DONOR-ADVISED FUNDS GUIDE SHEET EXPLANATION

July 31, 2008

PURPOSE

This Guide Sheet Explanation is designed to assist in the completion of the Donor-Advised Funds Guide Sheet. It contains two parts: a background part that explains the history and taxation regime applicable to donor-advised funds and an explanation part keyed to the donor-advised funds guide sheet.

BACKGROUND

Donor-advised funds ("**DAFs**") have been part of charity for nearly a century, and have long been a staple of community foundations. Prior to the Pension Protection Act of 2006 (Pub. L. No. 109-208), the term "donor-advised fund" was not defined in the Code or Regulations, but it was understood to include arrangements by which some charitable organizations (including community foundations) established separate funds or accounts to receive contributions from donors. Donor-advised fund arrangements were comparable to component funds maintained by certain community trusts.

In general, contributions to a DAF are treated as contributions to a public charity, thus providing donors some advantages over private foundations. For example, donors may claim a higher charitable contribution deduction (up to 50% of adjusted gross income (AGI) to a public charity vs. 30% to a private foundation), and donor-advised funds are not subject to the Chapter 42 restrictions that apply to private foundations, such as the section 4941 self-dealing rules and the section 4942 annual payout requirements. (Note that the Pension Protection Act expanded the taxes on excess business holdings applicable to private foundations to donor-advised funds.) Other advantages touted by promotional literature include: estate planning benefits, donor anonymity, lower start-up costs, and lower expenses in connection with legal, administrative, and accounting services to establish and maintain donor-advised fund accounts as compared to private foundations.

While donor-advised funds have been in existence in some form since the 1930s, during the 1990s, for-profit financial investment firms began to establish affiliated nonprofit organizations to maintain donor-advised fund accounts. Typically, these "commercial" DAFs hire the affiliated for-profit investment firm to manage the investment of the assets in the accounts for a fee that varies based on the balance in the account and the number of annual transactions.

In National Foundation, Inc. v. United States, 13 Cl. Ct. 486, 493 (1987), the court held that an organization that raised and distributed funds to other charities and administered a wide variety of charitable projects, mostly recommended by its donors, qualified for exemption under section 501(c)(3). The court found that National Foundation, Inc.

("**NFI**") would refuse to administer a project if it did not meet five stringent standards: (1) that it be consistent with a the charitable purposes specified in section 501(c)(3); (2) that it have a reasonable budget; (3) that it be adequately funded; (4) that it be staffed by competent and well trained personnel; and (5) that it be capable of effective monitoring and supervision by NFI. The court also found that donors had relinquished all ownership and control over the donated funds or property to NFI and that NFI exercised its discretion in authorizing charitable distributions of the funds. NFI's standard form of agreement provided that NFI had control of all donations, and it was free to accept or reject any suggestion or request made by a donor.

In New Dynamics Found. v. United States, 70 Fed. Cl. 782 (2006), the court determined that New Dynamics Foundation ("**NDF**") did not qualify for exemption because it permitted donors to use funds to serve their private interests (e.g., to allow the donor to attend retreats, conferences, or seminars; to research investment opportunities; to save for retirement; to provide scholarships to the donor's family members; to be paid "administrative," "fundraising," and "consulting" expenses; and to pay the donor's children for performing charitable work). The court found that NDF was designed to "warehouse wealth," that is, to allow donors to "contribute" property and cash to their foundations, control the investment of those resources, and then allegedly have the income and appreciation on that corpus accrue or be realized tax-free. Id. at 800. As such, "NDF and its Board strained, beyond any recognition, the concept of charity in approving personal expenditures." Id. at 801. The court distinguished National Foundation, Inc., finding no indication that plaintiff had a set of standards designed to prevent abuse of its funds or that donors relinquished all ownership and custody of the donated funds or property. To the contrary, donors were "encouraged to reformulate their requests to disguise the true nature of the expenditures involved," and were "allowed to treat NDF as a conduit for accomplishing the twin tax avoidance goals of building up their assets tax-free and then siphoning off the accumulated wealth to pay for personal expenditures." Id. at 801, 03.

The Pension Protection Act enacted several provisions intended to improve the accountability of donor-advised funds. It defined the terms "donor-advised fund" and "sponsoring organization," and enacted or amended various excise taxes designed to penalize improper acts of DAFs, their sponsoring organizations, donors, and advisors. The sponsoring organization and fund management are subject to excise taxes for distributions that don't accomplish a charitable purpose or for certain distributions where expenditure responsibility is not exercised. IRC 4966. Donors, donor advisors, and related persons are also subject to excise taxes if they receive more than an incidental benefit from a donor-advised fund. IRC 4967. The 4958 excess benefit transaction taxes were extended to include donors to DAFs and investment advisers to sponsoring organizations. IRC 4958(c), (f). Finally, donor-advised funds are limited by the excess business holding rules. IRC 4943(e).

