

## **Donor Advised Funds After PPA 2006**

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 who will receive the funds right now, but instead wants to distribute them 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, 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 it 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, the fund 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 fund with 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 50% of AGI for cash and 30% of AGI for appreciated property limits for public charities. The gift to DAFs will be deductible under these limits, but after February 14, 2007, the charity must give a "contemporaneous written acknowledgement" 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 that year, 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 now 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 now 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, 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. It will no longer be possible for

family members to receive substantial salaries for services rendered to the DAF. In addition, an annual winter trip at DAF expense to a tropical climate for the purpose of a family review of DAF grants will not be possible.

These 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).

### **Charitable DAF Distributions**

Distributions from DAFs may be made to public charities, Type I and Type II supporting organizations and "functionally integrated" Type III supporting organizations. Sec. 4966(d)(4)(A). The distributions may not be made to an individual. Distributions to the parent charity, to another DAF or to an operating foundation are permitted. However, distributions to a private non-operating foundation are permitted only if the expenditure responsibility is exercised. Sec. 4966(c)(1)(B)(ii).

### **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, family members and 35% controlled entities. Sec. 4943(e)(2).

For DAFs that receive a gift of a business interest, generally the property must be sold within five years, or potentially ten 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.

### **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, DAF rules present no major obstacles.

However, creative uses of DAFs may be rather limited. Sales of DAF assets to family members must now 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 ten years with Treasury permission. Finally, the annual Form 990 includes reporting requirements for the number of DAFs, their assets and distributions.