NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT RESPONDING TO NOTICE 2007-21 CONCERNING

DONOR-ADVISED FUNDS AND SUPPORTING ORGANIZATIONS

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Report No. 1129

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT RESPONDING TO NOTICE 2007-21 CONCERNING

DONOR-ADVISED FUNDS AND SUPPORTING ORGANIZATIONS[1]

This report responds to the request in Notice 2007-21[2] for public comments for a study being conducted by the Department of the Treasury (the "Treasury") and the Internal Revenue Service (the "Service" or "IRS") on donor-advised funds[3] ("DAFs") and supporting organizations[4] ("SOs"). The study is required by the Pension Protection Act of 2006 ("PPA").[5]

I. PPA Provisions

The PPA created a statutory definition for DAFs, which previously had been recognized in private letter rulings and case law, generally as separate funds or accounts established by public charities with funds from one or more donors. As components of sponsoring public

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1 The principal drafter of this report was Michelle P. Scott. Helpful comments were received from Kimberly S. Blanchard, Dale S. Collinson, Harvey Dale, Peter L. Faber, Patrick C. Gallagher, Carlyn S. McCaffrey, David S. Miller, Damon G. Rowe, Michael L. Schler, Jeffrey N. Schwartz and Richard R. Upton.

2 IRB 2007-9, February 26, 2007.

3 Section 4966(d)(2) of the Internal Revenue Code, as amended (the "Code"). Unless otherwise indicated, all "Section" references are to the Code.

4 Section 509(a)(3).

5 Section 1226, Pub. L. No. 109-280.

charities,[6] DAFs themselves have been treated as public charities. The legislation codifies rules that evolved from court decisions, determination letters and private letter rulings.

The Code has long recognized SOs and divided them into three types. SOs classified as Type I are "operated, supervised, or controlled by" one or more publicly supported organizations, in a relationship akin to that of a subsidiary and parent. A Type II SO is "supervised or controlled in connection with" one or more publicly supported organizations, in a brother-sister relationship. Type III SOs are "operated in connection with" one or more publicly supported organization, in a relationship that must meet a "responsiveness test."[7] The PPA delegated to the Secretary broad regulatory authority to impose a requirement that Type III SOs that are not functionally integrated distribute a percentage of their income or assets to their supported organizations.[8]

To improve the accountability of DAFs and Type III SOs, the PPA imposes new requirements and limitations on DAFs and SOs.[9] As a result, these entities are now subject to

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6 The PPA effectively limits the types of organizations that can act as sponsoring organizations for DAFs by denying charitable contribution deductions: (1) for contributions to DAFs for income tax purposes if the sponsoring organizations are veterans' organizations described in Section 170(c)(3), fraternal societies described in Section 170(c)(4), or cemetery companies described in Section 170(c)(5); (2) for gift tax purposes if the sponsoring organization is a fraternal society described in Section 2522(a)(3) or a veterans' organization described in Section 2055(a)(4); or (3) for estate tax purposes if the sponsoring organization is a fraternal society described in Section 2055(a)(3) or a veterans' organization described in Section 2055(a)(4). Also, charitable deductions are not allowed for income, estate and gift tax purposes, if the sponsoring organization is a Type III SO (other than a functionally integrated Type III) described in Section 509(a)(3)(B)(iii) and (d)(2).

7 Section 509(a)(3)(B)(i), (ii) and (iii).

8 PPA, Section 1241(d).

9 DAFs and SOs are subject to the generally applicable restrictions on public charities, including the Section 501(c)(3) prohibitions on private benefit and private inurement and the Section 4958 penalties on excess benefit transactions.

rules similar to, but not as comprehensive as, those applicable to private foundations.[10] Notice 2007-21 raises several issues that effectively compare the treatment of DAFs and SOs to that of private foundations.

This report focuses principally on DAFs because they are new statutory creations lacking a well-developed policy foundation and are growing rapidly in number and size. To a great extent, non-functionally-integrated Type III SOs present the same issues as DAFs and should be the subject of similar scrutiny and treatment. Unlike Type I and Type II SOs, Type III SOs are not subject to the external board control or supervision by their supported organizations. In addition, this category of SOs is not "functionally integrated," i.e., they do not conduct activities that the supported organizations would otherwise perform themselves. This relationship gives the supported organization little control and allows SO donors, directors and officers relative independence and powers over SO assets -- circumstances similar to those enjoyed by private foundation donors, boards and managers -- but without the regulatory protections imposed on private foundations. Thus, there is a particular risk that donors or others may make improper use of the assets of non-functionally-integrated Type III SOs. Because SOs involve risks similar to those presented by DAFs, and because the Congress has delegated authority to the Secretary to regulate SOs, the report deals with SOs in a summary manner.

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10 The PPA provisions include application of the excess business holdings rules under Section 4943 and more stringent automatic excess benefits transactions penalties under Section 4958(c)(2) and (3) for both DAFs and SOs (except for Type III "functionally integrated" SOs); taxes under Section 4966 on certain DAF distributions and under Section 4967 on prohibited benefits from DAFs to certain persons, including donors, advisors, related parties, entities controlled by such persons; treatment of private foundation distributions to certain SOs as nonqualifying distributions for purposes of the Section 4942 payout requirements and as Section 4945 taxable expenditures; and new disclosure requirements about DAFs for returns and applications for exemption filed by sponsoring organizations and for SOs' returns.

II. Summary of Recommendations

This report suggests an approach for the Treasury/IRS study required by the PPA and recommends the following legislative and regulatory changes:

1. Policymakers should conduct a comprehensive evaluation of DAFs and SOs in relation to established tax policy for the charitable arena. With respect to DAFs particularly, the study should cover their development, structure, operation, benefits and risks.
2. Because DAFs exhibit of many of the characteristics of private foundations, legislation should be enacted that generally subjects them to the same requirements and restrictions, in particular minimum distribution requirements, that are imposed on private foundations. Community foundations that maintain strong, enforceable sponsor controls over DAFs should be examined to determine whether any exceptions to the requirements are justified. Appropriate transition rules should be provided.
3. The report also recognizes the similarities between private foundations and Type III SOs that are not "functionally integrated" with their supported organizations and recommends they too should be subject to stricter requirements and greater restrictions through regulations where authority exists, as well as through new legislation.
4. If DAFs and non-functionally integrated Type III SOs are not subject to payout requirements, they should be limited to a maximum statutory term of years and should not be permitted perpetual existence.
5. In the absence of legislation applying the private foundation rules, we recommend regulations along the following lines:

a. In general, regulations should clarify and strengthen the requirements that donors must fulfill in order to divest themselves of control over assets. The regulations also should describe standards of oversight and control that sponsoring organizations must meet for donors to be assured that their contributions are deductible.

b. In view of the difficulties of applying a facts and circumstances tests to determine the permitted scope of donor "advisory privileges" and other donor rights under the statute, the regulations, as much as possible, should prescribe an objective test for DAFs, SOs and their sponsoring and supported organizations to determine whether or not contributions are complete. Where current law prevents the imposition of absolute requirements, regulatory safe-harbors can be created to provide certainty in establishing the deductibility of contributions. Such a safe harbor could include (1) a minimum payout standard to encourage current charitable distributions, (2) a rule that retention of an option or other rights by a donor to reacquire contributed property or to interfere with its use or disposition will prevent treating the contribution as complete, (3) limits or ceilings on management fees, (4) examination and reporting requirements for sponsors, (5) a limited duration for donor advisory rights, and (6) possibly a time limit on DAF and SO existence. These safe harbor conditions could be modeled after the private foundation rules.

c. Assuming a DAF satisfies these regulatory safe harbor conditions, we recommend a formalistic approach that would permit donors to render

investment and distribution advice, including with an expectation that the donee would follow the advice, provided the donee is not legally or contractually bound to follow the advice..

d. Regulations for DAFs and SOs should be designed not to increase, and if possible to reduce, common problems with valuation, lack of organizational transparency, statutes of limitations, and mixed motives or purposes for organizations and activities. They should increase disclosure requirements and provide guidance on practical issues such as pledges, benefit ticket purchases and quid pro quo gifts.

