” of the supported organization. It seems likely that existing analysis under section 509(a)(3)(C) concerning control of the SO will inform the determination of what constitutes control of the supported organization under the new provisions.

The definition of control under section 509(a)(3)(C) is itself uncertain, however, and our anecdotal experience with recent IRS administrative practice suggests that agents are applying an inappropriately broad interpretation of “indirect control” under section 509(a)(3)(C) in the determinations process. For example, agents have asserted that a disqualified person’s provision of grant recommendations to an SO constitutes “control,” even though grantmaking decisions rest with a properly configured board. Agents have even suggested that the board’s approval of a disqualified person’s recommendations is “proof” of such control. The fourth sentence of Regulation § 1.509(a)-4(j)(1) indicates that “control” includes a donor’s *right to designate* the recipients of grants from the SO. Our understanding of this provision – and our experience historically with IRS interpretation of this provision – is that it prohibits only mandatory designation rights, and not the mere privilege of making recommendations similar to those permitted in the context of donor-advised funds. To prohibit non-binding recommendations from a disqualified person who is a board member would prevent a donor/board member from participating equally with other board members. This seems clearly contrary to the Regulations, which allow minority board participation by disqualified persons.⁵⁸

We submit that a disqualified person’s service as a member of the governing board of an organization, or a disqualified person’s right to make recommendations for appropriate actions by the organization, do not by themselves or in combination with each other constitute control for purposes of section 509(a)(3)(C). Similarly, such rights should not by themselves or in combination with each other be treated as constituting control for purposes of determining control of a supported organization under sections 509(f)(2) and 4943(f)(3)(B).

(ii) Relationships that Give Rise to Indirect Control.

The Joint Committee Report indicates at 361 note 573 that “indirect control” under the new provisions includes a situation in which a donor, a related person to the donor and the donor’s attorney comprise a majority of a supported organization’s board. This is arguably consistent with the analysis in Rev. Rul. 80-207, 1980-2 C.B. 193, in which the IRS ruled that an organization with a board of four persons, of which one member was a substantial contributor and two were employees of a corporation of which more than thirty five percent of the voting stock was owned by the substantial contributor, failed the control test under section 509(a)(3)(C).

⁵⁸ See Reg. § 1.509(a)-4(j)(1), which provides (sixth sentence) that if the governing body of an organization “is composed of five trustees, none of whom has a veto power over the actions of the foundation, and no more than two trustees are at any time disqualified persons, such foundation will not be considered to be controlled directly or indirectly by one or more disqualified persons by reason of this fact alone.”

It is unclear how broadly this analysis should be applied, however. For example, if the board member in the Joint Committee Report's example were the donor's accountant, or investment advisor, or physician, would the result be the same? What if the board member is an accountant or attorney in the same firm as the donor's accountant or attorney, but the board member has no personal relationship with the donor? It would be helpful to have specific guidance, as recommended above, on what relationships will be deemed to give rise to indirect control, both under section 509(a)(3)(C) and under sections 509(f)(2) and 4943(f)(3)(B). Consistent with our comments in the donor advised fund context above at Section A.4.c.(iv) of these Comments, we suggest that the scope of relationships (beyond the employee relationship described in Rev. Rul. 80-207) be limited to persons who have a current relationship with the donor, and whose relationship involves fiduciary responsibilities to the donor relating to the SO.

(iii) Due Diligence to Avoid Application of Sections 509(f)(2) and 4943(f)(3)(B).

“Any contribution” from a person who controls a supported organization will disqualify an organization as a Type I or Type III SO, or cause a Type II SO to become subject to the excess business holdings rules, under new sections 509(f)(2) and 4943(f)(3)(B) (emphasis added). An SO must accordingly screen all donors or face potentially severe consequences.

It is unclear from the legislative history to these provisions what perceived abuse Congress was seeking to address, or why the penalties for accepting a prohibited contribution should be so different for Type I and III SOs as compared with Type II SOs. Given the confusion surrounding the new provisions and the potentially significant consequences of failure to comply with them, it would be very helpful for SOs to have a clear roadmap of the steps that they must take in order to avoid running afoul of the new provisions.

The challenge for an SO is in knowing whether a donor has a control relationship with a supported organization of the SO. We suggest that SOs should be allowed to demonstrate compliance with sections 509(f)(2) and 4943(f)(3)(B) through taking reasonable steps in good faith to identify persons who control supported organizations, and declining all gifts from such identified persons. In particular, an SO should be permitted to rely in good faith upon information received from its supported organizations, or information readily available to the public for purposes of identifying the governing body of the relevant supported organization(s). Such information includes IRS Form 990, including Forms 990 obtained from reliable third party sources such as GuideStar, and reports filed with state regulators.

If, after identifying the governing board, the SO obtains an affidavit from each relevant supported organization stating either that no person controls it directly or indirectly or in combination with others, or identifying any person who controls it directly or indirectly; or an affidavit of the donor stating that the donor does not control any supported organization of the SO directly or indirectly or in combination with others, we submit that this should constitute sufficient due diligence in identifying control

persons to create a safe harbor from application of sections 509(f)(2) and 4943(f)(3)(B). It would be impractical and, we suggest, an inappropriate diversion of the SO's resources for it to be required to perform further due diligence, such as investigating independently whether any board member of a supported organization serves as legal counsel for any other board member.

(iv) Ability to Return Donations.

Given the ambiguity of the definition of "control" and the likely informational challenges in identifying persons who control supported organizations, SOs should have some reasonable opportunity to return donations, without penalty, if received inadvertently, from a person who controls a supported organization, provided the return is made within a reasonable time from discovery of the donor's status.

(v) Application of Control Rule to SOs with Many Named Supported Organizations and to Type I SOs that Support a Class.

The new control rule presents particular difficulties for Type III SOs that have organizing documents that name a large number of supported organizations, and for Type I SOs that name a class of supported organizations.

An SO need not support a single organization, but may be organized for the support of "one *or more* specified organizations," under section 509(a)(3)(A) (emphasis added). Regulation § 1.509(a)-4(d)(2)(i)(b) notes that in the case of a Type I SO, the "specified organizations" need not, in some cases, even be specifically named in the SO's articles of organization. The articles may require instead that the organization support or benefit one or more beneficiary organizations designated by class or purpose. Regulation § 1.509(a)-4(d)(2)(i)(b), Example 1, describes an organization operated for the benefit of institutions of higher learning in a particular state. The Regulations also permit the "specified organizations" not to be named in the SOs organizing documents if there has been a historic or continuing relationship between the SO and the supported organizations such that there is a substantial identity of interest.⁵⁹ In many cases, the SO will not know the governing bodies of each member of the potential supported class. In the Regulation example, for instance, it would be difficult, if not impossible, for the SO to know at all times the governing bodies, not to mention related persons, of perhaps hundreds of institutions of higher learning in the state. Given this difficulty, and given the significant adverse consequences of an SO inadvertently accepting a contribution from a person who controls a supported organization, we suggest that application of the new rule be limited to prohibiting donations from persons who control the organization with respect to which the SO meets the relationship test.

⁵⁹ Reg. § 1.509(a)-4(d)(2)(iv).

2. Section 4943(f)(5): Definition of Type III “Functionally Integrated” SOs.

a. Background.

Section 4943(f)(5) defines a Type III SO as an organization that meets the requirements of section 509(a)(3)(A) and (C), and which is “operated in connection with” one or more organizations described in section 509(a)(1) or (a)(2). Section 4943(f)(5)(B) distinguishes between Type III SOs that are “functionally integrated” and those that are not as follows:

The term “functionally integrated type III supporting organization” means a type III supporting organization which is not required under regulations established by the Secretary to make payments to supported organizations (as defined under section 509(f)(3)) due to the activities of the organization related to performing the functions of, or carrying out the purposes of, such supported organizations.

Existing Regulations describe two alternative methods by which a Type III SO may meet an “integral part” test. The first method is by conducting activities described in Regulation § 1.509(a)-4(i)(3)(ii), as follows:

The activities engaged in for or on behalf of the publicly supported organizations are activities to perform the functions of, or to carry out the purposes of, such organizations, and, but for the involvement of the supporting organization, would normally be engaged in by the publicly supported organizations themselves.

The second alternative method is by satisfying certain payout requirements set out in Regulation § 1.509(a)-4(i)(3)(iii).

