

COMMENTS OF INDIVIDUAL MEMBERS OF THE AMERICAN BAR ASSOCIATION, SECTION OF REAL PROPERTY, PROBATE AND TRUST LAW, CHARITABLE PLANNING AND ORGANIZATIONS GROUP, CONCERNING INTERNAL REVENUE CODE SECTIONS 170, 4966, 4967 AND 4958, IN RESPONSE TO IRS NOTICE 2007-21

I. INFORMATION ON THE DRAFT OF THIS RESPONSE

The following comments were prepared by individuals who are members of the Charitable Planning and Organizations Group (the "Group") of the American Bar Association, Section of Real Property, Probate and Trust Law (the "Section"). We have prepared the attached comments concerning donor advised funds in response to the request for comments in IRS Notice 2007-21. The attached comments represent our own views and not the views or positions of the American Bar Association, the Section, the Group, or the firms or universities of which we are shareholders, partners or employees.

The principal responsibility was exercised by the Task Force leader for this project: Professor Christopher R. Hoyt, Univ. of Missouri (Kansas City) School of Law, Kansas City, Missouri. 64110. Telephone: (816) 235-2395. The comments were reviewed by Group and Committee chairs Carol Kroch, Jerry McCoy, Alan Rothschild and Mary Lee Turk. They also were reviewed by Linda B. Hirschson of the Section's Committee on Coordination of Governmental Submissions.

Although members of the Charitable Planning and Organizations Group of the Real Property, Probate and Trust Law Section of the American Bar Association who participated in preparing these comments and recommendations have clients who are affected by the federal tax principles addressed, or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a governmental submission with respect to, or otherwise influence the development or outcome of, the specific subject matter of these comments.

II EXECUTIVE SUMMARY

The Task Force concluded that donor advised funds serve the public good and should be encouraged. The sanctions that Congress enacted in 2006 to prevent non-charitable distributions from donor advised funds should provide greater assurance that the resources in these funds will be used for charitable purposes.

The Pension Protection Act of 2006<sup>1</sup> (the "PPA") enacted Code Sections<sup>2</sup> 4966 and 4967 and amended Code Section 4958 to define and regulate donor advised funds administered by sponsoring charitable organizations. That legislation required a study of donor advised funds.

These comments are in response to the Internal Revenue Service's (the "Service") request in Notice 2007-21<sup>3</sup> for "comments on the specific issues identified ... and other issues relevant to the study." With respect to the specific issues that the Service identified in the notice, the Task Force concluded that current law adequately answers most of those questions. The Task Force

would not be averse to a requirement that a sponsoring organization be required to distribute a minimum of 5% of the total value of all assets in all donor advised funds at the organization. It is the view of the Task Force that there should not be a minimum distribution requirement imposed on each donor advised fund.

With respect to the other issues, we would like to alert you to the need to promptly resolve four important legal questions. The administrators of donor advised funds frequently confront these four situations for which there is no clear answer in the legislation or in the technical explanation of the legislation by the Joint Committee on Taxation.<sup>4</sup> With the enactment of severe penalties for certain grants from donor advised funds, the stakes are high and guidance is needed. The Task Force recommends that the following four scenarios be permissible actions that will not trigger the 125% penalty tax of Section 4967 or any other penalty that may apply to donor advised funds:

\* A distribution from a donor advised fund to satisfy a charitable pledge made by the person who recommends the distribution from the fund.

\* A distribution from a donor advised fund to pay the charitable portion of a bifurcated grant; such as when an individual sponsors a table at a fund-raising dinner and pays the non-charitable meal portion and requests a grant from a donor advised fund to pay the charitable portion.

\* A fund established solely for the benefit of a public charity or governmental entity, that ordinarily would fall outside the definition of a donor advised fund, should be permitted to make disbursements to individuals or other parties pursuant to written instructions received from that public charity or governmental entity; such disbursements should not convert it into a donor advised fund.

\* With respect to a scholarship fund at a sponsoring organization which receives contributions from a tax-exempt membership organization, such as a Section 501(c)(4) social welfare organization, members of that organization who are otherwise unrelated should be able to comprise a majority of the scholarship selection committee.

We strongly recommend that the guidance issued by the Service be clear and easy to comply with. This is a practical necessity. Many donor advised funds are at small community foundations that have limited access to charitable legal specialists. Donor advised funds have much smaller balances and make smaller grants than private foundations. One study found that 18% of the donor advised funds at community foundations had balances under \$10,000 and 58% had balances under \$50,000.<sup>5</sup> Several sponsoring organizations, including the nation's largest, permit a person to establish a donor advised fund with as little as \$5,000 and permit charitable grants as low as \$100. In order for these small grants to be processed efficiently, the laws for donor advised funds need to be clearer and simpler than the very complicated and technical laws that apply to private foundations.

We appreciate the opportunity to comment on the new laws governing donor advised funds. Our hope is that additional guidance on the application of Code Sections 170, 4966, 4967 and 4958

will provide sufficient clarity to guide tax professionals, sponsoring organizations and donors. We appreciate your consideration of our comments and welcome the opportunity to discuss them further with you.

