DONOR-ADVISED FUNDS: THE CASE FOR CONSISTENT PRINCIPLES

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Abstract: Each and every sponsoring organization maintaining donor-advised funds – as well as each donor – is subject to a host of requirements under existing law to ensure that charitable funds are used exclusively for charitable purposes. Beginning with the requirements of the "operational test" for tax exemption and continuing through focused penalty provisions (which are not yet fully implemented), the foundation is in place to enforce compliance and prevent abuses, with much room for additional regulatory guidance and enforcement. Ensuring that charitable funds are properly used depends on rigorous employment and enforcement of these rules of general application, and not on arbitrary classifications and labels imposed on sponsoring organizations.

This conference is really a celebration of good news and shared commitment. Giving USA reported that overall charitable giving in 2014 was approximately $358.38 billion, the highest total in 60 years of reporting.[1] Last year was the fifth straight year of increased charitable giving, surpassing the prior record of $355.17 billion in 2007, and giving increased for every category of giver.[2] Each participant in this conference is part of that effort, and it is very important for each of us to be aware that we are working together to serve those important goals. We are not here only to celebrate last year's results, however.[3] We are here in a shared effort to ensure that charitable giving continues to thrive, and continues to support the charitable organizations carrying out their charitable missions.

Donor-advised funds are a part, albeit a relatively small part, of that growing charitable sector. Amid such good news, this program – or at least

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[1] Giving USA 2015: The Annual Report on Philanthropy for the Year 2014 (Giving USA Foundation 2015).

[2] *Id.*

[3] Patrick Rooney of the Lilly Family School of Philanthropy at Indiana University, which produced the Giving USA report, asked "For the most affluent nation in an affluent period, should we be giving more?" Cardwell, *Charitable Giving Rises Past Prerecession Mark*, N.Y. Times, June 16, 2015, at B3.

its printed title – presents a bit of a quandary. The published title for this entire program is "The Rise of Donor Advised Funds: Should Congress Respond?" The published topic for the last panel of the program, for which this article is written, is "Discussion: Should All Sponsoring Organizations Be Treated the Same?"

At first glance, the only rational answer to the question "should all sponsoring organizations be treated the same" is a resounding "yes, except when they should not be." That response may have the virtues of directly responding to the question and of being accurate, or at least not flat-out wrong. Unfortunately, it is undoubtedly less than useful in actual application.

What is the source of this difficulty? Each of the questions as posed begins with a premise, a presumption that there is a problem to be addressed, and that the only issue is that of identifying the proper remedy. If we were simply to accept the unstated premise, the remaining discussion would be distorted, and diverted into either correcting the faulty premise or addressing specific issues that had only been *assumed* to be true. By uncritically accepting the premise, we would have to struggle through many levels of clarifying definitions and facts before we could even get to what really ought to be the real questions.

This is not terribly surprising with respect to this topic, for public discourse regarding donor-advised funds has been hampered by a lack of analytical clarity and faulty assumptions. This is unfortunate, for we in the United States have a long history of a strong and vibrant charitable sector, and we have a long legal history and structure – including our federal income tax system[4] – for addressing these issues and to prevent abuses and ensure that exempt organizations serve charitable purposes.

We need to agree on a common starting point: each and every sponsoring organization of donor-advised funds is, in fact, subject to statutory and regulatory requirements and oversight. This paper will review those statutory and regulatory systems, which apply to *all* sponsoring organizations. Those systems are robust and fully capable of proper regulation of all sponsoring organizations. There is no basis in law or fact for treating donor-advised funds or entire sponsoring organizations differently based on any arbitrary and artificial distinction. Of course, we must have rules, and those rules must apply evenly and appropriately to prevent abuses. That should be the system we strive to support and perpetuate.

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[4] *See generally* Aprill, *Churches, Politics, and the Charitable Contribution Deduction,* 42 B.C.L. Rev. 843 (2001); Thorndike, *How the Charity Deduction Made the World Safe for Philanthropy*, 2012 Tax Notes Today 242-3 (Dec. 17, 2012).

As a threshold matter, one difficulty in asking whether "all sponsoring organizations should be treated the same" is that sponsoring organizations are not easily categorized. It is well known that many sponsoring organizations are community foundations, but there is no definition of community foundation that sufficiently distinguishes them from other sponsoring organizations.[5] Neither are all community foundation sponsoring organizations the same as each other, nor are they each different from other sponsoring organizations. While community foundation sponsoring organizations may tend to share certain characteristics, they are not limited to a particular legal structure, range of charitable programs, geography, or charitable mission.[6] In addition, a wide range of other charitable organizations are sponsoring organizations of donor-advised funds.[7] Those organizations are notable for the diversity of types of sponsoring organizations and the diversity (and much commonality) of their donor-advised fund programs. These are generally facts we ought to celebrate as reflecting a responsive and effective charitable sector.

