

THE PROS AND CONS OF DONOR ADVISED FUNDS AS ALTERNATIVES TO PRIVATE FOUNDATIONS¹

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This outline focuses on factors a donor should consider in choosing a donor advised fund over the alternatives, private foundations and supporting organizations.

I. THE POPULATION

According to NY Times reporter Stephanie Strom, "From 1990 to 2000, the number of private foundations in the United States increased 75 percent to almost 57,000, compared to an increase of 47 percent in the 80's. By far, the biggest growth was for foundations with less than \$10 million in assets."²

On May 15, 2003, the Chronicle of Philanthropy survey reported the existence of 70,066 DAF accounts, a number which now exceeds the number both of the 57,000 private foundations and the 29,843 supporting organizations recorded by IRS. But foundations still control far more in aggregate assets: sponsoring charities of DAFs surveyed by the Chronicle of Philanthropy in 2002 held \$12.3 billion in assets, compared with \$359 billion for the 8,502 independent foundations listed in The Foundation Directory, 2003 Edition.

The absolute number of sponsoring charities of donor-advised funds remains relatively small: There are probably no more than 800 sponsoring charities of donor-advised funds in the United States today, with the vast majority of sponsoring charities being community foundations (about 550 community foundations offer DAFs). (Of course, each sponsoring charity may administer dozens or hundreds or thousands of individual donor-advised fund accounts.)

As of December 31, 2002, there were 29,843 organizations qualified as supporting organizations under section 509(a)(3), up from 25,962 in 1999. By way of comparison, there were 501,268 organizations classified as §509(a)(1) public charities and 223,731 §509(a)(2) public

¹ Copyright © 2004 Victoria B. Bjorklund. This outline builds upon "The Emergence of the Donor-Advised Fund," presented at Georgetown University's 15th Annual Conference on Representing and Managing Tax-Exempt Organizations and reprinted at 3 Paul Streckfus' EO Tax Journal 15 (May 1998), 13 prior outlines on this topic published by ALI-ABA, and a paper delivered at the October 1999 meeting of The National Center on Philanthropy and the Law at NYU Law School, which was published in 27 E.O.T.R. 107 (Jan. 2000).

² "New Philanthropists Find Drudgery—Giving Away Cash Can Be More Cumbersome Than Glamorous," N.Y. Times, January 12, 2003.

charities as of December 31, 2002. The §509(a)(1) public charities include almost all of the charities that sponsor donor-advised funds.

II. CHOOSING AMONG A PRIVATE FOUNDATION, A DONOR-ADVISED FUND, A SUPPORTING ORGANIZATION, AND A PUBLIC CHARITY

The main advantage of a private foundation over the alternatives can be summarized in one word: Control. Generally, determining the degree of control that the donor requires will determine whether the donor must have a private foundation. If the donor is willing to give up some control over her gift, she can gain other advantages, including greatly reduced administrative responsibilities and costs. For a donor who is committed to becoming a philanthropist, no alternative other than the private foundation may provide a degree of control sufficient to allow the donor to achieve her goals. See Appendix A for a comparison of control by type of entity. This broadest latitude is the reason that private foundations are recognized as the free agents of the charitable world: They are not answerable to large public memberships or required continuously to raise funds, as are most public charities, including sponsoring charities of donor-advised funds. They enable the donor to refer grant seekers to her foundation, where their proposals can be evaluated against the donor's charitable goals. They can provide anonymity in giving and a shield from nonprofit bulk mail. But, as Stephanie Strom has also reported, new foundation managers have found that the legal requirements of running a foundation required "far more time and expense than they had imagined."³

But the features that make a private foundation so attractive are also present in a donor-advised fund in somewhat diluted form. Specifically, the donor may make non-binding grant recommendations for charitable grant making but is relieved of administrative and investment authority (and burdens). Thus, for many donors, the donor-advised fund represents the best of both worlds.

The donor-advised fund focuses on values important to contemporary donors: involvement and efficiency⁴ and all with significantly lower operating costs than would apply to a private foundation or supporting organization. Part of donor-advised funds' appeal is their ease of use: donors can open a gift account by application and delivery of a check or wire transfer without any advice of counsel or legal documents like certificates of incorporation or trust instruments. Most accounts can easily be opened online.

The first major advantage of a gift to a donor-advised fund over a gift to a private foundation is that federal tax law does not subject sponsoring-charities of donor-advised funds to the private-foundation excise-tax system discussed below.

