THE NEW YORK COMMUNITY TRUST

Professional Notes

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TAX & ESTATE PLANNING

Grants and Other Distributions from Donor-Advised Funds

This is the final column of our Professional Notes series on donor-advised funds. The first column examined the popularity of donor-advised funds and their legal underpinnings, and the second column looked at considerations for donors making contributions to donor-advised funds. This column addresses the treatment of grants and other distributions from donor-advised funds.

A gift to a donor-advised fund is, by definition, a gift to a public charity (sometimes referred to as a "sponsoring organization"). The donor, or persons selected by the donor, may be named as "advisors," with the right to recommend grants from the fund (together, "donor-advisors"). Recommendations by donor advisors are not binding on the sponsoring organization, which may decline to follow a recommendation in its sole discretion. Although working with donors through donor-advised funds is only part of what we do, The New York Community Trust and its affiliate, Community Funds, Inc., are considered to be sponsoring organizations of donor-advised funds.

Historically, federal tax laws had little specific to say about grants or other distributions from donor-advised funds (sometimes referred to as "DAFs"). But beginning with the Pension Protection Act of 2006

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(the "2006 Act"), that changed—and for the first time, there was a risk of substantial excise taxes, similar to the private foundation "taxable expenditure" and "self-dealing" excise taxes, if grants or other distributions from the fund fell outside the newly imposed limits. Depending on the circumstances, these excise taxes may be imposed on the sponsoring organization, the donor advisors, certain related parties, the managers of the sponsoring organization and/or the fund's investment advisor.

To be clear, wholly charitable grants from a donor-advised fund to a U.S. public charity (other than certain types of supporting organizations) or a U.S. private operating foundation generally are permitted. It is only when an advisor recommends grants beyond those organizations (e.g., to a non-U.S. charity), or where there is an element of a *quid pro quo* benefit or the donor-advised fund is used to pay compensation or make a loan, that the 2006 Act comes into play.

For many community foundations, the 2006 Act changed very little as a practical matter, simply because they already followed practices that prevented the use of donor-advised funds in ways that the 2006 Act was intended to discourage. Even so, the 2006 Act provided a strong incentive for all sponsoring organizations to re-evaluate and strengthen their systems and procedures to avoid triggering excise taxes.

For donors who have debated the pros and cons of having a donor-advised fund or a private foundation, the 2006 Act arguably made the two forms of giving more similar from a grantmaking perspective. But there is one key difference: with a donor-advised fund, the sponsoring organization should already have systems and procedures in place designed to ensure compliance with the rules. A private foundation, on the other hand, has to create and administer those systems and procedures itself.

Anyone thinking about using a donor-advised fund will want to do the due diligence to confirm that he or she is dealing with a sponsoring organization that understands the 2006 Act, is set up to comply with the rules with respect to its donor-advised funds, and has a demonstrated track record of working with donor advisors.

Taxable distributions

Code Section 4966[1] prohibits "taxable distributions" by a donor-advised fund, including any distribution to an individual as well as any distribution for a non-charitable purpose. Sponsoring organizations are subject to an excise tax of 20 percent of any taxable distribution. Under most circumstances, the sponsoring organization likely would allocate this tax to the donor-advised fund from which the taxable distribution was made. In addition, a five percent tax is imposed on any fund manager (e.g., an employee of the sponsoring organization) who agrees to a taxable distribution "knowing that it is a taxable distribution," up to a maximum tax for any one taxable distribution of $10,000. If there is more than one responsible fund manager, they are jointly and severally liable.

The prohibition on distributions to individuals precludes reimbursement of expenses incurred by a donor, for example, for the expenses of fundraising for a donor-

[1]All "Code Section" references are to the Internal Revenue Code of 1986, as amended, and all "Treas. Reg. Section" references are to regulations promulgated thereunder.

advised fund, or grants of scholarship awards to or for identified individual students from a donor-advised fund.

Grants to organizations other than certain U.S. public charities and private operating foundations will trigger the excise tax on taxable distributions, unless special measures are taken. Under Code Section 4966, certain U.S. supporting organizations—known as "disqualified supporting organizations"—are not treated like other U.S. public charities, and grants to them should not be made from a donor-advised fund *unless* expenditure responsibility is exercised. The class of "disqualified supporting organizations" consists of:

(1) any Type III supporting organization that is not functionally integrated with its supported organization, or

(2) any Type I, Type II, or functionally integrated Type III supporting organization if the donor-advisor (and any related parties) directly or indirectly controls the supported organization.

