

taxation of **exempts**

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HOW TO ESTABLISH DONOR-ADVISED FUNDS AND

The controversy over the roles of for-profits that set up donor-advised funds is less important than the ambiguities of what rules the Service will apply to them.

COMMUNITY FOUNDATIONS

WENDELL R. BIRD

Two years ago, the press was abuzz with outcries that donor-advised funds were enriching national mutual funds while community foundations were evading the rules on completed gifts for charitable deductions. The IRS National Office was identifying that as an area for scrutiny in the following year's work plan while the Administration's Green Book proposed new restrictions.¹ Tim Hanford, Tax Counsel for the House Ways and Means Committee, stated that Congress had "been looking at donor-advised funds for about two years on Capitol Hill,"² though he went out of his way to describe the Fidelity and Vanguard funds as having "bent over backwards to comply" with tax laws.³ The Fidelity Gift Fund broke into the top ten charities, then displaced the third largest charity, in the entire United States.⁴ As the climax approached, no death occurred, and in fact ... nothing happened.

The rise of community foundations and donor-advised funds

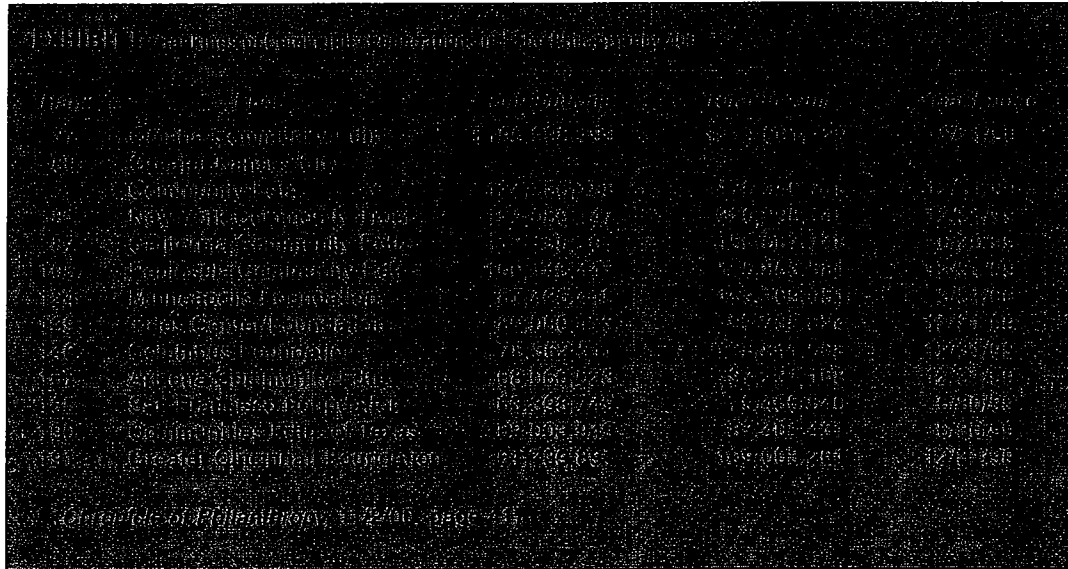
Both community foundations (CFs) and mutual fund donor-advised funds (DAFs)

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may allow donors to make contributions and later give nonbinding advice about distributions to public charities. Donors also may, at the time of creating a component fund, designate its charitable purpose or the supported charities.

The principal difference between CFs and DAFs is simply that charities or charitable-minded people have established most CFs, while mutual funds or banks have established most DAFs. Even that difference has exceptions, because some CFs are established by banks or trust companies, while some DAFs are established by charities. Another difference is that CFs (at least if formed as trusts) are subject to Reg. 1.170A-9(e), while the IRS has hesitated to state that those regulations apply to DAFs and the funds have crafted arguments against applying those regulations.

Other differences are more elusive. CFs tend to be trusts and DAFs corporations, but that is only historical accident. All seek to be charities under Section 501(c)(3), and to have public charity status under Section 509(a)(1) (except the occasional supporting organization that operates as a DAF,⁵ and the common pooled funds that are defined as private foundations and may seek to qualify as DAFs⁶).



Growth of CFs and DAFs. The first community foundation was established in 1914 by the Cleveland Trust Company—a bank. By 1991, the IRS estimated that there were over 400 CFs holding over \$8 billion in assets and distributing \$525 million to charities.⁷ Those CFs held almost \$20 billion in assets by 1997, but even in 1999 the number of CFs and DAFs combined came to fewer than 600.⁸ Some of the larger community foundations, along with their ranking in the *Chronicle of Philanthropy's* "Philanthropy 400," are listed in Exhibit I, above.

The first DAF formed by a mutual fund was established by Fidelity Investments in 1991. Since then, it has grown to assets of \$1.7 billion and annual income of \$867 million in the

year ending 6/3/99.⁹ Fidelity not only is the largest DAF, but is now the fifth largest charity in the United States, and has been the third largest. According to one estimate, the total assets in DAFs have more than tripled from 1995 to 1999, to \$7.5 billion.¹⁰

Many of the major mutual funds have established DAFs after seeing the huge potential for asset management and hopefully after seeing the enormous potential for good. Some are listed in Exhibit II on page 70. While Fidelity's Charitable Gift Fund reached the number three position in 1999 among charities, it actually failed to maintain momentum and dropped to the number five position for 2000, as shown in Exhibit III on page 71.

¹Department of the Treasury, General Explanation of the Administration's Fiscal Year 2001 Revenue Proposals 106 (Feb. 2000).

²Transcript of ABA Committee on Exempt Organizations, 29 Exempt Org. Tax Rev. 67 (July 2000).

³Hanford, Speech at Washington Non-Profit Tax Conference (3/9/00).

⁴"The Philanthropy 400," *Chronicle of Philanthropy* (11/4/99).

⁵See Section 509(a)(3). The Service notes that it is difficult for a fund of a DAF to qualify as a supporting organization. Shoemaker and Brockner, "Control and Power: Issues Involving Supporting Organizations, Donor Advised Funds," *Exempt Organizations Continuing Professional Educational Technical Instruction Program for FY 2001* (2000) page 116. But see Korman and Gaske, "Supporting Organizations to Community Foundations: A Little-Used Alternative to Private Foundations," 10 Exempt Org. Tax Rev. 1327 (December 1994). The Service also takes the position that a pooled common fund cannot qualify as a supporting organization, because of the right to designate income recipients. Shoemaker and Henchey, "Donor Directed Funds," *Exempt Organizations*

Continuing Professional Educational Technical Instruction Program for FY 1996 (1995) page 328.

