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Donor-Advised Funds: An Alternative for High-Net-Worth Philanthropists

12.01.15 | Linda J. Rosenthal, JD

"High-net-worth folks," we explained in an earlier post about family foundations, "have lots of choices about what to do with their money – including *how* to give it away."

The most popular option: Make a donation to one (or more) of the hundreds of thousands of 501(c)(3) public charities in the United States. It's simple, direct, and there are no strings attached.

Another choice: Create a private foundation. This alternative is at the *other* end of the spectrum of hands-on involvement. The wealthy person or family has the maximum possible control over how the charitable contribution is used. But there's a price: up-front and ongoing costs, a serious commitment of time and effort, and a complex maze of rules and restrictions.

There's also a third path, midway between the outright donation and the family foundation: the "donor-advised fund" (DAF). In this model, the philanthropist makes a charitable contribution, relinquishes *legal* control over the contributed money or assets to an independent public charity, the "supporting organization," and receives an immediate tax deduction. But the benefactor is permitted from time to time to recommend specific grants from the fund. "An easy way to think about a donor-advised fund is like a charitable savings account: a donor contributes to the fund as frequently as they like and then recommends grants … when they are ready."

There are pros and cons with the donor-advised fund. There's controversy, too; government regulators along with certain factions within the philanthropy community have concerns about this format.

What, Exactly, Is a Donor Advised Fund?

Donor-advised funds have been around for many decades, but not until recently – in the Pension Protection Act of 2006 – has the term been formally defined in a federal statute. There's a helpful timeline summary here of the development of DAFs.

Some History and Context

The Internal Revenue Service acknowledges that the DAF model has a long, established history. "Donor-advised funds … have been part of charity for nearly a century, and have long been a staple of community foundations."

> *Prior to the Pension Protection Act of 2006 (Pub. L. No. 109-208), the term 'donor-advised fund' was not defined in the Code or Regulations, but it was understood to include arrangements by which some charitable organizations (including community foundations) established separate funds or accounts to receive contributions from donors. Donor-advised fund arrangements were comparable to component funds maintained by certain community trusts.*

The first DAF was created in 1931 by the New York Community Foundation.

The 1969 Tax Reform Act marked another major development. This landmark legislation –

> *created distinctions between private foundations and public charities, including a more favorable tax deduction for contributions to public charities …. However, it also recognized a subset of private foundations that were entitled to the more favorable tax deductibility rate for donors. One of those private foundation types is described as a private foundation that has donations 'pooled into a common fund.' While the term donor advised fund was not used, this language provides the first regulatory recognition of funds that are held by a foundation but that are not contributed by a single donor.*

In 1972, new Treasury Regulations created the public support test for public charities including community foundations. They also authorized establishing "a single entity with component funds and permit[ting] a private foundation to terminate and transfer its assets to a fund at a public charity, provided the transferor did not impose any material restriction with respect to the transferred assets."

"Donor-advised funds emerged as an alternative to private foundations in the 1970s." It "made sense" to collect "small funds of this kind under one institutional roof for investment and management purposes…."

The Tax Reform Act of 1986 tightened up rules and obligations for private foundations; "as a result, DAFS at a sponsoring organization like a community foundation became a more attractive giving option …."

Donor-advised funds picked up steam – and controversy – in the following years. "[D]uring the 1990s, for-profit financial investment firms began to establish affiliated nonprofit organizations to maintain donor-advised fund accounts."

> *Typically, these 'commercial' DAFs hire the affiliated for-profit investment firm to manage the investment of the assets in the accounts for a fee that varies based on the balance in the account and the number of annual transactions.*

"A series of opinion pieces, legal publications, and articles" were published, "spurring increased debate" about the regulation (or lack of it) of DAFs. "Criticism … focused on commercial gift funds in particular."

In 2006, the federal Pension Protection Act included the first official definition of a donor-advised fund, as well as some rules for, and "additional clarity" on, DAFs.

Congress acted, again, in the Tax Reform Act of 2014, by adding an excise tax on failure to distribute contributed amounts within five years.

Statutory Definition of DAFs

The full text of new section 4966(d)(2) of the Internal Revenue Code, the definition of a donor-advised fund, is here.

The Internal Revenue Service offers this simple summary explanation on its website:

> *Generally, a donor advised fund is a separately identified fund or account that is maintained and operated by a section 501(c)(3) organization, which is called a sponsoring organization. Each account is composed of contributions made by individual donors. Once the donor makes the contribution, the organization has legal control over it. However, the donor, or the donor's representative, retains advisory privileges with respect to the distribution of funds and the investment of assets in the account.*

There are three key elements to a DAF, each of which must be established:

- “There is a fund or account that “is separately identified by reference to a contributions of a donor or donors;”
- The fund or account is “owned and controlled by a sponsoring organization,” and
- The “donor (or any person appointed or designated by such donor) has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in such fund or account.”

The IRS offered some additional “interim” guidance in December 2006, in its Internal Revenue Manual:

> *What’s the legal relationship between the donor-advised-fund (DAF) and the sponsoring organization? From the standpoint of the DAF, it’s a non-binding, advisory bond. ‘Once the donor makes the contribution [to the DAF], the organization has legal control over it.’ The only role of the donor (or the donor’s representative) is an advisory one regarding asset investment and management and ultimate distribution of the charitable funds. ‘In practical terms, the advice is generally followed by the sponsoring organization so long as grants to the identified grantees would not violate applicable laws or be outside of the sponsoring organization’s exempt purpose or mission.’*

Conclusion

The DAF model continues to develop as lawmakers, government regulators, and the philanthropy community grapple with questions and unresolved issues. What’s clear, though, is that DAFs are here to stay: They are enjoying a robust popularity – a trend showing no sign of abating.