³ "New Philanthropists Find Drudgery—Giving Away Cash Can Be More Cumbersome Than Glamorous," N.Y. Times, January 12, 2003.

⁴ See, e.g., "'Wired': Giving With a Bottom Line," Chronicle of Philanthropy, p. 37 (Sept. 9, 1999) ("A new breed of donors is trying to reinvent the art of philanthropy, matching generosity with the no-nonsense rules of business, Wired Magazine writes...."); "The Radical Philanthropist," Forbes p.114 (May 1, 2000).

The second major advantage is that a gift to a donor-advised fund is almost always a gift to a public charity. Therefore, it is subject to the more favorable public charity percentage and other limitations, which do not apply to gifts to most private foundations.⁵

III. COMPARISON OF CONTRIBUTIONS

There are three income-tax differences for the living donor who gives to an organization classified as a private foundation rather than as a public charity: treatment of gifts of cash, treatment of gifts of appreciated property, and valuation of gifts of appreciated property.⁶

First, an individual who donates cash generally is limited to deducting as a charitable contribution in any year an amount equal to no more than 50% of the donor's adjusted gross income. This 50% limitation applies to cash gifts to public charities (including the supporting organization and typical donor-advised fund) and to three types of special private foundations.⁷ Cash gifts to the main types of private foundations (namely, the usual endowed or family foundation) can be deducted up to 30%.

Second, the deduction limitations on gifts of appreciated property are 30% of adjusted gross income for gifts to public charities and to the three types of private foundations identified above, but 20% for gifts to main types of private foundations. If in any year the donor exceeds either of these limitations, the excess can be carried forward for the next five years.

Third, in addition to the percentage limitations for gifts of appreciated property, gifts of appreciated property to a private foundation are generally deductible only at basis, not at fair market value.⁸

Code section 170(e)(5) permits donors to deduct the full fair market value (up to their maximum percentage limitations) of gifts to a private foundation of qualified appreciated stock, which is stock

- for which market quotations are available on an established securities market,
- which is capital gain property in the donor's hands, and
- in a company of which the donor and her family will have contributed less than 10% in value, counting prior contributions.

⁵ Section 170. All section citations unless otherwise noted, are to the Internal Revenue Code of 1986, as amended (the "Code"). Operating and pass-through foundations are exceptions to this general rule.

⁶ The estate tax rules do not contain the same limitations.

⁷ They are the private operating foundation, the flow-through foundation, and the pooled common fund. Section 170(b)(1)(E)(i), (ii), and (iii).

⁸ Section 170(e)(1)(B)(i), although three types of foundations listed in the previous footnote qualify for the more favorable limits applicable to public charities. *Id.*

This rule applies only to gifts of qualified appreciated stock and does not apply to other types of appreciated property. As stated above gifts of appreciated property to public charities, a category which includes the sponsoring charities of almost all donor-advised funds and the supporting organization, are deductible at fair market value. Therefore, in weighing the alternatives to the private foundation, the donor-advised fund--with its relative administrative ease, lower costs, and equal-or-higher deductibility limitations--and the supporting organization are attractive alternatives to a private foundation, especially if the donor has appreciated property other than publicly-traded stock to contribute.

IV. WHAT IS A COMMUNITY FOUNDATION?

Despite the word “foundation” in its name, a community foundation is classified as a public charity, rather than a private foundation, for federal income tax purposes. This is because, by aggregating its component funds (if separate trusts) and carrying on a fund-raising program through banks, lawyers and other professionals, a community foundation can satisfy the mechanical public support test.⁹ This ability to aggregate multiple trusts and funds rather than treat those “component funds” as separate private foundations¹⁰ is a distinguishing feature of community foundations. Most new community foundations, however, are formed as corporations which manage segregated accounts, rather than separate trusts subject to the component-part tests. The component-part rules are not coherent when applied to corporations with segregated accounting entries rather than component entities. Nonetheless, many corporate community foundations have voluntarily adopted the rules applicable to community foundations in trust form.

Community foundations are among the fastest-growing subset of the U.S. philanthropic sector, thanks in large part to their donor-advised fund accounts. In 1995, there were more than 500 community foundations in the United States, up from approximately 400 in 1992.¹¹

A distinguishing characteristic of a community foundation is its separation of the investment function from the disbursement function. According to one commentator, this separation of functions allows each side to do what it does best: The trustee banks do best at making investments and the management committees do best at making grants that address the needs of the particular community. For example, The New York Community Trust (formed in 1923) currently has seventeen banks acting as its trustees and a large program staff and committee acting as its grantmakers. Community foundations may do more than make grants:

⁹ Section 509(a)(1) and section 170(b)(1)(A)(vi) and the applicable regulations. Community foundations have a modified “facts and circumstances” test in Treas. Reg. § 1.170A-9(e)(10).