TAXATION REGIME

Defined Terms

IRC 4966(d)(2) defines a "donor-advised fund" as (1) a fund or account owned and controlled by a sponsoring organization, (2) which is separately identified by reference to

contributions of the donor or donors, and (3) where the donor (or a person appointed or designated by the donor) has or reasonably expects to have advisory privileges over the distribution or investments of the assets. All three prongs of the definition must be met in order for a fund or account to be treated as a donor-advised fund.

Exceptions:

- Funds or accounts that make distributions only to a single identified organization or government entity are not DAFs. IRC 4966(d)(2)(B)(i).
- Funds or accounts for which a donor provides advice regarding grants to individuals for travel, study, or other similar purposes are not DAFs, provided
    - the donor's, or the donor advisor's, advisory privileges are performed in his capacity as a member of a committee, all the members of which are appointed by the sponsoring organization;
    - no combination of donors or donor advisors (or related persons) directly or indirectly control the committee; and
    - all grants are awarded on an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the board of directors of the sponsoring organization that meets the requirements of IRC 4945(g)(1), (2) or (3). IRC 4966(d)(2)(B)(ii).

IRC 4966(d)(1) defines a "sponsoring organization" as an organization that (1) is described in section 170(c) (other than a governmental entity described in section 170(c)(1), and without regard to any requirement that the organization be organized in the United States) [e.g., a charitable organization, including domestic fraternal organizations, war veterans organizations, and cemetery companies]; (2) is not a private foundation (as defined in section 509(a)); and (3) maintains one or more donor-advised funds.

IRC 4966(d)(3) defines a "fund manager" with respect to a sponsoring organization as an officer, director, or trustee of such sponsoring organization (or an individual having powers or responsibilities similar to those of officers, directors, or trustees of the sponsoring organization).

"Disqualified persons" include the following:

With respect to a donor-advised fund:

- A donor or any person appointed or designated by a donor [donor advisor] who has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in a donor-advised fund by reason of the donor's status as a donor. IRC §4958(f)(7)(A) (cross-referencing § 4966(d)(2)(A)(iii));
- A member of the family of an individual described above. IRC §4958(f)(7)(B);
- A 35% controlled entity. IRC § 4958(f)(7)(C) (cross-referencing §4958(f)(3)).

With respect to a Sponsoring Organization:

- An "investment advisor," which is any person (other than an employee of the sponsoring organization) compensated by the sponsoring organization for managing the investment of, or providing investment advice with respect to, assets maintained in donor-advised funds. IRC 4958(f)(8)(B);
- A member of the family of an individual described above. IRC §4958(f)(8)(A)(ii);
- A 35% controlled entity. IRC § 4958(f) §4958(f)(8)(A)(iii).

Excise Taxes

IRC 4966 imposes a 20-percent excise tax on *taxable distributions* made by a sponsoring organization. In addition, a 5-percent excise tax applies to a fund manager who makes a taxable distribution knowing that it is a taxable distribution.

Taxable distributions include any distribution by a sponsoring organization from a donor-advised fund account if the distribution is (1) to any natural person (i.e., individual), or (2) to any other person (i.e., estate, partnership, association, company, or corporation) if the distribution is not for a charitable purpose, or if the sponsoring organization does not exercise expenditure responsibility in accordance with IRC 4945(h).

Exceptions:

- Distributions to IRC 170(b)(1)(A) organizations (other than to disqualifying supporting organizations) are not taxable distributions.
    - Disqualifying supporting organizations are Type III non-functionally integrated supporting organizations and Type I, Type II, and functionally integrated Type III supporting organizations where the donor or donor advisors directly or indirectly control the supported organization. In addition, the Secretary may determine by regulations that a distribution to such organization otherwise is inappropriate. [Distributions to these entities do not meet the exception and are likely taxable distributions.]
    - Type I, Type II, and functionally integrated Type III supporting organizations are *not* disqualifying supporting organizations, *provided* the donor or any person designated by the donor for the purpose of providing advice to the donor-advised fund does not directly or indirectly control the supported organization. [Under these circumstances, distributions to these entities would meet the exception and generally not be taxable distributions.]
- Distributions from a donor-advised fund to the sponsoring organization of such donor-advised fund, or to any other donor-advised fund, are not taxable distributions.

IRC 4967 applies a 125-percent excise tax on a donor, donor advisor, or related person who gives advice to have a sponsoring organization make a distribution from a donor-advised fund, which results in such person receiving, directly or indirectly, a *more than incidental benefit* as a result of such distribution. The tax does not apply if a tax has

already been imposed with respect to such distribution under IRC 4958. In addition, a 10-percent excise tax applies to a fund manager who makes a taxable distribution knowing that it is a taxable distribution.

A benefit is more than incidental if, as a result of a distribution from a DAF, such person receives a benefit that would have reduced or eliminated a charitable contribution deduction if the benefit was received as part of the transaction. See Staff of the Joint Committee on Taxation, Technical Explanation of H.R. 4, The "Pension Protection Act of 2006" as Passed by the House on July 28, 2006, and as Considered by the Senate on August 3, 2006 (JCX-38-06) at 350.