### III. SPECIFIC QUESTIONS ASKED IN NOTICE 2007-21

The PPA enacted Code Sections 4966 and 4967 and amended Code Section 4958 to define and regulate donor advised funds administered by sponsoring charitable organizations. Section 1226 of the PPA provides that the Secretary shall undertake a study on the organization and operation of donor advised funds and supporting organizations. Certain aspects of the administration of donor advised funds were specifically identified for study.<sup>6</sup>

In Notice 2007-21, the Service specifically asked for comments on the following questions:

1. What are the advantages and disadvantages of donor advised funds and supporting organizations to the charitable sector, donors, sponsoring organizations, and supported organizations, compared to private foundations and other charitable giving arrangements?
2. How should the amount and availability of a charitable contribution deduction for a transfer of assets to a donor advised fund or a supporting organization, and the tax-exempt status or foundation classification of the donee, be determined if:
  - a. the transferred assets are paid to, or used for the benefit of, the donor or persons related to the donor (including, for example, salaries and other compensation arrangements, loans, or any other personal benefits or rights)?
  - b. the donor has investment control over the transferred assets?
  - c. there is an expectation that the donor's "advice" will be followed, or will be the sole or primary consideration, in determining distributions from, or investment of the assets in, the supporting organization or the donor advised fund?
  - d. the donor or the donee has option rights (e.g., puts, calls, or rights of first refusal) with respect to the transferred assets?
  - e. the transferred assets are appreciated real, personal, or intangible property that is not readily convertible to cash?
3. What are the effects or the expected effects of the PPA provisions (including the section 4958 excess benefit transaction tax amendments applicable to donor advised funds and supporting organizations) on the practices and behavior of donors, donor advised funds, sponsoring organizations, supporting organizations and supported organizations?
4. What would be appropriate payout requirements, and why, for:
  - a. donor advised funds?
  - b. funds that are excepted from donor advised fund treatment by statute or by the authority of the Secretary, but for which the donor retains meaningful rights with respect to the investment or use of the transferred amounts?

- c. supporting organizations?
- d. any other types of charities?

5. What are the advantages and disadvantages of perpetual existence of donor advised funds or supporting organizations?

6. What other types of charitable giving arrangements give rise to any of the above issues?

#### IV. COMMENTS ON ISSUES RAISED IN NOTICE 2007-21

*1. What are the advantages and disadvantages of donor advised funds and supporting organizations to the charitable sector, donors, sponsoring organizations, and supported organizations, compared to private foundations and other charitable giving arrangements?*

##### *Advantages Compared to Private Foundations*

A donor advised fund is a vehicle that permits a donor to engage in philanthropy – an activity that has significantly enhanced the lives of the nation’s citizens. Traditionally this activity has been carried on by grant-making private foundations, but the administrative costs of establishing and operating a private foundation have created a barrier-to-entry so that philanthropy had been effectively restricted to the wealthy. By dividing administrative costs among multiple donor advised funds, sponsoring charities have been able to allow the nation’s middle class to become philanthropists. An individual can establish a donor advised fund with as little as \$5,000 and make charitable grants of as little as \$100.<sup>7</sup>

Grants from donor advised funds now exceed 10% of the grants made by the nation’s private foundations.<sup>8</sup> Donor advised fund assets have experienced significant growth over the past ten years, averaging between 25% and 30% increases every year. Whereas donor advised funds held \$2.4 billion of assets in 1995, by 2003 the estimated total was somewhere between \$13 billion and \$15 billion.<sup>9</sup> Like private foundations, the resources in donor advised funds are irrevocably dedicated to charitable purposes

Another advantage of a donor advised fund is the oversight provided by the public charity’s governing body and staff to assure that every grant is made for a charitable purpose. They catch mistakes made by some donors. For example, occasionally donors do not recognize the technical legal distinction between a charitable gift to a Section 501(c)(3) charity and a similar gift to a Section 501(c)(4) social welfare organization or a Section 501(c)(6) chamber of commerce that would not qualify for a charitable income tax deduction. The staff of the sponsoring organization understands these legal nuances and catch these sorts of mistakes, thereby improving the administration of the tax laws. At many sponsoring organizations, particularly regional community foundations and religious community foundations, the staff has charitable expertise and can often suggest the best organizations for a donor to accomplish his or her philanthropic objectives.

Donors who would be subject to the 30% annual charitable deduction limitation for a cash gift to a private foundation receive more favorable income tax treatment for a cash gift to a donor

advised fund – up to a 50% annual deduction limitation. Donors with appreciated real estate can deduct the fair market value of the real estate contributed to a public charity compared to only deducting the property's cost if contributed to a private foundation. A justification for the difference between private foundation tax deductions and the more generous public charity tax deductions is the oversight provided by an independent governing body. Often the entire governing body of a private foundation consists of the organization's sole donors. This is not the case for a publicly-supported charity that administers donor advised funds.

### *Disadvantages Compared to Private Foundations*

Occasionally a donor would like to be compensated for his or her services for investigating and making charitable grants. A donor can receive reasonable compensation for services from a private foundation but is prohibited from receiving any compensation for services from a donor advised fund. Section 4958(c)(2).

*Task Force Recommendation:* The growth of donor advised funds should be encouraged. They serve as a vehicle for individuals to engage in philanthropy with oversight by an independent governing body and staff. The significant growth in the number of funds and their resources demonstrates public acceptance and support. The shared administrative costs have permitted the nation's middle class to become philanthropists, an activity that should be supported.