III. History of DAFs

Before determining how DAFs should be treated for tax purposes, it is important to understand their history. DAFs have never been the subject of comprehensive legislative consideration. The original DAFs are believed to have been created in the 1930's by community foundations whose multiple sources of support qualified them as public charities. DAFs, structured as internal separate accounts, were easier for sponsors to create and manage than separate trusts. Viewed as part of the sponsoring public charity, DAFs escaped the Code's private foundation requirements and restrictions, making them more appealing than private foundations to many donors. Community foundations continue to be a major sponsor of DAFs. Subsequently, other types of organizations became DAF sponsors.

Prior to the PPA, there was no statutory definition for a donor-advised fund and no regulations expressly addressing them. Legal commentary, as well as promotional materials for

DAFs, compare them favorably to private foundations.[11] Originating as charitable vehicles developed by the philanthropic community and the private bar, DAFs are easier to form and manage than private foundations. As public charities, they are not subject to the regulatory limitations on private foundations. Donors to DAFs also enjoy greater tax benefits because DAF donations, as contributions to public charities, can equal a higher percentage (50 percent) of donor income than gifts to private foundations (30 percent). The deductible amount of the value of DAF donations escapes most of the adjustments and limitations applicable to gifts to private foundations.

Taxpayers who form private foundations can retain full legal control over the selection of grantees and the investment of foundation assets. DAF donors must cede legal controls to the sponsoring public charity. Nevertheless, a donor's advisory rights with respect to the distribution and investment of DAF assets are substantial. Although the legal rights of DAF donors may be limited, in practice, many DAF arrangements seem to create de facto donor control.

DAFs have increased significantly over the last two decades. Two challenges against DAF sponsors during that period had different judicial outcomes. But, the two cases ultimately resulted in public charity status for both organizations and provided general guidance for other DAF organizers.

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11 See, e.g., Bjorklund, "The Pros and Cons of Donor Advised Funds as Alternatives to Private Foundations," ABA 2004 Fall Joint CLE Program, October 2, 2004, www.abanet.org/rppt/meetings/cle/joint2004/JointSectionPrograms/PhilanthropyinEstatePlanning/**VictoriaBjorklund**.pdf.

In National Foundation, Inc. v. U.S.,[12] the plaintiff sought a declaratory judgment that it qualified as a tax-exempt foundation. The Service sought to deny it tax-exempt status. The Service opposed the judgment on the grounds that the organization was a commercial enterprise that helped its clients escape private foundation status and avoid official scrutiny. The Service argued that instead of serving a charitable purpose, the defendant provided private benefit because it paid commissions for referrals of donors, charged excessive administrative fees and provided little oversight of donors' distribution recommendations. The court disagreed, found no private inurement, determined that the defendant qualified as a public charity and required the Service to recognize its exempt status.

In 2001, the Service prevailed in denying public charity status to an organization that facilitated anonymous gifts to charity in The Fund for Anonymous Gifts v. I.R.S.[13] Initially, the District Court agreed with the Service that the Fund was not entitled to tax-exempt status because more than an insubstantial part of its activities were not in furtherance of charitable purposes and the Fund permitted donors to retain improper investment control. On appeal, the U.S. Court of Appeals remanded the case after the Fund agreed to amend its rules to eliminate the donor control. Although the Fund adopted the promised amendment, the U.S. District Court for the District of Columbia held on remand that the Fund was a private foundation. The Court found that the Fund was not entitled to an advance ruling that it qualified as a public charity because it had not demonstrated that it could qualify as a publicly supported organization.

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12 13 Cl. Ct. 486 (1987).

13 The Fund for Anonymous Gifts v. U.S., 79 A.F.T.R. par. 97-874 (U.S. D.C. for the District of Columbia, No. 95-1629 (April 15, 1997); vacated in part by Fund for Anonymous Gifts v. IRS, 194 F.3d 173, D.C. Cir. No 97-5142 (Doc 1999-13695 (D.C.Cir. April 12, 1999); remanded to District Court; 88 A.F.T.R. 2d par 2001-5351 (D.D.C. 2001), which ruled the Fund a private foundation.

Subsequently, the Fund and the Service engaged in mediation and the Fund was granted advance ruling classification as a public charity.

Community foundations, which despite the common use of "foundation" in their names generally are public charities, were the sponsors of most of the early DAFs. Community foundations generally are local organizations with local boards and management. They focus on the needs of their communities or regions. In addition to maintaining collective funds, administering trusts and sponsoring DAFS, some provide advice to donors on worthy causes and potential beneficiaries and often help with planning bequests and family philanthropy. Some community foundations "incubate" new local charities, often educational or arts organizations, until the organizations are sufficiently substantial to establish their own independent charitable entities. The new charities rely on the tax-exempt status of the "umbrella" foundation.[14]

Because community foundations can establish DAFs as internal separate accounts without creating a separate legal entity, DAFs quickly became favored over trusts and other vehicles by these sponsors. DAFs now are the standard structures used by community foundations and their donors. Over the years, many community foundations as well as other charities that sponsor DAFs have increased their own governance and imposed a variety of limitations on donor involvement and eligible donees. A number of sponsors have adopted a common set of non-binding governance principles that require the sponsor to possess legal control, since codified by the PPA, and that establish responsibilities for boards and managers.

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[14] Community foundations, which typically have independent boards, should be distinguished from organizations whose sole function is to act as fiscal sponsors or incubators for new activities, or as DAF sponsors, for which the activities or DAFs are charged fees.

More recently, financial institutions, especially mutual fund companies, have created DAF vehicles. As the universe of sponsors has grown and diversified, the tax benefits associated with DAFs have been increasingly highlighted by both charitable and commercial organizers, as well as financial advisers and advertising.[15] In addition, with billions of dollars under management, organizers earn enormous management fees on assets that can accumulate indefinitely without any distributions to serve the charitable purposes for which the donors claimed tax deductions.