IRC 4943(e) applies the taxes on excess business holdings applicable to private foundations to donor-advised funds. The tax is equal to 10% of the value of the excess business holdings. If the excess business holdings are not disposed of within a specified time period, an additional tax of 200% of the excess holdings is imposed. The rule applies to taxable years beginning after August 17, 2006.

IRC 4958. Under the provision, any grant, loan, compensation, or other similar payment from a donor-advised fund to a person that with respect to such fund is a donor, donor advisor, or a person related to a donor or donor advisor automatically is treated as an excess benefit transaction under section 4958, with the entire amount paid to any such person treated as the amount of the excess benefit. IRC 4958(c)(2).

"Other similar payments" include payments in the nature of a grant, loan, or payment of compensation, such as an expense reimbursement. See Staff of the Joint Committee on Taxation, Technical Explanation of H.R. 4, The "Pension Protection Act of 2006" as Passed by the House on July 28, 2006, and as Considered by the Senate on August 3, 2006 (JCX-38-06) at 347.

Other similar payments do not include, for example, payments pursuant to bona fide sales or leases of property. Id. However, these transactions are still subject to the general rules of section 4958:

- As donors and donor advisors are disqualified persons with respect to DAFs, they may be subject to §4958 taxes if they engage in "excess benefit transactions," as defined in §4958(c)(1). See §4958(f)(1)(E).
- As investment advisors are disqualified persons with respect to sponsoring organizations, they may be subject to §4958 taxes if they engage in "excess benefit transactions," as defined in §4958(c)(1). See §4958(f)(1)(F).

IRC 508(f) requires that a sponsoring organization notify the Secretary that it maintains or intends to maintain donor-advised funds, including the manner in which it plans to operate such funds. Rules implementing disclosure of this information have not yet been issued.

Published Guidance

Notice 2006-109, 2006-51 I.R.B. 1121, provides interim guidance regarding certain requirements enacted as part of the Pension Protection Act of 2006 (PPA) that affect donor-advised funds. Notice 2006-109 excludes certain employer-sponsored disaster relief funds from the definition of donor-advised fund, and clarifies how the Internal

Revenue Service will apply the new IRC 4966 excise taxes with respect to payments made pursuant to education grants awarded prior to the date of enactment of the PPA.

Exemption Issues

Although donors or their advisors may provide advice or recommendations with regard to fund distributions and investments, to be consistent with exemption under section 501(c)(3), the charities maintaining the funds must have the ultimate authority over how the assets in the funds are invested and distributed. If a donor or his advisor continues to exercise control over amounts contributed, it might be found that sponsoring charities do not have legal ownership and control of the assets following the contribution. (In the case of a community foundation, the contribution may be treated as being subject to a material restriction or condition by the donor). See Staff of the Joint Committee on Taxation, Technical Explanation of H.R. 4, The "Pension Protection Act of 2006" as Passed by the House on July 28, 2006, and as Considered by the Senate on August 3, 2006 (JCX-38-06) at 340.

The Service has been concerned that some donors or related parties are exerting excess control or receiving undue benefits from a donor-advised fund. For example, some donors to donor-advised funds participate in schemes that allow them to regain the assets they contribute to their donor-advised funds. Assets in a donor-advised fund have been used to:

- partially pay for a grant to a public charity and partially pay for goods and services provided to the donor by grant recipient;
- provide "educational" loans to members of the donor's family;
- pay for donor travel expenses that are not substantially related to a charitable purpose.

For exemption purposes, the concern is whether the sponsoring organization has sufficient procedures and governance to ensure that the assets in its donor-advised funds accomplish charitable purposes, are used exclusively for charitable purposes and not for an impermissible private benefit. For example:

- Does the sponsoring organization allow donors to place limitations on the amounts that may be distributed from funds? These types of limitations may indicate that the assets in the account are not being used primarily to accomplish charitable purposes.
- Does the sponsoring organization permit investments in closely held corporations, limited partnerships, or limited liability corporations? These types of investments could be an indicator that the sponsoring organization is serving the private interests of its donors.
- Does the sponsoring organization allow the assets in its donor-advised funds to be used for fundraising events, for travel, or for other types of administrative items? This could mean that the assets in the donor-advised funds are being used to subsidize the donor's lifestyle rather than being used primarily to accomplish charitable purposes.

If donors have placed a material restriction on amounts transferred to a donor-advised fund, the sponsoring organization may be receiving donors' assets in trust rather than as the owner. Amounts received in trust would not qualify as public support for purposes of qualifying as a publicly supported organization under IRC 509(a)(1)/170(b)(1)(A)(vi) or IRC 509(a)(2).

The Internal Revenue Service has been interested in whether donor-advised funds should be required to distribute for charitable purposes a specified amount 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. See Notice 2007-21, 2007-9 I.R.B. 611, Study on Donor-Advised Funds and Supporting Organizations. Thus, the guide sheet asks whether the DAF has policies and procedures to require a minimum distribution from its fund accounts on an annual basis, such as whether distributions will equal or exceed 5 percent of the fund's average net assets on a rolling basis over a four-year period.