2. *How should the amount and availability of a charitable contribution deduction for a transfer of assets to a donor advised fund or a supporting organization, and the tax-exempt status or foundation classification of the donee, be determined if:*

*a. the transferred assets are paid to, or used for the benefit of, the donor or persons related to the donor (including, for example, salaries and other compensation arrangements, loans, or any other personal benefits or rights)?*

Current law already provides that a charitable income tax deduction should be reduced to the extent that a donor receives a financial benefit from a charitable contribution.<sup>10</sup> The same principle applies if a donor receives a personal benefit from a donor advised fund.<sup>11</sup> A challenge with philanthropic vehicles – whether a donor advised fund or a private foundation -- is that the donor may have claimed the tax deduction many years earlier and the claimed deduction cannot be reduced because of the statute of limitations.

*Task Force Recommendation:* If a donor receives a personal financial benefit from a donor advised fund that would reduce a claimed charitable income tax deduction, it should be reduced using the standards of current law. If the deduction cannot be reduced because of the statute of limitations, the Task Force concluded that the severe penalties that are imposed under current law whenever there is a personal benefit to the donor adequately punish the donor and make the government whole if the charitable contribution deduction cannot be adjusted. Section 4967(a)(1) imposes a 125% penalty on a donor who suggests a grant whereby the donor receives, directly or indirectly, a more than incidental benefit as a result of such distribution. There is also a 10% penalty on the sponsoring organization's fund manager who knowingly approves such a

grant. Section 4967(a)(2). Similarly, Section 4958(c)(2)(B) provides that the *entire* amount of a grant, loan, compensation or other similar payment from a donor advised fund to a donor is an excess benefit transaction. Normally only the *excess* amount over the reasonable value of the services received is an excess benefit payment. Section 4958(c)(1)(B).

*b. the donor has investment control over the transferred assets?*

Current law already delays a charitable income tax deduction if the donor retains so much control over the contributed property that a gift is deemed to be incomplete.<sup>12</sup> For completed charitable gifts, under prior law the Service had permitted donor involvement with investments under certain conditions.<sup>13</sup> The PPA legislation amended the definition of a donor advised fund to include a fund with respect to which the donor (or any person appointed or designated by the donor) has advisory privileges with respect to the *investment* of amounts held in such fund, even if the donor has no input on charitable grants.<sup>14</sup> Furthermore, payment to the donor or a related family member for investment advice with respect to assets maintained in a donor advised fund exposes parties to the penalty for an excess benefit transaction under Section 4958(f)(8).

*Task Force Recommendation Concerning the Charitable Deduction:* Current law already has adequate standards to determine whether a donor has made a completed gift of property that would affect the charitable deduction. The legislation concerning donor advised funds will effectively discourage investment involvement by the donor and members of the donor's family so that there is little need to legislate more complicated tax rules concerning the amount of the charitable tax deduction if such investment activity in fact takes place.

*Task Force Recommendation Concerning Investment Advice:* The Service should issue guidance that clarifies when uncompensated investment suggestions will not cause a gift to be classified as a donor advised fund. The best use of charitable resources requires some discussion of investments. For example, when a donor establishes a fund with a community foundation, the best investments will often depend on the disbursement time frame. A long-term endowment fund should probably have some investment in equities, but a fund that will be completely distributed within two years should probably be invested primarily in short-term investments, such as a money market fund, where there is not the market risk of equity investments.

*c. there is an expectation that the donor's "advice" will be followed, or will be the sole or primary consideration, in determining distributions from, or investment of the assets in, the supporting organization or the donor advised fund?*

*Investment Advice:* See the preceding response.

*Charitable Distributions:* The primary concern of Congress and the Service regarding distributions from a donor advised fund is that the resources be used solely for charitable purposes. The identity of the charitable recipient – the particular university, museum or social service agency – is not, and should not be, an issue.

Accordingly, present law permits a donor to make a fully deductible charitable gift notwithstanding the retention by the donor of a charitable power of appointment to redirect the gift to another public charity. Examples include the powers retained by a donor in a donor-directed fund,<sup>15</sup> the power of a donor to change which public charity will be the remainder beneficiary of a charitable remainder trust,<sup>16</sup> and the power to give stock to one charity and reserve the right to have that charity transfer the sales proceeds to any another public charity designated by the donor.<sup>17</sup> Donor involvement with gifts is a growing trend one that charities are encouraging in the hope of increasing future gifts. The United Way, for example, found that many donors wanted to take advantage of their program that allows the donor to designate specific agencies as beneficiaries of the gifts that they made to the United Way.

*Task Force Recommendation:* The Task Force recommends that the expectation that a donor's advice will be followed, or will be the sole or primary consideration in determining charitable distributions from a donor advised fund, should not have any impact on the amount of the charitable income tax deduction. Notwithstanding that involvement of the donor, the gift should qualify as a gift to a public charity.

