THE NEW YORK COMMUNITY TRUST NYCT

PROFESSIONAL TAX & ESTATE PLANNING NOTES

October 2007

3 Impact of the Pension Protection Act on Donor-Advised Funds

This article, the third in a series about the charitable reform provisions of the Pension Protection Act of 2006 (the "Act"), which became law on August 17, 2006, reviews their impact on donor-advised funds.

For almost a century, community foundations like The New York Community Trust have been building permanent charitable resources to meet the current needs of their communities and the unforeseen needs of the future. When we started in 1924, our donors set up unrestricted or broad field-of-interest funds, primarily through bequests, trusting tomorrow's leaders to spend it wisely.

Our first "donor-advised" fund was established in 1934, before there was even a name for it—and long before there were any specific laws or regulations. During her lifetime, this first "donor advisor" made grant suggestions to us. When she died, the assets in the fund became part of The Trust's permanent endowment, which supports our discretionary grantmaking program. That program relies on a professional staff to assess community needs, investigate nonprofits, vet their projects and finances, and recommend grants to our distinguished volunteer board. Grants from her fund, which is now worth $64 million, support a wide range of important projects. Today, The Trust has assets of $2 billion; $700 million of that total is held in more than 1,000 donor-advised funds, which range in size from $5,000 to $99 million.

The legal basis for donor-advised funds is imbedded in the 1969 Tax Reform Act that created the classifications of private foundation and public charity and imposed a number of restrictions on private foundations, i.e., those tax-exempt organizations that were typically controlled

ISSUES IN THIS SERIES

1 **March 2007**
The Pension Protection Act of 2006: Implications for Charitable Giving

2 **JUNE 2007**
Impact of the Pension Protection Act on Supporting Organizations

3 **OCTOBER 2007**
Impact of the Pension Protection Act on Donor-Advised Funds

Written by Jane L. Wilton, general counsel, The New York Community Trust

©The New York Community Trust 2007

This material was developed for the use of professionals by The New York Community Trust. It is published with the understanding that neither the publisher nor the author is engaged in rendering legal, accounting, or other professional advice. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

by a single donor or the donor's family. Ensuing regulations initially adopted in 1972 permitted a private foundation to terminate and transfer its assets to a fund at a public charity, provided the transferor did not impose any material restriction on the distribution or investment of the assets.[1] These regulations permit a transfer of assets by a private foundation to a public charity if the private foundation (or a disqualified person with respect to the foundation) provides advice, but does not *control* the disposition of the assets. Parts of the regulations were then integrated into the community foundation regulations,[2] enabling a fund created at a community foundation by a terminating private foundation to be considered a "component fund" of the community foundation, rather than a separate entity.

These regulations governing termination of private foundations, and the increasing visibility of community foundations, fueled the growth of donor-advised funds. Their growth, especially over the last 15 years, has prompted a host of questions about their proper administration, as well as some allegations of abuse. Concerned that donors have *de facto* control over assets contributed to donor-advised funds, and the possibility that such contributed assets were not being used for charity, Congress included extensive rules governing donor-advised funds in the Pension Protection Act of 2006, which are discussed in the pages that follow.

Much of the explanation of the donor-advised fund provisions is found in the Joint Committee Report,[3] which serves as the legislative history of the Act. In addition to explaining the new law, the Report at times seems to expand provisions affecting donor-advised funds in particular, and charities and foundations in general.

Donor-Advised Fund Defined

The Act provides the first statutory definition of a donor-advised fund:[4]

- a fund or account that is separately identified by reference to contributions of a donor or donors,
- is owned and controlled by a sponsoring organization, and
- with respect to which a donor (or any person appointed or designated by a donor) has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in such fund or account by reason of the donor's status as a donor.

The above three prongs of the definition require additional explanation.

