# CURRENT DEVELOPMENTS FOR CHARITABLE GIVING TO DONOR-ADVISED FUNDS AND SUPPORTING ORGANIZATIONS[1]

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## I. INTRODUCTION.

This outline addresses current developments in charitable giving to two kinds of charitable-contribution vehicles: the donor-advised fund and the supporting organization. Each of these vehicles is an established, legal, and recognized vehicle to which tax-deductible charitable contributions can be made.

This outline presents an overview of each of these vehicles in turn, considers applicable state and federal rules, comments on circumstances in which the vehicle is most helpful, and recommends ways to recognize and avoid improper use. It also presents new developments applicable to each vehicle.

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## II. THE DONOR-ADVISED FUND ("DAF").

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| State law: | The Sponsoring Charity of a DAF can be formed or operated as a not-for-profit corporation or trust. A DAF can be an activity of a new or existing charitable organization. The term "Sponsoring Charity" refers to the entity which houses the DAFs, each of which is a separately identified account as to which one or more donor advisors has the privilege to advise the sponsoring charity as to investments and grants. There are probably between 600 and 700 Sponsoring Charities offering DAFs today. |
| Federal law: | As noted above, a DAF is an activity of an organization recognized as exempt from taxation under IRC § 501(c)(3) and likely classified as a public charity and not a private foundation under IRC § 509(a) (the "Sponsoring Charity"). DAFs have existed since the 1930s and therefore predate the 1969 tax laws on classification of IRC § 501(c)(3) organizations. Contributions to a DAF are deductible under IRC § 170, subject to applicable limitations (e.g., gifts of tangible personal property must be put to a "related use", appraisals must be obtained to measure deduction). |
| Most helpful use: | DAFs have been praised for their "democratization of philanthropy" (See Eugene R. Steurele, "Will Donor-Advised Funds Revolutionize Philanthropy?", The Urban Institute, a brief in the series on Charting a Civil Society, No. 5, Sept. 1999). They offer a deduction at the most favorable public-charity level in the year in which the gift is made but allow payouts over a period of years. They are less costly to create and maintain than a private foundation while having many of the grantmaking advantages of a private foundation. Since almost all DAFs are classified by the IRS as public charities, donors may claim deductions at the higher public-charity levels. |

Improper use to avoid: A donor-advisor should not recommend a gift for which the donor-advisor would receive a quid-pro-quo benefit. Excess benefit transactions would be subject to the excess benefit penalties of IRC § 4958 to the extent that the donor-advisor is an insider subject to that provision. Most Sponsoring Charities have policies and donor-education materials to clarify what is and what is not an appropriate recommendation. For example, a donor-advisor should not make gifts from his private foundation to a DAF and then expect the DAF to give the money back to the donor's private foundation. This is a potential end-run around IRC § 4942, the 5% qualifying distribution requirement.

Control: A donor-advisor retains the privilege only to make nonbinding recommendations as to appropriate recipients and investments. The Sponsoring Charity has every right to say "No". The Sponsoring Charity's board is responsible for management, grantmaking, and investments.

## III. THE SUPPORTING ORGANIZATION ("SO").

State law: Like the Sponsoring Charity of a DAF, an SO can be formed as a not-for-profit corporation or trust. I know of no state law specially describing or governing SOs. This is because SOs are a creation of federal law.

Federal law: Unlike the DAF, which is not described in the IRC and Treasury Regulations, the SO is a creature of federal tax law in general and the 1969 Tax Reform Act in particular, i.e., IRC § 509(a)(3) and accompanying regulations. As such, the SO is the third of the three categories of public charities which are NOT private foundations under IRC § 509(a) (and, therefore, not subject to IRC §§ 4940-4946 private foundation excise taxes). Donors to SOs may claim deductions at the higher public-charity levels. IRS records listed 29,843 organizations classified as SOs as of 12/31/02.

SOs have one of three structures: Type 1 (parent-subsidiary), Type 2 (brother-sister affiliates), or Type 3 (operated "in connection with" one or more named public charities).