The Joint Committee Report at 360 note 571, states that there is “concern that the current regulatory standards” for Type III SOs that are not subject to a payout requirement “are not sufficiently stringent to ensure that there is a sufficient nexus between the supporting and supported organizations.” The Joint Committee Report goes on to state:

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 pay out. It is intended that, in revisiting the current regulations, if the distinction between Type III supporting organizations that are required to pay out and those that are not required to pay out is retained, which may be appropriate, the Secretary nonetheless shall strengthen the standard for qualification as an organization that is not required to pay out. For example, as one requirement, the Secretary may consider whether substantially all of the activities of such an organization should be activities in direct furtherance of the functions or purposes of supported organizations.⁶⁰

⁶⁰ The Joint Committee Report at 360 note 571.

b. Recommendations.

- (i) We recommend that guidance apply a facts and circumstances analysis to whether a Type III SO is functionally integrated. We suggest that a key factor in the facts and circumstances analysis should be the existence or absence of a continuing role by a substantial contributor⁶¹ (or a related person) in the SO's governance and operations. The absence of such a continuing role would tend to establish functional integration, while the continuing involvement of a substantial contributor (or a related person) would tend to indicate less nexus with the supported organization(s) (but should not be dispositive of the issue of whether the SO is functionally integrated).

We suggest that other facts and circumstances that would tend to indicate that an SO is functionally integrated include the following:

- The SO is organized to support a sole supported organization, or group of supported organizations under common control.
- The SO performs services for or on behalf of the supported organization(s) (including fundraising services) that assist those organizations in furthering their exempt purposes.
- The SO performs activities that were previously (or that continue to be, in part) conducted by the supported organization(s).
- The SO supports a governmental entity.
- The SO has an “historic and continuing relationship” with the supported organization in the manner contemplated under Regulation § 1.509(a)-4(i)(1)(ii).

Other facts and circumstances that would tend to indicate that an SO is not functionally integrated include the following:

- The SO holds assets that produce little or no income, which assets are not used by or on behalf of the supported organization(s) directly in furtherance of their exempt purposes.

⁶¹ We note that the definition of “substantial contributor” with respect to an SO at section 4958(c)(3)(C) for purposes of the excess benefit rules *includes* a supported organization that is qualified under section 501(c)(4), (c)(5) or (c)(6). For purposes of determining the level of nexus between a Type III SO and its supported organization(s), we submit that the continuing role of a substantial contributor *other than* a supported organization is the relevant consideration.

- The SO performs activities that the supported organization(s) have never conducted.
 - The SO does not have an “historic and continuing relationship” with the supported organization in the manner contemplated under Regulation § 1.509(a)-4(i)(1)(ii).
- (ii) We further recommend that the Secretary consider designating the following categories of Type III SOs (as described in more detail below) for classification as *per se* functionally integrated:
- Type III SOs that operate as the parent entity for a group of exempt organizations.
 - SOs created by the supported organization(s).
 - SOs that hold assets for use by or on behalf of a supported organization(s).

c. Explanation.

(i) Facts and Circumstances Analysis.

The Secretary has broad discretion under the Pension Protection Act to establish by regulation the Type III SOs that are functionally integrated. A Type III SO that is not functionally integrated, in addition to being subject to a payout requirement, will be subject to the excess business holdings rules of section 4943(f); grants to it from private foundations will be taxable expenditures unless the foundation exercises expenditure responsibility, under section 4945(d)(4); and, even if a foundation does exercise expenditure responsibility, a grant to a Type III SO that is not functionally integrated will not constitute a qualifying distribution in satisfaction of the foundation’s annual payout requirement, under section 4942(g)(4)(A)(i). Similarly, under section 4966(c), a grant by a donor advised fund to a Type III SO that is not functionally integrated will be a taxable distribution unless the donor advised fund exercises expenditure responsibility. The characterization of a Type III SO as one that is functionally integrated or not will accordingly have a significant impact on the SO’s operations and its access to funding sources.

The concern expressed regarding the standard for assessing the functional integration of a Type III SO in the Joint Committee Report is the level of “nexus” between the supporting and supported organizations. The legislative reforms in the SO area generally reflect concerns regarding the level of involvement in and influence over SOs by substantial contributors, and the need to ensure that SOs are accountable to their supported organizations. For example, the new automatic excess benefit rules under section 4958 for SOs and the requirement under section 6033 that an SO certify that it is not controlled by disqualified persons address the issue of the continuing role of a substantial contributor (and related persons) to an SO. In the Type III SO context

specifically the new rules requiring the SO to provide information to its supported organization(s) under section 509(f)(1)(A) and the requirement that a charitable trust demonstrate a “close and continuous relationship” with a supported organization also address the issue of nexus with and accountability to the supported organization(s).

We believe that it is important to distinguish between those situations in which a donor utilizes the Type III SO structure as essentially a substitute for a private family foundation where the donor or related persons remain involved in the SO’s operations, and those in which the supported organization(s) themselves utilize the Type III SO structure in order to achieve operational goals in furtherance of their exempt purposes. We submit that while the first situation may raise issues concerning the extent of donor control over the organization and the level of nexus with and accountability to the supported organization(s), the second situation generally does not. The existence or absence of a continuing role by a substantial contributor or a related person in a Type III SO should therefore be a significant factor in the determination of whether a Type III SO is functionally integrated.

The other relevant factors that we suggest are drawn in part from the existing Regulations. The fact that a supported organization either previously conducted the SO’s activities, and continues to do so in part, would seem to be a strong indicator of functional integration. Similarly, an “historic and continuing relationship” as contemplated under the existing Regulations would seem to support functional integration.

The fact that an organization supports a governmental entity, we suggest, should also be a positive factor in assessing functional integration. The Type III SO structure is used as a tool in the context of governmental entities to allow donors to identify a gift for a specific purpose of the governmental entity (*e.g.*, scholarships) without having the gift become part of the general fund. The Type III structure may be used in such situations to avoid a control relationship that could cause the SO itself to be treated as a governmental entity for state law purposes.

(ii) *Per Se* Categories of Functionally Integrated Type III SOs.

We recommend that the Secretary consider designating certain categories of Type III SOs for classification as *per se* functionally integrated, on the grounds that they by their nature establish a high level of nexus between the Type III SO and its supported organization(s), and they do not present opportunities for abuse with respect to donor control or failure to make distributions to supported organizations. The three *per se* functionally integrated categories that we recommend are described in detail as follows:

Parent Organizations. Type III SOs in some cases operate as the parent entity for a group of exempt organizations. This structure is common in the healthcare context where a Type III SO may be the parent organization in a system of charitable hospitals and other healthcare entities, such as exempt home health care and health plan organizations. The parent structure is also used in other areas where multiple charitable entities may be necessary or desirable to address regulatory issues, such as in groups of

organizations that provide financial aid for education where one or more organizations is qualified under section 150(d)(2). The parent entity in these contexts is commonly the sole member of the supported organization(s), and may have the power to appoint all or a majority of the governing boards of the supported organization(s). The parent typically carries on central administrative functions, such as strategic planning, finance and accounting, legal, information technology, human resources, purchasing, maintenance, security, and billing and collections. The functional relationship between the Type III SO and its supported organizations in such cases is so intertwined that the supported organizations would not function without the activities performed at the parent level. The IRS has recognized in numerous private letter rulings that a Type III SO that serves as a parent to other exempt organizations for which it performs centralized services qualifies as functionally integrated.⁶² We submit that the analysis under those rulings remains valid in determining the character of a Type III SO as functionally integrated.

SOs Created by the Supported Organization(s). Supported organizations may themselves create Type III SO affiliates (beyond the parent SOs described above) to achieve a variety of legitimate and appropriate business goals in furtherance of their exempt purposes. There may, for example, be compelling liability protection reasons for using a Type III structure, *e.g.*, to hold and manage a supported organization's endowment. In other circumstances a supported organization may utilize a Type III structure in order to separate property encumbered by debt from an exempt group that is consolidated for financial accounting purposes in order to enhance access to other financing.⁶³ Use of a Type I or Type II SO in such circumstances would not achieve the goal of separating the SO from the consolidated group. A group of exempt organizations under common control may create Type III SOs as affiliates (rather than parents, as described above) to perform centralized services on behalf of the group. Where one or more supported organization(s) create a Type III SO for purposes that enhance the supported organization(s)' ability to further their exempt purposes, there would seem to be little justification for imposing more restrictive rules on the SO than on the supported organization(s) themselves. There is of course a practical issue of determining when a Type III SO is in fact created by its supported organization(s). For these purposes we suggest a standard under which: (1) one or more supported organization(s) certify that the SO was created pursuant to its or their direction; and (2) no substantial contributor, as defined in section 4958(c)(3)(C) (excluding a supported organization, as discussed above), no person described in section 4958(c)(3)(B)(ii) (*i.e.*, a family member of a substantial contributor), and no twenty percent owner of a substantial contributor, as defined in section 4946(a)(1)(C), has a continuing role in the SO's governance or operations, such as by being a member of the governing board or an officer of the SO, or having a right to appoint a member of the governing board.