The Internal Revenue Service has also been interested in whether a donor-advised fund engages knowledgeable individuals to review donor distribution and investment recommendations. Thus, the guide sheet asks about the selection process and identity of investment advisors and how the sponsoring organization reviews donor advice.

EXPLANATION KEYED TO DONOR-ADVISED FUNDS GUIDE SHEET

This guide sheet is designed to assist in the processing of Form 1023 applications for recognition of exemption under IRC 501(c)(3) filed by sponsoring organizations that maintain donor-advised funds. The guide sheet assumes that an organization is otherwise qualified as an exempt organization and focuses on issues that are of special concern for a sponsoring organization.

Terms used in this guidesheet. Many items are written in the present tense; however, answers should be based on past, present, and planned activities. The terms "accounts" and "funds" are used in the guide sheet interchangeably to identify donor-advised funds that are under the ownership and control of a sponsoring organization. The term "donor" generally is meant to include any person appointed or designated by a donor [donor advisor] who has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in a donor-advised fund by reason of the donor's status as a donor; a member of the family of an individual described above; and a 35% controlled entity. The term "investment advisor" includes members of the investment advisor's family and any 35% controlled entities.

PART I

Part I is directed toward identifying whether the organization is a sponsoring organization because it maintains one or more donor-advised funds. If the answer to questions 1 through 3 is "Yes" and the answer to question 4a is "No," the organization is a sponsoring organization to which this guide sheet applies. Otherwise, the organization is not a qualifying sponsoring organization, and the guide sheet does not apply.

1. Is the organization described in IRC 170(c)(2)(B) [a charitable organization], IRC 170(c)(3) [a war veterans organization], IRC 170(c)(4) [a domestic fraternal organization], or IRC 170(c)(5) [a cemetery company], and is the organization not a governmental organization or a private foundation?

Most sponsoring organizations are public charities described in IRC 501(c)(3) and IRC 509(a,). Sponsoring organizations may also be war veterans' organizations, domestic fraternal organizations, or cemetery companies that maintain one or more donor-advised funds. Sponsoring organizations cannot be governmental organizations or private foundations. See 4966(d)(1).

2. Does the organization maintain one or more accounts or funds that are both (1) separately identified by reference to the contribution of a donor, and (2) owned and controlled by the organization?

The first prong of the definition requires that a donor-advised fund be separately identified by reference to contributions of a donor or donors. A distinct fund or account of a sponsoring organization does not meet this prong of the definition unless the fund or account refers to contributions of a donor or donors, such as by naming the fund after a donor, or by treating a fund on the books of the sponsoring organization as attributable to funds contributed by a specific donor or donors.

The second prong of the definition provides that the fund be owned and controlled by a sponsoring organization. To the extent that a donor or person other than the sponsoring organization owns or controls amounts deposited to a sponsoring organization, a fund or account is not a donor-advised fund.

3. Does the donor, or a person appointed or designated by the donor, have, or reasonably expect to have, advisory privileges over the distribution or investments of the account or fund established with the donor's contribution?

The third prong of the definition provides that with respect to a fund or account of a sponsoring organization, a donor or donor advisor has or reasonably expects to have advisory privileges with respect to the distribution or investment of amounts held in the fund or account by reason of a donor's status as a donor. Advisory privileges refer to the right of a donor to provide noncompulsory recommendations, suggestions, or consultative advice.

If any of the above questions is answered "No," this guide sheet does not apply because the organization is not a sponsoring organization. If all three answers are "Yes," continue using the guide sheet.

4a. Is the organization excepted from classification as a sponsoring organization because its accounts or funds consist of amounts that may only be distributed to a single identified organization or governmental entity as described in IRC 4966(d)(2)(B)(i)?

IRC 4966(d)(2)(B)(i) excepts as a donor-advised fund any fund or account that makes distributions only to a single identified organization or governmental entity. If an organization accepts a contribution of funds from a donor to be maintained by the organization in an identified account and disbursed as advised by the donor but only to a specifically named organization or government entity, the account would not be treated

as a donor-advised fund. (Of course, the disbursement would have to otherwise qualify as furthering charitable purposes to be deductible.)

For example, an endowment fund owned and controlled by a sponsoring organization that is held exclusively for the benefit of such sponsoring organization is not a donor-advised fund even if the fund is named after its principal donor and such donor has advisory privileges with respect to the distribution of amounts held in the fund to such sponsoring organization.

Accordingly, a donor that contributes to a university for purposes of establishing a fund named after the donor that exclusively supports the activities of the university is not a donor-advised fund, even if the donor has advisory privileges regarding the distribution or investment of amounts in the fund.

4b. Is the organization excepted from classification as a sponsoring organization because its accounts or funds consist of amounts that may only be distributed as educational grants to individuals as described in IRC 4966(d)(2)(B)(ii)?