Service officials and government investigators believe that DAFs pose significant tax compliance challenges because of abusive arrangements benefiting individuals and organizations other than charities. In some cases, sponsors fail to provide oversight adequate to prevent donors from using distributions for personal benefit, such as tuition payments, or to forestall other abusive arrangements.[16] A recent Court of Claims decision, New Dynamics Foundation v. U.S.,[17] illustrated the abuse potential of this type of entity. The opinion criticized multiple features of the organization's structure and operation. It held that the Foundation was created for a non-exempt purpose, i.e., to "warehouse wealth," and therefore was not entitled to tax-exempt status.

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15 See, e.g., National Philanthropic Trust website, http://www.nptrust.org/donors/become_a_donor.asp ; and American Endowment Foundation website, http://www.aefonline.org/ /tax-benefits.htm.

16 See "Tax-Exempt Organizations - Collecting More Data on Donor-Advised Funds and Supporting Organizations Could Help Address Compliance Challenges," GAO-06-799 (July 2006).

17 Ct. Clms. Nos. 99-197T (April 24, 2006).

IV. DAFs and Private Foundations -- Conformity Recommendation

In evaluating the appropriate treatment of DAFs and SOs, it is important to take into account the policy bases for granting tax benefits for charitable contributions and privileged, exempt status for charitable organizations. In allowing these benefits and privileges, Congress has emphasized particular purposes and principles. Tax deductions and privileged status are intended to create incentives for private sector individuals to support specified charitable purposes with societal benefit. A variety of tax law provisions were adopted to maximize charitable benefits and to minimize abuses. These relate to donor control, current payout to charity, public oversight or transparency, and the scale of tax benefits afforded donors. Because DAFs arguably function as agents for their donors, it is particularly important that they be governed by rules that ensure they are used for proper charitable purposes.

Private benefit is expressly prohibited for all charitable organizations. For charitable organizations that are particularly susceptible to abuse, specific restrictions apply. Donor influence or control has been a major concern. The special rules applicable to private foundations include detailed self-dealing restrictions on their donors, trustees, officers, managers and related parties. As a further guard against abuse, private foundations must file annual disclosure returns that must be made available to the public.

Generally donors are allowed tax deductions when contributions that transfer ownership and control of contributed assets to the charitable donee, or certain types of split-interest trusts (i.e., charitable lead and remainder trusts), are complete. Pledges and promises receive no recognition until fulfilled. Greater benefits, such as higher income limitations, are provided for gifts to "public charities," which generally are organizations with broad public support (and

presumably concomitant oversight), than for gifts to private foundations, which typically are controlled by the donor or related persons.[18] More liberal rules apply to contributions to private foundations that qualify as operating foundations than to contributions to non-operating foundations.

A number of tax provisions have discouraged long-term accumulation of assets in charitable vehicles, particularly closely-controlled arrangements, if no distributions are made for charitable purposes. The annual two percent excise tax on the net investment income of a private foundation is reduced to one percent if the foundation meets certain distribution requirements.[19] Private foundations, while enjoying the right to unlimited life, generally must distribute annually an amount equal to five percent of investment assets or incur a tax of 30 percent on the shortfall.[20] The term for a charitable remainder trust is limited to 20 years or the life or lives of individuals living at the time of the trust's creation.[21] DAFs do not have payout requirements and can exist in perpetuity.

Private foundations must make detailed, annual public disclosures covering (1) information about their assets and grants, (2) the identity of grantees, officers and directors, (3) the compensation paid to employees and fees paid to outside service providers, (4) lobbying activity and (5) operations. DAFs are largely invisible. Even the new PPA provisions require

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18 Some private foundations are run by independent boards.

19 Section 4940(e).

20 Section 4942. Failure to correct the shortfall in distributions results in an additional tax of 100 percent of the shortfall.

21 Section 664(d)(1).

disclosure only of the total number of DAFs owned by a sponsor and the aggregate of a sponsor's DAF contributions, distributions and asset value.[22]

As outlined above, DAFs share many features with private foundations, but are free from the requirements and restrictions that policymakers imposed on private foundations in order to discourage abuse of private foundations' charitable status and charitable assets.[23] In addition, DAF donors are allowed larger tax deductions than are foundation donors, by virtue of the more liberal treatment accorded gifts to public charities.

The sole area where DAFs appear subject to rules that are more restrictive than those applicable to private foundations is their control over the distribution and investment of assets. While private foundation donors or directors retain such control, albeit at the price of significant requirements and limitations, both caselaw and statutory rules limit DAF donors' authority to "advisory" rights with respect to asset distribution and investment. Although rights of control are legally distinguishable from advisory rights, in the DAF context it generally is a distinction without a difference. Even though some DAF sponsors impose payout requirements and limit donor input, most managers of DAFs sponsored by charitable organizations will be loathe to risk donors' support by scrutinizing their recommendations, thwarting their wishes and disregarding their advice, except when the donors' recommendations are patently illegal for DAFs. Similarly, commercial organizers of DAFs will be reluctant to conflict with donors. In addition, commercial organizers have no incentive to encourage charitable distributions which would

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22 Code Section 6033(k).

23 General Explanation of the Tax Reform Act of 1969, H.R. 13270, 91st Congress, Pub. L. 91-172, Staff of the Joint Committee on Taxation, December 3, 1970 (the "1969 Bluebook"), 29-62.

decrease the amount of assets under their management and reduce their fee income. In reality, most donors can treat their DAFs as if they were private foundations without regulation.

Moreover, it is probably impossible, except in an egregious case, to determine whether or not a sponsoring organization exercises its authority and performs adequate oversight, or always follows a donor's advice. The Service's ability to audit and enforce the law is severely hampered by the paucity of information required about DAFs.

In reality, DAFs today entail almost the same serious issues and risks that were presented by private foundations prior to enactment of the Tax Reform Act of 1969. Although DAFS, like private foundations, can serve substantial charitable purposes, DAFs, like private foundations, should be subject to rules that reduce their potential for abuse. We believe that abuse can be reduced by requiring regular and substantial distributions for charitable purposes, penalties on private benefit and private inurement, and disclosure requirements that create transparency and facilitate oversight. To this end, we recommend generally conforming the tax treatment of DAFs and of donations to DAFs to the treatment accorded with respect to private foundations, and we urge that the Treasury/IRS study support legislation to make the private foundation rules generally applicable to DAFs.

Specifically, we recommend that, in addition the PPA's application of rules on excess business holding and excess benefit transactions, DAFs should be subject to excise taxes of the type addressing self-dealing in Section 4941, failure to distribute income (payout requirements) in Section 4942, jeopardy investments in Section 4944, taxable expenditures in Section 4945 and related provisions. The Section 4940 excise tax on net investment income also should apply. Because the Section 4940 excise tax was enacted to cover the increased enforcement cost

expected to result from the 1969 legislation on private foundations,[24] we believe that the level of the tax on DAFs should correspond to the Service's costs. If the cost of enforcement for DAFs, which include many small funds, is less than the cost for private foundations (for example, because audits may focus on sponsoring organizations more than on individual DAFs), the tax should reflect the lesser cost. Consideration might be given to exempting DAFs with assets below a specified level from the excise tax.

