Information About Donor Advised Funds

Donor Advised Funds

One option for a donor who wants to make a gift to charity, does not want to create a private foundation and does not want to pick the charities that will receive the funds right now, but instead wants to both pick the charities and distribute the funds over time, is a donor advised fund (DAF). A DAF is an account that a donor establishes within a public charity, often a community foundation. When a donor makes contributions to the DAF, the donor must give complete control over the donated funds to the public charity. As a result, a donor gets a current income tax deduction for the full amount of the contribution to the DAF. Despite the fact that the donor relinquishes control over the donated funds, the unique aspect of a DAF is that the donor can remain involved by making non-binding recommendations to the public charity as to investment policy and DAF distributions. As a result, the donor is able to fulfill his or her philanthropic goals in a flexible, tax-favored and cost-effective way.

Sec. 4966 creates a comprehensive set of rules for DAFs. The DAF definition, distributions, donors, disqualified persons and deductible donations are all specified.

Definition of DAF

A DAF has three specific requirements. It must be separately identified and owned and controlled by the sponsoring charity, and the donor must have a reasonable expectation of advisory rights. If all three apply, the DAF is subject to various requirements and a number of prohibitions. Sec. 4966(d)(2)(A).

Separate identification is usually accomplished by creating a distinct fund or by naming a fund after a specific donor. Control is measured at the parent organization level. All DAF funds must explicitly note that the parent charity has full control. The existence of advisory rights will be based on the facts and circumstances involved. Even without a formal document, if a donor makes large gifts and regularly recommends gift beneficiaries and purposes that are followed by the donee charity, then a DAF may exist.

There are three specific exceptions to the DAF rules. A transfer to a field of interest fund or designated purpose fund will not create a DAF. Sec. 4966(d)(2)(A). This is the case even if the donor does have incidental benefits or involvement in the fund. For example, a donor may be a board member of a charity and make gifts to a specific purpose fund for that charity without that fund's becoming a DAF. Alternatively, a donor may make an unrestricted gift to a school with a child or grandchild in attendance without creating a DAF.

Under this exception, a DAF may make grants to students for travel, study or other similar purposes, provided that the donor is a member of the grant committee appointed by the charity, he or she does not have control of the committee, all grants are awarded on an objective and nondiscriminatory basis and the board of directors has approved the process. The grants must also meet the requirements of Sec. 4945(g) for grants by private foundations.

The second exception is a gift to a charity in which the donor retains advisory rights, but all distributions will be within that charity. Sec. 4966(d)(2)(B)(i). Therefore, a gift to a university for various programs exclusively at that university would not come within the DAF definition. Finally, a fund maintained with a governmental entity is excluded from the DAF definition. Sec. 4966(d)(2)(B)(i).

Deductible DAF Donations

DAFs are maintained by Sec. 501(c)(3) public charities, and gifts are typically deductible to the 60% of AGI for cash and 30% of AGI for appreciated property limits for public charities. The gifts to DAFs will be deductible under these limits, but after February 14, 2007, the charity must give a "contemporaneous written acknowledgment" of the DAF gift. Sec. 170(f)(18)(B). The receipt must be received prior to the date the donor files his or her tax return for the year of the gift, or the due date with extensions, whichever is earlier. A DAF receipt must also state that the charity has exclusive legal control over the contributed assets.

Deductions are not permitted for gifts to DAFs held by Type III supporting organizations that are not "functionally integrated" with the parent charities. Sec. 170(f)(18)(A). In effect, the typical Type III supporting organization that operates in connection with a public charity and makes grants to the charity is prohibited from maintaining a DAF. However, Type I and Type II supporting organizations may receive deductible DAF contributions. The Type III supporting organization that is operationally integrated into a public charity may also maintain a DAF and receive deductible contributions.

Prohibited Payments to Disqualified Persons

Donors and their advisors are disqualified persons for purposes of payouts or benefits from DAFs. Sec. 4967(a)(1). The disqualified person rules are similar to the private foundation rules. These rules are designed to minimize the improper use of DAFs in any manner that could produce improper benefits to the donor or his or her advisors.

The disqualified person category includes the donor, advisors to the donor, family members and 35% controlled entities. Sec. 4967(a)(1). The family includes donor's siblings, lineal ancestors and descendants, and spouses of lineals.

The DAF may not make any grant or loan, pay salary or reimburse expenses for any disqualified person. In direct contrast to other Sec. 4958 excess benefits, the DAF transfer is subject to an excise tax on the entire benefit, not just the excess over fair market value. A sale or lease of property at fair market value is an exception to the prohibited payment rule. Sec. 4958(c)(2).

The DAF excess benefit rule will require the donor and family members to cover expenses for travel to board meetings and any expenses related to their personal efforts with respect to the charitable transfers. These personal expenses will be potentially deductible under the normal charitable deduction rules. Family members may not receive substantial salaries for services rendered to the DAF. In addition, an annual winter trip at DAF expense to a tropical climate and similar perks for the purpose of a family review of DAF grants are not possible.