Separately identified by reference to contributions of a donor or donors. This prong requires that the sponsoring organization reference the contributions of a donor or donors to the particular fund or account on its books and records, by, for example, naming the fund after a donor, or by attributing contributions to a specific donor or donors.[5] Therefore, a fund of broad, general interest that attracts contributions from unrelated donors generally will not be considered to be a donor-advised fund, even if it has an advisor or advisors, provided the contributions of specific donors are not tracked for attribution purposes.[6]

Owned and Controlled by a Sponsoring Organization. A "sponsoring organization" is defined as a public charity (other than certain supporting organizations) that maintains one or more donor-advised funds.[7]

A Donor or any Person Appointed or Designated by the Donor has Advisory Privileges. The Act does not provide a complete definition of "advisory privileges" other than to refer to advisory privileges as to distributions (grants) or investments of amounts held in the fund by reason of the donor's status as a donor. The Joint Committee Report notes that the presence of an advisory privilege may be evidenced by a written agreement, even if the privilege is not exercised, or through the conduct of a donor or donor-advisor and the sponsoring organization.[8] The legislative history also distinguishes advisory privileges from a legal right or obligation, such as a gift instrument that specifies certain enforceable rights of the donor.[9]

The Joint Committee Report offers two notable exceptions or carve-outs to the concept of providing "advisory privileges." First, a donor is not deemed to be exercising advisory privileges if he or she is provid-

ing advice in a capacity as a board member or employee of the sponsoring organization.[10] Second, with respect to the *statutory* exceptions to the definition of a donor-advised fund (discussed below), a donor's recommendation to the sponsoring organization of individuals to serve as advisors on grants or investments will not be treated as "appointments" or "designations" by the donor so long as the donor employs objective criteria related to the individual's expertise.[11] This latter carve-out is applicable particularly to scholarship funds where the donor selects advisors based on their expertise.

The Joint Committee Report notes that the presence of an advisory privilege may be evidenced by a written agreement, even if the privilege is not exercised, or through the conduct of a donor or donor-advisor and the sponsoring organization.

Statutory Exclusions from the Definition of a Donor-Advised Fund

The Act expressly excludes from the definition of a donor-advised fund: (1) any fund that "makes distributions only to a single identified organization or governmental entity,"[12] i.e, a designated fund where the governing instrument names one designated organization to receive grants; and (2) any fund that makes grants to individuals "for travel, study, or other similar purposes."[13]

The second exclusion is limited and requires that:

1. the advisory privileges of the donor or person designated by the donor are performed exclusively as a member of a committee whose members all are appointed by the sponsoring organization;
2. no combination of the donor and any person appointed by the donor (or persons related to such persons) control, directly or indirectly, the committee; and
3. all grants from the fund 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 is "designed to ensure that all such grants meet the requirements of paragraphs (1), (2), or (3) of Section 4945(g)."[14]

In addition, the Secretary of the Treasury may exempt from the definition of a donor-advised fund a fund that is "advised by a committee not directly or indirectly controlled by the donor or any person appointed or designated by the donor" (and any related parties), or that "benefits a single identified charitable purpose," i.e., a field-of-interest fund.[15]

Restrictions on Donor-Advised Funds

The Act also imposes penalties on certain types of distributions from and on excess business holdings in donor-advised funds.

Taxable distributions prohibited. The statute prohibits certain distributions from donor-advised funds. These "taxable distributions" include distributions to:

1. an individual[16]
2. a person or entity if made for a non-charitable purpose[17]
3. a disqualified supporting organization, defined as:
   (i) a Type III supporting organization that is not functionally integrated,[18] or
   (ii) a Type I, Type II, or a functionally integrated Type III supporting organization if the donor or his designee, for the purpose of advising with respect to distributions from the donor-advised fund (and any related parties), directly or indirectly controls a supported organization,[19] or
4. a private non-operating foundation.[20]

Therefore, distributions to Code Section 170(b)(1)(A)[21] publicly supported organizations (such as churches, educational organizations, hospitals, other charities that meet the public support test) and private operating foundations are permitted. Distributions to other donor-advised funds also are not prohibited.[22] Grants to organizations other than publicly supported organizations such as foreign charities, private non-operating foundations, and disqualified supporting organizations, will trigger excise taxes unless the sponsoring organiza-

tion exercises expenditure responsibility in accordance with Code Section 4945(h).[23]

The restriction on the types of supporting organizations to which a donor-advised fund may make a grant requires the sponsoring organization to: (1) confirm that the donor-advisor or a related party does not control the supported organization; and (2) determine that the supporting organization is a Type I, Type II, or Type III functionally integrated supporting organization.[24]

Identifying an organization as a disqualified supporting organization, i.e., a non-functionally integrated Type III supporting organization, can be a daunting task, despite the IRS' issuance of interim guidance.[25] Practitioners must review this interim guidance closely in order to assist clients as they navigate these rules.