Generally, the private foundation rules should apply to each DAF separately. Compliance with these rules should be a responsibility of DAF sponsors who should exercise oversight over DAF distributions and investments and act to prevent violations. However, to the extent that a violation of the rules, such as an act of donor self-dealing, is the result of a donor's act or advice, and the sponsor did not know, or did not have reason to know, about the violation, penalties should be imposed on the DAF and the donor, not on the sponsor.

Penalties imposed for noncompliance also should be based on the private foundation rules. One donor's violation should result in penalties on the offending donor and the donor's DAF, but should not cause all DAFs sponsored by the same organization to suffer penalties.

In addition, we recommend subjecting donations to DAFs to the rules on deductibility for income, trust and estate tax purposes that apply with respect to contributions to private foundations, including the percentage of income ceiling, the adjustments relating to valuation, inherent gain or charitable use.[25]

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24 1969 Bluebook, 29.

25 Sections 170, 642(c), 2055(e) and 2522(c). See discussion of "Contributions of appreciated property" in V.2 below.

We also recommend that sponsoring organizations be required to file annual information returns for DAFs, which could be modeled after those required of private foundations, modified to take account of DAFs' lack of separate legal existence and the role of their sponsoring organizations.

To be effective, we recommend that the responsibility for compliance with the minimum distribution requirement for be imposed on the party with control over these funds, namely the sponsoring organization for DAFs and the supported organization for SOs. These controlling organizations would be obligated to withdraw funds from the DAFs or SOs and use them for the required charitable purposes. Penalties for failure to comply with the distribution requirement, however, should be based on the funds in the DAF or SO, as the case may be.

The Treasury/IRS study should address the role and operation of community foundations and similar traditional DAF sponsors. In particular, the study should determine to what extent any requirements or limitations that these sponsoring foundations impose on their DAFS make them less vulnerable to abuse and possibly appropriate for exemption from one or more of the proposed DAF restrictions.[26] Payout requirements, time limits on advisory rights and limiting DAFs to a small number of prescribed beneficiaries or investment options are examples of restrictions that can make DAFs less prone to noncompliance. Or, under authority delegated by the PPA to the Secretary, a fund advised by a committee that is not controlled by the donor or a fund which benefits a single charitable purpose may be exempted from DAF requirements.[27]

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[26] In contrast to the local control and focus of community foundations, DAF sponsors established by commercial organizations generally do not have a specific purpose other than to amass charitable funds. The charitable purposes funded by these sponsors are chosen by the DAF donors, except when a sponsor recognizes an improper distribution designation and rejects the donor's "advice."

[27] Section 4966(d)(2)(C).

Recognizing that DAFs are sponsored by many different types of institutions of varying size and capability, we support the provision of transition rules that allow sponsors a limited but reasonable period to adapt their organizations, procedures and operations to comply with the new rules.

The foregoing discussion and recommendations also apply to non-functionally integrated Type III SOs.

V. Responses to Questions in Notice 2007-21

This section of the report responds to the questions raised in Notice 2007-21 for which public comment is requested. The responses include some discussion of separate proposals that are included in the broad recommendation, above, that DAFs generally be subject to the same tax treatment as private foundations. Although our principal recommendations require legislative changes, we believe that some recommendations can be effected through regulations under existing authority.

The PPA gives the Treasury and the Service an opportunity to promulgate regulations and adopt audit and enforcement policies that better ensure that tax savings afforded through charitable contribution deductions produce commensurate benefits for the charitable sector. Particularly in the case of DAFs, which had no prior statutory recognition, the PPA provides an occasion to advance thoughtful and effective policies and to develop a clear and sound regulatory regime.[28]

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[28] DAFs were not previously given specific statutory recognition and were not the subject of special regulation (other than the provisions generally applicable to public charities). Therefore, the doctrine of legislative reenactment, whereby legislation amending a statutory provision under which regulations have been promulgated is viewed as approval of the regulations, has minimal relevance for DAFs, beyond acceptance of the legitimacy of the general structure. Accordingly, in drafting regulations based on the PPA provisions, we believe the government may adopt rules that depart from prior rulings and case law.

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

Although the practical impact of various giving arrangements may be best addressed by professionals in the philanthropic sector, our experience advising donors and charitable donees on legal issues provides a basis for relevant comments. Clearly the availability of different ways of structuring tax-deductible charitable contributions increases the potential number of donors and gifts. Donors may wish to make immediate gifts or plan bequests, address crisis situations or support long-term research or development, realize narrow or broad purposes, receive recognition or maintain anonymity, establish continuing relationships with a donee, realize immediate tax savings in a high-income year, establish a vehicle for long-term or family philanthropy, or achieve other purposes. All these goals and more can be attained properly through charitable donations that are appropriately chosen, designed, transferred and used.

The benefits of having a large variety of entities and methods for donating to charity are offset to some extent by the complexity of these arrangements. Choosing among the potential structures for charitable giving is itself a task made more difficult as the number of alternatives increases. From a donor's initial choice of giving arrangement to the regulatory and administrative requirements imposed on donors, intermediate funding entities and ultimate charitable donees, this complexity adds cost and creates greater risk that legal noncompliance, even inadvertent, may reduce tax benefits, result in penalties, and burden charitable pursuits. The variety of arrangements also increases the risk of abuse and increases administrative and enforcement burdens for the Service and state agencies.

Donors who wish to support specific interests and exercise continuing oversight, if not total control, may use private foundations, DAFs or SOs to assure that their contributions are used in accord with their charitable directives. Private foundations entail substantial regulatory limitations, record-keeping and disclosure requirements that can be difficult and costly to administer. Within these rules, their boards and officers control the distribution and investment of assets, subject only to general fiduciary-type standards. Private foundations must obtain determination letters on their exempt status.

In contrast, DAFs generally are relatively simple to create. DAFs rely on the status of their sponsoring organizations and are not required to obtain their own determination letters.[29] Their administration and compliance are largely the responsibility of sponsoring organizations. Because of their flexibility and the minimal administrative burden for donors, DAFs, which have a long history in the context of community foundations, have grown substantially over the last 20 years. DAFs enjoy public charity status that permits donor influence similar to that of private foundations, albeit short of the control permitted with the latter, but without the restrictions, excise taxes, limits on deductions (particularly for certain gifts of appreciated property), and the administration involved in setting up and running private foundations.

The growth of DAFs does not necessarily mean that they represent an addition to overall charitable resources. Funds that formerly might have been contributed directly to public charities or to private foundations may be contributed instead to less burdensome DAF structures, which have been heavily promoted by both philanthropic sponsors and the financial services industry. Even though it would be hard to determine reasons for donors' choice of

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[29] With only limited exceptions, the principal one for churches, organizations must apply for recognition of exempt status to be treated as described in Section 501(c)(3). Section 501(a); Treas. Reg. Sec. 1.508-1.

charitable giving arrangements, probably some of the growth in DAF assets should be attributed to diversion from private foundations and should not be viewed as an addition of new funds over and above what would have been contributed if DAFs did not exist.

Recommendation: As discussed in part IV above, we recommend legislative action to make DAFs and non-functionally integrated Type III SOs generally subject to the same tax treatment and restrictions as private foundations. Absent new legislation, we recommend that regulations be promulgated that subject DAFs and SOs to rules similar to those applicable to private foundations (which could be in the form of safe harbors for DAF or SO status), except where required otherwise by statute. Either approach should help to minimize the complexity of a new statutory regime and to prevent creating traps for the unwary.