⁶² See, *e.g.*, PLR 9517051 (Feb. 2, 1995); PLR 9426040 (April 4, 1994); PLR 9333046 (May 27, 1993); PLR 9139025 (July 2, 1991); PLR 9109057 (Dec. 5, 1990); PLR 9016053 (Jan. 23, 1990); PLR 9013049 (Dec. 28, 1989); PLR 8934030 (May 25, 1989).

⁶³ See, *e.g.*, PLR 200404057 (Jan 23, 2004) (Type III SO that held real property for lease to a supported organization under a structure designed to address debt financing and financial accounting issues was functionally integrated).

SOs that Hold Assets for Use by or on Behalf of a Supported Organization(s). Some Type III SOs hold assets that are used exclusively or primarily by or on behalf of the supported organization(s) in furtherance of their exempt purposes. This is the case, *e.g.*, for a Type III SO that holds real property which it leases to a supported organization for use in its exempt purposes, or which it leases at below-market rates to members of the charitable class for whose benefit a supported organization is operated. In some cases the assets may produce little or no income. Such organizations may be structured as Type III SOs for a variety of reasons, including asset protection and enhancing access to financing. Where a Type III SO's primary purpose is holding assets for use by or on behalf of one or more supported organizations, it would undermine the supported organization(s)' charitable operations to impose a payout requirement on the SO that could force it to dispose of the asset(s). This category of SO will in many cases overlap with the category above, *i.e.*, Type III SOs created by the supported organization(s). Where a Type III SO holds assets for use by or on behalf of the supported organization(s) as its primary activity, however, the question of whether the SO may have been created by a donor (*e.g.*, through a contribution of real property), or whether a substantial contributor has a continuing relationship with the organization would not seem to affect the policy reasons against requiring a payout.

3. Grants to Supporting Organizations by Private Foundations and Donor-Advised Funds.

a. Background.

As amended by the Pension Protection Act, section 4942(g) provides that a grant by a non-operating private foundation to the following is not a qualifying distribution:

- (i) a Type III SO that is not functionally integrated within the meaning of section 4943(f)(5)(B); and
- (ii) a Type I, Type II or Type III functionally integrated SO if a disqualified person of the private foundation directly or indirectly controls such SO or a supported organization of the SO.

The Pension Protection Act also amended section 4945(d)(4)(A) to provide that grants by all private foundations to SOs described above will be taxable expenditures unless the private foundation exercises expenditure responsibility with respect to such grants.

To comply with this new law, private foundations must be able to determine the type of SO to which they are making grants, and in the case of Type III SOs, whether the SO is functionally integrated. To assist foundations in making these determinations, the IRS issued Notice 2006-109. Notice 2006-109 provides interim guidance to private foundations and donor advised funds by setting forth a procedure for determining whether SOs are Type I, Type II, or Type III organizations and whether an organization (the SO or its supported organization) is controlled by disqualified persons. (Such control would cause the organization to fail the test for SO status.)

Determining Whether Grantee is a Public Charity under Section 509(a)(1), (2) or (3). In determining a grantee's public charity status under section 509(a)(1), (2), or (3), a grantor, acting in good faith, may rely on information from the IRS Business Master File (as referred to in Section 3.01 of Notice 2006-109) or the grantee's current IRS determination letter recognizing the grantee as exempt from federal income tax and indicating the grantee's public charity classification.

Determining Whether Grantee is a Type I, Type II or Functionally Integrated Type III. In determining whether a grantee is a Type I, Type II or functionally integrated Type III SO, a grantor, acting in good faith, may either (A) rely on a written representation from a grantee, along with specified documentation,⁶⁴ or (B) rely on a reasoned written opinion of counsel of either the grantor or grantee, regarding the SO status of the grantee. In addition, the grantor must verify that the grantee is listed in Publication 78 or obtain a copy of the grantee's current IRS determination letter recognizing it as exempt from federal income tax.

Determining Whether Disqualified Persons of the Grantor Private Foundation Control Any Supported Organization. Until new regulations are issued that provide guidance as to the meaning of "control" for purposes these new provisions, a private foundation is to apply the control standards established in Regulation § 53.4942(a)-3(a)(3) in determining whether one or more of its disqualified persons control an SO or one or more of the SO's supported organizations. Under this standard, an organization is controlled by one or more disqualified persons with respect to a private foundation if any such persons may, by aggregating their votes or positions of authority, require the SO or its supported organization to make an expenditure, or prevent the SO or its supported organization from making an expenditure, regardless of the method by which control is exercised or exercisable.

b. Recommendations.

- (i) We suggest that the procedures established in Notice 2006-109 be modified to adopt an affidavit procedure similar to that set out in Rev. Proc. 92-94⁶⁵ that permits the SO to prepare a single statement upon which all donors can rely. It would also be helpful for the IRS to set out a procedure under which a legal opinion can be relied upon by multiple grantors for an extended period of time.
- (ii) We recommend that Treasury provide guidance that allows donors to rely on an IRS determination as to the SO status of each public charity described in section 509(a)(3). To this end we recommend

⁶⁴ To establish functionally integrated Type III SO status, an officer, director or trustee of the SO must provide a written representation that it is a functionally integrated Type III SO that identifies the supported organization with which it is functionally integrated. The grantor must collect and review a written statement signed by an officer, director or trustee of each of the relevant supported organizations describing the activities of the grantee and confirming that but for the grantee's activities, the supported organization would normally be engaged in such activities itself.

⁶⁵ Rev. Proc. 92-94, 1992-2 C.B. 507 (addressing grants by private foundations to foreign grantees).

that the IRS expand its existing section 501(c)(3) determination letter process so that all new determination letters address the SO status of each public charity described in section 509(a)(3). Each new determination letter should address the SO status as a Type I, Type II, functionally integrated Type III, or non-functionally integrated Type III, and the SO status should be reflected in IRS Publication 78.

- (iii) In the case of organizations with existing determination letters, we recommend that the IRS implement a program to provide updated determination letters that addresses SO status. A program could be modeled on the helpful procedures set out in Notice 2006-93⁶⁶, which organizations can follow to request a change in their public charity classification from section 509(a)(3) to either section 501(a)(1) or (2). Alternatively, the IRS could employ a system similar to the self-assessment procedure adopted after the Tax Reform Act of 1969 using Form 4563 to report public charity/private foundation status.
- (iv) Prior to the time the IRS implements an expanded determination letter program that addresses an organization's SO status (as described above), we recommend that guidance permit grantors to rely on the information reported in a grantee's most recent Form 990 as to its status under section 509(a)(1), (2) and (3), and its status as a Type I, Type II, and functionally integrated Type III SO, unless the grantor has reason to believe that the information is inaccurate. We further suggest that guidance provide that grantors may rely on a copy of a grantee's most recent Form 990 provided by a reliable third party (such as GuideStar).
- (v) If the IRS adopts due diligence standards similar to those set out in Notice 2006-109 on a permanent basis, we suggest that it consider developing a rule under which a grantor can, in making small grants (*e.g.*, in the context of employee matching grants by corporate foundations), rely on the grantee's designation of non-private foundation status in IRS Publication 78, without further due diligence, or, in the period prior to implementation of new IRS determination letters and a new format for IRS Publication 78, the grantee's most recent Form 990.
- (vi) Finally, we request that guidance provide that a grantor private foundation is permitted to rely on the written representations of a grantee SO as to the identity of its supported organization(s).

⁶⁶ Notice 2006-93, 2006-48 IRB, 11/27/2006,

c. Explanation.

(i) Modifications to Notice 2006-109 Guidance.

While the procedures of Notice 2006-109 are helpful in that they set out safe harbors, the procedures are often impractical, time-consuming and expensive. The result is that many donors will simply forego making contributions to SOs.