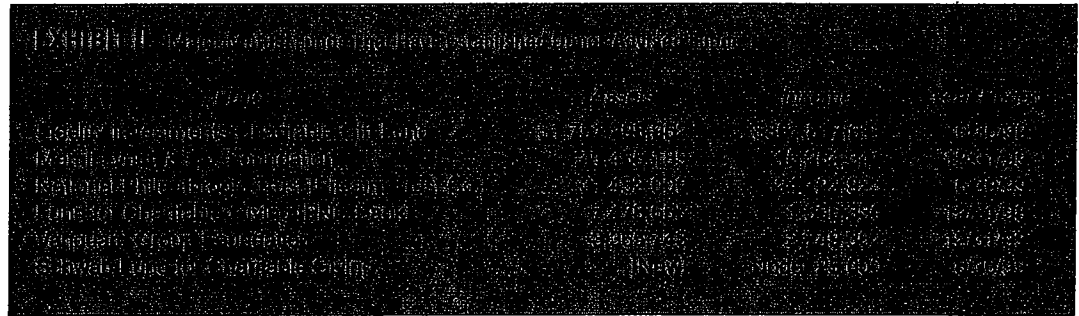
⁶See Section 170(b)(1)(E)(iii). The Service implies that a common pooled fund would not qualify, and is statutorily limited to being a private foundation. Shoemaker and Henchey, *supra* note 5 at 326; Rev. Rul. 80-305, 1980-2 CB 71; but see Troyer, "Important Developments Affecting Private Foundations," Exempt Org. Tax Rev. 213 (February 1992).

⁷Johnson and Jones, "Community Foundations," *Exempt Organizations Continuing Professional Educational Technical Instruction Program for FY 1994* (1993), page 135.

⁸The Foundation Center, *Foundation Giving*, xi (1999); Bjorklund, "Charitable Giving To a Private Foundation and the Alternatives, the Supporting Organization and the Donor-Advised Fund," *National Center on Philanthropy and the Law at NYU School of Law, Conference on Private Foundations Reconsidered: Policies and Alternatives, Old and New* (Oct. 28-29, 1999), page 59.

⁹IRS, Exempt Organization Master List (10/6/00).

¹⁰"The Boom in Donor-Advised Funds," *Chronicle of Philanthropy* at philanthropy.com/free/articles/v12/i13/stats/1213donor_advised.htm (12/13/00).



Advantages and disadvantages of community foundations and donor-advised funds

Charitable giving is on the upswing (other than in recessionary years), particularly in intergenerational wealth transfer. The oft-quoted 1990 estimate was that \$10.4 trillion would change hands in the 55 years from 1990-2044—\$189 billion per year.¹¹ That number was revised recently to a “low-range best estimate” of \$41 trillion in the 55 years from 1998-2052—\$745 billion a year—prompting the authors of the revision to state that “a golden age of philanthropy is dawning, especially among wealth holders and the upper affluent.”¹² This golden age of philanthropy will doubtless produce more giving through CFs, DAFs, and private foundations than at any time in history.

In addition to this general growth of charitable giving, there are several advantages encouraging donations to a CF or DAF.

1. *Partial control over distributions.* The donor has the right to recommend, or give advice on, distributions to charities. The donor to a private foundation, by contrast, has a much greater right to make a binding designation of the distributees. Similarly, the donor to a pooled common fund has the right “to designate annually the recipients, from among organizations described in paragraph (1) of section 509(a), of the income attributable to the donor’s contribution to the fund and to direct (by deed or by will) the payment, to an organization described in such paragraph (1), of the corpus in the common fund.”¹³ In that case, the designations of income must be made by the 15th day of the third month after the close of the fiscal year, and the designations of corpus must be made by one year after the donor’s or spouse’s death (if the spouse has the right to designate the recipients of corpus).

2. *Delaying distributions after contributions.*

The CF or DAF donor also can make a charitable contribution currently and enjoy a charitable deduction, while not selecting the distributees or making the distribution until a future year. This is of great benefit when the donor needs or wishes to make a large contribution now without having selected the beneficiaries, such as before the donor sells a business or other property. The donor to a private foundation or pooled common fund has the same advantage, except that the minimum distribution rule requires roughly a 5% distribution within a year of each tax year.¹⁴

3. *Simplicity of administration.* The donor does not have any administrative responsibility. The CF or DAF files the tax return for all funds jointly, meets the public inspection requirements, does the accounting, and sends out the distribution checks. The manager of a private foundation, by contrast, must file Form 990-PF, meet public inspection requirements,¹⁵ account for funds, and send out distribution checks. The donor to a CF or DAF also does not need to comply with the substantiation requirements,¹⁶ other than getting a receipt from the CF or

¹¹ Avery and Rendall, “Estimating the Size and Distribution of the Baby Boomers’ Prospective Inheritances,” Study from Department of Consumer Economics & Housing (Cornell University, 1990).

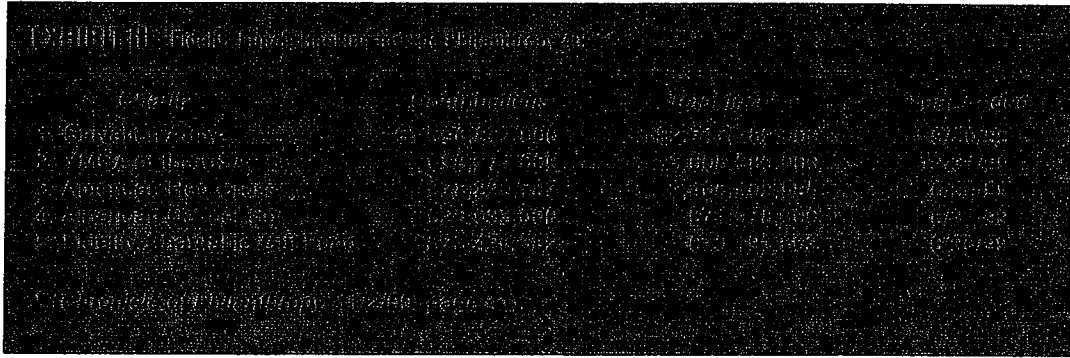
¹² Havens and Schervish, “Millionaires and the Millennium: New Estimates of the Forthcoming Wealth Transfer and the Prospects for a Golden Age of Philanthropy,” Study from Social Welfare Research Institute (Boston College, 1999).

¹³ Section 170(b)(1)(E)(iii).

¹⁴ Section 4942. The period for distribution, if the private foundation elects pass-through status, is the 15th day of the third month after the close of the fiscal year. Section 170(b)(1)(E)(ii).

¹⁵ Sections 6104, 6110.

¹⁶ Section 170(f)(8).



DAF (and having any required appraisal made). Neither does the donor need to get receipts from the ultimate distributees.