Where policies that apply to private foundations are not statutorily applicable to DAFs and SOs, the Treasury/IRS study should identify which of the policies are relevant to DAFs and SOs, and to their sponsoring and supported organizations. Consideration should be given to creating rules, such as safe harbors, that encourage practices that serve such policies. For example, if a payout requirement were a positive factor in a safe harbor for deductibility of DAF donations, it is likely that more DAFs and sponsoring organizations would adopt payout requirements on their own initiative. [30]

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

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[30] Some sponsoring organizations, such as the Fidelity Charitable Gift Fund, Schwab Charitable Fund and T. Rowe Price Program for Charitable Giving, already impose payout requirements, generally modeled on the private foundation minimum distribution rules.

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 SO or the DAF?***

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?***

DAFs and SOs currently receive tax-favored treatment as public charities. Our legislative recommendation in part IV above to generally subject DAFs and non-functionally integrated Type III SOs to the restrictions imposed on private non-operating foundations would include private foundation limitations on donor contributions. We believe such limitations would address concerns arising from the above questions. These issues, as well as possible regulatory approaches in the event the statute is not amended, are discussed below.

Use related to charitable purpose. The Code reduces deductions allowed taxpayers for contributions of tangible personal property with inherent long-term capital gain, if the property is not put to a "related" use.[31] This rule generally applies with respect to all public charitable

[31] Section 170(e)(1)(B)(i).

donees. However, for all gifts of tangible personal property to private foundations, deductions generally are limited to basis (except for gifts of publicly-traded stock).[32]

A "related" use is a use related to the purpose or function on which the tax-exempt organization's exemption is based. For "unrelated" uses, the amount of the deduction is determined by subtracting the long-term gain from the property's fair market value.[33] For example, donating a painting to a museum to display in its collection is a related use; but donating a painting to a public charity that sells it to raise funds is an unrelated use. Contributions to DAFs and SOs, which are classified as public charities, are subject to the related/unrelated use rules.

Use by donor. Generally charitable deductions are not allowed for charitable contributions of less than the taxpayer's entire interest in the contributed asset. For example, no deduction is allowed for foregone rent when a landlord gives a charity rent-free office space. Although there are certain exceptions to this general rule (for example, charitable remainder trusts, gifts of conservation easements, outright gifts of undivided interests in property, and remainders in personal residences), ordinarily the retention by the donor of the right to use or control property results in the gift not being complete and a deduction unallowable.

Recommendation. Donor use of, or influence over, assets contributed to DAFs or SOs, other than the DAF advisory privileges permitted by the Code, should result in disallowance of any associated deductions. (See discussion below relating to retention of advisory and other rights.) In all events, regulations also should address donor benefit problems. The practice of

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32 Section 170(e)(1)(A), (e)(1)(B)(ii), (e)(5).

33 Section 170(e); Treas. Reg. Sec. 1.170A-4A(b)(2).

sponsoring organizations of disclosing to recipients of DAF distributions the identity of the DAF donor who recommended the gift could result in some DAF donors receiving the quid pro quo benefits that the recipient gives its direct donors, such as benefit event tickets or prizes. In such cases, the DAF donor, having previously deducted the original contributions or excluded earnings thereon from income, should recapture as income the value of the benefits from the recipient charity. These situations could be deterred substantially if sponsoring organizations are required to inform donees that their donations are from DAFs and that that quid pro quo benefits to the DAF donor are impermissible. The Treasury/IRS study should include the income tax consequences for DAF donors who receive such benefits.

Contributions of appreciated property. In the case of private non-operating foundations, the deductions for all gifts of appreciated property generally are reduced, whether or not the property is put to a related or unrelated use.[34] However, gifts of "qualified appreciated stock," i.e. a highly liquid asset that is capital gain property and has market quotations readily available on an established securities market, to any private foundation entitle the contributor to deductions equal to the full fair market value of the stock.[35] In addition, exceptions to the broad private foundation rule are provided for gifts of appreciated property to private operating foundations and to private foundations that, within two and on-half months after the end of the year, distribute to qualifying charitable uses all contributions received during a year.[36]

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34 Section 170(e)(1)(A), (e)(1)(B)(ii).

35 Section 170(e)(5).

36 Section 170(e)(1)(B)(ii) and 170(b)(1)(F).

At the time the rules reducing deductions for certain gifts of appreciated property were enacted, Congress emphasized that a primary rationale for the changes was that the tax benefits of avoiding tax on the appreciation coupled with the charitable contribution deduction produced benefits greater than those accorded cash contributions.[37] However, the special rule for gifts to private foundations that quickly put their contributions to charitable uses also indicates a Congressional preference for the current use of contributed assets and a concern about accumulation of assets that are not devoted to charitable purposes for a length of time. This latter issue could be an even greater concern with respect to DAFs and SOs under present law, because unlike foundations, they do not have a payout requirement.

Recommendation: As discussed in IV above, our legislative recommendations for DAFs include treating contributions of appreciated property to DAFs and non-functionally integrated Type III SOs under rules that are the same as or similar to those applicable to private foundations. We believe this would be consistent with the general tax policy preference for putting assets to use in exempt functions rather than accumulating them. Such treatment would discourage contributions or acceptance of assets that are not readily convertible into cash. In the absence of a payout requirement, such illiquid assets might be held indefinitely by such DAFs or SOs.[38] In view of the present law classification of DAFs and SOs as public charities, such rules would require legislation.

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37 See 1969 Bluebook, 77-78.

38 The higher deduction allowed for contributing appreciated property (other than publicly traded stock) to a DAF rather than to a private foundation is a marketed DAF feature. See, e.g., Welch, "Comparing Financial and Charitable Techniques for Disposing of Low Basis Stock," Part II, Monitors, January 2003, Investment Management Consultants Organization.

Reducing deductions for contributions of tangible personal property to DAFs and non-operating SOs that accumulate assets without putting them to charitable use within a reasonable period would discourage long-term holding of such assets. To some extent, a payout requirement would serve the same purpose. However, because the PPA generally confirms the status of DAFs and SOs as public charities, there is no authority to impose such requirements through regulations, except in the case of certain Type III supporting organizations.[39] Nevertheless, the restrictions imposed by the PPA on DAFs and such SOs indicate that legislators believe that, at least in some cases, these entities may be more akin to private foundations than to public charities. Therefore, Congress may be receptive to legislative proposals to make them subject to the private foundation rules on gifts of appreciated property or to similar limitations.

Donor advisory rights. The recently enacted charitable contribution and organization amendments permit donors to retain "advisory privileges" with respect to the investment and distribution of DAF contributions.[40] Provided these rights impose no obligation on the donee to follow the advice from the donor (or donor's representative), and the donee has received unconditional control over the contributed assets, present law treats the donor's contribution as complete, entitling the donor to an immediate charitable contribution deduction. But what if there is an understanding or expectation, short of a legal or contractual obligation, that the

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39 PPA Section 1241(d)(1) authorizes the promulgation of new regulations on payments to be required by Type III supporting organizations which are not functionally integrated SOs. The regulations are to require these SOs to distribute a percentage of income or assets to supported organizations in order to ensure that a significant amount is paid to the supported organizations.