Such transfers are termed "automatic excess benefit" transactions. There is a penalty for distribution of "more than incidental benefit" to a donor, family member or donor advisor. The penalty is 125% of the benefit on the donor or family member, and potentially a penalty of 10% on the fund manager if he or she knew of the prohibited benefit. Sec. 4966(a)(2).

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If a donor has made a legally-binding pledge to a charity, the DAF may not fulfill that pledge. The payment by a DAF of a pledge will constitute a "more than incidental benefit" to the donor and is not permitted. Sec. 4966(a).

Charitable DAF Distributions

DAFs are permitted to make grants to Type I, Type II or Type III functionally integrated SOs. Notice 2006-109 describes guidelines for determining if the SO is a Type I, Type II or Type III functionally integrated charity that qualifies for distribution. A grantor may rely on a written representation that the grantee is a Type I or Type II supporting organization, provided that the representation describes how the grantee's officers and directors are selected, and references governing document provisions that establish a Type I or Type II SO.

For a functionally integrated Type III SO, a grantor may rely on a written representation that the grantee is so qualified, provided that the grantee identifies the one or more supported organizations with which the grantee is functionally integrated and the grantor collects and reviews grantee's governing documents. This review usually will include review of written representations of the supported organization that set forth the qualifying relationship. But for the involvement of the grantee in performing functions of the supported organization, the supported organization would carry out those activities itself.

Alternatively, the grantor may rely on a reasoned written opinion of counsel of either the grantor or the grantee concluding that the grantee is a Type I, Type II or functionally integrated Type III supporting organization.

A DAF foundation considering a grant to a Type I, Type II or functionally integrated Type III SO may need to obtain a list of grantee's supported organizations to determine whether they are controlled by disqualified persons of the private foundation. If such control exists, the private foundation will be required to exercise expenditure responsibility.

Control by a disqualified person is defined in Reg. 53.4942(a)-3(a)(3). An SO is controlled by disqualified persons if they may aggregate votes and require the SO or supported organization to make an expenditure or collectively prevent an expenditure.

Excess Business Holdings

DAFs are subject to Sec. 4943 excess business holdings rules. Gifts by disqualified persons who together with attributed family and entities hold 20% (or 35% with outside control) of an entity will trigger application of Sec. 4943. Disqualified persons include donors and family members and 35% controlled entities. Sec. 4943(e)(2).

For DAFs that receive a gift of a business interest, generally the interest must be sold within five years, or potentially 10 years with Treasury approval. This provision is designed to remove the ability of family members to maintain control of the family business through a DAF.

Disaster Fund Not a DAF

After a natural disaster many companies create disaster relief funds that are designed to permit an employee group to make distributions to employees in need. The disaster relief funds must

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meet Notice 2006-109 guidelines for objective and fair allocation of grants in order to avoid classification as a DAF.

Treasury excludes an employer-sponsored disaster relief fund from DAF status if it meets several requirements. It must serve a single identified charitable purpose to provide relief from a qualified disaster under Sec. 139(c)(1), (2) or (3). The class must be large or indefinite and grant recipients must be objectively selected by an independent committee. No disaster payments may be to officers, directors or independent committee members. Finally, adequate records must be maintained to show actual need by the grant recipients.

Creative Use of DAFs

Most DAFs exist to permit annual gifts to qualified exempt public charities. For those DAFs that are invested in securities, make no payments to donors and family members and annually make grants only to public charities, the DAF rules will present no major obstacles.

However, creative uses of DAFs may be rather limited. Sales of DAF assets to family members must be explicitly at fair market value. In addition, the private foundation excess business holdings rules apply to DAFs. Generally, transfer of business interests into DAFs will require sales of the assets within five years, or potentially 10 years with Treasury permission. Finally, the annual Form 990 includes reporting requirements for the number of DAFs, their assets and distributions.

DAF vs. Private Foundation

There are three particular benefits of DAFs. These are reasonable start-up costs, an excellent opportunity for the donor to research charitable organizations and find a match for his or her interests and the ability for moderate income donors to involve family in charitable giving.

For donors with more substantial charitable intentions, a DAF may also be considered as an alternative to a private foundation. These are the main advantages of a DAF over a private foundation:

1. **Higher Grant Distribution Rates.** DAFs often make grants of 15% to 30% each year. The Council on Foundations website indicates that private foundations grant an average of 6.23% of assets to charity on annual basis. Many DAFs transfer 15% to 20% of assets each year to charity.
2. **Access for Most Donors.** Many individuals are able to create a DAF with $10,000 or more. Private foundations are much more expensive to fund and operate. The development or creation of a private foundation could involve an expenditure of $10,000 simply to create the organization. In addition, the private foundation has substantial operating costs each year.
3. **Staff Oversight and Donor Support.** About 5% of private foundations have professional staff. Nearly all public charities with DAFs have highly qualified staff with great expertise in making effective charitable grants. Giving grants with optimum charitable impact requires a level of expertise that is more likely to be found with the public charity staff managing a DAF.