4. *Lower costs and fees.* The donor to a CF or DAF generally will have lower costs or fees charged by the CF or DAF than the founder of a private foundation, unless the foundation's administration is done on a volunteer basis.
5. *No private foundation restrictions on charitable deductions.* The donor to a CF or DAF enjoys the same charitable deduction rules as a donor to another public charity.¹⁷ Cash contributions are deductible by individuals up to 50% of adjusted gross income, and most property contributions are deductible up to 30% of adjusted gross income, in contrast to the private foundation limits for grant-making foundations of 30% and 20%, respectively. Contributions of long-term capital gain property to CFs and DAFs are deductible at fair market value, in contrast to the private foundation limit to a taxpayer's basis, with the sole exception of a fair market value deduction for stock for which market quotations are readily available.¹⁸ Thus, contributions of non-publicly traded securities, land, and art that have been held for more than a year are deductible at fair market value when given to a CF or DAF, but not when given to a private foundation.

¹⁷ Sections 170(b)(1), (e)(1).

¹⁸ Section 170(e)(5).

¹⁹ Sections 4940-4945.

²⁰ Reg. 1.507-2(a)(8)(iv)(A)(1).

²¹ *Fund for Anonymous Gifts*, 79 AFTR2d 97-2520 (DC D.C., 4/15/97), *vacated in part*, 194 F.3d 173, 83 AFTR2d 99-1796 (D.C. Cir., 4/12/99), *remanded*, No. 95-CV-1629 (DC D.C.),

²² Section 170(b)(1)(E)(iii).

6. *No private foundation rules and excise taxes.*

The private foundation rules and accompanying excise taxes do not apply to donor-advised accounts so long as they are treated as component parts of public charity CFs and DAFs.¹⁹ Thus, while CFs and DAFs are still subject to the prohibitions against private inurement, excess benefits, substantial lobbying, and any political activity, they are not subject to the rules and prohibitive excise taxes against self-dealing, failure to distribute income, excess business holdings, jeopardy investments, and taxable expenditures. They are also not subject to the rather minor tax on investment income.

7. *No donor disclosure.* The contributors to CFs and DAFs do not have to be publicly disclosed under Section 6104(b), and distributions can be made anonymously. The contributors to private foundations, by contrast, must be publicly disclosed as part of the inspection of their Form 990-PFs.

At the same time, contributions to CFs or DAFs do present some disadvantages when compared to private foundations:

1. *Restrictions on control.* The CF or DAF must have control over the donation, including the right to ignore or override donor advice, the right to determine the timing of distributions,²⁰ and the right to control investments.²¹ By contrast, the donor to a private foundation may have total control of its board of directors or trustees. The donor to a pooled common fund similarly may "designate" the income recipients annually and the corpus recipients before or at death.²²
2. *Restrictions on distributees.* The CF or DAF, in the view of the IRS, must not make distributions to private foundations (at least grant-making foundations). Donors

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may, however, recommend distributions to needy individuals or to nonexempt organizations, and private foundations may make distributions to them subject to expenditure responsibility rules and, for grants to individuals for travel, study, or similar purposes, subject to IRS preapproval of grant procedures.²³

3. *Absence of clear guidelines.* The CF or DAF must comply with all public charity standards, but it is not clear whether non-trust CFs or any DAFs must comply with the regulations in Regs. 1.170A-9(e) and 1.507. The Service takes the position that they must comply with requirements "similar" to those for trust CFs.²⁴ This lack of clear guidelines has prompted some CFs, led by Victoria Bjorklund, to propose legislation describing clearly the requirements for public charity status.²⁵

Community foundation requirements— component part and single entity

There are two tests that must be met for a "community trust" The first deals with the parts and is generally referred to as the "component part test." The second, referring to the whole, is called the "single entity test."

The component part test of Reg. 1.170A-9(e)(11)(ii) has two requirements, both of which must be met:

1. The trust or fund must be created by transfer to a community trust that is treated as a single entity under the single entity test.
2. The trust or fund may not be subject to material restrictions or conditions within the meaning of Reg. 1.507-2(a)(8).

These requirements, and thus the component part test, are redundant of other requirements. Similarly, the Service stresses that the contribution must be made "to," as contrasted with "for the use of," the community trust, even though the regulation states that all transfers to component parts of community trusts "will be treated as a transfer made 'to' a 'publicly supported community trust'" if the community trust meets the public support test.

There are six requirements in the single-entity test of Regs. 1.170A-9(e)(11)(iii)-(vi). As above, all of them must be met.

1. *Name.* The organization must be commonly known as a community trust, fund, foundation, or similar name con-

veying the concept of a capital or endowment fund to support charitable activities in the community or area.

2. *Common instrument.* The funds within the organization must be subject to a common governing instrument or master trust (which may be in one or several documents).
3. *Common governing body.* The organization must have a common governing body that either "directs or, in the case of a fund designated for specified beneficiaries, monitors the distribution of all the funds exclusively for charitable purposes." Thus, it is permissible for a donor at the time of contributing to a community trust to "designate" the specified beneficiaries.²⁶
4. *Powers of modification and removal.* The organization's governing body must have the power in a binding written document to do three things: (1) to modify any restriction or condition on the distribution of funds for specified charitable purposes or to specified organizations if the governing body, in its sole judgment without any other approval, finds that the restriction or condition is unnecessary, incapable of fulfillment, or inconsistent with charitable needs of the community or area; (2) to replace any trustee, custodian, or agent for breach of fiduciary duty; and (3) to replace any trustee, custodian, or agent for failure to produce a reasonable return of net income over a reasonable period. If one of these powers is inconsistent with state law, the community trust will be treated as meeting the requirements of such a provision if it meets it to the fullest extent possible under state law.

²³ Sections 4945(d)(3), (d)(4), (g), (h).

²⁴ Shoemaker and Brockner, *supra* note 5 at 16. The term "donor-advised fund" has been used only in a handful of private letter rulings, however. See TAM 8936002 and Ltr. Ruls. 8836033, 9412039, 9807030, 200009048, 200037053.

²⁵ Bjorklund, "Proposed Legislation on Donor Advised Funds" (rev. draft 7/24/00).

²⁶ See also Reg. 1.507-2(a)(8)(iii)(B). Accord, Johnson and Jones, *supra* note 7 at 135. The IRS has stated there, however, that such funds are not "to" but "for the benefit of" the community trust. On the other hand, the IRS also said that the decision in National Foundation, Inc., 13 Cl. Ct. 486, 60 AFTR2d 87-5926 (Cl. Ct., 1987), implicitly "indicates that such donor-controlled contributions are gifts 'to' corporate-form organizations."

5. **Reasonable return.** The governing body must commit itself affirmatively to obtain information and take steps appropriate to seeing that each trustee, custodian, or agent—for each restricted trust and for the aggregate unrestricted trusts—administers the trust or fund in accordance with the terms of its governing instrument and accepted standards of fiduciary conduct. Trusts must be administered to produce a reasonable return of net income or of appreciation where not inconsistent with the trust's need of current income, with due regard to the safety of principal, and in furtherance of the exempt purposes of the community trust, except for assets held for the active conduct of exempt activities.
6. **Common reports.** The organization must prepare periodic financial reports (for non-church community trusts, including a Form 990) treating all the funds as funds of the organization.