40 Section 4966(d)(2)(A)(iii).

donor's advice will be the sole or primary consideration in determining how the contributed assets are invested or distributed?

Consistent with our recommendation that future legislation generally apply the private foundation rules to DAFs, we believe that donors should enjoy no control or advisory rights over DAF assets unless the DAF is subject to minimum distribution and other rules imposed on private foundations. If subjected to appropriate private foundation restrictions, however, we would extend to DAF donors, directors and managers have the same rights to control distributions and investments that are enjoyed by private foundation donors, directors and managers.

Unless and until Congress enacts such legislation, we recommend that regulations be adopted to prevent abuse. The regulations should interpret narrowly the present law statutory rule allowing advisory privileges to be retained by DAF donors. We recommend that such regulations adopt clear and objective tests and describe fact patterns that constitute improper donor control. We believe that a facts and circumstances test for determining whether advisory rights amount to prohibited control would be impractical, create uncertainty in planning, and invite gamesmanship, making it difficult for taxpayers to comply and the Service to enforce. Objective tests provide clarity and greater certainty. Agreements between DAF donors and sponsoring organizations should clearly state that the sponsoring organization has control over all decisions with respect to the assets and has the right to reject the donor's advice. In this regard, it is helpful that the PPA requires that for a deduction to be allowable for a contribution to a DAF, the sponsoring organization must provide a written acknowledgement that it has

exclusive legal control over the contributed assets.[41] Although present law limits the authority for drafting absolute, objective rules for DAFs, new regulations could provide safe harbors with objective criteria that would provide certainty and promote compliance. We recommend that these criteria include minimum distribution requirements, prohibitions on the retention of options and other rights by donors, limits or ceilings on management fees, examination and reporting requirements for sponsors, a limited duration for donor advisory rights, and perhaps (subject to the discussion in V.6 below) a limit on the "life" of DAFs. Assuming a DAF satisfies these regulatory safe harbor conditions (which could be modeled after the private foundation rules), we recommend a formalistic approach that would permit donors to render advice, including with an expectation that the donee would follow the advice, provided the donee is not legally or contractually bound to follow the advice.

In the case of DAFs of a sponsoring organization created by a mutual fund company or other financial services organization, donor investment advice generally relates to the choice of funds for investment. If a sponsoring organization limits this choice to a small number of appropriate mutual funds, a donor's right to advise on investments might be regarded as sufficiently restricted so as not to constitute donor control, even without the other safe harbor conditions described in the preceding paragraph.

Other donor rights. Certain donor rights with respect to contributions may so vitiate donee control that the contribution should not be treated as a completed gift and no deduction should be allowed. If the donor retains an option to reacquire the contributed assets, whether an outright call on the assets or a right of first offer or first refusal in the event of sale, the donor has

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41 Sections 170(f)(18), 2055(e)(5) and 2522(c)(5)(B).

not completely parted with the assets. Moreover, the donee's control is limited because the donor can reacquire the property or at least prevent or interfere with its free transfer to third parties.

In some cases, donees may have the authority to refuse to grant donors any benefits attributable to contributed property, but nevertheless may grant them to the donors. If the benefits do not cause the contribution to be incomplete, they may nonetheless affect the value of the contributed property to the donee. There is a risk that such retained benefits may not be taken into account in valuing the property and that the value and the amount of the charitable contribution deduction are overstated.

The PPA penalizes many arrangements that provide benefits to donors. Sponsoring organizations are subject to a 20 percent tax on "taxable distributions" from DAFs, i.e., distributions to individuals or to organizations that are not eligible charitable entities.[42] In extending the excise tax on excess benefit transactions to DAFs and SOs, the PPA includes among the taxable transactions any grant, loan, compensation or other similar payment from such funds to any substantial donor, related party, 35-percent controlled entity, DAF donor-advisers and others persons treated as "disqualified."[43] The PPA further provides that if a DAF, following the advice of a donor, donor adviser or related person, makes a distribution that results in the adviser or related party receiving more than an incidental benefit from the distribution, a tax of 125 percent is imposed on the benefit.[44]

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42 Section 4966(c).

43 Section 4958(c)(2) and (3). In the case of DAFs and SOs, unlike other exempt organizations, there is no exception to the definition of excess benefit transaction for compensation paid for the performance of services. See discussion in V.3 below.

44 Section 4967.

Recommendations. Charitable contribution deductions should not be allowed if the donor imposes conditions that interfere with the donee's use or disposition of the contributed property. In addition, if a donor receives more than incidental benefits from the contributed assets (such as co-investment assistance, the coordinated exercise of stock voting rights, or use privileges), the donee may lack total control, particularly where the donee has no discretion whether to grant or deny the benefits to the donor. In such cases, no deduction should be allowed. We also recommend that the Service publicize the new rules and penalties and promptly incorporate them in their audit plans.

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

The PPA clarifies the basic rules for the organization and operation of DAFs. It will help these organizations, as well as their sponsoring and supported organizations, to resist attempts by donors and advisers to exercise improper influence over contributed assets. The new excise taxes on DAFs for taxable distributions and prohibited benefits[45] as well as the "automatic" excess benefits tax on the full value of certain transactions by DAFs and SOs will discourage self-dealing activities and other diversions of assets from charitable purposes. These rules are timely because DAF assets have grown enormously and continue to increase. The rules safeguard against charges for excessive management fees and are especially important in the case of sponsoring organizations created by financial or commercial institutions.

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[45] Sections 4966 and 4967.

In one area, inconsistencies between the statutory language of the PPA and legislative commentary appear likely to cause confusion. The PPA imposes an automatic excess benefit transaction tax on DAFs and SOs.[46] However, in the case of DAFs and SOs, the 25 percent tax applies to the full amount of the grant, loan, compensation or other transaction with certain disqualified persons and others, while the general rule applicable to public charities applies the tax only to the economic benefit in "excess" of the value of the transaction.[47] In addition, while the generally applicable rule excepts compensation intended as payment for the performance of services, all such compensation is treated as a benefit subject to the tax if paid by a DAF or SO.

The excess benefit transaction tax applies with respect to covered payments from a DAF to an individual in a position to exercise substantial influence with respect to the DAF, a donor, donor adviser or related persons and entities that are 35 percent controlled by such persons. In the case of an SO, the tax applies to grants, loans, compensation or similar payments to a substantial contributor or related person and to entities that are 35-percent controlled by a substantial contributor or related person.[48]

In its explanation of the excess benefits transaction tax applicable to DAFs, the Joint Committee on Taxation distinguishes payments made by sponsoring organizations from payments made by DAFs, a distinction that, while valid, is not grounded in the statute.[49]

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46 Section 4958(c)(2) and (3). The rule for DAFs and SOs adapts the concepts of the excise tax on the full amount involved in acts of self-dealing by private foundations in Section 4941.

47 Organization managers who knowingly participate in such transactions are subject to a 10% tax, capped at $20,000, on the excess benefit from any one transaction. Section 4958(a)(2).

