JOURNAL OF ACCOUNTANCY

PERSONAL FINANCIAL PLANNING / TAX

Donor-Advised Funds: Preparing for Closer Scrutiny

More restrictions may await this popular way to give.

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JANUARY 2008

EXECUTIVE SUMMARY

■ **Donor-advised funds (DAFs), as an alternative to private foundations,** have been a popular means of charitable giving, but fund managers, donors and their advisers must reckon with new laws and regulations stemming from the Pension Protection Act of 2006. A DAF allows the donor to advise the organization administering it on its use to support public charities. Congress is continuing to scrutinize issues of possible abuse of DAFs with a study mandated by the PPA.

■ **Donors benefit from fund managers' expertise** in selecting gift recipients and especially from the ability to deduct the fund donation before it is disbursed to the ultimate recipient.

■ **The possibility of an economic benefit to donors** has been among reasons for the scrutiny. Others relate to donor control of investments from the fund and the relationship between the organization sponsoring the fund and the one supported by it.

■ **Possible new directions in regulation of DAFs** could include a minimum required distribution of funds, since such a requirement has been raised as a possibility in both the study and an act that passed the Senate in 2005 but was not enacted into law.

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Congress has shown a great deal of interest in donor-advised funds (DAFs) in the last few years. The Pension Protection Act of 2006 introduced several significant restrictions on DAFs and directed the IRS to further study their organization and operation. In complying with that mandate, on Feb. 26 the Service issued Notice 2007-21, which raised some provocative and potentially wide-reaching issues concerning these funds. These issues may affect the ability of DAFs to continue to allow donors to defer some of the decisions relating to charitable contributions while obtaining immediate tax benefits.

This article explores the basic structure and characteristics of DAFs, their historic use and changes imposed by the PPA. It also explores issues raised by Notice 2007-21 and how future reforms may affect the planning opportunities DAFs offer.

ANATOMY OF A DAF

A DAF is an account at a charitable fund or foundation that results from a charitable contribution by a person who has an agreement with the fund or foundation that provides the donor the right to advise the foundation regarding the ultimate disposition of the gift. The gift is considered completed because the foundation is a public charity, and under the terms of the gift, future direction of the gift is limited to similarly situated and qualified charities. But the agreement provides the donor with rights that include recommending that the foundation make gifts to other charities from the DAF.

Although the foundation is not obligated to follow the donor's advice, it is understood and accepted that its failure to do so would be frowned upon by past and future donors. A DAF must also be identified with the donor or donors or a related person, usually by being named after them [IRC section 4966(d)(2)]. It offers tax and practical advantages for many taxpayers over private foundations, which are subject to lower limits on charitable deductions for donors, as well as special regulations concerning their operation and possible excise taxes.

DAF administrators can add significant value by assisting donors in identifying charitable giving opportunities consistent with their objectives. The administrator is obligated to ensure that the ultimate recipient of the funds is a qualified charity and to report to the donor on the earnings and disposition of the funds. DAF administrators benefit from this arrangement by receiving a fee for their services in handling and investing the funds.

Donors benefit from this arrangement by receiving a current tax deduction without having to decide on the ultimate recipient of the contribution. Donors often have the right to designate successor "advisers," such as their children, who can continue to advise the fund after the donor's death. This allows parents to build charitable giving habits in their children.

The DAF business is booming. Ninety-nine of the largest DAF administrators reported holdings of $19.2 billion in tens of thousands of individual accounts in 2006, up more than 21% from a year earlier (see Noelle Barton and Peter Panepento, "A Surge in Assets—Donor-Advised Funds Are Growing Exponentially," *The Chronicle of Philanthropy* , May 3, 2007). Donors' gifts to the funds amounted to $6 billion, an increase of 25% from 2005. Gifts to charities from the funds rose 18% to $3.5 billion, amounting to about 17% of the assets held in DAFs.

In Congress' Cross Hairs

Notice 2007-21 asked for public comments on several issues relating to DAFs:

1. Advantages and disadvantages of DAFs to the charitable sector, donors and others, compared to other charitable giving arrangements.

2. Propriety of deductions to DAFs when:

   a. Payments or other benefits are made back to donors or affiliates, that is, for compensation, loans, or other personal benefits or rights.
   b. The donor continues to control the investment of the assets.
   c. There is an expectation that the donor's "advice" will be followed in determining distributions or investments.
   d. The donor has option rights (for example, puts, calls or rights of first refusal) with respect to the assets.
   e. The transferred assets are appreciated real, personal or intangible property, not readily convertible into cash.

3. Expected impact of PPA provisions such as the section 4958 excess benefit transaction tax amendments.

4. Appropriate payout requirements.

5. Advantages and disadvantages of perpetual existence of DAFs.

6. Other types of giving arrangements, which give rise to these issues.

POTENTIAL ABUSES OF DAFs

In directing the Treasury Department to conduct its study, Congress was clearly concerned about several fundamental issues. One is that donors and their relatives might receive benefits from DAFs, such as compensation for services or loans. It is not uncommon for a person affiliated with a foundation to provide services and to be reasonably compensated for them. It is less common for a person to borrow back from a charity. Such a transaction could raise a question about whether the original gift was complete.

In any case, Congress' sensitivity to such transactions does not seem to be a serious concern to some in the philanthropy business. According to the Council on Foundations, "Even prior to the enactment of the PPA, Council members did not pay compensation to donors of donor-advised funds, nor did they make loans to them" (see comment letter in response to Notice 2007-21 of the Council on Foundations, April 9, 2007).

Another issue relates to control a donor may have over a gift. One form of control is the ability to direct the investment of the assets. Another is the influence a donor continues to have over the gifts to charities under the DAF agreement. Many DAF managers have developed procedures to prevent such activities from providing benefits to donors.