¹⁰ Treas. Reg. § 1.170A-9(e)(11)(ii).

¹¹ Cynthia Jones Eiseman, “Value Added: Donor-Advised Funds at Community Foundations,” *Trusts & Estates* 16 (March 1997); Council on Foundations, *Building Successful Community Foundations* (1992).

they may act as facilitators of charitable know-how in their communities, galvanize resources to respond to local problems, and incubate new charities to address local needs.¹²

The first donor-advised fund is reported to have been created at the New York Community Trust around 1931. Even though the donor-advised fund existed before the 1974 regulations, the regulations do not directly prescribe requirements for launching an advised-fund program. While community foundations have been the traditional home of the donor-advised fund, there have long been donor-advised funds at other public charities, e.g., the Jewish Communal Fund, which was formed in 1972.

V. WHAT IS A DONOR-ADVISED FUND?

What constitutes a donor-advised fund? First, there is no statute that defines what is or is not a donor-advised fund. Second, the term “donor-advised fund” is not to be found in the Treasury regulations. Third, the term “donor-advised fund” has been used in a relatively few private letter rulings and one general counsel memorandum.

We have only two decided cases ten years apart that discuss the donor-advised fund. The first, *National Foundation, Inc. v. U.S.*,¹³ involved an organization that the IRS declined to recognize as a tax-exempt public charity because, among other things, the organization paid commissions to ministers, insurance agents, and others to refer donors to the organization and exercised minimal review of the donor’s recommendations. In a sharply worded opinion, however, the court made clear its view that donations to National Foundation were destined for charitable recipients and the costs were not excessive to achieve that goal. Therefore, the court ordered the National Foundation to be recognized as exempt.

Ten years later, the IRS won in *Fund for Anonymous Gifts v. U.S.*,¹⁴ only to have the decision vacated by the United States Court of Appeals. The District Court for the District of Columbia was ordered to enter summary judgment to the Fund for Anonymous Gifts on the section 501(c)(3) determination. The District Court on remand was told to determine whether the Fund should be classified as a public charity or a private foundation under section 509. On September 25, 2001, the U.S. District Court ruled on remand that the Fund for Anonymous Gifts is properly classified as a private foundation, rather than as a public charity, because it did not appear from the record that the Fund’s trustee could reasonably expect to satisfy the public support test. This case was resolved in March 2003 through the federal government’s mediated settlement program. The Fund was classified as a public charity through December 2007, at which time it will have to prove that it has satisfied the § 509(a)(1) public support test.

¹² Christopher R. Hoyt, *Legal Compendium for Community Foundations* (Washington, D.C.: Council on Foundations, 1996) at 4. This book is a “must-have” for any lawyer planning to form or work with a community foundation.

¹³ 13 Cl. Ct. 486 (1987).

¹⁴ 1997 WL 198108, 79 A.F.T.R. ¶ 97-874 (U.S. D.C. for the District of Columbia, Number 95-1629 (April 15, 1997)), vacated in part by *Fund for Anonymous Gifts v. IRS*, 194 F.3d 173, 1999 WL 334519, D.C. Cir. No. 97-5142 (Doc 1999-13695), (D.C. Cir. Apr. 12, 1999).

If not a creature of the tax or case law, then, what is a donor-advised fund in practice?

A donor-advised fund is one where the donor or her designees exercises the privilege of making nonbinding recommendations to the sponsoring charity suggesting which charitable entities¹⁵ should receive grants from that particular fund. Donor "control" is replaced by donor "advice" in the donor-advised fund because the donor's recommendations can be advisory only. For that reason, a donor-advised fund is the term life insurance of charitable giving: naked grant making. Donors are attracted by the administrative ease of grant making, no need to collect and retain substantiation letters, and no need to prepare and/or file information returns, state reports, or other exemption applications or filings. Administrative costs are borne by all funds managed by the same sponsoring charity with the result that costs per advised-fund are usually significantly lower than for private foundations or supporting organizations. The boards of public charities offering donor-advised funds generally choose their own operating guidelines and fees.