48 Section 4958(c)(3).

49 General Explanation of Tax Legislation Enacted in the 109th Congress, Staff of the Joint Committee on Taxation, JCS-1-07, January 17, 2007 (the "Bluebook") 640.

According to the Bluebook, payments to persons providing services to the sponsoring organization who are also donors to that organization's DAF "will not be subject to the automatic excess benefit transaction rule of the provision unless the payment ... properly is viewed as a payment from the DAF and not the sponsoring organization." Transactions between the service provider and the sponsoring organization are not subject to the excess benefits tax, because the service provider is not a disqualified person with respect to the sponsoring organization (unless the service provider is on the organization's board or otherwise qualifies as a disqualified person). Only if the transaction were treated as between the service provider and the DAF would the excess benefits tax rules apply.

Although this explanation appears proper, the ensuing example relating to a bank service provider clouds the distinction. In the example, a sponsoring organization pays fees to a bank, a service-provider, who also is a donor to a DAF of the sponsoring organization. In the example, the fees are charged "uniformly"[50] to all the sponsoring organization's DAFs. The Bluebook states that the transaction "generally is considered to be between the sponsoring organization and the service provider.... [T]he transaction is not considered to be between a donor advised fund and the service provider even though an amount paid under the contract was charged to the donor advised fund of the service provider." [51] Because a DAF is part of its sponsoring organization, the legal obligation for a fee generally will be between the legal entity, the sponsoring organization, and the service provider. This legal relationship, however, does not explain how the cost is allocated within the sponsoring organization.

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[50] Bluebook at 641. The Bluebook does not explain how "uniform" fees are structured, e.g., pro rata according to value of each DAF's assets, or the same fixed charge per DAF.

[51] Bluebook at 642.

The Bluebook's example, if adopted without amplification in regulations, would outline a formalistic path for escaping the excess benefit rules. The question of who really is paying the service provider depends on additional facts, such as: How is the cost of the bank fees borne, by the sponsoring organization generally or by the DAF? Do the DAFs reimburse the sponsoring organization for their share of the fees? Is the sponsoring organization bearing the economic burden of the fees without charge to the DAFs? In addition, although the conclusion in the Bluebook example is reasonable in the case of a DAF contributor who has little or no influence over the sponsoring organization, it may not be appropriate in situations where the service provider's DAF represents a substantial part of the sponsoring organization's assets. The latter situation suggests that some limit might be appropriate, for example, a cap on the percentage of the sponsoring organization's assets that could be represented by the DAF.

By comparison, the Bluebook explanation of the application of the excess benefit rules to SOs merely repeats the statutory rules. The discussion about SOs contains no explanation or example comparable to the discussion in the DAF section on the bank fees. Therefore, it is unclear if the leeway accorded DAFs was also intended to apply to SOs. Because many SOs have similar relationships with their supported organizations and service providers who are also donors, the rationale for the example in the DAF discussion would seem equally apt for SOs.

For example, universities frequently structure research centers or special projects as SOs. Donors to these SOs could include university employees. A wealthy university professor teaching at a university and working part-time in one of its research centers might contribute funds to the center which is formed as an SO. Because the threshold for being a "substantial

donor" to an SO, and therefore a disqualified person, is low,[52] the payment of the professor's salary, if paid in whole or part by the SO, would be an excess benefit transaction. But, if the salary is paid by the university and not the SO, the analysis in the Bluebook discussion about bank fees paid by sponsoring organization of a DAF suggests that the payment by the university would not be treated as an excess benefit transaction.

Recommendation. Regulations should expressly provide that excessive management fees are subject to the excess benefit transaction penalties and can apply to investment managers, sponsoring organizations, DAFs and others, depending on their control over or benefit from such fees.

The absolute and automatic nature of the excess benefit transaction rules applicable to DAFs and SOs, and the related Bluebook commentary, create potential dilemmas for DAFs, SOs and their sponsoring and supported organizations with respect to compensation and other normal payments. We recommend that legislative clarification be sought promptly to eliminate the confusion. In the interim, the application of the excess benefit rules should be based on a substantive analysis of the facts surrounding payments and not merely on their form.

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

   a. DAFs?

   b. funds that are excepted from DAF 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. SOs?

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[52] A donor of an amount equal to more than $5,000 or 2 percent of the organization's aggregate annual contributions and bequests (if less than $5000) is a "substantial contributor" to an SO. Section 4958(c)(3)(C).

d. any other types of charities?

Our recommendation that DAFs and non-functionally integrated Type III SOs generally be subject to rules of the type imposed on private foundations includes especially the payout requirements. We acknowledge that arrangements that afford donors immediate tax deductions for contributions that are distributed to charity over a period of years enable the taxpayer to manage year-to-year tax-planning, and therefore can promote significant contributions. However, if the contributed funds that afford substantial tax benefit immediately in a single tax year are not distributed to, or used for, charitable purposes for lengthy periods, if ever, the benefit realized from the incentive deduction may be incommensurate with the charitable purposes served.

The Code imposes minimum distribution requirements on private foundations as well as time limitations on certain split-interest trusts. Even though the amount of the distribution requirement is debated and has been adjusted over time, this payout rule insures that some funds reach charitable purposes. By contrast, public charities, including their associated DAFs and SOs (except for a recently enacted minor SO exception)[53], have no specific pay-out requirement. The absence of distribution requirements may facilitate tax savings without providing charitable benefits. In the case of endowments, some managers discourage substantial distributions in order to increase endowment size. While this policy is claimed to help endowments keep up with inflation to insure that there is support for future needs, it also increases fees for investment

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[53] The PPA authorizes the Secretary to promulgate regulations under Section 509 imposing on Type III SOs that are not functionally integrated with their supported organizations a requirement to distribute a percentage of income or assets to the supported organizations in order to ensure that a significant amount is paid to the supported organizations. PPA, Section 1241 (d).

managers.[54] Because endowments support a single charity, that charity might be assumed to exercise some degree of oversight that prevents abuse. However, in the case of DAFs and SOs that allow donors to retain substantial privileges, sponsoring organizations do not have the same interest in the ultimate use of the assets, and their oversight may be deficient. Even though the PPA imposes new disclosure requirements on sponsoring organizations, the disclosures relate to aggregate amounts and do not require the type of public scrutiny borne by private foundations with respect to their grant-making, investments and other operations.

Recommendation. As noted previously, our recommendation to impose a minimum payout would require legislative action. Short of that, the Service could encourage a minimum payout by making a distribution requirement one of perhaps several factors that would constitute a regulatory safe harbor for determining the deductibility of DAF contributions and gifts to non-functionally integrated Type III SOs.