*d. the donor or the donee has option rights (e.g., puts, calls, or rights of first refusal) with respect to the transferred assets?*

Prudence dictates that a person who owns part of a closely-held business should enter into a buy-sell agreement with the other owners that restricts the ability to transfer ownership to other potential owners. If an asset being contributed to charity is subject to such a restriction, the value of the asset will be affected by the restriction as will the amount of the claimed charitable tax deduction.<sup>18</sup>

*Task Force Recommendation:* The Task Force believes that current law adequately takes into account the fact that restrictions on the transfer of donated property will affect the value of contributed property for purposes of determining the amount of the charitable income tax deduction.<sup>19</sup>

*e. the transferred assets are appreciated real, personal, or intangible property that is not readily convertible to cash?*

Substantial amounts of real property and personal property are contributed to charities every year. Except for a gift of an interest in a closely-held business,<sup>20</sup> current law does not distinguish between property that is contributed to a donor advised fund or to a fund for some other restricted charitable purpose at a particular organization. There is a distinction, however, for gifts of appreciated tangible personal property to a public charity. When the charity in fact uses the property for its exempt purpose, a donor can deduct the appreciated value of the property. If the property is not so used, the deduction is limited to the property's basis.

*Task Force Recommendation:* The Task Force believes that current law should continue to apply; that is, there should be no difference in the treatment whether such property is contributed to a donor advised fund or to a different type of fund.

*3. What are the effects or the expected effects of the PPA provisions (including the section 4958 excess benefit transaction tax amendments applicable to donor advised funds and supporting organizations) on the practices and behavior of donors, donor advised funds, sponsoring organizations, supporting organizations and supported organizations?*

The legislation should end the practices that are subject to penalties -- for example, grants to individuals, grants that compensate donors, and small grants to foreign charities where it is not cost-effective to exercise expenditure responsibility. For most “commercial gift funds” (sponsoring organizations associated with mutual fund companies and financial institutions), this has not been a great concern since most of these sponsoring organizations administer nothing but donor advised funds and they have always limited distributions to public charities.

On the other hand, the PPA has generated substantial administrative and compliance costs to charities -- notably geographic and religious community foundations -- that administer both donor advised funds and other charitable funds. Like most non-profit organizations, these charities use “fund accounting” and record each restricted gift in a separate fund. Many have gone through the extensive and arduous task of examining each and every fund agreement to determine whether or not it is a donor advised fund. Many are acting to eliminate minor provisions, such as statements that results will be reported to a donor, that were innocuous under prior law but that might cause a fund to be classified as a donor advised fund under current law.

*Task Force Recommendation:* There is considerable confusion and trepidation concerning the correct classification of a fund. The fear is that any involvement by a donor might make a fund a donor advised fund. Charities and donors need guidance and safe harbors that specify the minimal amount of donor involvement that will be permitted without triggering classification of a fund as a donor advised fund. Congress specifically authorized the issuance of such guidance. Section 4966(d)(2)(C)(ii). The Service issued extremely limited guidance in IRS Notice 2006-109 for educational grant commitments made before PPA was enacted and for employer-sponsored disaster relief assistance programs for federally declared disaster areas. Guidance is needed to cover many more situations.

From conversations with staff at numerous sponsoring organizations, four legal questions arise repeatedly. The first two concern the tax consequences of a distribution from a donor advised fund to pay a pledge or to pay the charitable portion of a bifurcated grant, which if paid directly by a donor would fully qualify for a charitable income tax deduction. The third concerns the proper classification of funds established by public charities and governments. The fourth relates to the administrative challenges for scholarship funds established by tax-exempt organizations. The Task Force believes guidance is needed with respect to these four questions and therefore addresses them in more detail at Part V of this document.

4. *What would be appropriate payout requirements, and why, for:*

*a. donor advised funds?*

Whereas annual grants from endowed private foundations usually hover near the legally mandated minimum of 5% of assets,<sup>21</sup> grants from donor advised funds at community foundations average 17% of assets and grants from commercial gift funds average in excess of 22%.<sup>22</sup> There is, of course, a wide variation among the organizations that administer the funds. In 2001, one sponsoring organization distributed less than 2% of its donor advised fund assets whereas another distributed nearly 30%. For commercial gift funds, the comparable range was between 7% and 28%.<sup>23</sup> Thus, donor advised funds as a group distribute a substantially higher percentage of assets than private foundations.

Conversations with staff at community foundations indicated a near universal consensus that a fund-by-fund minimum payout requirement would be overly burdensome. Each person could think of several funds at their organizations where there would be challenges. Examples include “acorn” funds and funds that recently received a contribution of real estate waiting to be sold. An acorn fund is a donor advised fund that begins with a small amount – often below the usual threshold minimum to establish a fund – but which is encouraged to grow in size. Many community foundations use this as a way to engage local donors in philanthropy and encourage growth and more gifts in the future.

*Task Force Recommendation:* The Task Force believes that it would be reasonable to require a sponsoring organization to make annual charitable distributions of at least 5% of the total value of all assets in all donor advised funds at the organization. Such a minimum distribution requirement is comparable to that for private foundations. With charitable distributions from donor advised funds averaging over 17% of assets, most sponsoring organizations are already distributing significantly more than most private foundations.

There should not be a minimum distribution requirement for each donor advised fund. Such a requirement would impose a difficult and expensive administrative burden on many community foundations and other sponsoring organizations. One commentator observed that the imposition of a minimum payout for each fund could actually reduce distributions. Some donor advisors might modify their behavior and reduce their recommended distributions to the legally mandated requirement, similar to the way most private foundations tend to distribute very nearly the precise required amount of 5% per annum.