IRC 4966(d)(2)(B)(ii) excepts as a donor-advised fund any fund or account where a donor has advisory privileges as to which individuals receive grants for travel, study, or other similar purposes provided that

> *(1) the donor's advisory privileges are performed as a member of a committee, all the members of which are appointed by the sponsoring organization,*
>
> *(2) neither the donor nor persons related to the donor directly or indirectly control the committee, and*
>
> *(3) all grants are awarded on an objective and nondiscriminatory basis pursuant to a procedure, approved in advance by the sponsoring organization's board of directors, that meets IRC 4945(g)(1), (2), or (3).*

4c. Is the organization excepted from classification as a sponsoring organization because its accounts or funds consist of amounts that may only be distributed as educational grants to individuals that are not excepted by IRC 4966(d)(2)(B)(ii) but made pursuant to a grant commitment entered into on or before August 17, 2006, as described in Notice 2006-109?

Notice 2006-109 excepts as a donor-advised fund any fund or account that makes educational grants to individuals that are not excepted by IRC 4966(d)(2)(B)(ii) but made pursuant to a grant commitment entered into on or before August 17, 2006. Notice 2006-109 sets out the special rules regarding whether a commitment will be considered entered into on or before August 17, 2006.

4d. Is the organization excepted from classification as a sponsoring organization because its accounts or funds consist of amounts that may only be distributed as employer-sponsored disaster relief funds as described in Notice 2006-109?

Notice 2006-109 excepts as a donor-advised fund any fund or account that is an employer-sponsored disaster relief fund that meets the following requirements:

(a) the fund serves a single identified charitable purpose, which is to provide relief from one or more qualified disasters within the meaning of IRC 139(c)(1), (2) or (3);

(b) the fund serves a large or indefinite class (a "charitable class");

(c) recipients of grants from the fund are selected based on objective determinations of need;

(d) the selection of recipients of grants from the fund is made using either an independent selection committee or adequate substitute procedures to ensure that any benefit to the employer is incidental and tenuous. The selection committee is independent if a majority of the members of the committee consists of persons who are not in a position to exercise substantial influence over the affairs of the employer;

(e) no payment is made from the fund to or for the benefit of (i) any director, officer, or trustee of the sponsoring organization of the fund, or (ii) members of the fund's selection committee; and

(f) the fund maintains adequate records that demonstrate the recipients' needs for the disaster relief assistance provided.

PART II

Part II asks a number of questions that are directed to whether an organization is in a position to ensure the accomplishment of charitable purposes, including whether it has ultimate authority over its accounts or funds.

1. Did the organization provide a copy of the fund agreement or contract that outlines the terms and conditions for participation by a contributor to a donor-advised fund?

The answer should be "Yes." If the organization answers "No," it should provide these documents before any decision is made on recognition of exemption.

2. Did the organization provide promotional or informational material that explains how the donor-advised fund operates?

The answer should be "Yes." The organization should provide these documents before any decision is made on recognition of exemption. If the organization claims that it does not have these documents, it should explain how it solicits donors.

3. If the organization has an Internet site, is the Internet site information regarding the operation of donor-advised funds consistent with the written information provided as part of the application process?

The answer should be "Yes." If the answer is "No" because the web site provides misleading representations or significant discrepancies with the organization's print representations, the web site should be made a part of the administrative record and the organization should be asked for a written explanation to address these issues, or this might provide grounds for denying exemption.

4. Does the organization specifically inform donors that they may not impose restrictions or conditions on the assets in their account?

The answer should be "Yes," because donors are not permitted to impose restrictions or conditions on the assets in their account. If an organization answers "No," the organization is not a sponsoring organization.

5. Does a donor receive a separate statement reporting account information about the donor's account, including balances, investments, and distributions?

The answer should be "Yes." If the answer is "No," the organization should explain how the advisory process works when the donor is not provided relevant information relating to the donor's account or fund.

6a. Is the donor permitted by the organization to provide recommendations as to charitable distributions made from the donor's account?

The answer should be "Yes." This is the essence of a donor-advised fund: the donor makes recommendations on how the donated assets are to be distributed. If the answer is "No," the organization may not be a sponsoring organization. Check for consistency with Part I, question 3.

6b. If the answer to question 6a is "Yes," does the organization review all donor recommendations for distributions?

The answer should be "Yes." If the organization answers "No," it should be asked how it evaluates distribution recommendations – and requested to provide appropriate supporting documentation, since this answer raises concerns about whether accounts or funds are subject to the organization's ownership and control.

6c. If the answer to question 6a is "Yes," has the organization provided to us its criteria to help ensure that distributions will accomplish charitable purposes?

The answer should be "Yes." If an organization answers "No," the organization cannot establish that it qualifies for exemption.

6d. If the answer to question 6a is "Yes," does the organization have the final decision-making authority on how distributions from a donor's account are made?

The answer should be "Yes." A sponsoring organization must always have the ultimate decision-making authority regarding how to distribute funds contributed by a donor. The donor's instructions are always advisory recommendations. If an organization answers "No," the organization is not a sponsoring organization.