One would be hard pressed to make any principled classification of the tax-exempt charitable organizations maintaining donor-advised funds, not to mention finding justification for treating them differently.[8] Moreover, it is difficult to see the need for the rush to such a classification, since there has been no showing of widespread abuse of donor-advised funds, not to mention abuse focused on any arbitrary classification of sponsoring organizations. What's more, there has been no showing that the enforcement and penalty regimes already in place – and that is even before regulations are issued in connection with penalty provisions enacted in the Pension Protection Act of 2006 – are inadequate to regulate and remediate any problems that occur. In short, the topic for this panel tries to address a proposed solu-

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[5] For example, there is no statutory definition of "community foundation," and much of the applicable regulatory provisions are contained in regulations governing the donor's charitable contribution deduction rather than the exemption of the entity itself. § 1.170A-9(e)(10)-(11). *See generally* Hoyt, Legal Compendium for Community Foundations, Council on Foundations (1996), *citing* Davis v. United States, 495 U.S. 472 (1990)(reviewing statutory and legislative history). It is important to note that much of the regulatory guidance addresses the standards applied under the component part test to treat multiple trusts as a single exempt entity.

[6] A number of community foundations, and other charitable organizations, support a range of charitable vehicles and grant to a wide range of charitable recipients. For example, the web sites of The New York Community Trust (www.nycommunitytrust.org) and Silicon Valley Community Foundation (www.siliconvalleycf.org) describe a wide array of charitable giving alternatives.

[7] See the discussion below in section II.

[8] Any arbitrary distinction and disparate treatment of sponsoring organizations would even raise important questions under the Equal Protection Clause. *See generally* Zielinski, *The First Amendment and the Parsonage Allowance*, Tax Notes (January 27, 2014); Brody, *Charities in Tax Reform: Threats to Subsidies Overt and Covert*, 27 Ex. Org. Tax Rev. 399 (2000).

tion to a problem that one cannot say has been shown to exist, or that existing legal provisions are insufficient to address problems that may arise.

Our inquiry should be reframed along different lines. To make any reasonable assessment of donor-advised funds, we should address the following issues in order:

1. What requirements must be met for an organization to qualify as a tax-exempt public charity?[9]
2. What standards must be applied to sponsoring organizations of donor-advised funds?
3. What standards apply to donors to donor-advised funds?
4. Are these standards appropriate and adaptable to variations of sponsoring organizations, donor-advised fund programs and donors?

Only after focusing upon and addressing these questions can we return to an overall assessment of whether this statutory and regulatory structure is properly adapted to ensure that charitable activities are indeed served, and that abuses are prevented and remediated.

I. QUALIFICATION OF PUBLIC CHARITIES

Any sponsoring organization operating donor-advised funds must be a qualified public charity. That means the sponsoring organization must meet a number of requirements under Section 501(c)(3) of the Internal Revenue Code[10] to ensure that the sponsoring organization serves charitable purposes.[11] The provisions particularly relevant to this discussion may be summarized as the organization must be (1) organized and (2) operated exclusively for charitable purposes, (3) no part of the earnings of which inure to any private party.[12]

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[9] This article focuses on the treatment of charitable organizations and donors for U.S. federal income tax purposes. In practice, charitable organizations are also subject to regulation under state law and also laws applicable to the relationship between the charitable organization and its donors.

[10] Section references are to the Internal Revenue Code of 1986, as amended.

[11] "Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation . . . , and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office." § 501(c)(3).

[12] Organizations seeking exemption must also meet the statutory requirements that (4) no substantial part of its activities consist of lobbying, and (5) the organization does not participate in any political campaigns or for or against any candidate for public office. § 501(c)(3). In addition, charitable organizations may not have a purpose that is illegal or contrary to public policy. Bob

"Organizational Test." The "organizational test" requires that the purposes of the organization be limited in its articles of organization to exempt purposes, and also that the articles do not expressly empower the organization to pursue ends that, in a more than insubstantial part, are not in furtherance of exempt purposes.[13] The "organizational test" is of fundamental importance in establishing eligibility for tax exemption. For many organizations, meeting the "organizational test" is frequently a relatively simple matter of proper definition and drafting in the entity's foundational documents.[14] In addition, the "private inurement" test, while a separately-stated requirement in the Code, is only occasionally addressed as a part of the "organizational test," and is most fully addressed in the regulations as part of the "operational test."[15]

Even if many organizations do not have difficulty meeting the "organizational test," the test emphasizes the critical point — central to this conference — that each sponsoring organization must itself qualify as a charitable organization. Far too much of the public discussion has missed that simple point. We must all agree on one straightforward statutory requirement that must be met by each and every sponsoring organization that maintains donor-advised funds: there must be an organization, and that organization must belimited to achieving exempt purposes.

"Operational Test." In addition to the "organizational test," an entity seeking tax exemption must also meet the "operational test." The "operational test" as set forth in the regulations states:

> An organization will be regarded as operated exclusively for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.[16] b

The regulations regarding the "operational test" call for an analysis of the specific activities of the organization, focusing on the facts and circum-

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Jones Univ. v. United States, 461 U.S. 574, 579 (1983) citing Rev. Rul. 71-447, 1971-2 C.B. 230. *See also* New Dynamics Foundation v. United States, 70 Cl. Ct. 782, 799-800 (2006).

[13] Treas. Reg. § 1.501(b).

[14] *See, e.g.,* New Dynamics Foundation, 70 Cl. Ct. at 800 ("In the case *sub judice*, there is not much debate that NDF was organized exclusively for exempt purposes – its articles of incorporation and bylaws repeat, virtually *in haec verba*, the flush language of section 501(c)(3).")