Reliance on a grantee's IRS current determination letter is a natural starting point for determining a grantee's SO status. Many older determination letters do not address whether the basis for an organization's public charity is under section 509(a)(1), (2) or (3), however. Furthermore, for many organizations the "current" determination letter is the original letter received on the organization's initial formation and may not actually reflect the organization's current status. Notice 2006-109 suggests that the grantor supplement determination letters with information in the IRS's Business Master File system. Currently, however, it is very difficult to access the information in these files, which effectively makes it unavailable to almost all grantors.

The IRS procedure does not permit the grantor simply to rely on the grantee's representation of its SO status. The grantor is required to evaluate the grantee's organizational documents to determine if they are consistent with the grantee's description of the basis for its SO status. This evaluation puts a heavy burden on the grantor, and many organizations will not have the resources to perform such evaluation. These organizations will likely decide simply not to make grants to SOs.

To streamline grantees' communications with potential grantors, the procedures established in Notice 2006-109 should be modified to adopt an affidavit procedure, similar to that set out in Rev. Proc. 92-94⁶⁷, that permits the SO to prepare a single statement upon which all donors can rely. This affidavit would be updated from time to time, as required by change of facts (similar to the update requirements of Rev. Proc. 92-94).

Grantors with sufficient resources will be able to obtain an opinion of counsel upon which they can rely. Grantees with sufficient resources could obtain an opinion upon which grantors could rely. However, many organizations may not be able to marshal the resources to obtain such an opinion.

It would also be helpful for Notice 2006-109 to explain a procedure order which a legal opinion can remain in effect for an extended period of time.

⁶⁷ Rev. Proc. 92-94, 1992-2 C.B. 507 (addressing grants by private foundations to foreign grantees).

(ii) Reliance on IRS Determination Letters Regarding SO Status and Program for Determining SO Status for New Organizations.

We have recommended above that the IRS provide guidance that allows donors to rely on an IRS determination letter as to SO status, and that it implement a program for determining the status of new SOs.

Under the rules of Regulations §§ 601.201(n), 1.170A-9(e)(4)(v)(b), 1.170A-9(e)(5)(iii)(c), 1.509(a)-3(c)(1)(iii) and 1.509(a)-3(e)(3), Rev. Proc. 81-6,⁶⁸ and Rev. Proc. 89-23,⁶⁹ grantors are permitted to rely on the IRS's determination of an organization's section 501(c)(3) status and its classification as a publicly supported organization described in sections 170(b)(1)(A)(vi) or 509(a)(2). It is logical and efficient that the IRS address a grantee's SO status in its determination procedure, and that grantors be permitted to rely on such determinations.

(iii) Program to Address Status of Existing SOs.

While a change in the information provided in new determination letters will address the classification of new SOs, the issue remains how existing SOs can obtain a determination letter on which donors may rely.

In order to provide information approved by the IRS regarding SO classifications on a timely basis upon which a grantor could rely, one option is for the IRS to adopt a procedure analogous to its response to a similar problem generated by the Tax Reform Act of 1969. Following that legislation, grantor private foundations had to determine for the first time the public charity, private foundation or private operating foundation status of a grantee. To address this new requirement, the IRS created Form 4563, which an existing organization filed with the IRS to indicate its public charity status. Grantors were permitted to rely on the organization's reported status if the IRS did not reject the grantee's non-private foundation status within thirty days of filing and the grantor did not directly or indirectly control the grantee.⁷⁰ Implementing a similar process would encourage an SO to approach the IRS to obtain an updated determination letter confirming what type of SO it is. In light of the IRS's current workload, it may be necessary to use a longer period for the IRS to respond negatively to an organization's filing.

(iv) Interim Reliance on Grantee's Status Reported on Form 990.

We have recommended above that prior to the time the IRS implements an expanded determination letter program that addresses an organization's SO status (as described above), grantors should be permitted to rely on the information reported in a grantee's Form 990 as to its status under section 509(a)(1), (2) and (3), and its status as a

⁶⁸ Rev. Proc. 81-6, 1981-1 C.B. 620.

⁶⁹ Rev. Proc. 89-23, 1989-1 C.B. 844.

⁷⁰ Reg. § 1.508-1(b)(4).

Type I, Type II, or functionally integrated Type III SO, unless the grantor has reason to believe that the information is inaccurate. The 2006 Form 990, Schedule A, provides sufficient information for the grantor to determine the grantee's status, as well as the identity of supported organizations (unless the SO supports a class of supported organizations). Specifically, the Form 990 requires an organization to disclose its SO status, including whether it is a Type III SO and whether it is functionally integrated. This information will thus become available as organizations file Form 990s for 2006. The 2005 Form 990 required public charities described in section 509(a)(3) to report their Type I, Type II and Type III status.

Form 990 is always signed, under penalty of perjury, by an officer of the SO. Since the IRS accepts information on a properly executed Form 990, we believe that grantors should be allowed to rely on the same information to determine grantee's status and the identity of controlled organizations.

Grantors should also be able to rely on a copy of a grantee's Form 990 provided by reliable third parties (such as GuideStar). Current law anticipates that donors should be able to rely on an exempt organization's annual information return since such returns are subject to public inspection (as provided in Reg. § 301.6104(d)-1(a)).

(v) Standards for Small Grants.

If the IRS permits grantors to determine an organization's SO status by relying on its Form 990 or expands the determination letter program, simpler reliance standards for small grants would not appear necessary. However, if the IRS adopts on a permanent basis due diligence standards similar to those set out in Notice 2006-109, we recommend giving serious consideration to a streamlined approach for smaller grants. Without such an approach, many small grants (including corporate foundation employee matching programs and donor advised fund grants) will be eliminated because the cost and time of performing such diligence will be too high in relation to the size of the grant. Such grants do not appear to present the opportunity for the abuses that prompted the new rules. One approach would be to provide that in the case of small grants (*e.g.*, grants of \$5,000 or less), the grantor can rely on the grantee's listing in IRS Publication 78, without further due diligence, or, for the period prior to implementation of new determination letters and a new format for IRS Publication 78, the grantee's most recent Form 990.

(vi) Reliance on SO Representations Regarding Supported Organizations.

A grantor private foundation should be permitted to rely on an SO's Form 990 or other signed, written representations of the grantee SO as to the identity of its supported organization(s). This reliance is anticipated in Notice 2006-109. Currently, each private foundation must identify its disqualified persons within the meaning of section 4941 and each disqualified person must disclose to the private foundation each of the section 501(c)(3) organizations, including SOs, that he or she controls (within the meaning of Reg. § 53.4942(a)-3(a)(3)), to determine whether the private foundation's grants are qualifying distributions. Based on this information, each grantor private

foundation should know whether any of its disqualified persons controls the grantee SO. However, a disqualified person of a grantor private foundation cannot disclose whether he or she controls any of an SO's supported organizations because he or she may not know the identity of these supported organizations. Only the SO possesses this information. Once the grantor private foundation possesses the list of the SO's supported organizations, the grantor private foundation will know whether any of its disqualified persons control the SO or any of its supported organizations.

4. Type III SO Responsiveness Test for Charitable Trusts.

a. Background.

In order to qualify as a Type III SO that is “operated in connection with” a supported organization, an organization must meet (1) a “responsiveness test” under Regulation § 1.509(a)-4(i)(2), and (2) an “integral part test” under Regulation § 1.509(a)-4(i)(3). The Regulations provide two alternative bases for meeting the responsiveness test.

Under the first test, at Regulation § 1.509(a)-4(i)(2)(i), one or more officers, directors or trustees of the SOs are elected or appointed by the officers, directors, trustees or membership of the supported organizations; or one or more members of the governing body/ies of the supported organization(s) are also officers, directors or trustees or hold other important offices in the SO; or the officers, directors or trustees of the SO maintain a “close and continuous working relationship” with the officers, directors or trustees of the supported organizations; and by reason of the relationship, the officers, directors or trustees of the supported organization have a “significant voice” in the investment policies, the timing of grants, the manner of making them, and the selection of recipients of the SO, and in otherwise directing the use of the SO's income or assets.

Alternatively, under the second test, at Regulation § 1.509(a)-4(i)(2)(ii), the organization is a charitable trust under state law; each specified supported organization is a named beneficiary under such trust's governing instrument; and the beneficiary organization has the power to enforce the trust and compel an accounting under state law.

Section 1241(c) of the Pension Protection Act (Requirements for Supporting Organizations) provides that a charitable trust that is a Type III SO shall not be considered to be operated in connection with a section 509(a)(1) or (2) organization

. . . solely because –

(1) it is a charitable trust under State law,

(2) the supported organization . . . is a beneficiary of such trust, and

(3) the supported organization . . . has the power to enforce the trust and compel an accounting.