Appreciated gifts can receive extra scrutiny, due to the obvious potential benefits of sheltering gain on this kind of property. DAFs don't necessarily bring any new issues to the table in considering the tax effect of such contributions. Generally, DAFs will liquidate these investments promptly, within the bounds of obtaining a fair price for the assets.

A good indication of how Congress might deal with potential abuses of DAFs is S 2020, the proposed Tax Relief Act of 2005. Although never signed into law, S 2020 proposed a number of limitations on DAFs that correspond with the issues under study as a result of the PPA. They included required distributions of 5% of the fund assets, forcing the DAF to liquidate assets within a certain time (see Council on Foundations, Analysis of S 2020, The Tax Relief Act of 2005).

Indeed, one of the most significant issues relating to DAFs is how long the assets should be "parked" in a fund between the time the donor receives the deduction and the ultimate charity receives the benefit. Although DAFs as a whole seem to be distributing more than the distribution requirement proposed by S 2020, some individual funds may be distributing less and would be adversely affected by such a requirement. Donors argue that administering such a standard would be costly and might cause distributions to decrease (see Peter Panepento, "Managers of Donor-Advised Funds Wary of New Rules," *The Chronicle of Philanthropy*, May 3, 2007).

S 2020 also would have greatly expanded the definition of *disqualified persons* . Under current law, a disqualified person is one who is involved in the management of a charity or who makes a substantial contribution to it. An *excess benefit transaction* , one that provides an economic benefit to the disqualified person, can require payment of a 25% excise tax by the disqualified person on the value of the benefit received that exceeds its consideration. If the violation is not corrected within a specified time, an additional tax of 200% applies. (For a broader discussion of intermediate sanctions on excess benefit transactions, see " NPO Compensation in the Spotlight," *JofA*, Oct. 07, page 54.)

S 2020 would have made all donors to and advisers of DAFs disqualified persons, along with members of their families and businesses under their control. This would have greatly enlarged the pool of disqualified persons by including many individuals who lack any ability to substantially influence the organization's decisions. It would have posed particular problems for charities in smaller communities and those with large numbers of donor-advised funds, and could have substantially increased their operating costs.

How the Pension Protection Act of 2006 Affects Donor-Advised Funds

- It directs the Treasury secretary to conduct a one-year study to determine whether charitable contribution deductions are "appropriate" for gifts to advised funds, whether advised funds should be subject to a payout requirement, whether retention of advisory rights is consistent with the treatment of the transfers as "completed gifts," and whether the preceding issues also apply to other forms of charities or charitable gifts.

- Defines *donor-advised fund* as any fund or account that is separately identified by reference to the contributions of a donor or donors, owned and controlled by the sponsoring organization; and with respect to which a donor or person appointed by the donor has or reasonably expects to have advisory rights with respect to investments or distributions.

■ Identifies *prohibited grants* —grants to individuals or any entity if the payment is not for a charitable purpose—as taxable distributions, subject to a 20% excise tax on the recipient and 5% excise tax on the manager of the sponsoring organization who knowingly makes the distribution.

■ Denies deductibility for contributions to certain sponsoring organizations, including certain veterans and fraternal organizations and cemetery companies.

■ Requires donors to obtain a contemporaneous written acknowledgment from the sponsoring organization providing that the organization has exclusive legal control over the assets contributed.

■ Requires sponsoring organizations to exercise "expenditure responsibility" over certain grants.

■ Provides for penalties of:

- 125% of the amount of any *prohibited benefits* —more than incidental benefits from a donor-advised grant to the donor, adviser or related parties. The penalty can be imposed on the person who recommended the grant or the person who received the benefit.

- 10% for fund managers who knowingly approve prohibited benefit grants.

- 25% of *excess benefits* —grants, loans, compensation and similar payments from donor-advised funds to donors, advisers and related parties—and requires that the amount involved be repaid. Also included are any excessive payments to investment advisers.

■ Applies the excess business holdings rule to assets held by donor-advised funds.

■ Requires charities to disclose:

- How they will maintain such funds (on Form 1023, *Application for Recognition of Exemption*).

- The number of donor-advised funds, aggregate assets held, contributions to and distributions by those funds (on their annual Form 990, *Return of Organization Exempt From Income Tax*).

PLANNING ISSUES AND OPPORTUNITIES

In changes that took effect Feb. 13, 2007, the PPA eliminated income tax deductibility for DAF contributions to certain types of organizations, specifically war veterans and cemetery organizations and domestic fraternal lodges. It also specified how organizations that sponsor DAFs for the support of other organizations must be related to the supported organizations and increased requirements for substantiating contributions. These restrictions may seem relatively benign, but they portend greater challenges ahead. In advising clients as to the benefits of DAFs, CPAs should ensure that they explain the issues and possible future constraints. For example, the client should be willing to accept the responsibility of

recommending a significant amount of the fund assets be paid out to charities each year in the future, even though this is not currently required. A client in a small community should consider how stricter definitions of disqualified persons might affect the structure of the nonprofit organization and its cost of doing business. ❖

AICPA RESOURCES

***JofA* articles**

- " Monthly Checklist: Tune Up for High-Performance Wealth," July 07, page 25
- "The Right Philanthropic Vehicle," July 01, page 22

Conference

- Advanced Personal Financial Planning, Jan. 20—23, Las Vegas

For more information or to register, go to www.cpa2biz.com, or call the Institute at 888-777-7077.

OTHER RESOURCES

Web sites

- Council on Foundations, www.cof.org
- IRS Notice 2007-21, www.irs.gov/irb/2007-09_IRB/ar11.html

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