[15] *See* Treas. Reg. § 1.501(c)(3)-1(c)(2). *But see* United Cancer Council, Inc. v. Commissioner, 165 F.3d 1173 (7th Cir. 1999) (reversing Tax Court, which had upheld IRS revoking exemption under the "organizational test" based on finding that the charity's payments to a professional fundraiser constituted private inurement).

[16] Treas. Reg. § 1.501(c)(3)-1(c)(1).

stances of the organization's activities to ensure that it meets the requirements for exemption under the Code.[17] As summarized by the Supreme Court, "[t]he presence of a single non-exempt purpose, if substantial in nature, will destroy the exemption."[18] In *B.S.W. Group Inc. v. Commissioner*, the court interpreted the "operational test" to require that the organization's "primary purpose" be its exempt purpose, and not a non-exempt purpose.[19] The court held that the "primary purpose" test must be determined based on the facts and circumstances, applying the relevant factors to the factual record.[20]

The "operational test" has been an important and valuable regulatory structure to ensure that tax-exempt charitable organizations serve charitable purposes rather than private purposes.[21] To be sure, some commentators argue that the requirements for exemption – particularly under the "operational test" – should be more rigorously enforced, and that the regulations should be revised.[22] Nonetheless, the regulatory structure has provided important guidance for IRS determinations and court adjudication, including sponsoring organizations of donor-advised funds.[23] There is little justification for an argument that these regulatory requirements are inadequate when it comes to evaluating sponsoring organizations of donor-advised funds, nor for an argument that a brute-force arbitrary distinction would serve better in regulating sponsoring organizations.

II. SPONSORING ORGANIZATIONS OF DONOR-ADVISED FUNDS

In considering the proper application of the "operational test" to donor-advised funds, it is important to bear in mind the history of donor-

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[17] *Id.* The regulations also include the statutory "private inurement" prohibition through both the "organizational test" in Treas. Reg. § 1.501(c)(3)-1(b)(4) (distribution of assets upon dissolution) and the "operational test" in Treas. Reg. § 1.501(c)(3)-1(c)(2) (distribution of earnings). In addition, the regulations detail factors to be taken into account in determining whether an organization meets the "operational test." Treas. Reg. § 1.501(c)(3)-1(f).

[18] Better Business Bureau of Washington, D.C., Inc. v. United States, 326 U.S. 279, 283 (1945).

[19] B.S.W. Group, Inc. v. Commissioner, 73 T.C. 352, 357 (1978).

[20] *Id.*

[21] *See, e.g.,* Better Business Bureau of Washington, D.C., Inc. v. United States, 326 U.S. 279 (1945); National Foundation, Inc. v. United States, 13 Cl. Ct. 486 (1987); Fund for Anonymous Gifts v. Internal Revenue Service, 194 F.3d 173 (D.C. Cir. 1999) *summary judgment granted upon reh'g* 88 A.F.T.R.2d (RIA) 6040 (2001).

[22] *See, e.g.,* Molk, *Reforming Nonprofit Exemption Requirements*, 17 Fordham J. Corp. & Fin. L. 475 (2012); Peña & Reid, *A Call for Reform of the Operational Test for Unrelated Commercial Activity in Charities*, 76 N.Y.U. L. Rev. 1855 (2001).

[23] *See, e.g.,* United States v. Guess, 472 Fed. Appx. 546 (9th Cir. Cal. 2012) *cert. denied* 133 S. Ct. 298 (2012); New Dynamics Foundation v. United States, 70 Fed. Cl. 782 (2006); National Foundation, Inc. v. United States, 13 Cl. Ct. 486 (1987); Fund for Anonymous Gifts v. Internal Revenue Service, 194 F.3d 173 (D.C. Cir. 1999).

advised funds, and the range of sponsoring organizations that maintain them. It is reported that the first donor-advised funds appeared in 1931, created by the New York Community Trust.[24] Donor-advised funds appeared at a number of other community foundations across the country in following years. In addition, over the following decades a number of additional sponsoring organizations began to maintain donor-advised funds, including religious organizations, universities, field of interest funds, other public charities, national donor-advised funds,[25] and others.[26] Today, the array of sponsoring organizations maintaining donor-advised fund programs is remarkably diverse, with each sponsoring organization adapting its donor-advised fund programs to fit with the sponsoring organization's overall charitable mission. This diversity and adaptation to the needs of donors and supported charities alike is a hallmark of this grant-making sector, and should be welcomed and encouraged.[27]

At the same time, however, it is difficult – and often misleading – to make sweeping generalizations about sponsoring organizations and their donor-advised fund programs based solely on the labels attached to various sponsoring organizations. The inescapable truth is that, while donor-advised fund programs may differ, there is not a principled way to distinguish spon-

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[24] Department of the Treasury, *Report to Congress on Supporting Organizations and Donor Advised Funds* 21 (2011) *citing* Bjorklund, *The Emergence of the Donor-Advised Fund*, 3 Streckfus' EO Tax J. 15 (May 1998).