Community foundation requirements—no material restriction

The component part test incorporates the private foundation rules of Reg. 1.507-2(a)(8), adapted to apply to the community foundation. The reasoning is that a fund with a material restriction is not a component part, and that a gift with a material restriction is not a completed gift.²⁷ The requirements are extensive.

Factors indicating whether a restriction is material. Any of the following four factors indicate that a restriction is material.

1. **Ownership.** Whether the community foundation is the owner in fee of the assets it receives.
2. **Consistency with exempt purposes.** Whether the assets are to be held and administered by the community foundation consistent with one or more of its exempt purposes.
3. **Governing body control.** Whether the governing body of the community foundation has the ultimate authority and control over the assets.
4. **Independence.** Whether the governing body of the community foundation is organized and operated to be independent from the donor.

²⁷ Reg. 1.507-2(a)(8)(i).

²⁸ Reg. 1.507-2(a)(8)(iv).

The independence of the governing body is “one of the more significant facts and circumstances,” and some of the ways in which it can be shown include the following:

- Whether members of the governing body are not selected by the donor or disqualified persons of the donor, or are disqualified persons with respect to the donor.
- Whether members of the governing body are selected by public officials.
- How long each member of the governing body may serve.

Neutral factors. The following four factors do not adversely affect the determination.

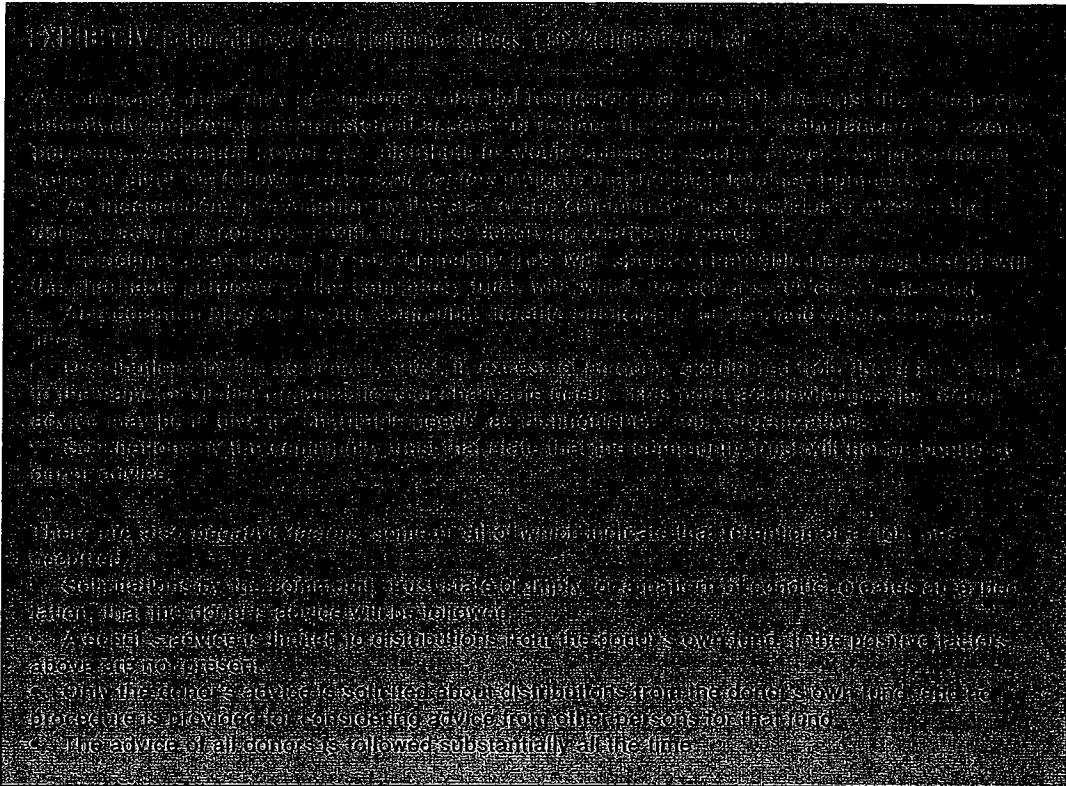
1. **Name.** The fund can be given a name that is the same as or similar to the donor's, and may memorialize the donor or the donor's family.
2. **Purpose.** The income and assets of the fund may be used for a “designated purpose” or for specified public charities, so long as that use is consistent with the exempt purposes of the community trust.
3. **Administration.** The contributed assets may be administered in an identifiable or separate fund. Some or all of the principal may be restricted from distribution for a specified period, if the community trust is the legal and equitable owner of the fund, the governing body exercises ultimate and direct authority and control over the fund, and the transferred assets are administered in or as a component part of the community trust. The example given is a chair at a university or a medical research fund at a hospital.
4. **Restrictions on disposition.** The donor may, at the time of contribution, require the retention of the property, if that retention is important to the achievement of charitable or similar purposes because of the peculiar features of the property. The example given is a woodland preserve that must be maintained as an arboretum.

Adverse factors. Any of the following factors prevents the community trust from freely and effectively employing the transferred assets—or income from them—in furtherance of its exempt purposes, and so can be a material restriction.²⁸

1. **Retained power over distributions.** It is an adverse factor if a disqualified person with respect to the donor, or a person designated by the donor or a disqualified



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person, either reserves the right to name the persons to which the community trust must distribute, or reserves the right to direct the timing of distributions. Advice from the donor is permissible, but will be examined "carefully." Designating public charity recipients in the instrument of transfer is permissible. Directing the timing of distributions in the instrument of transfer, to the extent of saying that some or all of the principal may not be distributed for a specified period, is permissible so long as it does not preserve specific assets. Factors indicating whether power over distributions has been retained are shown in Exhibit IV, above.

2. *Other action or withholding of action.* It is an adverse factor if the transfer agreement—or any express or implied understanding—requires the community trust to take or withhold action regarding the transferred assets that is not designed to further one or more exempt purposes of the public charity, if the action or withholding would have subjected a transferor private foundation to excise taxes other than for failure to make minimum distributions.
3. *Assumption of leases or other obligations.* It is an adverse factor if the community trust

assumes leases, contractual obligations, or liabilities of the donor, or takes assets subject to such liabilities, for purposes inconsistent with the charitable purposes or best interests of the community trust.