The donor-advised fund alternative to a private foundation is especially attractive in the following circumstances:

- As an easier and less costly alternative for accepting memorial gifts following a death, before a funeral, or for a special birthday or other event,
- for family giving without administrative responsibilities,
- for lower start-up and annual operating costs, and
- to terminate a foundation into a donor-advised fund.

In selecting a sponsoring charity of a donor-advised fund, a prospective donor-advisor should:

- Consider its grantmaking policies:
 - any geographic limits within the U.S.?
 - overseas grants?
 - fees after a certain number of grants?
- What kind of assets will it accept?

VI. NEW DEVELOPMENTS REGARDING DONOR-ADVISED FUNDS

A. *New Determination Letters Involving DAFs*

Community foundations have been the traditional home of the DAF. In the 1970s, however, public charities (including religious organizations) that wished to become Sponsoring

¹⁵ Grantee entities are almost always public charities or private operating foundations rather than private non-operating foundations. If the grantees are private non-operating foundations, questions could be raised about the donor improperly circumventing charitable-deduction and private-foundation excise-tax provisions, e.g., by means of a private foundation grant advised back to the same private foundation that made a qualifying distribution to the advised fund ("roundtripping"). But there are ways to address this problem, e.g., disallow a qualifying-distribution deduction for an advised gift to a private foundation controlled by the donor-adviser.

Charities of DAFs began running DAF programs. In addition, new Sponsoring Charities that wished to run DAFs as their main activity applied for and received private letter rulings and favorable determination letters in response to submissions of IRS Form 1023 (Application for Recognition of Exemption). This main-activity trend accelerated in the 1980s and the 1990s. In 1991, the Fidelity Charitable Gift Fund began its operations. In 1992, the Council on Foundations published Ed Beckwith's and David Marshall's treaties entitled "Establishing An Advised Fund Program," which includes model documents and resolutions for existing charities wishing to sponsor DAFs. In 1996, the National Philanthropic Trust was recognized by the IRS as a public charity. In 1998, the Vanguard Charitable Endowment was recognized by the IRS as a public charity.

The Vanguard Charitable Endowment application came to the IRS at a time when questions had been raised by some in the charitable community as to whether Sponsoring Charities of DAFs required particular characteristics and whether a Sponsoring Charity could invest in a particular mutual fund family. Therefore, the EO community read with interest the detailed files on the Form 1023 and supplemental correspondence between the Vanguard Charitable Endowment and the IRS National Office reviewers.¹⁶ In this detailed review, a number of operating characteristics were reviewed favorably. They have been voluntarily and uniformly adopted by the national donor advised funds formed in the 1990s and currently. For example, the American Gift Fund accepted these principles on its way to recognition by the IRS as a public charity in 1998.¹⁷ In July 1998, the Fidelity Charitable Gift Fund voluntarily adopted (and reported to the IRS its adoption of) operating procedures consistent with these principles.

Current Developments: While it is difficult to find statistics, it appears that fewer new Sponsoring Charities have been created and applied to the IRS for recognition of exemption over the past twenty-four months than in prior recent years.

I commend Paul Streckfus for the excellent public records he has created by publishing the exemption applications for all of these and many other Sponsoring Charities. I believe that these records also reveal that a pattern of consistency has emerged on the part of IRS reviewers. While one might quibble with misses here or there, by and large these organizations show a relative uniformity in organization which means that identifying any "outliers" will depend on reviewing their practices, policies and operations.

At the April 28, 2004 Georgetown Conference in Washington, D.C., a senior senate staff member told the audience that the staff is concerned about DAFs. A questioner asked for more details of the nature of their concern. In response, the staff member mentioned cases where DAFs paid tuition or reimbursed travel expenses of donor-advisors. He added that the concern does not extend to organizations that operate in accordance with "the Vanguard Principles" and that there is no concern with organizations like "the Fidelity Gift Fund." These comments suggest that concern focuses on actions perceived to be donor accommodations where Senate staff members perceive more opportunity for "mischief makers" to take advantage of sponsoring charities.

¹⁶ For a reprint of the complete IRS administrative file, see Paul Streckfus' EO Tax Journal, May 1998, at 33ff.

¹⁷ For a reprint of the complete IRS administrative file, see Paul Streckfus' EO Tax Journal, June 1998, at 37ff.