This provision is effective one year after the date of enactment for existing trusts, and on the date of enactment for new trusts.

The Joint Committee Report states at 362:

In general, under [this] provision, a Type III supporting organization that is organized as a trust must, in addition to present law requirements, establish to the satisfaction of the Secretary, that it has a close and continuous relationship with the supported organization such that the trust is responsive to the needs or demands of the supported organization.

Following the Tax Reform Act of 1969, Treasury issued regulations providing a transitional rule for charitable trusts in existence on the date of enactment of the 1969 legislation in order to allow such trusts to meet the integral part test for Type III SO status if such trusts met certain requirements. Specifically, under Regulation § 1.509(a)-4(i)(4), a charitable trust was treated as meeting the integral part test if it was required by its governing instrument to distribute all of its net income currently to a designated publicly supported beneficiary; the trustees of the trust did not have discretion to vary either the beneficiaries or the amounts payable to the beneficiaries; none of the trustees would be disqualified persons with respect to the trust within the meaning of section 4946(a) (other than as foundation managers) if the trust were treated as a private foundation; and the trust made annual written reports to all of the beneficiary publicly supported organizations setting forth a description of the trust's assets, including a detailed list of the assets and the income produced by the assets.

b. Recommendations.

(i) We recommend that changes in Regulations to implement Pension Protection Act section 1241(c) provide an alternative test for existing trusts to meet the responsiveness test. Specifically, we suggest amplifying the “responsiveness test” to provide that the test is met if a charitable trust that is established before August 17, 2006 (the date of enactment of the Pension Protection Act) meets the current requirements under Regulation § 1.509(a)-4(i)(2)(iii), plus the following additional requirements:

(1) No trustee is a person described in section 4958(c)(3)(B) (a substantial contributor, members of a substantial contributor's family or a thirty five percent controlled entity).

(2) A trustee has no power to distribute less than the annual net income of the trust or a fixed annuity amount.

(3) A trustee has no power to vary the amount of annual net income paid to the charitable beneficiary of the trust, or if there are multiple beneficiaries, the amount paid to each beneficiary is a fixed portion of the annual net income.

(4) A trustee provides the supported organization with an annual written report listing the assets of the trust, the income produced by such assets and the current investment policy applicable to the trust.

- (ii) We further recommend that the Regulations provide that for charitable trusts established on or after August 17, 2006, in addition to the above requirements, a trustee must maintain a close working relationship with the supported organization in order to meet the “responsiveness” test in Regulation § 1.509(a)-4(i)(2). We suggest adding an example of such a relationship, such as the following:

Example: X is a charitable trust described in section 501(c)(3) established after August 17, 2006 for the benefit of two organizations described in section 509(a)(1) (the “charitable beneficiaries”). The trust holds income-producing property and has a trustee who is not a disqualified person described in section 4958(c)(3)(B). The trustee is required by the terms of the trust’s governing instrument to distribute currently to the charitable beneficiaries in fixed shares all of the trust’s net income or a fixed annuity amount. The trustee does not have the discretion to change the beneficiaries (unless a beneficiary ceases to be a public charity described in section 509(a)(1) or (2)) or the amounts payable to the beneficiaries. After consultation with the charitable beneficiaries, the trustee earmarks the annual distributions for a substantial program of at one or more of the charitable beneficiaries in a manner that meets the “integral part” test in Regulation § 1.509(a)-4(i)(2). The trustee provides an annual written report to the charitable beneficiaries on the income, expenses and investments of the trust and consults with the charitable beneficiaries concerning the investment policy of the trust. By reason of the foregoing, X maintains a close working relationship with the charitable beneficiaries. X qualifies as a Type III supporting organization described in section 509(a)(3)(B)(iii).

c. Explanation.

- (i) **Recommended Rules for Trusts Established Before August 17, 2006.**

Our recommendation regarding the responsiveness test for trusts in existence as of the date of enactment is based on the transitional rules that Treasury issued regarding the “integral part” test for trusts established prior to November 20, 1970 in Regulation § 1.509(a)-4(i)(4).

We understand that section 1241(c) of the Pension Protection Act was intended to address abusive situations in which a donor “parks” assets, often non-income producing assets such as real estate, in a charitable trust for the purpose of providing a donor or related persons with continued indirect control of or access to such assets, while there is little or no oversight by the named supported organization.

This new provision will reach far more broadly, however, and result in many charitable trusts being reclassified as private foundations, unless tempered by regulations. Specifically, the provision may adversely affect charitable trusts, including testamentary charitable trusts established before the enactment of the Tax Reform Act of 1969, where (1) there is no involvement by the donor or related persons in the administration of the trust; (2) the trustee(s) are wholly independent from the donor, such as a bank or a trust company; (3) there is a payout provision that requires the payment of all net income to one or more specified charitable beneficiaries; and (4) the trustee(s) have no power to vary the amount paid to each charitable beneficiary. Such trusts effectively function as part of the restricted endowment funds of a charitable beneficiary. After the Tax Reform Act of 1969, such trusts were able to establish that they qualified as organizations described in section 509(a)(3) if they could demonstrate that the payments they made met the integral part test in Regulation § 1.509(a)-4(i)(3)(iii) because the amount of support provided by the trust was sufficient to insure the attentiveness of the charitable beneficiary.

Trusts that fit the profile above do not appear to present opportunities for abuse. If they are allowed to lose Type III SO status they will become subject to the excise tax under section 4940 on their investment income, which will effectively penalize their charitable beneficiaries. The enactment of new excess benefit rules for SOs under section 4958(c)(3) that impose excise taxes on grants, loans, compensation and other payments to disqualified persons of an SO, and the extension of the section 4943 excess business holdings rules to Type III SOs further help to assure that such charitable trusts will not be involved in abusive transactions. It therefore seems appropriate, to accord continuing status as Type III SOs to trusts established before the enactment date that fit the profile above.

(ii) Recommended Rules for Trusts Established on or after August 17, 2006.

The adoption of more detailed rules defining a “close working relationship” as suggested above is needed to clarify how charitable trusts established after the date of enactment could qualify as Type III SOs. Charitable trusts established by donors with the profile described above in effect serve as permanent endowment funds for public charities. One reason that a donor may determine that such a charitable trust is more appropriate than a direct gift or bequest to the public charity is that the donor has concerns about the public charity’s capacity to manage the investment of the gift or bequest or is concerned that the public charity may invade the principal of the gift or bequest. If there is no donor involvement, such trusts do not present the opportunity for abuse that may be present when charitable trusts have donor involvement and make

discretionary distributions or are established to hold non-income-producing or closely held assets.

5. Status of Pre-1969 Supporting Organizations.

a. Background.

Certain organizations that were in existence before the effective date of the Tax Reform Act of 1969 were exempted from many of the rules governing the organization and operation of SOs. These “grandfathered” SOs continue to receive special treatment in the Regulations under section 509(a)(3).⁷¹

b. Recommendation.

We suggest that Treasury consider whether grandfathered SOs that received special treatment under the rules developed following the Tax Reform Act of 1969 should also be accorded special consideration under the rules promulgated under the Pension Protection Act. The existing provisions at Regulation § 1.509(a)-4(i)(4) could serve as a model for a provision along the following lines:

(4) Rules modified by the Pension Protection Act; transitional rule. (i) A trust (whether or not exempt from taxation under section 501(a)) which on November 20, 1970, has met and continues to meet the requirements of subdivisions (ii) through (vi) of Regulation § 1.509(a)-4(i) shall be treated as meeting the requirements of the Pension Protection Act if for taxable years beginning after October 16, 1972, the trustee of such trust makes annual written reports to all of the beneficiary publicly supported organizations with respect to such trust setting forth a description of the assets of the trust, including a detailed list of the assets and the income produced by such assets. A trust organization which meets the requirements of this subparagraph may request a ruling that it is described in section 509(a)(3) in such manner as the Commissioner may prescribe.

c. Explanation.

Many of these grandfathered SOs do not have organizing documents that comply with the 1969 rules. Similarly, they will likely fail to comply with any new rules promulgated under the Pension Protection Act. The exclusions for grandfathered SOs after the 1969 legislation saved many organizations the expense of a court proceeding to reform their governing documents. This savings is particularly important for small charities where the costs of reforming the documents would reflect a substantial portion of the charity’s assets.

