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Two Often Misunderstood Issues Involving Distributions From a Donor Advised Fund to a Private Foundation

There is a widely held but misguided belief that the law prohibits a donor advised fund ("DAF") from making a distribution to a private foundation. While the Pension Protection Act of 2006 imposed a myriad of restrictions on DAFs, it did not completely proscribe distributions from a DAF to a private foundation so long as the DAF sponsoring organization undertakes certain expenditure responsibility measures. Moreover, a DAF may make distributions to a private foundation even when a donor or donor advisor to the DAF is also a disqualified person with regard to the recipient private foundation.

I. DAF Distributions to a Private Foundation: Expenditure Responsibility Required

A. Legal Background.

Internal Revenue Code ("IRC") § 4966 imposes excise taxes on any *taxable distribution* made from a DAF. More specifically, this section provides that a *taxable distribution* is any distribution made from a DAF to an organization not described in IRC § 170(b)(1)(A).

The organizations described in IRC § 170(b)(1)(A) include — with some exceptions not relevant here — the various types of publicly-supported charities and private operating foundations. The genesis of the belief that DAFs are prohibited from making distributions to a private non-operating foundation ("PF") may have arisen as a result of the fact that PF's are specifically excluded from the list of organizations under IRC § 170(b)(1)(A).

There is, however, an important caveat included under IRS § 4966 that permits a DAF to make a distribution to a PF so long as the DAF sponsoring organization exercises *expenditure responsibility* over the distribution. Accordingly, a DAF may make a distribution to a PF without the risk of IRS § 4966 excise taxes so long as the DAF sponsoring organization exercises *expenditure responsibility* with regard to the distribution.

Expenditure responsibility requires a DAF sponsoring organization to, among other things, exert reasonable efforts and to establish certain procedures to see that the grant made from the DAF is spent solely for the purpose for which it was made, to obtain full and complete reports from the grantee PF on how the funds are spent, and to make full and detailed reports with respect to such expenditures on the DAF sponsoring organization's Internal Revenue Service ("IRS") Form 990.

B. Nuts and Bolts of *Expenditure Responsibility*.

Pursuant to Treasury Regulations § 53.4945-5(b) and § 4945-6, a DAF sponsoring organization will exercise the requisite *expenditure responsibility* only when it conducts a pre-grant inquiry with regard to the PF, enters into a written grant agreement with the PF, imposes a duty on the PF to separately account for and to provide periodic reports to the DAF sponsoring organization regarding the distributed funds, and reports certain information about the distribution on its IRS Form 990.

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1. Pre-grant Inquiry.

To fulfill the pre-grant inquiry requirement, before making a grant to a private foundation, a DAF sponsoring organization must conduct a limited inquiry concerning the potential PF grantee. Such inquiry should be complete enough to give a reasonable person assurance that the PF grantee will use the grant for proper purposes.

2. Written Grant Agreement.

If the pre-grant inquiry if favorable and it decides to proceed with the grant, a DAF sponsoring organization must next enter into a written grant agreement with the PF governing the funds distributed from the DAF to the PF. The written grant agreement must signed by an appropriate PF officer, director, or trustee, must clearly specify the purposes for which the DAF is making the distribution to the PF, and must include the PF's agreement that the PF will:

- Repay to the DAF any portion of the amount granted the PF does not use for the specified charitable purposes of the grant;

- Submit full and complete reports to the DAF sponsoring organization detailing the manner in which the PF spent the funds and the progress the PF made in accomplishing the charitable purposes of the grant (See item #4 below for additional details);

- Maintain records of receipts and expenditures and to make its books and records available to the DAF sponsoring organization; and

- Not to use any of the funds for any purposes that would constitute a taxable expenditure under IRC § 4945 (e.g., carrying on propaganda; influence legislation; political electioneering activities; noncompliant grants to an individual for travel, study, or other similar purposes; grants to a non-functionally integrated supporting organization; etc.)

3. Separate Account.

Additionally, the DAF sponsoring organization must require the PF to agree to maintain the grants funds in a separate fund or account or otherwise to account separately for the funds. This requirement should also be included in the written grant agreement.

4. Reporting by Grantee.

The PF must also agree to provide to the DAF sponsoring organization, at minimum, an annual report within a reasonable time after the close of the PF's annual accounting period. Each such annual report must detail:

- The PF's use of the funds,

- Compliance with the terms of the written grant agreement, and

- Progress the PF made towards achieving the purpose of the grant.

The PF must agree to continue to submit such annual reports until it expends all grant funds. The written grant agreement may require more frequent reports if and when the DAF sponsoring organization determines more frequent reports are warranted or otherwise

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necessary. The final report must include reporting on all expenditures made by the PF with the funds distributed to it by the DAF sponsoring organization, as well as progress made toward accomplishing the charitable goals of the grant.