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| Most helpful uses: | Where a public charity needs to segregate funds (e.g., an endowment fund, a grant of illiquid assets) or where unusual grants would negatively affect a public charity's public support test. The SO is the only category of organization that is not subject to the 33% public-support test, other than churches, schools, hospitals and medical research organizations. |
| Improper use to avoid: | Any structure where members of the donor's family or individuals (e.g., employees) obligated to the donor are a majority of the SO's board of directors. The default classification for a defective SO is that of private foundation. |
| Control: | As the prior paragraph shows, donor control kills SO classification outright. One exception is the Type 3 trust SO, which arguably can be controlled by the donor so long as a public charity named in the trust instrument has the right to enforce the trust. Question: What if the named charity(ies) have not been notified of being named or have no incentive to enforce? |

## IV. ADMINISTRATIVE DEVELOPMENTS.

### 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 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 treatise 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.[2] 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.[3] In July 1998, the Fidelity Charitable Gift Fund voluntarily adopted (and reported to the IRS its adoption of) operating procedures consistent with these principles. In 2001, the OppenheimerFunds ® Legacy Program received recognition of exemption from the IRS.

Given the favorable review by the IRS of the Oppenheimer application for exemption, it was therefore equally noteworthy when the IRS National Office released on February 15, 2001, a favorable determination letter approving the application for recognition of exemption for a new Sponsoring Charity for DAFs but only after the IRS had first rejected the organization's initial application.[4] Review of the letter suggests that the application did not comply on its face with the principles set out in prior applications, which led to the IRS's rejection. The organization, the Tompkins Community Charitable Gift Fund (the "Tompkins Fund"), was organized by the Tompkins Community Trust Company (the "Bank") a state-chartered bank in Ithaca, New York. Among other things, the IRS required that the Tompkins Fund amend its by-laws to provide that a majority of the Tompkins Fund's directors will not have any connection with the Bank and that the Tompkins Fund will adopt a conflict-of-interest policy. In addition, the IRS required the materials sent to donors by the Tompkins Fund to inform potential donors that their contributions are unconditional and irrevocable.[5]

Paul Streckfus has published the IRS's favorable determination letter dated November 21, 2001, to the National Charitable Gift Fund in Houston, Texas.[6] In its application for

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

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

4 See Tax Notes Today for March 6, 2001 for an article analyzing the letter.

5 For a reprint of the complete IRS administrative file, see Paul Streckfus' EO Tax Journal, April 2001, at 125ff.

6 For a reprint of the complete IRS administrative file, see Paul Streckfus' EO Tax Journal, March/April 2002, at 123ff.

exemption, the National Charitable Gift Fund said that it elected to seek to qualify as a "community trust" within the meaning of Treas. Reg. § 1.170A-9(e)(10). The Fund stated that, in order to distinguish itself from other existing community foundations, the Fund intended to enter into affiliations with colleges and universities throughout the United States to offer DAFs for them and that it had held preliminary discussions with Texas Christian University.

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 twelve months than in prior recent years.

In his November/December 2002 EO Tax Journal, Paul Streckfus published the exemption application materials of Allfirst Charitable Gift Fund, Inc. of Baltimore, MD. The Fund has an independent board of directors and answered 17 additional questions asked by the IRS in a request for supplemental information. The IRS granted recognition of exemption in a letter dated July 18, 2002.[7]

In his January/February 2003 issue, Mr. Streckfus published the correspondence leading to the favorable recognition of the Wealthnet Charitable Gift Fund.[8] In his Editor's Notebook, Mr. Streckfus offers editorial comments on the application process for new Sponsoring Charities and, in particular, the IRS's review of the applicant's governance. In that connection, Mr. Streckfus stated in part, "I think the recommended 'Common Operating Procedures' . . . are correct in stating under 'Governance of a Sponsoring Charity,' that '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.*'" (Emphasis added.)[9]

**B. *New Private Letter Rulings Involving DAFs and SOs.***

1. Priv. Ltr. Rul. 2002-36-051 (Jun. 17, 2002): A Code section 509(a)(3) supporting organization formed to support M, a business school at N university, proposed to acquire and/or develop student housing projects on or near N's campus to house only N's students and

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7 For a reprint of the complete IRS Administrative file, see Paul Streckfus' EO Tax Journal, November/December 2002 at 159ff.

8 For a reprint of the complete IRS Administrative file, see Paul Streckfus' EO Tax Journal, January/February, 2003, at 211ff. This is the most recent in the series of Sponsoring Charities exemption files helpfully published by Mr. Streckfus.

9 *Id*. at pp. 235-6.

assist these students in finding affordable housing. The housing projects will be used as a clinical program for M's students, who would be involved in the acquisition, management and development of the projects under the supervision of an M professor. The IRS ruled that this activity would assist both N and M in fulfilling their respective educational purposes and therefore would not affect the supporting organization's section 501(c)(3) exemption or generate UBTI under Code section 512.