If grandfathered SOs that are subject to special rules under the Tax Reform Act of 1969 do not receive similar special treatment in rules created under the Pension

⁷¹ See Reg. §§ 1.509(a)-4(b)(2), 1.509(a)-4(i)(4).

Protection Act, many such organizations will need to be reformed or will become private foundations under the new rules.

C. Provisions Regarding Section 4958 Intermediate Sanctions

1. Section 4958 Excess Benefit Transactions Common to Donor Advised Funds and Supporting Organizations.

a. Background on Issues Common to Donor Advised Funds and Supporting Organizations.

Section 4958 imposes punitive excise taxes on any “excess benefit transaction” between a public charity and a “disqualified person.” Prior to the Pension Protection Act an excess benefit transaction was limited to transactions where a disqualified person received an economic benefit that exceeded the value of the consideration that he or she provided to the public charity. For example, if a disqualified person performed services for a public charity with a value of \$100,000 but received compensation of \$150,000, the \$50,000 excess was regarded as an excess benefit subject to excise tax under section 4958.

Sections 1232(b) and 1242(b) of the Pension Protection Act added two categories of automatic or *per se* excess benefit transactions that apply only to transactions involving donor advised funds and SOs. Under section 4958(c)(2) and (3), automatic excess benefit transactions are subject to excise tax whether or not the disqualified person receives an excessive economic benefit, and the excise tax is imposed on the entire amount received by the disqualified person.

Under section 4958(c)(2), an automatic excess benefit transaction with respect to a donor advised fund “includes any grant, loan compensation, or other similar payment from” the donor advised fund to a donor, a donor advisor, a family member of either, or a thirty five percent controlled entity within the meaning of section 4958(f)(7). The Joint Committee Report elaborates on this provision as follows:

Other similar payments include payments in the nature of a grant, loan, or payment of compensation, such as an expense reimbursement. Other similar payments do not include, for example, a payment pursuant to bona fide sale or lease of property, which instead are subject to the general rules of section 4958⁷²

Section 4958(c)(3) creates a comparable category of automatic excess benefit transactions for transactions between a SO and any substantial contributor, family member, or thirty five percent controlled entity within the meaning of section 4958(c)(3)(B). The Joint Committee Report describes the “similar payment” reference in section 4958(c)(3) with the same language it uses to describe the reference in section

⁷² Joint Committee Report at 347.

4958(c)(2).⁷³ With respect to SOs, however, the Joint Committee Report goes on to make the following additional statement:

The provision applies to payments by a supporting organization to a substantial contributor but not to payments by a substantial contributor to a supporting organization.⁷⁴

The automatic excess benefit provision applicable to SOs is broader in one important respect than the automatic excess benefit provision applicable to donor advised funds. Under section 4958(c)(3)(A)(i)(II), the automatic excess benefit provision applies to loans between the SO and any of its disqualified persons other than certain public charities, not just to the prohibited group of substantial contributors, family members, and thirty five percent controlled entities.

b. Recommendations on Issues Common to Donor Advised Funds and Supporting Organizations.

- (i) We recommend that guidance confirm the Joint Committee Report statements that a sale or lease of property is not subject to the automatic excess benefit provisions with respect to either donor advised funds or SOs.
- (ii) We recommend that guidance confirm that all forms of property and property transactions are excluded from the automatic excess benefit provisions, including transactions involving real, personal, tangible and intangible property, and licenses as well as sales and leases.
- (iii) We recommend that guidance confirm that a loan, compensation or similar payment from a disqualified person to a donor advised fund or SO is not subject to the automatic excess benefit provisions, but is subject to the general excess benefit rules.

c. Explanation of Recommendations on Issues Common to Donor Advised Funds and Supporting Organizations.

(i) Confirming Joint Committee Report Property Exception.

The Joint Committee Report states as to both donor advised funds and SOs that the automatic excess benefit provisions do not apply to a payment pursuant to a bona fide sale or lease of property. Presumably deferred payments or other financing that arises in the course of a sale, such as seller financing by the donor advised fund or SO, would still be treated as a loan and therefore an automatic excess benefit transaction. Otherwise, however, this helpful legislative history would exclude sales and leases from the scope of

⁷³ Joint Committee Report at 358.

⁷⁴ *Id.* at 358-359.

automatic excess benefit transactions. This will reduce the “traps for the unwary” created by these new rules and should be confirmed in guidance.

(ii) Scope of Property Transactions Excepted.

The Joint Committee Report states that the term “other similar payment” subject to the automatic excess benefit penalty does not include “for example, a payment pursuant to a bona fide sale or lease of property.” Joint Committee Report at 347. Accordingly, a sale or lease of property is not “similar” to a loan for this purpose. The use of “for example” in the Joint Committee Report indicates that other forms of property and property transactions are also excluded. There is no reason to distinguish between real and personal property, or between tangible and intangible property. A license of intangible property such as software is the same in principle as a lease of tangible property, and should be treated in the same manner. Thus, a royalty arising from such a license should be excluded from the automatic excess benefit provisions to the same extent as rent under a lease.

(iii) Loans and Other Payments to the Fund or Supporting Organization.

The automatic excess benefit rules apply to payments “from” or “provided by” a donor advised fund or SO to a person in the prohibited group. Section 4941(d)(1)(B) and (C). This is unlike the private foundation self-dealing rules, which prohibit loans and the provision of services “between” the private foundation and a disqualified person.⁷⁵ This indicates that a loan or payment for services from a donor to a donor advised fund or SO is not an automatic excess benefit transaction.

This view is supported by the Joint Committee Report, which states, as quoted above, that the automatic excess benefit provision for SOs “applies to payments by a supporting organization to a substantial contributor but not to payments by a substantial contributor to a supporting organization.” Thus, for example, if a donor makes a loan to a donor advised fund or SO, that loan would not be an automatic excess benefit transaction, but would be tested under the general excess benefit rules. In addition, an SO could provide services to the donor, and the donor could pay for those services, without triggering an automatic excess benefit transaction, but again subject to the general excess benefit rules.

• Section 4958(c)(2) Excess Benefit Transactions Involving Donor Advised Funds.

d. Background on Donor Advised Fund Issues.

Compensation for Services Provided to Sponsoring Organization. The Joint Committee Report states that the payment of compensation by a sponsoring organization to a person who is both a donor to a particular donor advised fund and a service provider

⁷⁵ Section 4958(c)(2)(A) and (c)(3)(A)(i)(1).

to the sponsoring organization generally will not give rise to an automatic excess benefit transaction under section 4958(c)(2) unless the payment is viewed as a payment from the donor advised fund and not from the sponsoring organization to the service provider.⁷⁶ Such a situation could be separately subject to the provisions of section 4958 if the service provider is a disqualified person of the sponsoring organization (*i.e.*, by reason of serving on the sponsoring organization’s governing board). The Joint Committee Report provides the following example:

For example, if a sponsoring organization pays an amount as part of a service contract to a service provider (a bank, for example) who also is a donor to a donor advised fund of the sponsoring organization, and such amounts reasonably are charged uniformly in whole or in part as routine fees to all of the sponsoring organization’s donor advised funds, the transaction generally is considered to be between the sponsoring organization and the service provider in such service provider’s capacity as a service provider. The transaction is not considered to be a transaction between a donor advised fund and the service provider even though an amount paid under the contract was charged to a donor advised fund⁷⁷

Investment Advisors as Disqualified Persons of Donor Advised Fund. Under section 4958(f)(1)(F) an investment advisor and its related parties are disqualified persons with respect to a sponsoring organization regardless of whether the investment advisor or its related parties have any other relationship with the sponsoring organization or its donor advised funds. The term “investment advisor” is defined in section 4958(f)(8) as any person (other than an employee of the sponsoring organization) compensated by the sponsoring organization for managing the investment of, or providing investment advice with respect to, assets maintained in donor advised funds owned by the sponsoring organization. Payments by a sponsoring organization to an investment advisor are subject to the general intermediate sanctions rules, and are not treated as automatic excess benefit transactions.

Sponsoring organizations commonly enter into investment advisory relationships with one or more investment advisors pursuant to which donor advised funds owned by the sponsoring organization invest in the mutual funds or other investment vehicles managed by the investment advisors. Each investment advisor is paid a fee set forth in its contract with the sponsoring organization. In the alternative, the investment advisor can be compensated directly by the underlying mutual funds, so that no fee is charged to the sponsoring organization or to its donor advised funds. Subject to guidelines established by the sponsoring organization, a donor advisor may recommend that a donor advised fund be invested in one or more of the mutual fund options.

e. Recommendations on Donor Advised Fund Provisions.