[25] It is important to note that the term "national donor advised fund" has neither statutory nor regulatory definition, but has generally been used to distinguish sponsoring organizations for which operate donor advised fund programs as their principal activity from other sponsoring organizations, including community foundations. It appears that the earliest use of "national donor-advised funds" was in 1996. C. Hoyt, *Legal Compendium for Community Foundations*, Council on Foundations (1996). The term subsequently began appearing regularly, beginning in earnest with Victoria Bjorklund's presentation at the Georgetown conference on Charitable Giving Techniques in May 2001. *See* Bjorklund, *Choosing Among the Private Foundation, Supporting Organization and Donor-Advised Fund*, ALI-ABA Course of Study Materials, Charitable Giving Techniques (2001). That presentation also included publication of "Common Operating Procedures of Donor Advised Funds," which had been developed by a number of national donor advised funds as common operating procedures in the nature of best practices and self regulation. *See also* American Bar Ass'n, *Comments Concerning Temporary and Proposed Regulations under Section 4958 of the Internal Revenue Code of 1986*, April 16, 2001, reprinted in 2001 TNT 74-18.

[26] *See* Bjorklund, *Choosing Among the Private Foundation, Supporting Organization and Donor-Advised Fund* (May 2003), Appendix D, listing and categorizing a broad range of sponsoring organizations in existence in 2002. Many of these donor-advised funds have been in existence for decades, including the Jewish Communal Fund since 1972, the National Christian Foundation since 1982, the Tides Foundation since 1976, the American Ireland Fund since 1976, and the Philanthropic Collaborative since 1991. *Id.*

[27] *See generally* Husock, *Growing Giving: American Philanthropy and the Potential of Donor-Advised Funds*, Civic Report No. 97 (Manhattan Institute April 2015).

soring organizations based solely on a label or arbitrary classification.[28] There is no easily identifiable difference in form of legal organization or makeup of the governing body, whether directors or trustees. Neither is there a single distinction based on the public charities eligible to receive grants from donor-advised funds from a type of sponsoring organization; for example, community foundation sponsoring organizations may choose to focus on local charitable organizations, but also may support grantmaking nationally; a religious or field of interest sponsoring organizations may permit a part or even all of grantmaking to be made to public charities addressing unrelated charitable missions; and any sponsoring organization may choose to provide tools, advice and other assistance in grantmaking. In addition, some sponsoring organizations may include a donor-advised fund program as only one of a wide range of charitable programs, ranging from discretionary grantmaking from unrestricted funds of the sponsoring organization (such as an endowment), to pooled income funds and other forms of planned charitable giving vehicles, and on to direct charitable activities. Other sponsoring organizations may focus on a smaller set of charitable activities. This variety is not tied to any particular label attached to a sponsoring organization. Instead of focusing on labels, it is necessary to consider the facts applicable to each specific sponsoring organization, and to the donor-advised fund programs it maintains; the facts and the actions of the individual sponsoring organization are what matter, not the label.

Ruling Standards for Exemption Application. The statutory and regulatory structure, as interpreted and applied by the IRS and by the courts to the particular facts of an individual sponsoring organization, sets an appropriate and responsive legal structure to ensure that sponsoring organizations – each a charitable organization maintaining donor-advised funds – serves public charitable purposes rather than private interests. An important part of this regulatory compliance structure is contained in a sponsoring organization's application for exemption[29] and ongoing regulatory review and enforcement. For example, when the Vanguard Charitable Endowment Program applied for exemption, there was extensive discussion and refinement between the IRS and the Vanguard Charitable Endowment Program.[30] Shortly thereafter, the Fidelity Charitable Gift Fund voluntarily adopted

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[28] In this respect, it is important to note that even the attempt by Victoria Bjorklund to categorize sponsoring organizations of donor-advised funds in her 2003 outline reflects the difficulty in drawing sharp lines. *See* Bjorklund, *supra* note 26, Appendix D.

[29] One must note that, under current exemption procedures, the application for exemption on Form 1023 and the regulatory back-and-forth is diminished. *See* Viswanathan, *Form 1023-EZ and the Streamlined Process for the Federal Income Tax Exemption: Is the IRS Slashing Red Tape or Opening Pandora's Box?*, 163 U. Pa. L. Rev. Online 89 (2014).

[30] *See* Paul Streckfus' EO Tax Journal, June 1998. See also Bjorklund, *supra* note 26, at 8.

grantmaking and other principles developed in that process.[31] A number of other sponsoring organizations went through similar review processes with the IRS.[32]

In addition to this regulatory process, many sponsoring organizations independently and collectively developed principles and best practices. One such process culminated in 2002 in the "Common Operating Procedures for Donor Advised Funds" that were developed and adopted by a number of national donor-advised funds. These Common Operating Procedures were published,[33] and remain an important foundation in policy guiding these sponsoring charities' operations. A copy is attached as Appendix I.