2. Priv. Ltr. Rul. 2002-33-025 (May 23, 2002): Reorganization of a hospital group such that X, a tax-exempt hospital, will be organized and operated to support Y, a Code section 501(c)(3) organization, will result in X being reclassified as a Code section 509(a)(3) supporting organization.

3. Priv. Ltr. Rul. 2002-04-040 (Oct. 30, 2001): The IRS ruled X, a supporting organization to Y, a community trust, could qualify as a community trust described in Treas. Reg. sec. 1.170A-9(e)(10) and still maintain its status as a Code section 509(a)(3) supporting organization. As an SO is a public charity, and gifts to SOs are deductible by donors, it is not evident why the community foundation would think it needed this ruling. On further inspection, however, one finds that this SO made some unusual organizational choices. First, the SO amended its articles of incorporation and by-laws to refer to the community-trust provisions of the regulations. Second, it elected to treat each account as a component fund. These complicated operations, however, do not defeat SO classification or deductibility of gifts, although it is not clear from the ruling why this component-part structure was desirable.

4. Tech. Adv. Mem. 2002-08-027 (Oct. 4, 2001): The IRS ruled that an organization formed to support and further the charitable purposes of a tax-exempt hospital "and other affiliated and related Code section 501(c)(3) health care organizations" would continue to be classified as a Code section 509(a)(3) supporting organization, even though an affiliate of the hospital and another organization have the right to elect an undisclosed percentage of the directors of the supporting organization (assuming that this percentage is less than 50%).

5. PLR 200149045 (Aug. 3, 2001): Y, an IRC § 501(c)(6) business league, believed to be the American Bar Association, is supported largely by member dues. If it were a charity described in 501(c)(3), it would qualify as a fee-supported public charity under IRC § 509(a)(2). This fact is important because it means that under Treasury regulations Y can have an SO. And Y does in fact have an SO, whose members are all members of Y. A majority of the SO's board is elected by the members and "several Y officers serve ex officio" as directors. The SO's primary activity is making grants to two charities also "established by and affiliated with Y that conduct charitable and educational activities pertaining to the field of Y's membership."

The SO "proposed to establish a charitable gift fund for its members" to make charitable contributions. The SO expects this fund to appeal to members who wish to provide for the long-term needs of the two affiliated charities and similar organizations. Contributions will be maintained in separate accounts. Those accounts can be of two types: a specific donee account or a DAF account. The SO will also permit grants to governmental units and public charities but not to individuals or private foundations. Grants can be recommended to foreign organizations that are the functional equivalent of U.S. public charities or governmental units. The SO also retained a variance power, which is a modification right usually retained by community foundations. The SO will "strongly urge" donors to "designate or recommend that at least 20% of distributions from each account" be paid to charities of the type supported by the business league and the SO.

The IRS ruled that the SO will operate in a manner similar to a community trust, and therefore furthers charitable purposes. The SO is a Type 3 SO and the IRS ruled that its operation of DAFs will not adversely affect this classification. Finally, analogizing to the component-part rules applicable to community trusts, the IRS ruled that the gift fund and its separate accounts will be treated as integral parts of the SO and not as separate entities. This is the first ruling to state that an SO can be a Sponsoring Charity of DAFs.

6. Tech. Adv. Mem. 2002-18-037 (Mar. 27, 2001): The IRS ruled that A, which was organized as a supporting organization to provide MRI facilities to an area that lacked such facilities, could no longer qualify as a Code section 509(a)(3) supporting organization. Specifically, because A was currently supporting three other supporting organizations, as well as one hospital, A could not meet the organizational test because its Article of Incorporation listed Code section 509(a)(3) supporting organizations, as well as one Code section 170(b)(1)(A) hospital; could not meet the operational test because it actually supported Code section 509(a)(3) supporting organizations; and could not meet any of the three SO relationship tests in large part due to the ability of the three Code section 509(a)(3) supporting organizations to appoint members of A's board of trustees. The IRS ruled, however, that due to A's activities as general partner of a partnership that owned and managed a MRI facility, A could continue to qualify as a Code section 501(c)(3) organization, but would instead be classified either as a medical facility under Code section 509(a)(1) and 170(b)(1)(A)(iii) or a section 509(a)(2) public charity.

**C. *IRS FY 2002 EO Implementing Guidelines.***

On October 5, 2001, the Exempt Organizations Division of the Internal Revenue Service (the "IRS") 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.