A penalty tax of 20 percent of each taxable distribution is imposed on the sponsoring organization[26] and a 5 percent tax is imposed on any fund manager who agrees to the distribution "knowing that it is a taxable distribution," up to a maximum tax for any one taxable distribution of $10,000.[27] If there is more than one manager, they are jointly and severally liable.[28]

Other prohibited benefits. New Code Section 4967 imposes a penalty tax on a donor-advisor who recommends a grant from a donor-advised fund that results in more than an "incidental benefit" being received from the grantee by a disqualified person.

For this purpose, the new special definition of "disqualified person" applicable to donor-advised funds under Code Section 4958 is used. Thus, the tax is imposed on any donor or donor-advisor, or member of the family of a donor or donor-advisor or a 35 percent controlled entity of which a donor or donor-advisor owns more than 35 percent of the combined voting power, profits interests, or beneficial interest.[29] For this purpose, family members include a spouse, ancestors, lineal descendants (down to great-grandchildren), and siblings (whether whole or half), as well as their spouses.
The Joint Committee Report indicates that "more than incidental benefit" refers to the receipt of benefits that would have reduced or eliminated a charitable contribution deduction if the benefit was received in connection with the contribution to the sponsoring organization.[30] This will include, for example, tickets and seats at events or benefits received in exchange for a grant from a donor-advised fund. The Joint Committee Report offers a not very helpful example of an incidental benefit: a grant is made from a donor-advised fund to the Girl Scouts of America and the donor's daughter is a member of a local girl scout troop. The legislative history states that the indirect benefit to the donor is considered incidental in this instance because "it generally would not have reduced or eliminated the donor's deduction if it had been received as part of a contribution by the donor to the sponsoring organization."[31]

The penalty tax is 125 percent of the prohibited benefit received, directly or indirectly, when the donor, advisor, or a related person receives *more than an incidental benefit* from the grantee.[32] The penalty is on the advisor or the person who receives the benefit, and is paid to the government, not to the charity.[33] In addition, the fund manager who agreed to make the distribution, knowing the distribution would confer a prohibited benefit, is subject to a 10 percent tax, up to $10,000 for any one distribution.[34] Liability will not be imposed if the distribution has already been subject to an excise tax under the intermediate sanctions rules of Code Section 4958.[35]

Excess Benefit Transactions. The Act extends the intermediate sanction rules of Code Section 4958 to donor-advised funds. Code Section 4958 already applies to sponsoring organizations because they are public charities. Excess benefit transactions are those transactions where a disqualified person receives an economic benefit, directly or indirectly, that exceeds the value of the services provided to the charity. There are now two types of excess benefit transactions that are subject to a penalty tax: automatic benefit transactions and those that require an analysis of the actual benefit conferred.

Automatic excess benefit transactions include "any grant, loan, compensation, or other similar payment" from a donor-advised fund to a disqualified person.[36] The excess benefit is the *full* amount of that grant, loan, or other

payment. The expanded definition of disqualified persons under Code Section 4958 as noted above includes all donors and donor-advisors, and their family members, and 35 percent controlled entities.[37]

New Code Section 4967 imposes a penalty tax on a donor-advisor who recommends a grant from a donor-advised fund that results in more than an "incidental benefit" being received from the grantee by a disqualified person.

In addition, investment advisors are now considered disqualified persons with respect to sponsoring organizations.[38] This includes those who provide investment advice on investment pools that include donor-advised assets, whether or not related to a donor.[39] If an investment advisor is overpaid for his services, it constitutes an excess benefit transaction, even though the person does not otherwise exercise substantial influence over the sponsoring organization.
The Joint Committee Report indicates that an expense reimbursement is considered a "similar payment," but that payments pursuant to a *bona fide* sale or lease are not automatic excess benefits.[40] Accordingly, reimbursement of legitimate fundraising expenses from a donor-advised fund to a disqualified person with respect to the donor-advised fund is prohibited. For the few sponsoring organizations that permit fundraising for individual funds, a gift acknowledgement may enable the donor to deduct out-of-pocket expenses incurred in undertaking a charitable activity.