Intermediate Standards – Excess Benefit Transactions. Although these statutory, regulatory and self-regulatory standards provided both standards and mechanisms for enforcement for *all* charitable organizations, there was lingering concern that revocation of an organization's tax exemption was too blunt a tool to enforce compliance.[34] In 1996, Congress added to the statutory standards and enforcement tools applicable to all charitable organizations when it enacted the Section 4958 "intermediate sanctions" regime as part of The Taxpayer Bill of Rights 2.[35] Section 4958 imposes penalty taxes on "excess benefit transactions" involving charitable organizations and "disqualified persons."[36] Section 4958 imposes a 25% excise penalty tax on a disqualified person benefitting from an "excess benefit transaction," plus a 200% penalty excise tax for failure to correct within the taxable year. In addition, Section 4958 imposes 10% penalty excise tax on an organization manager who knowingly participates in an excess benefit transaction.

Donor-Advised Funds under Pension Protection Act of 2006. In 2006, Congress directly addressed sponsoring organizations and donor-advised funds for the first time, enacting Section 4966 and Section 4967 as part of the Pension Protection Act.[37] Section 4966 imposes a 20% penalty excise tax on a sponsoring organization that makes a "taxable distribution" to a natural person or otherwise not for charitable purposes. Section 4966 also imposes a 5% penalty excise tax on a fund manager who knowingly makes a taxable distribution. Section 4967 imposes a 125% penalty excise tax on a donor (or related person) who gives advice resulting in a prohibited

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[31] *See* Bjorklund, *supra* note 26, at 8.
[32] *Id.* at 8-9.
[33] *Id.* at Appendix E.
[34] *See* H. Rep. 104-506 at 53-59 (March 28, 1996).
[35] Taxpayer Bill of Rights 2, Pub. L. 104-168 (1996).
[36] § 4958. The penalty taxes under § 4958 apply to public charities generally, and not only to sponsoring organizations of donor-advised funds; this article focuses on sponsoring organizations, donor-advised funds, and donors.
[37] Pension Protection Act of 2006, Pub. L. 109-280 (2006).

benefit, and also imposes a 10% penalty excise tax on a fund manager who knowingly makes a distribution conferring a prohibited benefit.

The penalty regime imposed under Section 4966 and Section 4967 is broad and severe, and the provisions are appropriately drafted to apply to every sponsoring organization. Furthermore, as of this date, this penalty regime is not even fully implemented. Treasury has not yet issued regulations under these provisions, and there is little news regarding application of these penalties by the IRS to sponsoring organizations or to donors. In short, there is little evidence of widespread abuse, and no showing that application of these provisions would be insufficient to address potential abuses with respect to donor-advised funds. Those provisions should be developed and allowed to work.

III. DONORS TO DONOR-ADVISED FUNDS REQUIREMENTS AND ENFORCEMENT RELATED TO DONOR'S CHARITABLE CONTRIBUTIONS.

It is essential to bear in mind from a tax policy perspective that much of the enforcement with respect to charitable giving is through enforcement of the requirements for a charitable contribution deduction under Section 170. Ensuring compliance with deduction requirements is most often the most effective level for enforcement. For example, a donor is not entitled to a charitable contributions deduction unless there is a completed gift, which transfers full dominion and control to the charitable organization.[38] Many of the potential abuses related to donor-advised funds are addressed by an IRS challenge to a donor's tax deduction.[39] In addition to enforcing requirements regarding completed gift, including transfer of dominion and control, the IRS also has at its disposal the penalty regimes described above under Section 4958, Section 4966, and Section 4967. Enforcement through audit of donors' tax returns, although cumbersome and potentially expensive, is a particularly effective means of addressing the potential abuses regarding donor-advised funds (in addition to penalties applicable to the foundation managers and the sponsoring organizations themselves). We are not able to give full assessment to the effectiveness of the statutory and regulatory structure because regulations under the provisions added under the Pension Protection Act have not yet been issued. It is entirely appropriate to increase guidance and enforcement. Moreover, even if a particular sponsoring organization were implicated in a donor-level abuse, one could not merely assume abuses would be connected with or limited to any particular type of

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[38] § 170(c). *See also* Davis v. United States, 495 U.S. 472 (1990).

[39] *See, e.g.,* United States v. Guess, 472 Fed. Appx. 546 (9th Cir. Cal. 2012) *cert. denied* 133 S. Ct. 298 (2012) (taxpayer convicted of criminal tax fraud for fraudulent charitable contribution deductions).

sponsoring organization. There is no basis for making arbitrary distinctions among sponsoring organizations.

IV. ASSESSMENT

In summary, there is a fairly complete statutory and regulatory foundation in place to set guidelines for and to support proper enforcement of sponsoring organizations, donor-advised funds and donors. That foundation should be more fully implemented with regulations pursuant to Section 4966 and Section 4967 and increased IRS review and enforcement with respect to the tax exemption of sponsoring organizations maintaining donor-advised funds.[40] In addition, in order to prevent abuses as well as respond to them, one might argue that the IRS also ought to increase enforcement with respect to the operations of sponsoring organizations, donor-advised funds, donors, and recipient charitable organizations, bringing to bear the power of intermediate sanctions and other penalty excise taxes applicable to sponsoring organizations and donors. Finally, the IRS ought to increase compliance and enforcement with respect to tax returns of donors to donor-advised funds.[41]

In addition to the statutory and regulatory protections and guidance, the IRS has a host of compliance tools, including tax returns, transactional and other informational returns, as well as audits. There are many compliance steps – including guidance, reporting and enforcement – that the IRS could yet take. At best, it is premature to begin drawing conclusions on an incomplete and developing record.