**D.** ***IRS FY 2003 EO Implementing Guidelines*.**

In the Implementing Guidelines for Fiscal Year 2003, the IRS said that seven market segment studies will start in FY 2003.

One of those studies is of SOs:

- Section 509(a)(3) Supporting Organizations: After determining whether this is one or more segments, we will capture data on issues relating to supporting organizations. A key focus will be whether organizations appropriately claim section 509(a)(3) status under the "in-connection-with" rules.[10]

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[10] FY 2003 Implementing Guidelines, www.irs.gov, p. 7.

**E.** ***Update on DAF Cases.***

On March 20, 2003, the Chronicle of Philanthropy reported that the longstanding dispute over the Fund for Anonymous Gifts ended with the granting by the IRS of an advance ruling classification as a public charity.[11]

Set up in 1994 by the late William Lehrfeld, the Fund had originally been denied exemption in 1996. Since then, reporting on the Fund's status in litigation had become an annual event at this conference. Ironically, the final chapter in this saga occurred when the case was randomly selected for a mediated settlement program. The Fund will now have until December 2007 to prove that it has sufficient support to satisfy the public support test.

**F.** ***Two New Cases on Type 3 Supporting Organizations.***

Late in 2002, the Tax Court concluded in two separate decisions that two separate organizations each failed the Type 3 SO tests. These cases are analyzed in detail by my Simpson colleague, David Shevlin in an article published in the January 2003 Exempt Organization Tax Review. The article is attached as Appendix I.

The IRS and the Tax Court have given clear signals that the Type 3 "in-connection-with" tests are not to be trifled with. It is my personal opinion that too many practitioners are too casual about the Type 3 tests and either fail properly to apply the tests or to instruct their clients about satisfying the tests in practice.

I predict that the IRS and Tax Court will reclassify as private foundations many more Type 3 SOs before these projects are completed. I attach as Appendix II my chart of the SO regulations and draw the reader's attention to the additional criteria applicable to the Type 3 sub-classification. Clearly, the Type 1 and 2 tests, which depend largely on governance, are easier to satisfy than Type 3, which depends both on governance and on operations. Neither component should be underestimated.

## V. COMMON OPERATING PROCEDURES OF DONOR ADVISED FUNDS.

Over a fourteen-month period, several national donor advised funds developed a self-governance document entitled “Common Operating Procedures for Donor Advised Funds.” This document was widely circulated in 2002 and has been reviewed by and subscribed to by a number of Sponsoring Charities. A roadmap to common operating procedures currently being

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[11] Stephen G. Greene, "Anonymous-Gift Fund Gets Final OK From IRS," March 20, 2003.

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 III.

APPENDIX I

**Recent Court Decisions Analyze the Rules**
**Governing "Type 3" Supporting Organizations**

By David A. Shevlin[12]

## Introduction

In two separate decisions, the Tax Court concluded that two organizations failed to qualify for recognition as a supporting organization under section 509(a)(3) of the Internal Revenue Code of 1986, as amended (the "Code"),[13] and therefore would be classified as a private foundation.[14] These cases highlight the complexity, and to some degree the subjectivity, inherent in the regulations that govern "Type 3" supporting organizations. The cases also illustrate the difficulty that a newly-formed organization may have in demonstrating to the Internal Revenue Service ("IRS") that it satisfies the tests required to qualify for recognition as a Type 3 supporting organization.

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[12] Copyright © 2003. Mr. Shevlin is counsel with the firm Simpson Thacher & Bartlett in New York and practices in the firm's Exempt Organizations and Corporate Departments Mr. Shevlin wishes to gratefully acknowledge the contributions of Victoria Bjorklund and Marion Ringel in the preparation of this article.

[13] Unless otherwise indicated, all "section" references are to the Code.

[14] *Lapham Foundation Inc. v. Commissioner*, T.C. Memo 2002-293 (2002); *Christie E. Cuddeback and Lucille M. Cuddeback Memorial Fund v. Commissioner*, T.C. Memo 2002-300 (2002).

**Background**

*Supporting Organizations Generally*

In summary, supporting organizations are organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of, one or more public charities;[15] are operated, supervised or controlled by or in connection with one or more public charities; and are not controlled directly or indirectly by a disqualified person.[16] Organizations that qualify for recognition as supporting organizations under section 509(a)(3) are excluded from the definition of "private foundation" and therefore enjoy the same favorable tax treatment as other types of public charities.