5. Reporting on IRS Form 990.

Finally, the DAF sponsoring organization must report the *expenditure responsibility* grants on its IRS Form 990.

C. Failure to Exercise Expenditure Responsibility.

In the event a DAF sponsoring organization fails to exercise the required *expenditure responsibility*, the distribution from a DAF to a PF will constitute a *taxable distribution*. For each *taxable distribution* made from a DAF:

a. An excise tax equal to 20% of the amount distributed is imposed and must be paid by the DAF sponsoring organization; and

b. A tax equal to 5% of the amount distributed is imposed on any DAF sponsoring organization *fund manager* who knew the distribution was a taxable expenditure and still participated in the distribution. This 5% tax must be paid personally by any *fund manager* who agreed to the making of the taxable distribution. If more than one *fund manager* is liable for the making of a taxable distribution, they are all jointly and severally liable for the tax. The amount of this 5% tax is limited to $10,000. Under IRC § 4966, a fund manager is defined as an:

(1) Officer, director, or trustee of the DAF sponsoring organization;

(2) Individual having powers or responsibilities similar to an officer, director, or trustee of the DAF sponsoring organization; or

(3) Employee of the DAF sponsoring organization who has authority or responsibility with respect to the act constituting the *taxable expenditure*.

Finally, the DAF sponsoring organization must file IRS Form 4720 to calculate, report, and pay the excise taxes on any t*axable distributions* it made. Each *taxable distribution* must be reported separately. Fund managers liable for the tax must also use IRS Form 4720 to calculate, report, and pay excise taxes on a *taxable distribution*.

II. DAF Distributions to a PF: More than Incidental Benefit to Disqualified Persons?

There is another oft-cited misconception that a DAF may not make a distribution to a PF — even when *expenditure responsibility* is exercised — if a donor or donor advisor is a director or officer of the PF. This is not the case.

First, under IRC § 4958(f), an excise tax is imposed on any distribution from a DAF to any *disqualified person* as to the DAF. A *disqualified person*, under IRC § 4958(f), is defined as any donor, a donor advisor, or a family member of a donor or donor advisor with regard to a DAF or a *35%-controlled entity* of such persons.

With regard to the definition of a *35%-controlled entity,* Treas. Reg. § 53.4958-3(b)(2) provides (in relevant part) that such an entity is a “a corporation in which [*disqualified persons*]

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own more than 35% of the combined voting power." For this purpose, c*ombined voting power* means "voting stock, direct or indirect, but does not include voting rights held only as a director, trustee, or other fiduciary."

With regard to the restriction contained in IRC § 4958(f), a PF is not a *35%-controlled entity* because no *disqualified person* exercises any voting power other than as a director or fiduciary of the PF. Consequently, a distribution made from a DAF to a PF is not a distribution to a *disqualified person* as to the DAF. It is merely a distribution from a DAF to a PF.

Second, IRC § 4967 imposes excise taxes on distributions from a DAF that results in a *disqualified person* receiving *more than an incidental benefit*. For these purposes, *more than an incidental benefit* generally means any benefit that otherwise would have reduced the *disqualified person's* charitable deduction if received in connection with the contribution to the DAF sponsoring organization in establishing or funding the DAF.

Generally, a distribution from a DAF to a PF — even when a *disqualified person* with regard to the DAF is a *disqualified person* with regard to the PF — does not result in a *disqualified person* receiving *more than incidental benefit* under IRC § 4967 because no *disqualified person* is receiving any consideration as a result of the distribution, which is what appears to be contemplated under the IRC and the Treasury Regulations.

Consequently, even a distribution from a DAF to a PF, even when formed and controlled by the DAF donor, does not benefit the DAF donor, directly or indirectly, under the IRC and the Treasury Regulations. Even though the DAF donor would have received a smaller charitable deduction by making a direct contribution to the PF as a result of the difference in deductibility limitations as between a PF and a DAF, this is difference is arguably not what IRC § 4967 is addressing.

Furthermore, a donation to a DAF evidences the donor's intent to benefit the DAF sponsoring organization. And by making a completed gift to the DAF, the donor is transferring exclusive control over the donated funds to the DAF sponsoring organization. In such a case, the donor is entitled to the full deduction. Also, written DAF agreements typically always substantiate the donor's clear intent that the contribution will benefit the DAF sponsoring organization.

If the funds later end up in the donor's PF, it is only because the DAF sponsoring organization approved of the distribution to the PF and exercised the requisite *expenditure responsibility*, as discussed above, over the funds transferred to the PF. Anything less would result in a *taxable expenditure*. *Expenditure responsibility* clearly imposes more of an administrative burden and confers less discretion on the donor over the use of the funds than the same donor would have over the funds if they simply remained part of the DAF. As a result, IRC § 4967 does not apply in this case.