The automatic excess benefit provisions of Code Section 4958 generally do not apply to a sponsoring organization's payment of an expense reimbursement or to a vendor except when paid from the donor-advised fund. For example, a payment for legal services rendered to the sponsoring organization to a person who is a disqualified person with respect to a donor-advised fund is not an automatic excess benefit transaction. This distinction is made clear in the legislative history.[41]

The penalty on an excess benefit transaction is 25 percent on the person who received the excess benefit.[42] It is repaid to the charity, and may not go to the donor-advised fund. If not corrected, the penalty is 200 percent of the excess benefit.[43] In the case of automatic excess benefits, the full transaction amount is deemed an excess benefit.[44] In addition, fund managers who participate in the transaction knowing it is an excess benefit transaction are subject to tax of 10 percent (up to $20,000).[45]

Excess Business Holding Rules Applied to Assets Held in Donor-Advised Funds

The Act extends the private foundation excess business holdings excise tax to donor-advised funds, giving rise to a 10 percent penalty on excess business holdings.[46] The holdings of a donor-advised fund in a business enterprise, aggregated with the holdings of disqualified persons with respect to the fund, will be subject to penalties on the excess holdings if the aggregate holdings exceed:

- 20 percent of the voting stock of a business in corporate form (35 percent if persons who are not disqualified have effective control of the business)
- 20 percent of the profits interest in a partnership
- 20 percent of the beneficial interest of a trust or estate

A *de minimus* exception applies when a donor-advised fund together with its disqualified persons (as defined in Code Section 4943), owns not more than 2 percent of the voting stock of a business enterprise.[47]

Disqualified persons for this purpose are donors and individuals designated as advisors by donors, their families, and 35 percent controlled entities.[48] The statute does not define "family" for this purpose, and presumably this will be clarified in regulations.

A "business enterprise" is defined as the active conduct of a trade or business. Among the relevant exclusions[49] is a business that derives at least 95 percent of its income from passive sources (dividends, interest, royalties, capital gains). Interests in family limited partnerships, REITs, and hedge funds generally will come under this exclusion.

The excess business holdings rules and the accompanying Treasury Regulations are remarkably complex. In general, if a donor-advised fund receives a gift or a bequest of an interest in a business enterprise after the date of enactment, it has 5 years to divest itself of any excess holdings, with a possibility of an additional 5 years under limited circumstances if approved by the Secretary of the Treasury. However, if purchases by the disqualified persons cause the donor-advised fund to have excess holdings, the fund has only 90 days to dispose of the excess. Transition relief provisions provide more time to dispose of assets held by a donor-advised fund on the effective date of the Act.

There are now two types of excess benefit transactions that are subject to a penalty tax: automatic benefit transactions and those that require an analysis of the actual benefit conferred.

Monitoring the aggregate holdings of donor-advised funds and disqualified persons is likely to be difficult for sponsoring organizations, and sponsoring organizations will want to implement procedures for accepting gifts of holdings in business enterprises that might be subject to excess business holdings. These might include the agreement of the donor to annually report his or her aggregate holdings, and the understanding that if not disposed of in a timely fashion, such holdings would be transferred out of the donor-advised fund to a non-advised fund of the sponsoring organization.

Other Changes Affecting Donor-Advised Funds and Sponsoring Organizations

The Act imposes new reporting requirements on sponsoring organizations, including disclosure on the annual Form 990 of the total number of donor-advised funds owned, the aggregate value of their assets at the end of the tax year, and their aggregate contributions and grants during the year.[50] In addition, the acknowledgement for a contribution to a donor-advised fund must state that the sponsoring organization has exclusive legal control over the assets contributed.[51]

The Act also requires a sponsoring organization to give notice to the IRS in its application for exemption if it maintains or intends to maintain donor-advised accounts, and the manner in which it intends to operate them.[52]

Future changes

The statute directs the Treasury to conduct a study "on the organization and operation of donor-advised funds" and to specifically consider[53]:

1. Whether charitable deductions are "appropriate" for gifts to advised funds in consideration of (A) the use of contributed assets (including the type, extent, and timing of such use), or (B) the use of the assets of such organizations for the benefit of the person making the charitable contribution (or a person related to such person),
2. Whether donor-advised funds should be subject to a distribution requirement in order to ensure that the sponsoring organization with respect to such donor-advised funds is operating consistent with the purposes or functions constituting the basis for its exemption,
3. Whether retaining the privilege of recommending grants or the investment of assets in the fund is consistent with the treatment of the contribution as a completed gift for income, gift, and estate tax deduction purposes, and
4. Whether these issues should be considered in connection with other forms of charities or charitable donations.

The report was due August 17, 2007, one year from enactment of PPA. As of the date that this issue of Professional Notes went to press, no report has been issued.

Conclusion

Advisors to individuals considering establishing donor-advised funds will want to familiarize themselves with the requirements imposed on donor-advised funds and potential penalties on donors, advisors, and their families. Regulations interpreting the complex and sometimes confusing provisions of

the Act are likely to take some time. The IRS already has issued proposed regulations regarding Type III supporting organizations.[54]

The extensive rules now applicable to donor-advised funds, while significant at the institutional level, generally will have little effect on individual donors who have set up funds in reputable sponsoring organizations. Sponsoring organizations, such as The Trust, that have long-standing policies and practices already assure donors that they are in compliance, and their experience has enabled them to smoothly adapt to new requirements.

End Notes

1 Treas. Reg. § 1.507-2(a)(8).
2 Treas. Reg. § 1.170A-9(e)(11)(ii)(B).
3 Joint Committee on Taxation, Technical Explanation of H.R.4, the Pension Protection Act of 2006, as Passed by the House on July 28, 2006, and as Considered by the Senate on August 3, 2006 (JCX-38-06), August 3, 2006 ("Joint Committee Report").
4 I.R.C. § 4966(d)(2)(A).
5 Joint Committee Report, at 342-43.
6 Id.
7 I.R.C. § 4966(d)(1).
8 Joint Committee Report, at 343-44.
9 Id. at 343.
10 Id. at 344.
11 Id.
12 I.R.C. § 4966(d)(2)(B)(i); Joint Committee Report at 345.
13 I.R.C. § 4966(d)(2)(B)(ii).
14 Id.
15 I.R.C. § 4966(d)(2)(C).
16 I.R.C. § 4966(c)(1)(A).
17 I.R.C. § 4966(c)(1)(B).
18 I.R.C. § 4966(d)(4)(A)(i).
19 I.R.C. § 4966(d)(4)(A)(ii)(I)
20 I.R.C. §§ 4966(c)(2)(a), 170(b)(1)(A) (vii), 170(b)(1)(E).
21 I.R.C. § 4966(c)(2)(A).
22 I.R.C. § 4966(c)(2)(C).
23 I.R.C. § 4966(c)(1)(B)(ii).
24 See IRS Notice 2006-109, I.R.S. 2006-51, www.irs.gov/pub/irs-drop/n-06-109.pdf, which defines impermissible control by one or more donor or donor-advisors or any related parties to be present where any such persons may, "by aggregating their votes or positions of authority, require a supported organization to make an expenditure, or prevent a supported organization from making an expenditure, regardless of the method by which the control is exercised or exercisable."
25 See id.
26 I.R.C. § 4966(a)(1).
27 I.R.C. §§ 4966(a)(2), 4966(b)(2).
28 I.R.C. § 4966(b)(1).
29 I.R.C. §§4967(d), 4958(f)(7), 4958(f)(4). Note that the attribution rules can be complex and require close reading.
30 Joint Committee Report at 350.
31 Id.
32 I.R.C. § 4967(a)(1).
33 Id.
34 I.R.C. §§ 4967(1)(2), 4967(c)(2).
35 I.R.C. § 4967(b).
36 I.R.C. § 4958(c)(2)(A).
37 I.R.C. § 4958(f)(7).
38 I.R.C. § 4958(f)(8).
39 I.R.C. § 4958(f)(8)(B).
40 Joint Committee Report at 347.
41 Joint Committee Report at 348.
42 I.R.C. § 4958(a)(1).
43 I.R.C. § 4958(b).
44 I.R.C. § 4958(c)(2)(B).
45 I.R.C. § 4958(a)(2).
46 I.R.C. § 4943.
47 I.R.C. § 4943(c)(2)(C).
48 I.R.C. § 4943(e)(2).
49 I.R.C. § 4943(d)(3) and Treas. Reg. § 53.4943-10.
50 I.R.C. § 6033(k).
51 I.R.C. §§ 170(f)(18), 2055(e), 2522(c).
52 I.R.C. § 508(f).
53 Act §1226.
54 Advance notice of proposed rulemaking REG-155929-06.