Having discussed the statutory and regulatory structure, only now can one begin to address the question posed to this panel, perhaps reframed: whether these standards are appropriate to enforce the overriding policy requirement that sponsoring organizations – as tax-exempt charitable organizations – and the charitable contributions they receive are used exclusively to serve charitable purposes. These legal standards are sturdy and flexible enough to address specific facts of particular organizations and donors. In addition, there is room for substantial additional guidance and enforcement, including both regulations under Section 4966 and Section 4967 as well as enforcement of the penalties they impose.

The type of distinction suggested by the topic presented to this panel – treating sponsoring organizations and their donor-advised fund programs differently based upon a label attached to them – is premature at best, and specious at worst. Labels attached to particular sponsoring organizations are in large part descriptive rather than structural, are often of little practical

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[40] *See, e.g.,* Viswanathan, *supra* note 29.
[41] *See, e.g.,* United States v. Guess, *supra* note 39.

value, and are easily changed or manipulated. The essence of the legal requirements imposed on charitable organizations and their donors is based on the statutory and regulatory structures described above, and these must be adapted and applied to the particular facts of each specific sponsoring organization. The statutory and regulatory foundation already in place – together with the room for additional regulations, guidance and enforcement – is fully adequate to address abuses, as well as the legitimate questions and concerns that many thoughtful observers have raised. Those abuses are not dependent upon an arbitrary classification or label, but upon specific facts and circumstances.

For example, for those concerned that a particular sponsoring organization serves commercial rather than charitable purposes, the existing legal structure is fully prepared to address this issue as part of the requirements for exemption, principally through the "operational test,"[42] and also through imposing penalties on particular abuses.[43] To the extent a concern is overpayment to a service provider, in addition to the exemption and penalty provisions outlined above, there are many legal standards (both federal and state) that apply to enforce the directors' or trustees' fiduciary duties. Similarly, if the potential abuse is excess donor control or private benefit, the donor's income tax deduction under Section 170 for a charitable contribution is at risk, in addition to the enforcement provisions outlined above on the charitable organization and the penalties that may be imposed on the organization, its managers, and the donor.

Although some may be concerned that donor-advised funds, including and perhaps especially national donor-advised funds, have changed the charitable landscape, upon more careful examination and reflection one recognizes that this really a matter of old wine in new bottles; matters may arise in new forms and factual settings, but they raise the same legal issues regarding exemption, deduction and potential abuses. Our legal and enforcement structure is fully prepared to address those enduring and recurring issues. Beyond those bedrock principles, and enforcing those standards in particular factual circumstances, little is to be gained by introducing arbitrary and capricious categorization, labels, and treatment of various sponsoring organizations.

Not only is the statutory and regulatory structure well suited to ensure compliance and prevent abuses, it is important to note that there has been no showing of a systemic problem with donor-advised funds generally, not to mention any specific subset of sponsoring organizations. Moreover, there is

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[42] See, e.g., Better Business Bureau of Washington D.C. v. United States, 326 U.S. 279 (1945); National Foundation, Inc. v. United States, 13 Cl. Ct. 486 (1987); B.S.W. Group, Inc. v. Commissioner, 73 T.C. 352 (1978).

[43] Penalties may be imposed, for example, under any or all of § 4958, § 4966 and § 4967.

no basis in experience or in theory to suggest that there is a principled or even effective method to address any such concerns by making arbitrary distinctions between sponsoring organizations of donor-advised funds. Where there are abuses, we have the tools in place to improve compliance and to punish transgressing sponsoring organizations, donors and others.

Although donor-advised funds make up a small portion of the charitable sector, they have proven helpful to many donors in achieving their charitable giving goals; one observer has suggested that donor-advised funds "could signal a new era in U.S. mass philanthropy."[44] Even while heralding these benefits to the charitable sector, it is undeniably important to ensure that they serve charitable purposes and to prevent abuses. Although their recent growth has been notable, donor-advised funds have existed for over eighty years. The emergence of new sponsoring organizations and the increasing technological efficiency have made these charitable giving vehicles increasingly attractive to individual donors in achieving their charitable giving goals. The issues that donor-advised funds raise, however, remain fundamentally unchanged, and well-addressed by the underlying legal and compliance structure. The tools are in place to ensure compliance and to prevent abuses, even as we celebrate charitable giving and help donors put those funds to use by supporting operating charities.

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[44] Husock, *supra* note 27, at 12.

APPENDIX I

COMMON OPERATING PROCEDURES FOR DONOR ADVISED FUNDS FEBRUARY 2002

I. INTRODUCTION.

The charitable community has recently seen tremendous growth in the area of Section 501(c)(3) public charities operating donor advised funds. In a donor advised fund, a donor makes a charitable contribution to a sponsoring charity that maintains the donor's contributions in a separately-identified account (each of which is referred to as a "donor advised fund account"). The sponsoring charity receives and retains exclusive ownership and legal control over amounts contributed to and investment returns of each donor advised fund account. The sponsoring charity allows the donor and persons designated by the donor ("donor advisers") to have advisory privileges with respect to grants from each donor advised fund account. In addition, the sponsoring charity may allow the donor and donor adviser to have advisory privileges with respect to the investment allocation of assets in each donor advised fund account.