*b. funds that are excepted from donor advised fund treatment by statute or by the authority of the Secretary, but for which the donor retains meaningful rights with respect to the investment or use of the transferred amounts?*

Section 4966(d)(2)(B)(i) exempts from the definition of a donor advised fund a fund “which makes distributions only to a single identified organization or governmental entity.” The benefiting organization should be monitoring such a fund.

*Task Force Recommendation:* The Task Force recommends that funds that are exempted from the definition of a donor advised fund not be subject to a minimum distribution requirement.

*c. supporting organization?*

The Task Force does not have a recommendation with respect to a minimum distribution requirement from a supporting organization. The universe of supporting organizations is very diverse, from fund-raising organizations to university endowments to functionally-integrated hospital organizations. A uniform minimum distribution requirement could adversely affect some supporting organizations as well as the publicly supported charities that they were established to support.

*d. any other types of charities?*

The Task Force does not have a recommendation with respect to minimum distribution requirements for other types of public charities.

*5. What are the advantages and disadvantages of perpetual existence of donor advised funds or supporting organizations?*

*Task Force Recommendation:* The advantages and disadvantages of the perpetual existence of donor advised funds or supporting organizations are comparable to the advantages and disadvantages of the perpetual existence of any charity or of a charity's endowment fund. Charitable organizations and their endowments should not have an artificially imposed time limit.

## V. PLEDGES AND BIFURCATED GRANTS

### A. Penalty If There Is a More than Incidental Benefit

Section 4967 imposes a 125% penalty tax on a donor who recommends a distribution from a donor advised fund where the donor or a related person receives, directly or indirectly, a "more than incidental benefit" as a result of such distribution. The legislative history explains: "In general ... 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 with respect to such fund receives a benefit that would have reduced (or eliminated) a charitable contribution deduction if the benefit was received as part of the contribution to the sponsoring organization."<sup>24</sup> The example in the report (an unrestricted gift to the Girl Scouts of America is permitted if the donor's daughter is a Girl Scout) does not shed light on the issue of pledges or bifurcated grants.

## B. Pledges

The private foundation tax regulations provide that if a private foundation satisfies a disqualified person's legally binding pledge, the private foundation has engaged in an act of self-dealing that is subject to the self-dealing excise tax.<sup>25</sup> An exception applies to pledges made before 1973 "so long as the disqualified person obtains *no substantial benefit*, other than the satisfaction of its obligation, from such grant or payment."<sup>26</sup>

Many donors to private foundations are not aware of this rule and consult a legal advisor only after a pledge has been made. The rule has spawned much legal work surrounding the issue of whether a pledge was legally binding or not. The results can vary from state to state because of their different laws. One commentator observed that the law has become a trap "only for the uninformed philanthropist."<sup>27</sup> Educated donors have learned to make joint pledges with a private foundation or have carefully worded supportive commitments to a charity that don't rise to the status of a legally binding pledge.<sup>28</sup>

Educating donors, however, doesn't solve the problem. Every year we hear of reports where donors artfully worded an intention to make a gift (e.g., "I will recommend a grant from a donor advised fund") but the benefiting charity mistakenly records the statement on its books as a pledge. When the charity contacts the sponsoring organization and mentions the word "pledge", all chaos breaks out as the staff try to sort out the actual nature of the donor's statement.

With the growth of donor advised funds, the number of well meaning philanthropists has grown. There have been many requests for pledges to be paid from donor advised funds. The absence of any written guidance from the Service as to whether a pledge can be paid from a donor advised fund has resulted in considerable speculation and debate within the field.<sup>29</sup> With the enactment of severe penalties for certain grants from donor advised funds, the stakes are high and guidance is needed.

## C. Bifurcated Grants

A typical bifurcated grant is a ticket to a charitable fund-raising event where the donor proposes to pay the non-deductible portion of the cost (e.g., the value of the dinner) and a private foundation or donor advised fund is requested to pay the portion allocable to the charitable contribution for the fund-raising event. The only written guidance on this issue is a 1990 private letter ruling.<sup>30</sup> The Service concluded therein that it would be a self-dealing transaction for a private foundation to pay the charitable portion of a ticket to a charitable fund-raising event that would permit the donor corporation's employees to attend the event. The direct economic benefit to the corporation – the ability for its employees to attend the event – was considered not sufficiently tenuous or incidental so that it could be ignored. In other words, the donor corporation would have received a "more than incidental benefit." There has been no published guidance from a court or the Service on the consequences of such a disbursement from a donor advised fund.

#### D. Analysis

Permitting a donor advised fund to pay a donor's pledge, or to pay the charitable portion of a bifurcated grant, would mean that there is a discrepancy between the rules that apply to such funds and the rules that apply to private foundations. Similar such discrepancies already exist, however, and are not necessarily bad. There are many transactions that a public charity can engage in that a private foundation cannot, such as issuing a charitable gift annuity. Part of the justification for the difference is that a private foundation's sole contributor might control the entire governing body and operations of a private foundation, which is not the case with a donor advised fund administered at a public charity.