If you know a colleague who would like to receive complimentary copies of Professional Notes, or if you wish to obtain past issues, please call our receptionist at 212-686-0010, Ext. 0, or visit our Web site at: www.nycommunitytrust.org.

1997 Using Mutual Funds for Charitable Gifts
Giving Limited Partnerships to Charity
Charitable Gifts of Stock of Subchapter S Corporations

1998 Using Charitable Remainder Trusts
Reforming a Defective Charitable Remainder Trust
Charitable Lead Trusts

1999 A Private Foundation or a Fund in a Community Foundation: Weighing the Options
Terminating a Private Foundation & Transferring the Assets to a Community Foundation
How a Private Foundation Can Use the Grantmaking Expertise of a Community Foundation

2000 Charitable Gifts Using Publicly Traded Securities
Charitable Gifts Using Restricted or Closely Held Stock
Charitable Gifts Using Life Insurance

2001 Gifts of Partial Interests in Property
Timing of Charitable Contributions

2002 Grants by Private Foundations to Individuals & Foreign Organizations
Grants by Public Charities to Individuals
Grants by Public Charities to Foreign Organizations

2003 Investment Standards of Charities
Uniform Principal & Income Act
Endowment Funds of Not-for-Profit Corporations

2004 Use of Qualified Disclaimers in Estate Planning
Estate Planning Using Retirement Assets

2005 Legislative Proposals to Reform Charity: Chapter I
Legislative Proposals to Reform Charity: Chapter II
Legislative Proposals to Reform Charity: Chapter III

2006 Estate Planning for Married Couples
Spousal Right of Election in New York
Estate Planning for Individuals and Non-Traditional Families

About The Trust

Since 1924, The New York Community Trust has served the needs of donors and nonprofits in the New York area. One of the oldest and largest community foundations, The Trust, with assets of $2 billion, is an aggregate of funds set up by individuals, families, and businesses to support charitable organizations.

A fund in The Trust can help your clients carry out their charitable objectives while qualifying for the maximum tax deduction. Funds can be set up during lifetime or by will and often are an essential part of financial and estate planning. In addition to gifts of cash and publicly traded securities, funds can be established with a wide variety of assets including closely held stock, limited partnerships, mutual funds shares, retirement plan assets, and copyrights.

Because of our administrative efficiency, we are able to offer our services for a very low fee; investments fees are also low. Expert financial management of funds is not tied to any one company or investment vehicle; investments are matched to each donor's grantmaking plans.

Trust staff are always available to advise donors about grantmaking opportunities and ensure that their charity will be carried on beyond their lifetimes. Donors can recommend grants to qualified charities anywhere in the U.S., with assurance that each nonprofit is carefully scrutinized for its fiscal and programmatic soundness.

THE NEW YORK COMMUNITY TRUST NYCT
909 Third Avenue
New York, NY 10022
www.nycommunitytrust.org

Long Island Community Foundation
Nassau Hall
1864 Muttontown Road
Syosset, NY 11791
(516) 348-0575
www.licf.org

Westchester Community Foundation
200 North Central Park Avenue, Suite 310
Hartsdale, NY 10530
(914) 948-5166
www.wcf-ny.org

THE NEW YORK
COMMUNITY TRUST

909 Third Avenue
New York, NY 10022
www.nycommunitytrust.org

Non Profit
Organization
U.S. POSTAGE
PAID
NEW YORK, N.Y.
PERMIT NO. 5013

PROFESSIONAL
TAX & ESTATE PLANNING
NOTES
OCTOBER 2007

Impact of the Pension
Protection Act on
Donor-Advised Funds