6e. If the answer to question 6d is "Yes," has the organization explained the procedures and criteria it will use to ensure that the assets in the DAF account are used to accomplish charitable purposes?

The answer should be "Yes"; otherwise, the organization cannot establish that it qualifies for exemption.

7a. Does the donor have the ability to **select** investment options from a list of pre-approved options?

If the organization answers "Yes," continue to question 7b. Not all sponsoring organizations offer donors the ability to select investment options. If the organization answers "No," continue to question 8a.

7b. Has the organization provided its list of pre-approved options?

The organization should provide a list of the options it offers, including investment options outside the organization. The options should be scrutinized for impermissible private benefit.

7c. Has the organization explained how the assets in the funds will be used to accomplish charitable purposes in light of the investment options?

Explaining details about the investment options is important for determining whether the sponsoring organization operates exclusively for charitable purposes or whether a substantial part of its activities serves the private interests of its donors, donor advisors, fund managers, or other persons.

8a. Does the donor have the ability to **recommend** investment options for the donor's account?

Note the word "select" in question 7a and the word "recommend" in question 8a. Selecting an option from a list that the sponsoring organization has pre-approved indicates that the organization exercises ultimate decision-making authority regarding how to distribute funds contributed by a donor. If the donor has the ability to recommend an option, the organization must exercise ultimate decision-making authority in deciding whether such distribution will accomplish charitable purposes.

Not all sponsoring organizations offer donors the ability to recommend investment options. If an organization answers "Yes," continue to question 8b. If the organization answers "No," continue to question 9.

8b. Has the organization explained how it evaluates whether to approve or deny an investment option selected by a donor?

The organization should answer "Yes," since it must ensure that the assets are being used to further charitable purposes and not to create impermissible private benefit. If it answers "No," the organization does not qualify for exemption.

8c. Does the organization have the final decision-making authority on how investments from a donor's account are made?

The answer should be "Yes." The sponsoring organization must have the ultimate decision-making authority regarding how to invest funds contributed by a donor. If the answer is "No," the organization is not a sponsoring organization.

9. Does the donor have the ability to select successor advisors for the donor's account?

The sponsoring organization is not required to offer this option. If the answer is "Yes," the organization should explain how this provision operates. If the answer is "No," the organization should explain what happens to assets in the donor's account (e.g., will they be distributed to a designated organization or will they default to the sponsoring organization's unrestricted fund?).

10a. Are there provisions in the fund agreement for investments and distributions if a donor's account is inactive?

There are no prohibitions on a sponsoring organization having procedures regarding inactive accounts. Sometimes the organization will impose additional fees or close an inactive account. This question relates to whether the organization has a provision to ensure the continuation of distributions where an account becomes inactive.

If the organization answers "Yes," continue to question 10b. If the organization answers "No," continue to question 11.

10b. Has the organization explained how often the donor is required to provide advisory recommendations, and what happens if the donor does not offer any advisory recommendations?

This question relates to whether donor-advised funds should be required to distribute for charitable purposes a specified amount 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. See Notice 2007-21, 2007-9 I.R.B. 611, Study on Donor-Advised Funds and Supporting Organizations.

11a. Does the sponsoring organization require a minimum yearly distribution across all DAFs?

While there is no specific requirement in place to require a fixed distribution amount, sponsoring organizations have generally taken steps to demonstrate that they fulfill their tax-exempt purpose by making distributions.

Generally, sponsoring organizations have policies regarding minimum yearly distributions spread across all funds, usually at least 5%.

11b. Does the sponsoring organization require a minimum yearly distribution from each DAF?

This question continues 11a. Some sponsoring organizations may require a minimum distribution from each fund or account instead of across all accounts.

11c. If the answer to 11a or 11b is "Yes," has the organization described its minimum?

This question aims to understand what percent payout the organization has adopted. If the policy requires less than 5%, the organization should be asked to explain how it will fulfill its tax-exempt purpose that includes making distributions.

11d. If the answer to 11a or 11b is "Yes," has the organization explained its mechanism to ensure that a minimum annual distribution from a donor's account is made?

Without a mechanism to ensure that distributions from donors' accounts or funds are distributed, the organization may not be able to describe how it intends to fulfill its tax-exempt purpose.

11e. If the answer to 11a or 11b is "No," has the organization explained how it will fulfill its tax exempt purpose including making distributions?

Without a requirement that a certain amount of assets be paid out annually, the organization must establish that it is not being used to serve private interests instead of public interests.

PART III

Part III asks a number of questions that are directed to concerns regarding prohibited benefits, including private benefits that are inconsistent with exempt status. An organization will be denied exemption if it fails to establish that it satisfies all the requirements for exemption, including furthering private interests instead of public interests.

1a. Does the organization have an agreement or arrangement with any investment or financial company to invest its assets? If the answer is "Yes," continue to question 1b. If the answer is "No," skip to question 2.

While sponsoring organizations will typically hire an investment advisor or financial company, the arrangement must be scrutinized to ensure it doesn't produce prohibited private benefit.