4. *Required retention of investment assets.* It is an adverse factor if the community trust is required by a restriction (other than of law or regulatory authority), express or implied, to retain any securities or other investment assets transferred to it. If transferred assets produce a consistently low return, the IRS will examine carefully whether they were required to be retained.
5. *Rights of first refusal.* It is an adverse factor if the donor or any disqualified person is granted by agreement a right of first refusal for transferred securities or other property, unless the securities or other property were acquired by the donor subject to that right of first refusal and prior to 10/9/69.
6. *Required retention of relationships.* It is an adverse factor if the donor enters an agreement with the community foundation establishing irrevocable relationships with regard to maintenance or management of donated assets, such as continuing relationships with banks, brokers, investment advisors, or other advi-

EXHIBIT V. Tax and funding rulings issued by the IRS involving DAFs

1990's

- 9501046 A private foundation transferred its assets to a DAF within a CF, which were contributed to the foundation to fund the foundation's charitable purposes. The assets were contributed to the foundation for the purpose of the donor's pooled common fund provision. The donor advised the foundation.
- 9526124 A private foundation transferred its assets to a DAF within a CF, which were contributed to the foundation to fund the foundation's charitable purposes. The assets were contributed to the foundation for the purpose of the donor's pooled common fund provision. The donor advised the foundation.
- 9530024 A private foundation transferred its assets to a DAF within a CF, which were contributed to the foundation to fund the foundation's charitable purposes. The assets were contributed to the foundation for the purpose of the donor's pooled common fund provision. The donor advised the foundation.
- 9521142 A private foundation transferred its assets to a DAF within a CF, which were contributed to the foundation to fund the foundation's charitable purposes. The assets were contributed to the foundation for the purpose of the donor's pooled common fund provision. The donor advised the foundation.
- 9536024 A private foundation transferred its assets to a DAF within a CF, which were contributed to the foundation to fund the foundation's charitable purposes. The assets were contributed to the foundation for the purpose of the donor's pooled common fund provision. The donor advised the foundation.
- 9527038 The IRS has only twice established a rule for the purpose of DAFs (with the exception of the Service's approval of the DAFs for that purpose in 1995 and 2000). The Service approved a private foundation grant to a CF to support the research team in the 1995 case, and the Service indicated in a 2000 ruling that the IRS had not issued a ruling on the issue of exchange and self-dealing by the founders of government.
- 9504021 A charitable lead trust made a grant to a DAF within a CF, which was proposed to fund the construction of a fountain in a city plaza. The Service approved the grant.
- 9762076 A fund within a CF was properly established by a private foundation for the funding of scholarships, and the scholarship program did not violate the self-dealing rules. (The ruling did not address the taxable expenditure rules.)
- 9807030 A DAF within a CF was a component part, and there were no material restrictions on the assets transferred. The transferor was a private foundation that would give the donor advice.
- 200028638 A private foundation's transfer of its assets to a DAF within a community foundation was not a taxable termination, and did not result in excise taxes on self-dealing, jeopardy investment, or taxable expenditure. (The author obtained this ruling.)
- 200009048 A private foundation transferred all its assets to a DAF within a CF, and that did not constitute a taxable termination under Section 507. The foundation's board of directors would give donor advice.

sors. It is not adverse, however, to have an agreement with a trustee, custodian, or agent of the community trust itself, or to have relationships created under a pre-1976 agreement, if continuing those relationships is in the best interests of the community trust.

- 7. *Other factors.* It is an adverse factor if any other condition is imposed on the community trust that prevents it from exercising ultimate control over the assets donated for its exempt purposes.

It is difficult to understand why it is a "material" restriction if the donor to a CF or DAF can make binding designations or direct distributions to public charities. There is no

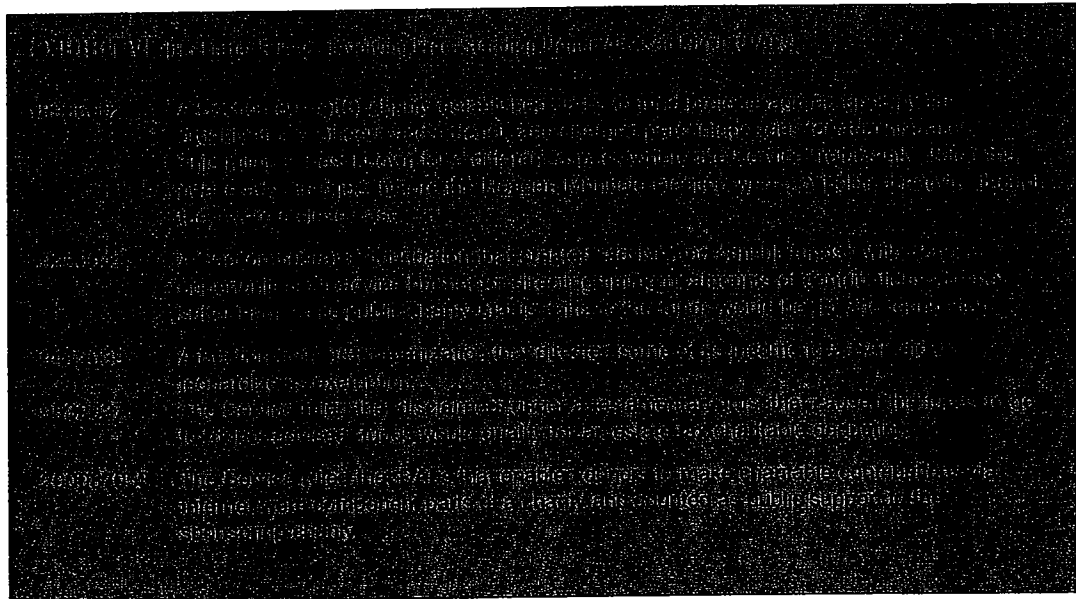
abuse potential, so long as such a gift counts only toward public support of the ultimate distributee, and is subject to the 2% rule in calculating public support.²⁹ The Service has argued otherwise,³⁰ and has made the valid point that this would render the pooled common fund provision unnecessary (donor direction to public charities), and would render the pass-through private foundation provision unnecessary, if donor directed funds could do the same thing. The Green Book last year acknowledged that a DAF would not be disqualified simply because the charity regularly followed donor advice.

Community foundation requirements—the Service's positions

There have been a number of IRS private letter rulings involving funds sponsored by CFs, summarized in Exhibit V, above, as well as the

²⁹ Reg. 1.170A-9(e)(6)(i). The public charity exception does not apply, and the 2% rule does, when a distribution was earmarked. Regs. 1.170A-9(e)(6)(v), 1.509(a)-3(j)(3).

³⁰ See Shoemaker and Henchey, *supra* note 5 at 328.



rulings involving free-standing DAFs that are summarized in Exhibit VI, above. In other rulings, the Service has dealt with CFs without ruling on DAFs specifically.³¹

What happens if the CF fails the single entity test or component part test? The individual fund then fails to qualify as a component part. The most likely alternative is that it becomes a private foundation,³² with the disadvantages listed above. Those who argue that the regulations apply to only trust CFs, and not to corporate CFs or DAFs, point out that the individual fund is not an entity that can be treated as a private foundation, so it cannot become a private foundation. It appears, however, that the individual fund becomes an unincorporated association, governed by articles of organization consisting of the CF or DAF procedures, and thus can be treated as a private foundation. Another alternative is that the fund becomes a pooled common fund under Section 170(b)(1)(E)(iii).