In an informal conversation I had with three IRS officials on April 20, 2004, I learned of their concerns regarding "split gifts" such as benefit-event tickets and memberships to museums, societies, operas, philharmonics, and religious institutions. The only guidance on these topics for public charities is addressed to substantiation by the charity of the donor's deductible gift amount. Given that paperwork, some donors apparently concluded that they could directly pay the non-deductible portion of an event charge or membership and advise their donor-advised fund to pay the deductible "gift" portion, thereby creating a split gift. Sponsoring charities of DAFs might be unaware of the donor's plan until a call or note from the recipient charity said that tickets or some other benefit did flow back to the donor.

The IRS officials stated their view to be that no valuable benefit should run back to the donor-advisor. If a gift did give rise to any valuable benefit, such as tickets or membership benefits, they believe the benefit would properly belong to the sponsoring charity. Since private foundations routinely buy benefit-event tables, this would appear to put DAF donor-advisors at a disadvantage relative to private foundation managers. It will be interesting to see if and how the IRS addresses this topic formally in the future.

On June 22, 2004, the Senate Finance Committee held a hearing on charitable governance reforms. This hearing was accompanied by release of a White Paper. The DAF provisions from that paper are excerpted at Appendix B. On July 22, 2004, Senate Finance Committee staff held an invitation-only roundtable mostly to discuss the contents of the White Paper. At the time of this writing (August 11, 2004), the Council on Foundations and others were still preparing written comments on the DAF provisions of the White Paper. It is also uncertain whether any DAF provisions will be included in any draft legislation coming out of the Senate activity.

B. *IRS FY 2002 EO Implementing Guidelines*

On October 5, 2001, the Exempt Organizations Division of the Internal Revenue Service released its Implementing Guidelines for Fiscal Year 2002 (the "IRS 2002 Workplan"), which included projected activities and emphasis areas for EO Rulings and Agreements, EO Examinations, and EO Customer Education and Outreach.

In the IRS 2002 Workplan, the EO Examinations group stated that it would begin six market segment studies in fiscal year 2002, including a market segment study of community trusts. The market segment study of community trusts would involve collating available information, including compliance information regarding the organizational test, employment tax, unrelated business income tax, fundraising, inurement/private benefit, charitable contribution deductions, intermediate sanctions and public disclosure, for the "community trust" market segment and then identifying and analyzing the compliance risks associated with that market segment. The IRS indicated that the market segment study would involve "a nation-wide sample of 150 returns."

In addition, in the IRS 2002 Workplan, the EO Examinations group stated that it had designated several compliance/education projects for fiscal year 2002 to "address concerns or known areas of non-compliance." These projects included a project involving donor-advised funds whereby "a cross-functional taskforce will provide the Director, EO Examinations, by April 1, 2002, with a detailed plan specifying how the IRS will identify organizations that provide donor-advised funds as well as strategies to determine the organizations' level of

compliance with the tax laws, including the rules relating to [charitable contribution deductions].” In the IRS 2002 Workplan, the IRS stated that this project is being undertaken as a result of the “large volume of contributions” being received by national donor advised funds.

C. *IRS FY 2004 EO Implementing Guidelines*

Like SOs, DAFs have been identified by the IRS in connection with tax-shelter concerns:

Donor-Advised Funds: A number of organizations have come to light through examinations, referrals from other parts of the Service, and public scrutiny, which appear to abuse the basic concepts underlying donor-advised funds. The organizations, while promoted as legitimate donor-advised funds, appear to be established for the purposes of generating questionable charitable deductions, providing impermissible economic benefits to the donors and their families (including tax-sheltered investment income for the donors), and providing management fees for the promoters. While not a part of the coming study on National donor-advised funds, a compliance strategy will be developed to address questionable donor-advised funds as an adjunct to this study.

Under "Continuing Compliance/Education Projects," the IRS reports that the coordinating committee has developed a process to begin the DAF studies:

Donor-Advised Funds: The committee has developed a process to begin the study of the donor-advised area. For inclusion in the donor-advised fund study, the committee considered so-called National donor-advised funds, other organizations having donor-advised mechanisms as their primary activity or purpose, and organizations utilizing donor-advised giving mechanisms as part of their fundraising apparatus, but which operate the mechanism primarily as an additional method to get funding for the organization itself. Work is continuing on how to segment the entire grantmaking sector. An examination study of a selection of National donor-advised funds will begin in FY 2004. While this is a separate study, the work in this area will be coordinated with the work relating to other grantmaking areas including, community foundations, private foundations, supporting organizations, and fundraising organizations. In addition, work on donor-advised funds that utilize more aggressive tactics will be coordinated with the proposed study.¹⁸

¹⁸ The full text is available at www.irs.gov.