Sponsoring charities, including those that operate donor advised fund programs as their principal activity (often known as "national donor advised funds" or "NDAFs"), play an important and growing role in the world of philanthropy. In the past few years, NDAFs have raised and granted billions of dollars for charitable purposes. As they have evolved, NDAFs have developed a number of common operating procedures. These procedures are continually being improved by NDAFs in response to changes and developments in charitable giving and in response to guidance from the IRS, the U.S. Treasury Department and other sources of legal authority.

This document describes the common operating procedures currently being used by many NDAFs. The procedures discussed below cover a broad range of potential activities by a NDAF, and not every NDAF participates in all of these activities. This document is intended to be a general resource for new and existing sponsoring charities. Each sponsoring charity should consult its own advisers as it develops its own operating procedures.

II. GOVERNANCE OF A SPONSORING CHARITY.

A. A Sponsoring Charity Has an Independent Board.

A sponsoring charity is governed by a board, the majority of whose members are independent from any for-profit organization that provides goods or services to the sponsoring charity. The board is responsible for all

aspects of the sponsoring charity's operations, including (i) overall stewardship of the charitable mission, (ii) grants and expenditures from each donor advised fund account, (iii) investment of funds maintained in each donor advised fund account; (iv) grantmaking from the sponsoring charity's general fund, and (v) the reasonableness of its contractual and other relationships with third parties.

B. A Sponsoring Charity Has a Written Conflicts of Interests Policy.

A sponsoring charity adopts a written conflicts of interest policy governing participation by board members and officers in matters involving the sponsoring charity

C. A Sponsoring Charity is Subject to an Annual Audit.

A sponsoring charity's financial records are audited annually by an independent public accounting firm.

III. Roles and Privileges of the Sponsoring Charity, the Donor and the Donor Adviser.

A. Roles of the Sponsoring Charity.

A sponsoring charity has exclusive ownership and legal control over amounts contributed to or earned by each donor advised fund account. This means that contributions made to a donor advised fund account of a sponsoring charity are irrevocable and that advice regarding grant recommendations and investment allocation is not binding on, and is subject to review and approval by, the sponsoring charity.

B. Privileges of a Donor.

The donor makes charitable contributions to a donor advised fund account, and has the privilege of (i) naming the donor advised fund account, (ii) designating donor advisers and successor donor advisers, (iii) making recommendations regarding grants paid out of a donor advised fund account, and (iv) advising on the investment allocation of assets in a donor advised fund account.

C. Privileges of a Donor Adviser.

A donor adviser (who may also be the donor) may have the privilege of (i) making recommendations regarding grants paid out of a donor advised fund account, (ii) advising on the investment allocation of assets in a donor advised fund account, and (iii) naming successor donor advisers.

IV. INTERACTION BETWEEN A SPONSORING CHARITY AND DONORS AND DONOR ADVISERS.

A. Solicitation and Ongoing Communications.

Solicitation materials for a sponsoring charity's donor advised fund program and ongoing communications with donors, donor advisers and other third parties make explicit that (i) the sponsoring charity has exclusive ownership and legal control over amounts contributed to and investment returns of each donor advised fund account, (ii) contributions to the sponsoring charity are irrevocable, and (iii) a donor or donor adviser's recommendations regarding grants and advice regarding investment allocations are not binding on, and are subject to review and approval by, the sponsoring charity.

B. Education of Donors and Donor Advisers.

A sponsoring charity educates its donors and donor advisers on an ongoing basis about charitable giving and ways to increase philanthropy. These educational endeavors can take a wide variety of forms, including one-on-one counseling, technology-based communications, efforts to provide broader access to sources of information about charitable organizations, and communications regarding grants from the sponsoring charity's general funds.

C. Certain Transactions with Donors or Donor Advisers

Most sponsoring charities that are NDAFs have elected not to engage in certain transactions with donors or donor advisers in part because of the significant additional review that would be required. A sponsoring charity that does engage in these transactions with donors or donor advisers must ensure that such transactions serve exclusively charitable purposes and do not result in any impermissible benefit. Such transactions might include, for example, the purchase or sale of assets, the lending or borrowing of funds, the payment of compensation or reimbursement of expenses, or the receipt of contributions of property that is illiquid and cannot be converted to use for charitable purposes within a reasonable period. In the unusual case where a sponsoring charity determines that a proposed transaction with a donor or donor adviser is appropriate and in the charity's best interest, it will document the basis for such determination, including appropriate data used by the charity to determine that such transaction is on a fair market value basis.

V. GRANTMAKING PROCEDURES.

A sponsoring charity adopts procedures and safeguards with respect to grantmaking to ensure that funds are used exclusively in furtherance of charitable purposes. A sponsoring charity does not necessarily engage in all the grantmaking activities described below. In certain circumstances, a sponsoring charity may have made specific representations to the Internal Revenue Service that it will not engage in a particular type of the grantmaking described below.

Most sponsoring charities that are NDAFs have elected not to engage in the following activities in part because of the significant additional review that would be required in order to assure that such activities serve exclusively charitable purposes and do not result in any impermissible benefit: (i) grants to individuals; (ii) grants to U.S. private foundations; and (iii) grants to foreign organizations.