Non-trust community foundations? The Service acknowledged some years back that whether or not the rules described above also apply to non-trust CFs is a matter of debate.

The arguments for applying these requirements beyond trust CFs include the fact that Regs. 1.170A-9 and 1.507 refer principally to "community trusts," and presuppose a trust form of organization.³³ The Court of Claims in *National Foundation, Inc.*, 13 Cl. Ct. 486, 60 AFTR2d 87-5926 (Ct. Cl., 1987), dealt with an incorporated CF, and implied that the regulations would not apply by never mentioning them

or applying them. With the statement that the National Foundation is "a unitary organization," the court also said that funds within corporate organizations are mere accounts and not separate organizations. GCM 39748, 8/3/88, suggested that corporate-form CFs could not take advantage of Reg. 1.170A-9(e) for trust-form CFs, which is what "caused the withdrawal of the GCM."³⁴

On the other hand, the regulations refer to trusts simply because nearly all CFs were trusts, and DAFs did not yet exist. One can argue that the requirements should be applied to non-trust and corporate CFs and DAFs because the same rules should apply to all functionally similar entities. The law of charitable trusts applies

³¹ E.g., Ltr. Ruls. 8635044, 8831006, 8906008, 9016078, 9203038, 9212030, 9551033. A case from the New York Surrogate's Court is also of interest. In *Community Service Society v. The New York Community Trust*, the issue was whether the CF was improperly redirecting income from bequests that were to benefit Community Service Society. The judge ruled against the CF, saying it had not shown the Society's activities had changed so much that the donors (including a Rockefeller memorial trust and the wife of film maker D.W. Griffiths) would have redirected the funding. See McMorris, "Community Foundations' Power to Alter Recipients of Donations Is Restricted," *Wall St. J.*, 10/25/99, page B20.

³² Reg. 1.170A-9(e)(14). See generally Johnson and Jones, *supra* note 7 at 135 (noting also that the lapsed fund could possibly become a supporting organization or could possibly be described in other provisions of Sections 509(a)(1)-(4)).

³³ E.g., Bjorklund, *supra* note 8 at 8.

³⁴ Johnson and Jones, *supra* note 7 at 149. GCM 39748, 8/3/88, was withdrawn by GCM 39875, 7/6/92, which stated that the Service withdrew the earlier Memorandum because it "has been applied in factual circumstances beyond those we contemplated."

to nonprofit corporations, as the U.S. Supreme Court ruled in *Bob Jones University*, 461 U.S. 574, 52 AFTR2d 83-5001 (1983). Clear rules are a good way to let organizations know if they are complying or not.

Must the community be geographical?

The Service has taken the position that a CF must serve a limited geographical area, whereas a DAF may serve a larger or national area, based on the reference in the regulations to a "community or area."³⁵

That does not appear to be a proper interpretation of the requirements, and it also offers a troublesome handicap to CFs in comparison to DAFs. Instead, the regulations appear, for several reasons, to define the community to be either a geographical area or a topical community.

1. *"Area" distinguished.* The phrase "community or area" in the regulations distinguishes a community from an area. The term "area" in this context almost certainly refers to a geographic region. The term "community" presumably must refer to something different; otherwise, it would be superfluous.

2. *Use in other regulations.* In Reg. 301.6110-3(a)(1)(ii), the portions of exempt organization tax returns that are open to public inspection are described and "community" is expressly defined to allow a national "community" not limited to a geographical area:

The "appropriate community" is that group of persons who would be able to associate a particular person with a category of transactions one of which is described in the written determination or background file document.... The appropriate community may vary according to the nature of the transaction which is the subject of the written determination. For example, if a steel company proposes to enter a transaction involving the purchase and installation of blast furnaces, the "appropriate community" may include all steel producers and blast furnace manufacturers, but if the installation process is a unique process of which everyone in national industry is aware, the "appropriate community" might also include the national industrial community.... [Emphasis added.]

3. *Recognized in precedent.* The Court of Claims overturned the denial of exemption to a community foundation that was strictly national in *National Foundation, Inc.* The decision notes that the National Foundation's "operations are similarly unrestricted geographically." That decision was rendered when

³⁵ Regs 1.170A-9(e)(10), (11)(v)(B)(1), (11)(v)(C)(1)(i).

³⁶ E.g., Carter, *The Culture of Disbelief* (Basic Books, 1993).

free-standing DAFs did not exist, and when only CFs were recognized. Similarly, in private letter rulings as recent as Ltr. Rul. 200037053, the Service noted that a donor-advised fund would "operate like an on-line nationwide community foundation, giving donors the ability to contribute to X, support charitable activity all around the country, and participate in philanthropy."

4. *Common characteristics.* The usual definition of "community" includes groups of people that share a common characteristic or characteristics, whether that characteristic is a geographic location or something entirely different. The most common current use of the term is "community of faith" to represent all religious people,³⁶ or to represent subgroups of religious people. For example, the Amish are a distinctive community of people that share the same cultural, religious, and social heritage and expression. This community, however, does not exist in one defined geographic region, but rather in pockets throughout the eastern United States. Each geographic settlement may be too small to make a community foundation cost-effective, but the entire Amish community may allow a community foundation to be feasible. It would be a rule without reason for the Service to require ten identical community foundations for ten geographical pockets rather than one community foundation for them all. It is difficult to conceive that the ten could qualify as community foundations, while the one could not even though it is identical to the ten. The same would be true of all small religious organizations, and of many larger ones.

5. *Interpretations should make sense.* It would not make sense to impose a geographical prerequisite, particularly in today's world of instant communications, greater personal mobility, and national giving. The imposition of a geographic distinction on the term "community" would thwart the intent and purpose of the existence of community foundations in the context of the present day. While community foundations initially were predominant for specific geographic areas, advances in transportation, communication, and personal mobility since 1914 have created various communities of people who are not residents of the same geographic area, but are easily joined together by other shared characteristics.

6. *Avoiding an unfair advantage to DAFs.* DAFs are nearly all national, and gain economies of

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scale from that. CFs should not be put at a disadvantage by dubious interpretation of regulations that may not even apply to the corporate CFs. CFs can serve charitable needs, just as DAFs do, just as well in a larger area as in a smaller area.³⁷

Donor-advised fund requirements

The Service initially questioned whether DAFs could qualify for exemption, and delayed approval of Fidelity's exemption application. The CPE manual noted:

One can argue that if a gift fund's role is limited to administrative and managerial duties with respect to the funds it holds, it conducts no charitable program; and, as discussed above, funds it holds are not support to it.³⁸

That article concluded much more moderately, however, stating that:

Finally, the commercial donor directed fund should be scrutinized to determine if it qualifies....³⁹

The Service essentially took this position, unsuccessfully, in *National Foundation, Inc.* That DAF did not purport to be a community foundation, and the Court of Claims granted its exemption and did not subject it to the requirements of Regs. 53 1.170A-9(e) and 1.507-2.