⁷⁶ Joint Committee Report at 348.

⁷⁷ Joint Committee Report at 348.

- (i) We recommend that guidance confirm the foregoing position stated in the Joint Committee Report. Specifically, the automatic excess benefit provisions should not apply if (i) the sponsoring organization retains the disqualified person of a donor advised fund to provide services to the sponsoring organization or its donor advised funds and (ii) any amount charged to a donor advised fund in connection with such services is pursuant to a uniform and ratable allocation across all of the donor advised funds that receive such service. If the disqualified person of a donor advised fund is otherwise a disqualified person of the sponsoring organization itself (*e.g.*, the donor is a member of the board of trustees of the sponsoring organization), then section 4958 would apply to the disqualified person separately in that capacity. This principle could be illustrated by the following example:

Example: A sponsoring organization retains an independent accountant to audit its books and records. The accountant is a disqualified person of a donor advised fund of the sponsoring organization, but not the sponsoring organization itself. The accountant's fees, negotiated by the sponsoring organization, are charged uniformly across all of the sponsoring organization's donor advised funds. Section 4958(c)(2) does not apply because the accountant is not retained to provide services specifically for the donor advised fund with respect to which the accountant is a disqualified person, and the sponsoring organization has negotiated compensation for the accountant at a rate that will apply uniformly to all of its donor advised funds.

- (ii) We recommend that guidance confirm that, so long as the sponsoring organization retains an investment advisor for the benefit of all of its donor advised funds (or a subset based on objective criteria), and the allocation of the investment advisor's fee to the investment advisor's donor advised fund is calculated on a uniform and objective basis that applies in the same manner to the other donor advised funds invested with that same investment advisor, the automatic excess benefit rules of section 4958(c)(2) do not apply, but the investment advisor is still subject to the general intermediate sanctions rules with respect to its overall arrangement with the sponsoring organization.

f. Explanation of Donor Advised Fund Recommendations.

(i) Services Provided to Sponsoring Organization.

Our recommendation, including the example, is derived from the Joint Committee Report. We agree with the Joint Committee Report's analysis and urge that it be reflected in formal guidance as indicated above.

(ii) Services Provided by Investment Advisor.

This second recommendation is similar to the first and is also supported by the Joint Committee Report’s analysis. Investment advisors are different from most other service providers because their services may be provided to some but not all of the donor advised funds held by the sponsoring organization. This is true where the sponsoring organization provides several investment options to its donor advised funds, ranging from the most conservative to more aggressive strategies. For this reason, it is important that guidance not require that all of a sponsoring organization’s donor advised funds be charged ratably or uniformly for the investment advisor’s fee, but rather that all of a sponsoring organization’s donor advised funds that are eligible to benefit or that receive the services in question be charged ratably or uniformly. In addition, it is important that guidance not require that the same fee or compensation apply to the affected donor advised funds but rather that an objective and uniform rate apply. It is not uncommon, for example, for investment advisors to charge a lower advisory fee to accounts in excess of a certain size.

• **Section 4958(c)(3) Excess Benefit Transactions Involving Supported Organizations.**

g. Background on Supporting Organization Issues.

Section 4958(c)(3) imposes excise tax on certain “excess benefit transactions” engaged in by SOs. The term “excess benefit transaction” is defined to include any grant, loan, compensation, or similar payment provided by a substantial contributor and certain related persons and controlled entities. Section 4958(c)(3)(B) does not, however, deal clearly with the situation in which the substantial contributor is itself a supported organization of the SO that is classified under section 501(c)(4), 501(c)(5) or 501(c)(6). Section 4958(c)(3)(C)(ii) provides that the term substantial contributor does not include an organization described in paragraphs (1), (2), or (4) of section 509(a) but is not explicit about the situation in which the supported organization is one described in section 501(c)(4), 501(c)(5) or 501(c)(6).

h. Recommendation on Supporting Organization Provisions.

We recommend that Treasury issue guidance confirming that transfers of assets and cost-sharing between an SO and (1) a supported organization described in section 501(c)(4), 501(c)(5) or 501(c)(6); or (2) another SO within the same controlled group, are not excess benefit transactions.

i. Explanation of Supporting Organization Recommendations.

Section 509(a) provides that a supported organization may be an organization described in section 501(c)(4), 501(c)(5) or 501(c)(6) which would be described in paragraph 509(a)(2) if it were an organization described in section 501(c)(3). It is common for organizations such as section 501(c)(6) trade associations to have related charitable entities that are classified as public charities by virtue of their SO relationship

to the section 501(c)(6) supported organization. In these situations it is common practice for the two organizations to share employees and to pay for accounting, technology and other services on a shared cost basis. Section 4958(c) is intended to forestall transactions that may result in benefits to private persons. Such abuse does not appear likely in transactions between related exempt organizations where the cost-sharing is allocated strictly on a use basis.

A similar issue exists with regard to cost-sharing and transfers of assets between one SO and another SO within a group of organizations where the parent is an SO and some affiliates are SOs. This is a common structure for healthcare and certain other industries, including higher education financing, in which the parent disburses funding to the other group members, including SOs. Again, this situation does not appear to present the potential for the type of abuses that the excess benefit transaction rules were designed to prevent. Cost-sharing and the ability to transfer capital efficiently to meet community needs are important in reducing overall costs of exempt organizations and in accomplishing exempt purposes.

D. Provisions Regarding Section 4943 Excess Business Holdings

1. Application to Donor Advised Funds.

a. Background on Donor Advised Fund Issues.

Section 4943 imposes an excise tax on a private foundation that holds, at any time during the taxable year, more than twenty percent of the voting stock of any corporation. Sections 4943(a)(1), (c)(2). For purposes of this measurement, voting stock held by a private foundation is aggregated with all voting stock held by “disqualified persons” with respect to the foundation, as defined in section 4946(a).⁷⁸ .

Solely for purposes of the excess business holdings rules, a foundation that is effectively controlled by the same persons who control the private foundation in question, or substantially all of the contributions to which were made by the same persons who made substantially all of the contributions to the private foundation in question, will be treated as a disqualified person with respect to the foundation in question.⁷⁹ This means that the business holdings of a foundation under common control or with substantially the same donors as the foundation in question will be aggregated for purposes of applying the excess business holdings limitations. Regulation § 53.4946-1(b) provides guidance and examples regarding these rules.

Where a foundation can establish that one or more persons who are not disqualified persons with respect to the foundation hold effective control of the corporation, the aggregate limit is increased to thirty five percent, under section 4943(c)(2)(B). Similar rules apply with respect to ownership interests in other business enterprises, such as partnerships and trusts.

⁷⁸ Section 4943(c)(2)(A)(ii).

⁷⁹ Section 4946(a)(1)(H).

Under a *de minimis* rule at section 4943(c)(2)(C), a foundation may own a two percent interest in any business enterprise, regardless of the ownership interests held by disqualified persons.

Donor advised funds have not historically been subject to the section 4943 excess business holdings rules. Section 4943(e) extends the excess business holdings rules to donor advised funds, as defined in section 4966(d)(2). Transitional rules and limited grandfathering rules apply.⁸⁰

For purposes of applying the aggregation rules under section 4943 to donor advised funds, section 4943(e)(2) sets out a definition of “disqualified person” that is different from the definition that applies to private foundations for the same purposes, under section 4946(a). The new definition encompasses any person described in section 4966(d)(2)(A)(iii), *i.e.*, a donor or donor advisor; a member of the family of such an individual; and an entity in which such persons own more than a thirty five percent interest.

b. Recommendations on Donor Advised Fund Provisions.

- (i) Guidance should confirm that in the event that a donor advised fund is subject to excise tax liability under section 4943(a), only the assets of the donor advised fund, and not other assets of the sponsoring organization, are liable for the tax.
- (ii) It would be helpful for guidance to confirm that the excess business holdings rules do not apply to the sponsoring organization’s holdings outside its donor advised funds.
- (iii) It would further be helpful for guidance to clarify that the two percent *de minimis* exception in section 4943(c)(2)(C) generally applies to each donor advised fund on a separate basis.
- (iv) It would be helpful for guidance to indicate the circumstances under which “related” donor advised funds held by the same sponsoring organization may be aggregated for purposes of applying the excess business holdings rules.

c. Explanation of Donor Advised Fund Recommendations.