1b. Has the organization identified the investment or financial company and provided all the relevant documentation, such as copies of any contracts or agreements between the organization and the investment or financial company?

The organization should describe how each investment or financial company is paid for its services. The arrangement should be scrutinized for impermissible private benefit.

1c. Has the organization described its policies and procedures to ensure that it will not permit excessive brokerage fees, such as the buying and selling of securities on a frequent basis in order to earn brokerage commissions at the expense of serving charitable purposes?

Donor-advised funds are intended to accomplish charitable purposes rather than to generate fees from securities trading for investment advisors. If the arrangement produces too much private benefit to the financial company, the organization does not qualify for exemption.

1d. Are any of the organization's board members related to or associated with the investment or financial companies described in answer to question 1a?

An organization that answers "Yes" has potential conflicts of interest. Its ability to enter into arm's length transactions could be impaired. It is preferable for the organization to hire independent investment or financial advisors. However, all the facts and circumstances of the arrangement must be explored to determine whether the arrangement serves impermissible private interests.

1e. Will the organization and the investment company share office space, common phone numbers, promotional literature, or common Internet addresses?

1f. If the answer to question 1e is "Yes," has the organization explained how it will undertake these shared arrangements to avoid impermissible private benefit to the financial or investment company?

The organization should provide an explanation that describes how it will undertake these arrangements to ensure that the investment or financial company is not obtaining more than an incidental benefit from its relationship with the organization.

1g. Has the organization used a competitive bidding process for selecting the investment advisor to manage its funds? If not, has it described criteria and a process to select the investment advisor that indicates that private interests are not being served more than incidentally?

A competitive bidding process is one method to ensure that a particular financial or investment company is not obtaining more than an incidental benefit from its relationship with the organization. If a competitive bidding process is not used, the answer should include a description of the process used for selecting the investment advisor, and the arrangement should be scrutinized for impermissible private benefit.

2. If the organization answered "No" to question 1a, has the organization explained who supervises its investments and how they are managed?

This question is aimed at understanding whether the organization has an in-house staff or some other arrangement for managing its investments.

3. Will the organization make distributions from its donor-advised funds to any natural person (i.e., a live person rather than a corporation, trust, partnership, or other artificial legal entity)?

Section 4966 imposes an excise tax on distributions from a DAF to natural persons, unless one of the exceptions applies (see questions 4 and 5 below). If a DAF is making such distributions, it may not qualify for exemption because this raises questions about whether it is operating for impermissible private purposes instead of public purposes.

4a. With respect to distributions from its donor-advised funds, will donors be allowed to recommend grants to individuals for travel, study, or other similar purposes?

Section 4966 imposes an excise tax on distributions from a DAF for grants to individuals, unless one of the exceptions in 4b or 5b below applies. If a DAF is making such distributions, it may not qualify for exemption because this raises questions about whether it is operating for impermissible private purposes instead of public purposes.

4b. If the answer to question 4a is "Yes," will the organization apply the rules set forth in the exception applicable to certain individual educational grant programs as described in IRC 4966(d)(2)(B)(ii)?

IRC 4966(d)(2)(B)(ii) excepts certain educational grant programs from being treated as donor-advised funds even though advice is given with respect to such grants to individuals for travel, study, or other similar purposes (e.g., scholarships, educational loans, or grants to achieve a specific objective, produce a report or other similar product, or improve or enhance a literary, artistic, musical, scientific, teaching or other similar capacity, skill, or talent of the grantee). The following conditions must be met:

> *(1) The advisory privilege must be performed exclusively in the person's capacity as a member of a committee, the members of which are appointed by the sponsoring organization;*

(2) no combination of persons with advisory privilege may control the committee, directly or indirectly; and

(3) all grants from the fund or account must be awarded on an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the sponsoring organization's board of directors, and such procedure must be designed to ensure that all such grants meet the requirements of IRC 4945(g)(1), (2), or (3).

5a. With respect to distributions from its donor-advised funds, will donors be allowed to recommend grants for employer-sponsored disaster relief funds?

Section 4966 imposes an excise tax on these distributions, unless the exception below applies. If a DAF is making such distributions, it may not qualify for exemption because this raises questions about whether it is operating for impermissible private purposes instead of public purposes.

5b. If the answer to question 5a is "Yes," is the grant program excepted from classification as a donor-advised fund under Notice 2006-109?

IRC 4966(d)(2)(C) authorizes the Secretary to exempt a fund or account from the definition of donor-advised fund. Pursuant to this authority, Notice 2006-109, 2006-51 I.R.B. 112, excludes from the definition of donor-advised fund any employer-sponsored disaster relief fund that meets certain enumerated requirements.

6. Will the organization make distributions from its donor-advised funds to any other person (i.e., corporation, trust, estate, partnership, or association)? If "Yes," continue to question 7. If "No," skip to question 12.

Distributions to persons other than natural persons (e.g., corporations, trusts, estates, partnerships, or associations) are taxable distributions unless one of the exceptions applies (see questions 7 through 11). If a DAF is making taxable distributions, it may not qualify for exemption because this raises questions about whether it is operating for impermissible private purposes instead of public purposes.