However, other sponsoring charities, including some NDAFs, currently engage in these grantmaking activities or may choose to do so in the future. If so, significant review should be conducted and documented, as described in section V.B.2. below.

A. In General.

A.1. Grant Recommendations Are Not Binding On, and Are Subject to Review and Approval By, a Sponsoring Charity.

Grant recommendations made by a donor or donor adviser are not binding on, and are subject to review and approval by, a sponsoring charity, and any recommendations that fail the sponsoring charity's grantmaking criteria will be declined.

A.2. A Sponsoring Charity Will Not Make Grants That Confer an Impermissible Benefit.

A sponsoring charity will not make any grant that would confer an impermissible benefit on a donor, donor adviser or other third party. A sponsoring charity obtains a representation from the donor or donor adviser that neither the donor, the donor adviser nor a third party will receive an impermissible benefit if the grant recommendation is approved by the sponsoring charity. A sponsoring charity also notifies the grant recipient that, by accepting the grant, the grant recipient acknowledges that the grant will not be used to provide an impermissible benefit to the donor, donor adviser or other third party.

A.3. A Sponsoring Charity Makes Grants Only In Furtherance of its Charitable Purposes.

A sponsoring charity makes grants only in furtherance of its charitable purposes.

B. A Sponsoring Charity Reviews Grant Recommendations in a Manner Appropriate to the Status of a Proposed Grant Recipient.

B.1. Grants to U.S. Public Charities, Private Operating Foundations and Governmental Units.

Grants may be recommended to organizations formed under the laws of the United States and its territories that are public charities described in Section 509(a)(1), (a)(2), or (a)(3) of the Internal Revenue Code, or private operating foundations described in Section 4942(j)(3) of the Internal Revenue Code. A sponsoring charity reviews such recommendations by verifying a proposed grant recipient's exempt, public charity or exempt, private operating foundation status, as appropriate, in IRS Publication 78.

In addition, depending on the particular circumstances, the sponsoring charity may perform additional review of grant recommendations to U.S. public charities and private operating foundations. Such additional review may include: (i) requesting relevant documents from the proposed grant recipient (e.g., IRS determination letter, audited financial statements, IRS Forms 990 or 990-PF), (ii) requiring the proposed grant recipient to provide information on its operations (e.g., charitable objectives, operating budget, directors), (iii) obtaining additional assurances that the donor or donor adviser will not receive an impermissible benefit from the proposed grant, and (iv) obtaining a current address and the name of a contact person from the grant recipient.

Furthermore, grants may be recommended to governmental units defined in Section 170(c)(1), if the grant funds are used for exclusively public purposes.

B.2. Grants to U.S. Private Foundations, Foreign Organizations, and Individuals.

Most sponsoring charities do not currently make grants to U.S. private foundations, foreign organizations or individuals. Where a sponsoring charity chooses to make grants to individuals or to entities other than public charities and private operating foundations, additional review procedures are appropriate to ensure that funds are used for charitable purposes.

B.2.1. Grants to U.S. Private Foundations and Foreign Organizations.

A sponsoring charity choosing to make grants to a U.S. private foundation or a foreign organization requires that the proposed grant recipient provide the sponsoring charity with information specifying the charitable purposes for which the grant funds will be used, including information on the proposed grant recipient's charitable objectives and how use of the grant funds will further those objectives. A sponsoring charity generally enters into a written grant agreement with the U.S. private foundation or foreign organization providing (i) the charitable purposes for which the grant funds will be used, and (ii) that the grant recipient will periodically submit reports describing the expenditure of grant funds and the grant recipient's progress in accomplishing the charitable purposes for which the grant was made. The sponsoring charity monitors the performance of the grant recipient under the terms of such agreement. The sponsoring charity may follow other appropriate procedures where the foreign organization is the equivalent of a U.S. public charity.

B.2.2. Grants to Individuals.

A sponsoring charity choosing to make grants to individuals within a charitable class adopts procedures to assure that there is no impermissible benefit being conferred on the individual. A sponsoring charity also keeps records specifying (i) the name and address of the grant recipient, (ii) the amount of the grant, (iii) the charitable purposes for which the grant funds will be used by the individual, (iv) the manner in which the sponsoring charity selected the grant recipient, and (v) the relationship (if any) between the grant recipient and (a) members, officers or trustees of the sponsoring charity, (b) the donor or donor adviser, or (c) a family member or controlled corporation of either.

VI. A Sponsoring Charity Maintains a Minimum Level of Activity in its Donor Advised Fund Accounts.

A. Aggregate Grant Distributions Will Exceed a Minimum Threshold.

Grant distributions from the aggregate of a sponsoring charity's donor advised fund accounts exceed a minimum threshold of, for example, 5% of the sponsoring charity's net assets on a fiscal five-year rolling average basis.

B. A Sponsoring Charity Has a Policy Ensuring a Minimum Level of Activity in Each Donor Advised Fund Account.

A sponsoring charity has a policy ensuring that a minimum level of activity occurs in each donor advised fund account. The Internal Revenue Service, for example, has approved a policy requiring activity, in the form of contributions or grant recommendations, within a seven-year period.