5. ***What are the advantages and disadvantages of perpetual existence of DAFs or SOs?***

The issue of perpetual existence for any type of charitable giving arrangement entails conflicting considerations. Assuming an entity is contributing to charitable purposes on a regular basis, whether through grants or its own operations, perpetual existence would facilitate the indefinite continuation of its charitable support. If the entity's purposes are flexible or broadly defined, perpetual existence would allow its assets to be available for unpredictable future needs or for emergencies. Sponsoring organizations, such as some community foundations, may

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[54] Gravelle, "Charities and Charitable Giving: Proposals for Reform, Congressional Research Service, Senate Finance Committee Hearing, April 5, 2003, citing Kerkman, Lewis and Krause, Chronicle of Philanthropy, vol. 16, issue 16, May 27, 2004.

impose distribution requirements and/or require their DAFs to permit such broader uses of funds. Perpetual existence, however, is undesirable if it has the effect of withholding assets from active charitable uses or maintaining funds for purposes that lose their charitable character or become unneeded.

Many donors establish DAFs or SOs to insure that the donated assets are used for the particular charitable purposes or for a particular supported organization specified by the donor. Limiting the duration of DAFs or SOs might discourage some potential donors who are disinclined to deal with the complexities of private foundations or the requirements imposed by institutions on endowment funds. On the other hand, experience with charitable trusts of limited duration suggests that perpetual existence is not a necessary condition for philanthropy. In addition, donee institutions greatly prefer unrestricted contributions. Financial management for such institutions might be made easier if they could rely on receipt of the remaining corpus of restricted DAFs or SOs to use for general purposes, if so desired, at a fixed date in the future.

In the case of private foundations, perpetual existence also can conflict with charitable goals. However, compared to the case of DAFs, perpetual existence for foundations probably presents less of a problem. Unlike DAFs,[55] private foundations, as separate legal entities required to file their own tax returns, have higher visibility to both tax and nonprofit (state) regulators. Limiting the lifespan of a private foundation (or other corporate entity) would change a fundamental concept in corporate law. In principle, tax and state authorities should take an interest in private foundations that endure but fail to serve a charitable purpose. Sponsoring organizations could change the purposes of, or terminate, DAFs by exercising their rights of

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[55] DAFs generally are internally designated funds or accounts of a sponsoring organization. SOs, while separate entities, generally are included in a charitable group of entities.

control over DAFs. However, independent, outside legal intervention challenging an entity's charitable bona fides would be more likely to occur in the case of private foundations because their separate filing requirements make them more transparent to authorities.

Perpetual existence seems undesirable for entities that are treated as charities for tax purposes but do not expend or distribute a meaningful portion of their assets for charitable purposes on a current basis. DAFs and SOs are more vulnerable to becoming undistributed accumulations than are public charities, which generally enjoy diverse support, or private foundations which are already subject to minimum payout rules. DAF donors are not the only charitable contributors who can steer funds and assets to restricted or narrow groups or purposes for an indefinite period. Private foundations and restricted endowment funds of major institutions, such as universities, also can serve particular charitable objectives chosen by the original contributors. However, private foundations and most restricted endowments are more transparent than DAFs and the use of their funds can be challenged under general law if they come into conflict with public policy. DAFs are not subject to filing or disclosure requirements that would reveal inappropriate use of their assets. Although SOs are separate legal entities with separate filing requirements, they are not subject to the same level of disclosure as are private foundations. Requiring more information on SOs' returns could increase their accountability.[56]

Recommendation: Limiting the existence of DAFs, SOs and private foundations would require legislation. If an appropriate minimum payout requirement is imposed, we believe that limiting the life of DAFs and SOs is unnecessary. If no payout requirement is imposed, we

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[56] Compared to the case of DAFs, there is stronger statutory authority for regulating SOs. SOs' somewhat greater visibility would reduce to some degree the risk of unlimited existence for SOs, even in the absence of a payout requirement.

recommend enacting legislation that denies DAFs and SOs perpetual existence. In determining the permissible term for DAFs and SOs, it would be important to craft a rule that recognizes their donors' legitimate interest in the long-term purposes and the performance of the organizations benefiting from their donations. Any of a variety of rules could address this issue. A rule might set a maximum term of years for a fund, requiring distribution of its assets at the end of the period. Or, in the case of DAFs, a rule might provide a maximum number of years for donor advisory rights, after which such rights would lapse and the sponsoring organization would no longer need to consult with the donor. Without adopting the complexities of the rule against perpetuities, the limitation might be tied to the life of the donor, or that of the donor and an appointed successor. In addition to substantive changes in law and regulations, more comprehensive information disclosure rules should be imposed on DAFs and SOs.

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

Although any charitable giving arrangement can be abused, the issues posed by DAFs and to a somewhat lesser extent by SOs are less likely to arise in the case of arrangements that are more strictly regulated, subject to oversight or control by beneficiaries or more transparent. For example, private foundations can have donor control, narrow focus and perpetual existence. However, they are subject to a special regime[57] of excise taxes on inadequate distributions, self-dealing and other activities conflicting with charitable purposes.

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[57] Secs. 4040-4946. Private foundations also are subject to requirements that are generally applicable to organizations qualifying under Section 501(c)(3).

Charitable remainder trusts are subject to distribution requirements and limits on their existence.[58] Endowments are subject to the control of their beneficiary institutions. Supported organizations generally have a relationship with their SOs that enables them to influence, if not always control, the SOs' activities. Organizations that must make their own separate federal tax and state regulatory filings are more likely to receive official or public attention.

Certain organizations and trusts that qualify as public charities because they meet the technical "public support" requirements[59] but are closely controlled and have limited sources of support also may provide opportunities for abuse. Although they may resemble private foundations more than typical "public" charities, they nevertheless are subject to the general rules applicable to public charities, not the private foundation regime, and are not subject to the new DAF and SO provisions.

7. ***Other Issues***

More important than any new issue created by the 2006 legislation on DAFs and SOs may be its impact on long-standing problems. The ability of financial institutions to establish sponsoring organizations and DAFs was settled long before the PPA. Careful planning with respect to the new rules will enable such activities to continue and spread. Although the "commercial" sponsors of DAFs are increasingly adopting their own payout requirements and many restrict contributions to cash and marketable securities, the qualification of these entities as tax-exempt charitable organizations presents a potential threat to the generally applicable standards for allowing "charitable" tax benefits. Investment houses earn significant fees for

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58 Section 664(d).

59 Section 509(a)(2).

managing DAF assets. Accordingly, in some cases, the formation of charitable sponsoring organizations for DAFs devolves at least in part from profit motivation. Vigilance is required to insure that the peculiar history of the commercial DAF industry is not invoked in tax controversies to dilute the definition of "charitable" in other contexts.

Under present law, DAFs and SOs can accept types of property that lack public markets. The Service is likely to encounter valuation problems with such contributions. The ability of donors to retain advisory rights and privileges with respect to DAF contributions may lead to some arrangements where donors retain rights so extensive that their contributions should not be regarded as completed gifts. More charitable deductions may be disallowed on these grounds. However, because incomplete gifts are more likely to be apparent on the donee's return than the donor's, there is a risk that disallowances will have little impact if they occur after the statute of limitations has run on the donor's return. Disallowances resulting from disqualifications of DAFs or SOs also present this problem.

A number of issues that have arisen in the context of private foundations also occur with respect to DAFs. Regulations should address the use of DAF assets to fulfill individuals' legally binding pledges, which in the case of private foundations cannot be fulfilled with foundation assets. Regulations also should address benefit ticket purchases, which are barred for private foundations, and quid pro quo gifts.