Assuming the 1.170A-9(e) regulations do not apply to DAFs, what rules do govern them? The Service says that it reviews DAFs "using the principles similar to the material restriction or condition requirements of Reg. 1.507-2(a)(8),"⁴⁰ but does not expressly refer to the rest of the component part test or the single entity test. The Service elsewhere has said that "both groups are subject to the same rules,"⁴¹ and has referred to similar but unclear rules. These rules are fairly similar to the Administration's Green Book proposals in February 2000.

The component part requirement. As noted above, the Service initially approved "donor-advised funds" and "donor-directed funds" in GCM 39748, which was later withdrawn.

In *National Foundation, Inc.*, the Service denied exemption to a free-standing DAF formed as a corporation, and the Court of Claims granted the exemption. The National Foundation created DAFs that would make grants to Section 501(c)(3) organizations, and that prohibited private benefit to the

donors or others. While the Service argued that at best each fund was a separate private foundation, the Court of Claims agreed that they together were a public charity, in effect, with component parts.

In *Estate Preservation Services*, 202 F.3d 1093, 85 AFTR2d 2000 (CA-9, 2000), the Ninth Circuit found New Dynamics Foundation, which had DAFs among its various facets, to be an abusive tax shelter.

There have been numerous letter rulings, some of which are summarized in Exhibit VI. In addition, various letter rulings refer to "donor-advised funds" in community foundations.⁴²

No material restrictions. The Service has tried to manipulate the CF rule in Reg. 1.507-3(a)(8)(B)—under which it is a negative factor for material restrictions if the donor "required the public charity to take or withhold action"—into meaning that "a public charity's failure to distribute the minimum that it would be required to distribute if it were a private foundation may indicate a degree of donor control inconsistent with achieving charitable purposes."⁴³ The IRS says that meeting the minimum distributions requirement for private foundations will cause this "not [to] affect the fund's exempt status."⁴⁴

In *Fund for Anonymous Gifts*, 79 AFTR2d 97-2520 (DC D.C., 4/15/97), *vacated in part*, 194 F.3d 173, 83 AFTR2d 99-1796 (D.C. Cir., 4/12/99), *remanded*, No. 95-CV-1629 (DC D.C.), the Service argued successfully at the U.S. district court level that a donor's retaining investment authority amounted to a material restriction, and that the fund was not entitled to exemption. Interestingly, that court compared the fund to the Fidelity Gift Fund, and described the latter as clearly charitable and exempt. The District of Columbia Circuit reversed, after the fund abandoned the retained investment power, and referred to "the government's

³⁷This "community or area" point is currently being discussed with the National Office by the author in connection with a pending ruling request.

³⁸Shoemaker and Henchey, *supra* note 5 at 346.

³⁹*Id.* at 347.

⁴⁰Shoemaker and Brockner, *supra* note 5 at 116.

⁴¹Shoemaker et al., "Donor Control," *Exempt Organizations Continuing Professional Educational Technical Instruction Program for FY 1999* (1998), page 297.

⁴²8134046, 8836033, 9530024, 9537035, 9604031, 9807030.

⁴³Shoemaker et al., *supra* note 41 at 300.

⁴⁴*Id.* at 301.

apparent intransigence.” It ordered the trial court to enter summary judgment granting the fund a Section 501(c)(3) exemption, and remanded to the trial court to determine whether the fund was a public charity or a private foundation.

The Service’s informal requirements. The Service, under the able guidance of Ron Shoemaker and Bill Brockner in the rulings area, has crafted some requirements that DAFs must meet:

Common elements in these cases include representations by the applicant organizations that subject them to conditions similar to those imposed on private foundations under IRC 4942 and 4945:

- i. The organization expects that its grant distributions for the year will equal or exceed 5 percent of its average net assets on a fiscal year rolling basis. If this level of grant activity is not attained, the organization will identify the named accounts from which grants over the same period totaled less than 5 percent of each account’s average assets. The organization will then contact the donor-advisors of these accounts to request that they recommend grants of at least this amount. If a donor-advisor does not provide the qualified grant recommendations, the organization is authorized to transfer up to 5 percent of assets from the donor-advisor’s named account to the charity selected by the organization.
- ii. The organization will add language to its promotional materials which indicates that the organization will investigate allegations of improper use of grant funds for the private benefit of donor-advisors.
- iii. The organization will add language to its grantee letters to the effect that grants are to be used by grantees exclusively in furtherance of charitable purposes, and cannot be used for the private benefit of donor-advisors.

These representations were critical factors in establishing exemption and public charity status, but do not by themselves assure exemption or public charity status in any particular case.⁴⁵

The Service is also “considering whether this triggering mechanism [whereby distributions

may be triggered only by donor recommendations] should be a negative factor.”⁴⁶

The Service does not apply Reg. 1.170A-9(e) to DAFs directly, because those regulations repeatedly refer to “community trusts.” It applies the substance of them, however, along with the above informal requirements. It is ambivalent in saying “both groups are subject to the same rules.”⁴⁷

One-source relation to mutual fund? The Fidelity Gift Fund application for exemption was approved by the Brooklyn key district without review by the IRS National Office, but the IRS was watching when American Guaranty and Vanguard came visiting with their exemption applications. The Service imposed the informal requirements described above, and required American Guaranty to change the gift fund name to reduce the similarity with the mutual fund name,⁴⁸ but approved the exemptions despite the exclusive relation to the sponsoring mutual fund.⁴⁹

Counsel for one community foundation prepared a publicly circulated legal memorandum arguing that a DAF furthers a substantial nonexempt purpose, paying fees to the commercial sponsor, when it has an exclusive or primary relationship to a mutual fund.⁵⁰

The author does not see it as any less appropriate for a mutual fund to form a DAF and have an exclusive relationship with it, than for a bank or trust company to form the first CF and for most CFs to have an exclusive relationship with a particular bank, trust company, or broker. So long as the service provider is not charging more than it charges comparable customers, or more than comparable service providers would charge the fund, the service provider is simply being fairly compensated for services that someone would need to provide and has taken the entrepreneurial risk of funding the startup costs for another vehicle for charity. That should be commended, not condemned.

How to establish a community foundation or donor-advised fund

One author has summarized the minimum steps necessary to create a DAF under current law:

An organization described within Section 501(c)(3) can create a donor-advised fund program to further its exempt purposes by (1) adopting a resolution creating the program, (2) creating



THE SERVICE INITIALLY QUESTIONED WHETHER DONOR-ADVISED FUNDS COULD QUALIFY FOR EXEMPTION

⁴⁵ Shoemaker and Brockner, *supra* note 5 at 221-22.