7. With respect to distributions from its donor-advised funds to other organizations, will the organization make distributions to IRC 170(b)(1)(A) organizations?

Distributions to the following IRC 170(b)(1)(A) organizations are generally permissible (i.e., not taxable distributions).

Such organizations include:

A. Public charities described in IRC 509(a)(1) or 509(a)(2);

B. Supporting organizations described in IRC 509(a)(3) that are Type I, Type II, or functionally integrated Type III supporting organizations, provided the donor or any person designated by the donor for purposes of advising with respect to distributions from a donor-advised fund does not directly or indirectly control the supported organization;

C. Private foundations described in IRC 170(b)(1)(F) [i.e., (i) private operating foundations, (ii) private foundations that distribute all of their

contributions, and (iii) private foundations all of the contributions of which are pooled in a common fund.]

8a. With respect to distributions from its donor-advised funds to other organizations, will the organization make distributions to supporting organizations defined in IRC 509(a)(3)?

Only some distributions to supporting organizations are permissible. See question 8b, below.

8b. If the answer to question 8a is "Yes," will the organization only make distributions to supporting organizations defined in IRC 509(a)(3) that are Type I, Type II, or functionally integrated Type III supporting organizations and where the donor who has advisory rights does not directly or indirectly control the recipient supported organization?

The above distributions are permissible (i.e., not taxable distributions).

However, distributions to (1) a Type III supporting organization other than one that is functionally integrated, and (2) to any supporting organization with a donor who has advisory rights and who directly or indirectly controls the recipient supported organization are taxable distributions. If a DAF is making taxable distributions, it may not qualify for exemption because this raises questions about whether it is operating for impermissible private purposes instead of public purposes.

9. With respect to distributions from its donor-advised funds to other organizations, will the organization make distributions to the sponsoring organization of such donor-advised fund, or to another donor-advised fund?

Distributions to the sponsoring organization of such donor-advised fund or to another donor-advised fund are not taxable distributions.

10. With respect to distributions from its donor-advised funds to other organizations, will the organization make distributions from its donor-advised funds solely to a single identified organization or governmental entity?

Distributions from any donor-advised fund from which a sponsoring organization makes distributions only to a specified organization or governmental entity are not taxable distributions.

11a. Apart from distributions specified by questions 7 through 10, does the organization make distributions to other organizations?

If the answer to question 11a is "Yes," continue to question 11b below. If the answer is "No," continue to question 12.

11b. If the answer to question 11a is "Yes," will distribution be for a purpose specified in IRC 170(c)(2)(B) (i.e., a charitable purpose)?

If the distribution is not for a charitable purpose, it is a taxable distribution. Even if the distribution is for a purpose specified in IRC 170(c)(2)(B), go on to question 11c below.

11c. If the answer to question 11a is "Yes," will the organization exercise expenditure responsibility as described in IRC 4945(h) with respect to such distributions?

The expenditure responsibility rules generally require that an organization exert all reasonable efforts and establish adequate procedures to see that the distribution is spent solely for the purposes for which made, to obtain full and complete reports from the distributee on how the funds are spent, and to make full and detailed reports with respect to such expenditures to the Secretary.

Grants to other organizations for purposes specified in IRC 170(c)(2)(B) and where the organization exercises expenditure responsibility are not taxable expenditures.

If the organization does not exercise expenditure responsibility, the grant would be a taxable distribution. If a DAF is making taxable distributions, it may not qualify for exemption because this raises questions about whether it is operating for impermissible private purposes instead of public purposes.

12. Has the organization provided a copy of policies and procedures that it has adopted to ensure that it will not permit the distribution of funds from its donor-advised funds to be used to directly or indirectly provide more than an incidental benefit to any donor, donor advisor, or related person?

The answer should be "Yes." Without such information, the organization would likely not be able to establish that it qualifies for exemption. It also would likely be subject to the 4967 excise tax in future years.

13. Has the organization provided a copy of policies and procedures that it has adopted to prohibit distributions from donor-advised funds in the form of grants, loans, compensation, or other similar payments, including expense reimbursements, to the donor, donor advisor, a member of the donor or donor advisor's family, or a 35% controlled entity of the aforementioned?

The answer should be "Yes." Such transactions are automatically treated as excess benefit transactions under IRC 4958(c)(2), with the <u>entire amount</u> paid to such person treated as the amount of the excess benefit. Without such information, the organization would likely not be able to establish that it qualifies for exemption. It also would likely be subject to the 4958 excise tax in future years.

14. Has the organization provided a copy of policies and procedures that it has adopted to prohibit excess benefit transactions from donor-advised funds to donors or donor advisors (or related persons) and from sponsoring organizations to investment advisors (or related persons)?

The answer should be "Yes." Without such information, the organization would likely not be able to establish that it qualifies for exemption. It also would likely be subject to the 4958 excise tax in future years. Related persons are a member of the donor or donor advisor's family, or a 35% controlled entity of the aforementioned.