A grant to a non-U.S. organization won't result in the imposition of excise tax if an "equivalency determination" is made, in accordance with IRS rules, that either (1) the proposed non-U.S. grantee is the equivalent of a public charity that would otherwise qualify to receive a non-taxable grant from a donor-advised fund, or (2) it is the equivalent of a private operating foundation. (As a result of this definition, the foreign organization cannot be the equivalent of a disqualified supporting organization.)

Alternatively, if the process for "expenditure responsibility" under Code Section 4945 is followed, a grant to a foreign charity, a private non-operating foundation, disqualified supporting organization, or even a for-profit entity, whether or not organized in the United States, won't be a taxable distribution. The goal of expenditure responsibility is to ensure that the granted funds are used exclusively for charitable purposes.

The burden of making equivalency determinations or exercising expenditure responsibility and, in the case of supporting organizations, the effort of confirming the requisite lack of control by the donor or donor's designee, can be significant (and even costly) for the sponsoring organization. As a consequence, sponsoring organizations may have policies that discourage or prohibit the use of donor-advised funds for grants to private non-operating foundations, foreign organizations, disqualified supporting organizations, and/or non-charities.

WHAT IS AN EQUIVALENCY DETERMINATION?

For purposes of the 2006 Act, an equivalency determination is a "good faith determination" that a non-U.S. organization meets the same organizational and operational requirements as a U.S. organization classified either as (1) a public charity that is not a disqualified supporting organization or (2) a private operating foundation. Typically, the sponsoring organization would obtain current written advice from a qualified tax practitioner concerning the equivalency of the contemplated foreign grantee. This might be someone on the staff of the sponsoring organization, outside legal counsel, an accountant, or a third-party repository that specializes in making equivalency determinations. If a sponsoring organization is willing to undertake an equivalency determination for grants from a donor-advised fund, it would likely allocate the associated cost to the donor-advised fund from which the non-U.S. grantee has been recommended.

More than incidental benefit and other prohibited arrangements

Code Section 4967 imposes a 125 percent excise tax on a donor-advisor who recommends a grant from a donor-advised fund that results in a "more than an incidental benefit" to a disqualified person, including

the donor or an advisor, or a broad class of related persons, consisting of certain covered family members of the donor-advisor (a spouse, ancestors, lineal descendants for three generations, and siblings, as well as their spouses) and certain corporations, trusts, and partnerships. (Corporations, trusts, and partnerships generally are disqualified persons based on a 35 percent threshold for ownership or control.) Although the term "related persons" is not used in the Code, we use the term in this column as a convenient shorthand for the family members, corporations, trusts, and partnerships that are covered by these rules. The Code Section 4967 tax must be paid by the donor-advisor or any person who receives such a benefit as a result of the distribution. In addition, a fund manager who agrees 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. Liability will not be imposed if the distribution has already been subject to an excise tax under the excess benefit transaction rules of Code Section 4958.

WHAT IS EXPENDITURE RESPONSIBILITY?

Broadly speaking, "expenditure responsibility" is a formalized process for due diligence in grantmaking. It requires (1) advance collection and review of certain information about the grantee (known as a "pre-grant inquiry"), (2) a grant agreement containing certain IRS-mandated provisions (e.g., annual reporting to the funder, a requirement to maintain adequate books and records, a prohibition on use of the granted funds for political campaign activity, and a refunding obligation to the extent funds are not used as required), (3) reporting by the grantee to the sponsoring organization, and (4) reporting by the sponsoring organization to the IRS on Form 990 on the status of the grant and its use by the grantee organization.

The Code does not define or elaborate on what constitutes a "more than incidental benefit". The Joint Committee Report to the 2006 Tax Act (the "JCT Report") indicates that there is "more than incidental benefit" if there is a benefit that would have reduced or eliminated a charitable contribution deduction if the benefit had been received in connection with a contribution to the sponsoring organization. This would include, for example, situations in which a grant from a donor-advised fund enables a donor or advisor to receive membership benefits from the grantee organization that would have reduced or eliminated the individual's income tax charitable deduction if he or she had received the same benefits in exchange for a charitable gift.

It is unclear whether the JCT Report language was intended to treat bifurcated payment arrangements as involving a "more than incidental benefit." A bifurcated payment arrangement is one in which the cost of a ticket to a fundraising event is divided between a charity (paying the portion that would be deductible for an individual purchasing the ticket) and an individual such as a donor-advisor (paying the portion that would not be deductible). Notice 2017-73, issued by the U.S. Department of the Treasury and the Internal Revenue Service in December 2017, proposed to treat bifurcated payment arrangements as creating a "more than an incidental benefit," and therefore as taxable. The Notice states, "The Treasury Department and the IRS currently agree that the relief of the . . . obligation to pay the full price of a ticket to a charity-sponsored event can be considered a direct benefit . . . that is more than incidental."