⁴⁶ *Id.* at 220.

⁴⁷ Shoemaker et al., *supra* note 41 at 297.

⁴⁸ Boisture and Mayer, “Weighing the Alternatives to Private Foundations,” 11 JTEO 257 (May/June 2000).

⁴⁹ Paul Streckfus’ EO Tax J. 33 (May 1998); Paul Streckfus’ EO Tax J. 37 (June 1998).

⁵⁰ Rodriguez, Choi, and Mittermaier, “The Tax-Exempt Status of Commercially Sponsored Donor Advised Funds,” 17 Exempt Org. Tax Rev. 95 (July 1997).

THERE WAS MUCH TALK OF LEGISLATION TARGETING THE 'INCURSION OF FOR-PROFIT COMPANIES.'

documentation and procedures for soliciting and considering donors' advice, and (3) creating separate accounts and payout procedures. An existing public charity or private foundation should advise IRS of a not-previously-reported activity on Form 990 in the year it launches a donor-advised fund program.⁵¹

The Service's informal requirements (at least if a fund wants an exemption or a ruling), summarized above, call for

1. Distributions of 5%, or remedial action.
2. Express warnings against private benefit by donors.
3. Express language in grantee letters against private inurement.⁵²

Possible legislation or rules

Many community foundations "protested to government officials" when the commercially sponsored DAFs arose, and targeted the "incurSION of for-profit companies, led by Fidelity Investments, into philanthropy." There was much talk of legislation, and meetings with members of Congress in early 1998. The talk continued in 2000.⁵³

The Green Book proposal. The Clinton Administration included proposed restrictions on DAFs in its Green Book in early 2000, though the proposal did not result in proposed legislation.⁵⁴ Under the proposal, a charitable organization that had, as its primary activity, the operation of one or more DAFs, could have qualified as a public charity only if:

1. There was no material restriction or condition preventing the organization from freely and effectively employing the assets in such DAFs, or the income therefrom, in furtherance of its exempt purposes.
2. Distributions were made from such DAFs only as contributions to public charities (or private operating foundations) or governmental entities.
3. Annual distributions from DAFs equaled at least 5% of the net fair market value of the organization's aggregate assets held in DAFs (with a carryforward of excess distributions for up to five years).

The proposal would also have amended the definition of disqualified person under the Section 4958 intermediate sanctions to clarify that a person who is a donor or a designated advisor to a particular DAF maintained by any public charity (and such person's family

members and controlled entities) would be treated as having substantial influence with respect to any transactions involving that particular fund.⁵⁵

The definition of "material restriction" would have been based on Reg. 1.507, but the existence of a material restriction would not have been "presumed from [the] fact that a charity regularly follows a donor's advice." Failure to comply with these requirements would have triggered treatment as a private foundation. Organizations offering DAFs, but not as a primary activity, also would have been subject to these requirements.

The Green Book proposal would have applied to CFs and commercial DAFs.

The community foundation Code amendment. In May 2000, the Council on Foundations gave Congress a proposal for Code changes to govern DAFs that was generally consistent with the Green Book proposals, but more detailed.⁵⁶

Victoria B. Bjorklund, the vice-chair of the ABA Committee on Exempt Organizations and counsel to some DAFs, coordinated the drafting of proposed legislation—released a week after the Council on Foundations paper—by a DAF Working Group.⁵⁷ That group initially included most of the leading commercially sponsored DAFs (listed in Exhibit II),⁵⁸ and gained the co-sponsorship of several CFs,

⁵¹ Bjorklund, *supra* note 8 at 41.

⁵² Shoemaker and Brockner, *supra* note 46 at 217, 221-22.

⁵³ E.g., Billitteri, "Support Grows for Adoption of New Federal Rules on Donor-Advised Funds," *Chronicle of Philanthropy*, 4/20/00.

⁵⁴ Note 1, *supra*; see also Joint Committee on Taxation, Description of Revenue Provisions Contained in the President's Fiscal Year 2001 Budget Proposal 241 (3/6/00).

⁵⁵ Similarly, DAFs of private foundations would have been subject to self-dealing rules under Section 4941.

⁵⁶ Council on Foundations, "Response to Proposal To Enact Standards for Operating Donor-Advised Funds In a Manner Consistent with the Requirements of Section 501(c)(3)" (5/11/00). Among the more thoughtful comments on the legislation was Hoyt, "Framework for Donor Advised Fund Legislation," *Charitable Gift Planning News* 5 (March 2000).

⁵⁷ Bjorklund, *supra* note 25. Ms. Bjorklund had proposed similar legislation in her presentation at the National Center on Philanthropy and the Law at NYU School of Law, "Charitable Giving To a Private Foundation and the Alternatives, the Supporting Organization and the Donor-Advised Fund" (10/28-29/99).

⁵⁸ The nine sponsoring charities were the American Guaranty Fund, U.S. Charitable Gift Trust, Fidelity, Schwab, Vanguard, National Philanthropic Trust, Raymond James, Ayco Charitable Foundation, and the Fund for Charitable Giving. The attorney participants were Victoria Bjorklund, Fred Goldberg, Celia Roady, and Howard Schoenfeld. Bjorklund, *supra* note 25 at 2, fn. 7.

such as National Christian Charitable Foundation. The proposed bill, which has not been introduced in Congress as of this writing, is a more sophisticated approach than the Green Book's. It provides that:

1. A DAF would be defined in Section 170, which would acknowledge that a contribution to a DAF is a contribution to a public charity.
2. A minimum distribution of roughly 5% of asset value would be required, via an excise tax, of each DAF organization but not of each individual fund. This would be similar to the private foundation rule in Section 4942.
3. A prohibition on self-dealing by DAFs with donors would be imposed, via an excise tax, similar to the private foundation rule in Section 4941.

4. The excise taxes would be subject to abatement in appropriate circumstances.⁵⁹

And the Service? The Service doubtless will issue examination guidelines for DAFs and possibly for CFs, and will continue to discuss the issue in its CPE Manual. A Revenue Ruling would be useful, but it seems that those are no longer issued in the exempt organization area. ■

Conclusion

The 1990s saw a donor-advised fund surpass all but two other charities in annual donations and, not coincidentally, saw the IRS change from mounting an attack to recognizing a permanent new charitable vehicle. The 2000s are likely to see massive growth in the donor-advised fund segment of the nonprofit world, not by drawing donations away from other nonprofits, but by attracting a growing portion of the \$41 trillion wealth transfer over the years 1998-2052. This should be welcomed, not feared. ■

⁵⁹ "A Bill To Amend the Internal Revenue Code of 1986 To Clarify the Rules Applicable to Donor Advised Funds" (rev. draft 6/8/00).