It is critical that there be clear and simple rules for the administration of donor advised funds. That may result in the phrase "more than incidental benefit" meaning one thing for a private foundation and another for a donor advised fund. The tax code already has provisions where the same term has one meaning for a private foundation and a different one for a public charity. For example, a "disqualified person" is defined one way in the context of a private foundation, a different way for a public charity, and a third way for a donor advised fund at a public charity.<sup>31</sup>

If a private foundation engages in a self-dealing transaction, there is a 10% penalty imposed on the disqualified person and the transaction must then be corrected.<sup>32</sup> By comparison, if a donor-advisor suggests a distribution whereby he or she receives a more than incidental benefit, there is a 125% penalty imposed on the donor-advisor.<sup>33</sup> The payment of either a pledge or the charitable portion of a bifurcated grant by a donor advised fund, which would qualify as a fully deductible charitable contribution if it had been paid directly by the donor-advisor, does not warrant such a severe penalty.

E. *Task Force Recommendation:* The Task Force recommends that there be a bright-line legal standard. To the extent that a donor's own payment to a Section 170(b)(1)(A) public charity would qualify for a charitable income tax deduction, an identical distribution from a donor advised fund should be a permissible distribution that will not produce a "more than incidental benefit" to the donor for purposes of any of the donor advised fund penalty taxes, particularly the 125% penalty tax.<sup>34</sup> This is consistent with the legislative history.<sup>35</sup> Thus, a distribution from a donor advised fund could satisfy a donor's pledge and could pay for the charitable portion of a bifurcated grant.

Such a rule provides an objective legal standard that donors, administrators of donor advised funds and benefiting charities can understand. The legal clarity should improve compliance with the tax laws. The rule also should increase distributions from donor advised funds to benefiting charities as compared to a more complicated restriction that would prohibit such charitable distributions. The Service announced in Notice 2007-7 that distributions from IRAs could be used to pay charitable pledges. We believe that a similar rule for grants from donor advised funds is appropriate.

VI. FUNDS THAT BENEFIT ONLY A SINGLE PUBLIC CHARITY OR GOVERNMENTAL ENTITY – – *Permit grants to non-charities per instructions from the public charity or government*

The definition of a donor advised fund potentially includes any fund that has any continuing donor involvement.<sup>36</sup> Exempted from the definition, however, is “any fund or account which makes distributions only to a single identified organization or governmental entity” (emphasis added). Section 4966(d)(2)(B)(i).

Many public charities place their endowments with community foundations because of their investment expertise. Similarly, several city governments have established funds at community foundations or other charities to receive charitable contributions for a public project, such as the construction or maintenance of a park. In the past, these charities and governments would routinely instruct the sponsoring organization to make disbursements to third parties, such as payments to a construction company or some other service provider. This arrangement was usually more advantageous than having the check first issued to the charity or government which would then deposit the amount and then issue a new check to pay the expense. The procedure was particularly helpful for government funds since many governments had accounting systems that did not satisfactorily track voluntary charitable contributions to the government.

If it were not for the exemption for “distributions only to a single identified organization,” designated charitable and government funds would fall within the definition of a donor advised fund since the charity or government that established the fund is identified with the fund, often is a contributor to the fund, and is also involved with making disbursements. The problem is that the exemption requires that all disbursements be made “only to” the charity or government. Since PPA was enacted, community foundations and other sponsoring organizations have had to deny the reasonable requests of the public charity or government to issue checks to third parties for fear of losing the exemption from the definition of a donor advised fund and for fear of triggering the penalty taxes for making ineligible distributions from a donor advised fund, such as a grant to an individual. Instead, the checks must be issued to the supported charity or government which must then reissue the check to the service provider or individual. This prohibition has resulted in the inefficient use of charitable resources, especially with government funds.

*Task Force Recommendation:* The exemption from the definition of a donor advised fund contained in Section 4966(d)(2)(B)(i) should be interpreted to include a fund that benefits a single public charity (other than a disqualified supporting organization) or governmental entity so that disbursements can be made to another party pursuant to instructions received from that public charity or governmental entity. This clarification will increase the efficient use of charitable resources.

## VII. PERMIT TAX-EXEMPT MEMBERSHIP ORGANIZATIONS – PARTICULARLY 501(c)(4) SOCIAL WELFARE ORGANIZATIONS -- TO COMPRISE A MAJORITY OF A SCHOLARSHIP SELECTION COMMITTEE.

When someone contributes to a scholarship fund at a sponsoring organization, the fund could fall within the definition of a donor advised fund if that person is also on the scholarship selection committee. Potential penalties are serious since the grants from a scholarship fund are usually to or for the benefit of an individual, which is a per se violation for a donor advised fund. Section 4966(c)(1)(A). Fortunately, Congress enacted an exemption for a scholarship fund if certain criteria are met. One of the requirements is that “ no combination of [donors or people appointed or designated by donors) ] ...(or persons related to such persons) control, directly or indirectly, such committee”. Section 4966(d)(2)(B)(ii)(II).