Some comments in response to the Notice, including comments from the tax section of the American Bar Association, favored permitting bifurcated payment arrangements, and noted that a bifurcated payment does not reduce the charitable deduction that would have been received. Other commentators agreed with

the position expressed in the Notice. Many sponsoring organizations are concerned that bifurcated payment arrangements may indicate impermissible donor or advisor control of the donor-advised fund, or they may resist such payments simply because of the administrative burden the arrangements can present.

In the case of pledges, the general position of the IRS, in the context of private foundations, is that the payment of a disqualified person's enforceable pledge by a private foundation is an act of self-dealing, and therefore subject to an excise tax. Yet Notice 2017-73 proposed a "don't ask, don't tell" approach to cases where a donor-advised fund is used to pay the enforceable pledge of the donor, an advisor, or a related person. As the Notice explains, "The Treasury Department and the IRS currently agree … that it is difficult for sponsoring organizations to differentiate between a legally enforceable pledge by an individual to a third-party charity and a mere expression of charitable intent. The Treasury Department and the IRS are of the view that, in the context of [donor-advised funds], the determination of whether an individual's charitable pledge is legally binding is best left to the distributee charity, which has knowledge of the facts surrounding the pledge."

Under the proposed rules, so long as the sponsoring organization makes no reference to the pledge, and provided the grant is not claimed as a deductible charitable contribution, the mere fact that the grant is credited by the grantee against the pledge of the donor-advisor or a related person would not be treated as a "more than incidental benefit" for purposes of the donor-advised fund rules.

The Notice was clear to signal that its proposed regulation for donor-advised funds was not a change in IRS position in the private foundation context. "Because the relationship between a private foundation and its disqualified persons typically is much closer than the relationship between a … sponsoring organization and its Donor/Advisors, this special rule regarding certain charitable pledges would apply for purposes" of Section 4967 only. The Notice said that taxpayers are permitted to rely on the proposed guidance concerning charitable pledges until the IRS issues additional guidance.

The IRS's approach to the pledge issue drew mixed reviews from commentators, with several arguing it was impractical and that the IRS should issue guidance simply permitting a donor-advised fund to pay enforceable pledges of its disqualified persons.

Excess benefit transactions

Under Code Section 4958, the definition of "excess benefit transaction" includes any transaction in which a public charity (including a sponsoring organization) provides any economic benefit to or for the benefit of a disqualified person in excess of what is received in return.

The 2006 Act expanded the definition of "disqualified persons" in the donor-advised fund context to include the fund's donors, advisors, and their related persons. External investment advisors for donor-advised funds were also added to this list of disqualified persons, regardless of the number or size of the donor-advised funds whose assets they manage. The tax for an excess benefit transaction is 25 percent on the person who receives the excess benefit. The excess benefit must be corrected by repaying it to the sponsoring organization (and may not go to the donor-advised fund). If not corrected, a penalty of 200 percent of the excess benefit

MORE CHANGES ON THE HORIZON?

Notice 2017-73 also signaled that the Treasury Department and the IRS may have further regulatory changes in store for donor-advised funds. In particular, the Notice said that the government is considering both a modification in the manner in which an organization described in Code Section 170(b)(1)(A)(vi) treats distributions from a donor-advised fund for purposes of its public support calculation, and a minimum distribution requirement for donor-advised funds.

Public support calculation. Under current law, distributions from a donor-advised fund generally are counted as a distribution by the sponsoring organization and therefore as "public support" for purposes of the grantee's public support calculation, which typically requires that at least one-third of an organization's total support be classified as "public support." Grants from any individual and that individual's related persons, on the other hand, are public support only to the extent they do not in the aggregate exceed two percent of the grantee's total support. The Notice indicates that the Treasury Department and the IRS are contemplating attribution rules that would treat donor-advisors with respect to a donor-advised fund as if they are the donors for purposes of the public support calculation. As a result, a donor-advised fund's distributions would be aggregated with individual contributions from the donor-advisors and their related persons for purposes of the two percent limitation in calculating a grantee's public support under Code Section 170(b)(1)(A)(iv). The Notice further suggests that anonymous contributions would all be aggregated as if from a single donor. A number of comments to this proposal focused on the administrative burden and complexity of the analysis that would be required of grantee organizations if attribution rules are applied to support from donor-advised funds.