In order for an organization to qualify for recognition as a supporting organization under section 509(a)(3), it must demonstrate one of three types of relationships with the public charity it supports (the "supported charity"), as set forth below. The purpose behind this required relationship is to ensure that the supporting organization is responsive to the needs or demands of the supported charity and the supporting organization constitutes an integral part of, or maintains a significant involvement in, the operations of the supported charity.[17]

> (1) The Type 1 supporting organization is "operated, supervised, or controlled by one or more public charities," which the regulations analogize to a "parent-subsidiary" relationship,[18]
>
> (2) the Type 2 supporting organization is "supervised or controlled in connection with" one or more public charities, like "brother-sister" organizations,[19] and

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15 In lieu of, or in addition to, supporting a 509(a)(1) or 509(a)(2) organization, a supporting organization may support a 501(c)(4), 501(c)(5) or 501(c)(6) organization that would qualify as a 509(a)(2) organization if it were a 501(c)(3) organization. See section 509(a).

16 Section 509(a)(3)(A), (B) and (C).

17 Treas. Reg. § 1.509(a)-4(f)(3).

18 Treas. Reg. § 1.509(a)-4(g)(1).

19 Treas. Reg. § 1.509(a)-4(h)(1).

(3) the Type 3 supporting organization is "operated in connection with" one or more public charities.[20]

*Type 3 Supporting Organizations*

The organizations that are the subject of the cases discussed in this article sought recognition as Type 3 supporting organizations. Of the three types, Type 3 supporting organizations require the least supervision and control by the supported charity. However, in exchange for this independence, Type 3 supporting organizations still must demonstrate a sufficient nexus with the supported charity, as set forth in detailed regulations. In particular, the regulations set forth two tests that must be satisfied by organizations seeking recognition as Type 3 supporting organizations: a responsiveness test and an integral part test. The Tax Court summarized the policy behind these two tests, as follows:

> "While the responsiveness test guarantees that the supported organization will have the ability to influence the supporting organization's activities, the integral part test insures that the supported organization will have the motivation to do so."[21]

To satisfy the responsiveness test, the supporting organization must show the IRS how it is responsive to the needs or demands of the supported charity. The supported charity must have a significant voice in the supporting organization's investment policies, the timing of and manner of making grants, the selection of recipients and in directing the use of the income or assets of the supporting organization.[22] If the supporting organization is a trust, the responsiveness test will be satisfied if the supported charity is a named beneficiary of the trust and has enforcement powers as to the trust under state law.[23]

The main focus of the Court in the cases discussed in this article was the integral part test. To satisfy the integral part test, the supporting organization must maintain a significant involvement

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[20] Treas. Reg. § 1.509(a)-4(i).

[21] *Nellie Callahan Scholarship Fund v. Commissioner*, 73 T.C. 626 (1980), at 637-638.

[22] Treas. Reg. § 1.509(a)-4(i)(2)(ii).

[23] Treas. Reg. § 1.509(a)-4(i)(2)(iii).

in the operations of the supported charity and the supported charity must in turn be *dependent* upon the supporting organization for the type of support which it provides.[24] The integral part test can be satisfied in one of two alternate ways, as follows:

"But For." The supporting organization engages in activities that perform the functions of, or carry out the purposes of, the supported charity and, but for the involvement of the supporting organization, such activities would normally be carried out by the supported charity itself.[25]

"Substantially All." The supporting organization makes payment of substantially all[26] of its income to or for the use of the supported charity, and the amount of support is sufficient to ensure the "*attentiveness*" of the supported charity to the supporting organization. The amount of support received by the supported charity must represent a sufficient part of the supported charity's total support so as to ensure attentiveness.[27] If it does not, the integral part test may still be satisfied if it can be demonstrated that in order to avoid the "*interruption*" of the carrying on of a particular function or activity, the supported charity will be sufficiently attentive to the operations of the supporting organization. This may be the case where the support received from the supporting organization is earmarked for a particular program or activity. The particular program or activity need not be the primary activity of the supported charity, but it must be a substantial one.[28] The regulations cite as examples a chamber music series at a museum and an endowed chair of international law at a law school.[29]

In determining whether the amount of support received by the supported charity is sufficient to ensure the attentiveness of the organization to the supporting organization, the regulations

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24 Treas. Reg. § 1.509(a)-4(i)(3)(i).