While the prohibition of donor control over a scholarship fund makes sense when the donor is an individual, it is posing serious administrative challenges when “the donor” is a membership organization. Rather than form a separate Section 501(c)(3) charitable organization with the ensuing administrative costs and tax returns (also a burden for the Service), many Section 501(c)(4) social welfare organizations and 501(c)(8)&(10) fraternities and sororities have instead established scholarship funds at area community foundations. Perhaps the most common are Rotary scholarship funds. The arrangement had been mutually beneficial since the community foundation has charitable expertise and can help educate the scholarship selection committee on objective and charitable standards for selecting scholarship recipients.

In the past, the membership organization was able to appoint competent, unrelated members who would comprise the entire scholarship selection committee. Under the PPA, however, this is no longer permitted since “the donor” cannot control the committee. This has led to awkward situations. For example, community foundations must inform the local Rotary that the Rotary scholarship recipient must be selected by a committee, the majority of which are non-Rotarians. Furthermore, the community foundation has a difficult time finding numerous motivated non-Rotarians to serve on a Rotary scholarship selection committee.

Nor is the problem likely to be solved by Rotary, for example, establishing a separate Section 501(c)(3) Rotary Foundation to administer its scholarship programs. If the Section 501(c)(4) Rotary Club makes a contribution to such scholarship fund, the Rotary Foundation could be in non-compliance unless a majority of the committee consisted of individuals who were not members of Rotary.

*Task Force Recommendation:* The prohibition that a donor cannot directly or indirectly control a scholarship selection committee should be interpreted to permit members of many types of Section 501(c) tax-exempt organizations to comprise all or part of the scholarship committee. Specifically, the exemption should include Section 501(c)(3) public charities, 501(c)(4) social welfare organizations, 501(c)(5) labor and agricultural organizations, 501(c)(6) business leagues, 501(c)(8) and (10) fraternal organizations, and 501(c)(19) war veterans organizations. Section 501(c)(3) private foundations should continue to be subject to the requirements under existing law concerning grants made to public charities that are to be used for scholarships.

The committee should still be subject to all of the other requirements to avoid classification as a donor advised fund. For example, a majority of committee members should not be related family members. In addition, there is the requirement that “all grants from such fund or account are awarded on an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the board of directors of the sponsoring organization, and such procedure is designed to ensure that all such grants meet the requirements of paragraph (1), (2), or (3) of section 4945(g).” Section 4966(d)(2)(B)(ii)(III).

## VIII. CONCLUSION

Our hope is that additional guidance on the application of Code Sections 4966, 4967 and 4958 will provide sufficient clarity to guide tax professionals, sponsoring organizations and donors. We appreciate your consideration of our comments and welcome the opportunity to discuss them further with you.

## FOOTNOTES

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1. The Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780 (2006).
  2. References in these comments to Code Sections are to sections of the Internal Revenue Code of 1986 (the "Code"), as amended and, if preceded by "Treas. Reg. Section," to sections of the Treasury Regulations under the Code.
  3. Published in Internal Revenue Bulletin 2009-9.
  4. 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, (JCX-38-06), August 3, 2006, at 350.
  5. Statement of Jane G. Gravelle of the Congressional Research Service, Senate Finance Committee Hearings on Charities and Charitable Giving: Proposals for Reform (April 5, 2005), page 5. <http://www.senate.gov/~finance/hearings/testimony/2005test/jgtest040505.pdf>
  6. The study shall specifically consider:
    - (1) whether the deductions allowed for income, gift, or estate taxes for charitable contributions to sponsoring organizations of donor advised funds or to supporting organizations are appropriate in consideration of (i) the use of contributed assets (including the type, extent, and timing of such use) or (ii) the use of the assets of such organizations for the benefit of the person making the charitable contribution (or a person related to such person),
    - (2) whether donor advised funds should be required to distribute for charitable purposes a specified amount (whether based on the income or assets of the fund) in order to ensure that the sponsoring organization with respect to the fund is operating consistent with the purposes or functions constituting the basis for its exemption under section 501 or its status as an organization described in section 509(a),
    - (3) whether the retention by donors to donor advised funds or supporting organizations of rights or privileges with respect to amounts transferred to such organizations (including advisory rights or privileges with respect to the making of grants or the investment of assets) is consistent with the treatment of such transfers as completed gifts that qualify for a deduction for income, gift, or estate taxes, and
    - (4) whether any of the issues described above also are issues with respect to other forms of charities or charitable donations.
  7. The Fidelity Charitable Gift Fund. <http://www.charitablegift.org>.