D. Update on DAF Cases

1. The Tim Mosely Case. On June 21, 2003, the Marin Independent Journal ran a story headlined "Father Gets 5 Months for Tax Evasion." The body of the story went on to report that Tim Mosely, an insurance broker, pleaded guilty to evading taxes through tuition payments to his children's private school:

Mosely, an insurance broker, pleaded guilty in December to evading more than \$70,000 in taxes through corporate deductions and tuition payments to San Domenico Primary School in San Anselmo, authorities said.

The investigation involved a fund called the Tim and Carol Mosely Family Foundation, which Mosely created in 1995 through the National Heritage Foundation, a nonprofit that helps administer charitable projects. Foundations launched through the NHF can share its tax ID number and its tax-exempt status.

From 1995 through 1999, Mosely made payments to the NHF under the premise that they were tax-sheltered charitable donations for the San Domenico Convent, federal prosecutors said. Under Mosely's direction, the NHF issued checks to the convent, prosecutors said.

But authorities said the money, instead of being used as charitable donations, was used to pay for the tuition of Mosely's children. Mosely claimed the payments as charitable contribution deductions anyway, according to court documents.

The annual tuition at San Domenico Primary School is approximately \$14,000, according to the school's Web site. The school itself was not suspected of wrongdoing in the case.

Two articles on the case are attached as Appendix C.

The Mosely case shows that the IRS will crack down hard on DAF cases involving impermissible private benefit and that tuition scams are prime targets. What the articles do not explain is how "gifts" to San Domenico Convent ended up being transferred to the San Domenico Primary School.

VII. COMMON OPERATING PROCEDURES FOR DONOR ADVISED FUNDS

As noted above, successful sponsoring charities that operate donor-advised fund programs as their principal activity (often known as "national donor-advised funds" or "NDAFs") have certain operating procedures in common. These procedures have become standardized largely through the parade of Forms 1023 and the ensuing correspondence between the applicants and the IRS. These operating procedures are not static and have and

will continue to evolve in response to developments in the legal, philanthropic and Internet environments.

In 1992, several national donor advised funds developed a self-governance document entitled “Common Operating Procedures for Donor Advised Funds.” This document has been reviewed by and subscribed to by a number of Sponsoring Charities. A roadmap to common operating procedures currently being used by many national donor advised funds, this document is intended as a general resource for new and existing Sponsoring Charities. It contains useful definitions and plain-English discussions of governance of a Sponsoring Charity; roles and privileges of the Sponsoring Charity, the Donor, and the Donor Adviser; interaction between a Sponsoring Charity and Donors and Donor Advisers; grantmaking procedures for many different categories of grants; and maintaining levels of activity in DAF accounts. A copy of the current version is attached as Appendix D.

#

A MATRIX OF CONTROL

	Favorable Deduction Levels?	Donor Can Have Exclusive Control Over Grantmaking?	Donor Can Have Exclusive Control Over Investments?	Remarks
Endowed Private Foundation	NO	YES	YES	Deductibility limits and I.R.C. Chapter 42 excise-tax boundaries are the trade off for complete control over contributions (except for the completed gift rules), investments, expenditures.
Type 3 Corp SO	YES	NO	NO	SO must meet responsiveness test which requires one or more common officers or directors or close and continuous working relationship <u>AND</u> the supported organization's managers have a "significant voice?? in the supporting organization's investment policies, grant timing, grant making, selection of recipients, directing use of income or assets.
Type 3 Trust SO	YES	YES	NO	Special trust responsiveness test: Each public charity is named in and can enforce the trust and compel an accounting.
Pooled Common Fund	YES	YES	NO	A defective supporting organization: "would be described in section 509(a)(3) but for the right of any substantial contributor . . . or his spouse to designate annually" public charity recipients described in 509(a)(1) only.
Donor Advised Fund	YES	NO	NO	Component-part test has been voluntarily adopted by community foundations, although only component-part trusts must likely abide by it. Material-restriction rules look to lack of completed gift and excessive donor control for purposes of private-foundation terminations. Newly created sponsoring charities DAFs generally provide in Forms 1023 that they will operate in accordance with "Vanguard Principles".

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.

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**ABA
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FALL JOINT CLE PROGRAM**

**OCTOBER 2, 2004
BOSTON, MASSACHUSETTS**

**THE PROS AND CONS OF DONOR ADVISED FUNDS
AS ALTERNATIVES TO PRIVATE FOUNDATIONS**

BY

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