Section 4943 was added to the Code by the Tax Reform Act of 1969. The legislative history to the provision indicates that the use of foundations to maintain control of businesses appeared to be increasing, and that there was a need for clarity as to

⁸⁰ See section 4943(e)(3).

the point at which this noncharitable purpose should disqualify a foundation for exemption.⁸¹

The Joint Committee Report does not address the rationale for applying the excess business holdings rules to donor advised funds. We assume that the reasons were similar to those for the addition of section 4943 to the Code in 1969: *i.e.*, there was a concern that donors were seeking to retain control (or at least influence) with respect to businesses through the use of donor advised funds.

Section 4943(e) provides that a donor advised fund, as defined in new section 4966(d)(2) shall be treated as a private foundation for purposes of the excess business holdings rules. Under that definition, a donor advised fund is held by a “sponsoring organization,” *i.e.*, a public charity other than an SO under section 509(a)(3). A sponsoring organization such as a community foundation may hold hundreds of such donor advised funds and may hold a large portfolio of investments and assets outside its donor advised funds.

If the concern is that a donor may seek to retain control or influence over a business through a donor advised fund, the rationale for applying the excess business holdings rules extends only to the donor advised fund (or funds) over which the donor or related persons have influence, and not to the sponsoring organization (which by definition under section 4966(d)(1)(B) must be a public charity) generally with respect to its investments and assets outside of its donor advised funds. Similarly, under this rationale the excess business holdings limits and the two percent *de minimis* rule should apply separately to each donor advised fund (except to the extent that two or more donor advised funds may be related, as addressed below).

Because it is possible for a donor and/or related persons to establish multiple donor advised funds, some form of aggregation rule among “related” funds would seem to be necessary in order to carry out the apparent intent of section 4943(e). While sections 4946(a)(1)(H) and section 4943(f)(4)(A)(v) provide aggregation rules for private foundations and SOs that are subject to section 4943, section 4943(e) does not contain similar rules in the donor advised fund context. We presume that the lack of a Congressional mandate with respect to aggregation in the donor advised fund context stems from a determination that the practical difficulties for a sponsoring organization to determine whether there is a “related” donor advised fund held by another sponsoring organization, and to calculate the section 4943 limits in combination with any such donor advised fund, were too great to justify aggregation. It may nevertheless be appropriate to consider whether aggregation should apply between or among donor advised funds held at the same sponsoring organization where there is a relationship between or among such funds. Guidance would be helpful as to whether any such aggregation will apply, and the nature of any relationship that may give rise to aggregation.

2. Application to Supporting Organizations.

⁸¹ Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1969, H.R. 13270, 91st Congress, Pub. L. No. 91-172, 40, (December 3, 1970).

a. Background on Supporting Organization Issues.

SOs have not historically been subject to the section 4943 excess business holdings rules. Section 4943(f) extends those rules to (1) Type III SOs, other than “functionally integrated” Type III SOs, as defined in section 4943(f)(5)(B), and (2) any Type II SO that accepts a gift or contribution from a person who directly or indirectly controls, either alone or together with one or more related persons, the governing board of the supported organization. Transitional rules and limited grandfathering rules apply.⁸²

For purposes of applying the aggregation rules under section 4943 to SOs, section 4943(f)(4) sets out a definition of “disqualified person” that is different from the definition that applies to private foundations for the same purposes, under section 4946(a), and different from the definition that applies to donor advised funds under section 4943(e)(2), described above. The new definition mirrors the language of section 4958(f)(1), and in addition includes at section 4943(f)(4)(A)(v) any organization that is effectively controlled by the same persons who control the SO, and organizations substantially all of the contributions to which were made by the same or related persons. This last provision appears to mirror the rule for private foundations at section 4946(a)(1)(H).

The Joint Committee Report describes the definition of a “disqualified person” with respect to an affected SO as follows:

In applying such rules, the term disqualified person has the meaning provided in section 4958, and also includes substantial contributors and related persons and any organization that is effectively controlled by the same person or persons who control the SO or any organization substantially all of the contributions to which were made by the same person or persons who made substantially all of the contributions to the supporting organization.⁸³

Under section 4943(f)(2), Treasury “may exempt the excess business holdings of any organization” from the application of the new rule as it applies to SOs if the Secretary determines that such holdings are consistent with the purpose or function constituting the basis for the organization’s exemption under section 501.

b. Recommendations for Supporting Organization Provisions.

- (i) We recommend that guidance clarify that the principles reflected in the Regulations under section 4958 and other guidance under section 4958 will apply for purposes of determining who is a disqualified person for purposes of section 4943(f)(4).

⁸² See sections 4943(f)(6) and (f)(7).

⁸³ Joint Committee Report at 360.

- (ii) We further recommend that Treasury create a bright line standard for determining when an organization is under common control with an SO within the meaning of section 4943(f)(3)(A)(v). Alternatively, it would be helpful to have clarification whether the standard for common control under section 4943(f)(3)(A)(v) is the same as that under section 4946(a)(1)(H) for private foundations, and whether rules similar to the rules at Regulation § 53.4946-1(b) will apply.
- (iii) Clarification would also be helpful as to whether the reference to an “organization” in section 4943(f)(4)(A)(v) refers only to an SO, as “organization” is defined at section 4943(f)(3), or to any type of organization.

c. Explanation of Supporting Organization Recommendations.

(i) Apply Guidance Under Section 4958.

Private foundations that are subject to section 4943 use the definition of a disqualified person in section 4946(a) for purposes of determining whose stock must be aggregated with the foundation’s in calculating applicable holding limits. The definition in section 4946(a) is reasonably clear and it is generally possible to identify with a fairly high degree of certainty who are the disqualified persons with respect to a foundation.

That is not the case, unfortunately, with the definition of a disqualified person with respect to an SO under section 4943(f). First, while the language of section 4943(f)((4)(A)(i)-(iv) largely mirrors and cross-references that of section 4958, it is not clear whether SOs may rely on Regulations and other guidance under section 4958 in interpreting section 4943(f)(4)(A)(i) regarding persons in a position to “exercise substantial influence.” It is often quite difficult to determine with certainty whether a person will be deemed to exercise substantial influence over an organization at any time over a five-year period. SOs should at a minimum have certainty that they can rely on the guidance in the Regulations under section 4958 as to how to apply this provision.

(ii) Create Bright-Lines for Determining Common Control.

Beyond mirroring the definition in section 4958, the concept of a disqualified person in section 4943(f)(4)(A)(v) extends to organizations “effectively controlled (directly or indirectly) by the same person or persons who control” the SO.

Questions regarding whether an organization is controlled or not by a particular person or group are often the subject of controversy in the context of both SOs and the excess business holdings rules.⁸⁴

⁸⁴ See, e.g., Rev. Rul. 81-111, 1981-1 C.B. 509 (foundation may qualify for thirty five percent limit by demonstrating that an unrelated party or “cohesive group” of unrelated parties exercises control, but not by showing that foundation and disqualified persons cannot exercise control).

In order to avoid ambiguity and disputes concerning the meaning of an organization under common control in the context of defining a disqualified person, we recommend that Treasury create a bright line regarding what is and what is not an organization effectively controlled by the same persons.

We note that the language at section 4943(f)(4)(A)(v) appears to mirror that at section 4946(a)(1)(H) for private foundations. Given that there are existing Regulations under section 4946(a)(1)(H) at Regulation § 53.4946-1(b) that address issues of common control and common contributors, it would be helpful to have guidance as to whether rules similar to those rules will apply in the SO context.

(iii) Clarify Definition of “Organization.”

Finally, we are aware anecdotally of confusion and disagreement among tax advisors concerning the meaning of the word “organization” at section 4943(f)(4)(A)(v). The confusion stems from the fact that section 4943(f)(3) defines an “organization” as a Type III SO (other than one that is functionally integrated) and certain Type II SOs. There is perceived ambiguity as to whether the word “organization” in section 4943(f)(4)(A)(v) has the same meaning as set out in section 4943(f)(3) (*i.e.*, only certain SOs), or whether instead it means any organization, whether or not described in section 4943(f)(4)(A)(v). If indeed the provision is based on section 4946(a)(1)(1), which makes certain private foundations disqualified persons with respect to other private foundations for purposes of section 4943, then the word “organization” in section 4943(f)(4)(A)(v) would seem to refer only to certain SOs, which would be disqualified persons with respect to other SOs.