Minimum payout. There is no legally mandated minimum payout requirement for donor-advised funds, but most sponsoring organizations have a clear expectation that grants will be made. The National Philanthropic Trust reports that its survey of donor-advised funds at more than 1,000 organizations found that, in the aggregate, they paid out at the rate of 22 percent in 2017. Private non-operating foundations are subject to a five percent payout requirement in order to avoid stiff excise taxes. However, that requirement counts not only grants but also certain administrative expenditures. Although some commentators have urged the imposition of a minimum payout on donor-advised funds, sponsoring organizations have argued that a payout requirement is unnecessary (per the statistic noted above, for example) and that fund-by-fund accounting would be unduly burdensome.

is imposed. In addition, fund managers who participate in the transaction knowing it is an excess benefit transaction are subject to a 10 percent tax (up to $20,000), unless such participation is not willful and is due to a reasonable cause.

In the excess benefit transaction context, there are two areas of particular concern. First, the use of donor-advised fund assets to make a grant or a loan, or to pay compensation or make a similar payment, to a donor-advisor or related person would be an *automatic* excess benefit transaction, without regard to whether the grant, loan, or compensation is reasonable. The Joint Committee Report indicates that an expense reimbursement is considered a "similar payment." Accordingly, reimbursement of legitimate fundraising expenses from a donor-advised fund to a donor-advisor or related person is prohibited not only under Code Section 4966, but also under Code Section 4958. (For the few sponsoring organizations that permit fundraising for individual funds, it may be possible to provide a gift acknowledgement to enable the donor to deduct the expense as an out-of-pocket expense incurred in undertaking a charitable activity.) Payments or reimbursements to a donor-advisor or related person that are *not* paid from a donor-advised fund (but rather are paid from the general assets of the supporting organization) fall outside this automatic excess benefit transaction rule, but would still amount to an excess benefit transaction if they are in excess of what is reasonable.

Second, if the sponsoring organization uses outside investment advisors for donor-advised funds or even an investment pool that includes DAFs, those investment

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advisors could be subject to the excess benefit transaction excise tax to the extent they receive unreasonable compensation for their services with respect to donor-advised funds. This would be the case even though the investment advisors are not in a position to exercise substantial influence over the sponsoring organization as a whole.

Concluding observations

It should be noted that community foundations are equipped to handle funds without donor-advisors, such as a "field-of-interest" fund (for a purpose such as education, the environment, or human justice), or unrestricted funds for local priorities set by the foundation's board. In those cases, the 2006 Act's limitations on donor-advised funds simply do not apply.

Even though the rules governing donor-advised funds have become more complex, and now have some elements in common with the rules that govern private foundations, donor-advised funds are an exceptionally convenient and efficient tool for individual and family philanthropy.

Compared to the next-closest philanthropic vehicle, the private foundation, donor-advised funds remain less costly and less burdensome to establish and administer, and the compliance burden falls on the sponsoring organization, not the donor or the donor's friends and family. Furthermore, a donor-advised fund held by a community foundation, such as The New York Community Trust, enjoys access to professional philanthropic expertise that is often not available in other settings, such as a family foundation. Advisors with philanthropic clients need to be aware of the limitations that apply to donor-advised funds—but neither the advisors nor their clients should be daunted by them. The pluses still outweigh the minuses.

***For further reference, see*:**

I.R.C. §4958

I.R.C. §4966

I.R.C. §4967

Treas. Reg. §1.507-2(a)(7)

Notice 2006-109, IRB 2006-51, www.irs.gov/pub/irs-drop/n-06-109.pdf

Notice 2014-4, IRB 2014-2, www.irs.gov/pub/irs-drop/n-14-04.pdf

Notice 2017-73, IRB 2017-51, www.irs.gov/pub/irs-irbs/irb17-51.pdf

ABA Section of Taxation, Comments on Notice 2017-73, *Tax Lawyer* Vol 72, No. 1 at 103.

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

Information Letter 2000-0140 (September 30, 2000), www.irs.gov/pub/irs-wd/00-0140.pdf (Donor-advised fund payment of personal pledge)

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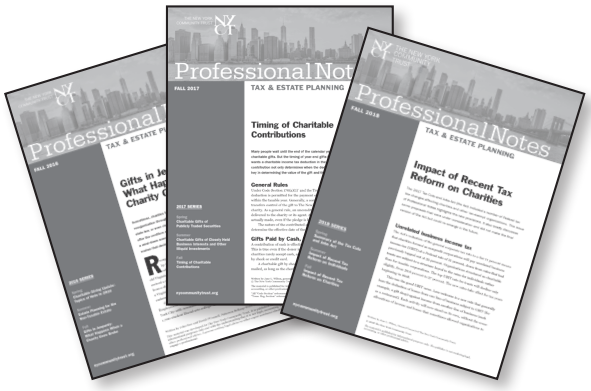

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