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8. Statement of Jane G. Gravelle of the Congressional Research Service, Senate Finance Committee Hearings on Charities and Charitable Giving: Proposals for Reform (April 5, 2005), page 5. <http://www.senate.gov/~finance/hearings/testimony/2005test/jgtest040505.pdf>
  9. *Id.* at page 3.
  10. For example, a charitable remainder trust is part charitable and part non-charitable. The tax deduction is limited to the value of the charitable remainder interest. Section 170(f)(2).
  11. *United States v. L. Donald Guess et al. (Xelan Foundation)*; No. 04 CV 2184-LAB (AJB) (U.S. Dist CA --Dec. 2004).
  12. See *Goldstein v. Commissioner*, 89 T.C. 535, 541-42 (1987) (citing *Weil v. Commissioner*, 31 B.T.A. 899, 906 (1934), *aff'd*, 82 F.2d 561 (5th Cir. 1936), *cert. denied*, 299 U.S. 552 (1936)). *Pauley v. United States*, 459 F.2d 624, 627 (9th Cir. 1972). See also *Hansen v. Commissioner*, 820 F.2d 1464, 1468 (9th Cir. 1987). *Transamerica Corp. v. United States*, 15 Cl. Ct. 420, 466 (1988), *aff'd*, 902 F.2d 1540 (Fed. Cir. 1990).
  13. Private Letter Rulings 200445023 and 200445024 (July 12, 2004).
  14. Section 4966(d)(2)(a)(iii).
  15. Section 170(b)(1)(F)(iii). Note that even if the donor directed fund is part of a private foundation, Congress determined that the donor should be able to claim a charitable income tax deduction for a gift to such a fund under the more generous rules that apply to gifts to public charities. Section 170(b)(1)(A)(vii).
  16. Rev. Rul. 76-371, 1976-2 C.B. 305 (public charity tax deduction if eligible charities are limited to those described in Sec. 170(b)(1)(A)).
  17. Rev. Rul 69-276, 1969-1 C.B. 64.
  18. *Jeffrey L. Okerlund. v. United States*, 365 F. 3<sup>rd</sup> 1044 (Fed. Cir. 2004); Private Letter Ruling 200321010 (Feb. 13, 2003).
  19. *Id.*
  20. Section 4943(e), enacted by PPA, extended the private foundation excess business holdings tax to donor advised funds.
  21. Ludlum, Melissa, Domestic Private Foundations, Tax Years 1993-2002, Statistics of Income Bulletin, Fall, 2005, pp. 162-182, at p. 170.
  22. Statement of Jane G. Gravelle of the Congressional Research Service, Senate Finance Committee Hearings on Charities and Charitable Giving: Proposals for Reform (April 5, 2005), page 4. <http://www.senate.gov/~finance/hearings/testimony/2005test/jgtest040505.pdf>.

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23. *Id.*

24. 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, (JCX-38-06), August 3, 2006, at 350.

25. Treas. Reg. Section 53.4941(d)-2(f) states: "In general, the transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation shall constitute an act of self-dealing..... [I]f a private foundation makes a grant or other payment which satisfies the *legal* obligation of a disqualified person, such grant or payment shall ordinarily constitute an act of self-dealing to which this subparagraph applies. However, if a private foundation makes a grant or payment which satisfies a *pledge, enforceable under local law*, to an organization described in section 501(c)(3), which pledge is made on or before April 16, 1973, such grant or payment shall not constitute an act of self-dealing to which this subparagraph applies so long as the disqualified person obtains *no substantial benefit*, other than the satisfaction of its obligation, from such grant or payment" (emphasis added). The Service concluded, for example, that establishing a charitable remainder trust to satisfy a pledge was an act of self-dealing, since a CRT is subject to the private foundation self-dealing taxes. Private Letter Ruling 9714010 (Dec. 20, 1996). The Service also concluded in a revenue ruling that a private foundation engaged in a prohibited act of self-dealing when it paid the dues of a member of a religious congregation, even though the payment of such dues by that have person would have qualified for a full charitable income tax deduction. The Service concluded that membership was a direct benefit and the private foundation was relieving the individual of a legal obligation. Revenue Ruling 77-160, 1977-1 C.B. 351.

26. *Id.*

27. Katzenstein, Lawrence, "Reformation of Charitable Contribution Deduction: Areas for Reform," 35 *Exempt Organization Tax Review* 33 (Jan. 2002).

28. *Id.* and James B. Lyon, James, "Charitable Giving -- Pledges v. Letters of Intent," 2003 *Tax Notes Today* 249-28 (Dec. 30, 2003).

29. See the analysis in the pre-PPA legal memorandum of the law firm Arnold & Porter LLP which concluded that donor advised funds could pay pledges. "Firm Addresses Satisfaction of Charitable Pledges by Donor Advised Funds," 2005 *Tax Notes Today* 226-26 (Nov. 18, 2005). Among other things, the firm concluded that a donor did not have cancellation of indebtedness income when a third party paid a donor's pledge, citing Revenue Rulings 64-240, 1964-2 C.B. 172 and 55-410, 1955-1 C.B. 297 and the Tax Court case of *Wekesser v. Commissioner*, T.C. Memo. 1976-214. See also Section 108(e)(2) which provides for an exclusion from income when a third party pays a legal liability which, if paid by the original debtor, would have produced an income tax deduction. The same reasoning would apply to the satisfaction of a pledge since the payment by the person who made the pledge would produce a charitable income tax deduction.

30. Private Letter Ruling 9021066 (March 1, 1990).

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31. Compare Section 4966(a)(1) for private foundations, Section 4958(f)(1) for public charities and Section 4958(f)(7) for donor advised funds.
  32. Section 4941(a)(a)
  33. Section 4967(a)(1).
  34. Section 4967.
  35. See the text that accompanies *supra* n. 24.
  36. A donor advised fund is “a fund or account (i) which is separately identified by reference to contributions of a donor or donors, (ii) which is owned and controlled by a sponsoring organization, and (iii) with respect to which a donor (or any person appointed or designated by such donor) has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in such fund or account by reason of the donor's status as a donor.” Section 4966(d)(2)(A).