25 Treas. Reg. § 1.509(a)-4(i)(3)(ii).

26 "Substantially all" has been interpreted to require that the supporting organization distribute at least 85 percent of its income to one or more supported charities. See Rev. Rul. 76-208 (1976). The IRS has stated that accumulations of income in some years are acceptable if the accumulations are not extended and the income is ultimately distributed to the supported charity. See GCM 36523 (December 18, 1975).

27 Treas. Reg. § 1.509(a)-4(i)(3)(iii)(a).

28 Treas. Reg. § 1.509(a)-4(i)(3)(iii)(b).

29 Treas. Reg. § 1.509(a)-4(i)(3)(iii)(c).

provide that "all pertinent factors" will be considered, including (i) the number of supported charities, (ii) the length and nature of the relationship between the supported charity and the supporting organization and (iii) the purpose for which the funds are used. The more substantial the amount of support in terms of the supported charity's total support, the greater the likelihood that sufficient attentiveness will be present. Evidence of actual attentiveness, however, is of "almost equal importance."[30] For example, the regulations cite as acceptable evidence of actual attentiveness the imposition of a requirement that the supporting organization furnish reports at least annually to the supported charity to assist the charity in ensuring that the supporting organization has invested its endowment in assets productive of a reasonable rate of return and has not engaged in any activity which would give rise to a penalty excise tax if the supporting organization were classified as a private foundation.[31]

**The Cases**

***Lapham***

The Lapham Foundation (the "Lapham Foundation" or the "Foundation") was formed on December 29, 1998 to operate exclusively for the benefit of The American Endowment Foundation (AEF), an Ohio nonprofit corporation exempt under section 501(c)(3) and qualified as a public charity under section 509(a)(1).[32] AEF is a community foundation that benefits the community consisting of the "inhabitants of the United States of America."[33] AEF operates a donor-advised fund program pursuant to which donors are entitled to make non-binding recommendations regarding the charitable use or beneficiaries of their contributions. The ultimate decision with respect to the timing, manner and recipient of any distribution lies with AEF.[34]

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30 Treas. Reg. § 1.509(a)-4(i)(3)(iii)(d).

31 Treas. Reg. § 1.509(a)-4(3)(iii)(d). The IRS, however, has stated that it does not accept the position that there is a safe harbor for achieving attentiveness simply by virtue of a large grant and providing annual reports to the supported charity. See Internal Revenue Service Continuing Professional Education Text for Fiscal Year 1997, Chapter I., "Public Charity Status on the Razor's Edge."

32 *Lapham*, T.C. Memo 2002-293 at 2-4.

33 *Id.* at 4-5.

34 *Id.* at 6.

Upon formation, the Lapham Foundation received from Charles and Maxine Lapham a contribution of a promissory note in the face amount of approximately $1.5 million. The obligor under the note was a family business controlled by the Laphams. The note was payable in quarterly interest-only installments of approximately $30,000 and principal on the note was due in December 2013.[35] Contemporaneously with the contribution of the note, the Laphams entered into a charitable gift annuity agreement whereby the Foundation agreed to pay the Laphams an annual annuity of approximately $116,000 over the joint lives of the Laphams, payable in quarterly installments of approximately $29,000.[36]

The Lapham Foundation's Form 1023 stated that the Foundation intended to pay at least 85 percent of its income to a donor-advised fund account at AEF and in that regard anticipated an annual contribution of approximately $7,600.[37] In correspondence with the IRS, the Foundation stated that one-third of its contributions to its donor-advised fund account at AEF would be recommended to support activities in southeastern Michigan and two-thirds would be recommended to support charities in Northville, Michigan.[38]

The IRS issued an adverse ruling regarding the Foundation's status as a supporting organization, on two grounds.[39] First, the IRS determined that the Foundation failed to satisfy the "attentiveness" requirement under the integral part test. Second, the IRS determined that disqualified persons controlled the Foundation. In particular, because the Foundation's primary asset was a promissory note secured by assets of a corporation controlled by the Laphams, the IRS determined that the Laphams are in a position to control the Foundation by means of the power they exercise over the Foundation's primary asset.[40]

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35 *Id.* at 3-4.

36 *Id.* at 8.

37 *Id.* at 10.

38 *Id.* at 11.

39 After the IRS issued a proposed adverse ruling as to its supporting organization status, the Foundation proposed to amend its articles of incorporation to include the First Presbyterian Church of Northville, Michigan and the Boy Scouts of America Detroit Area Council as supported charities. However, on procedural grounds, the Court reached its decision without considering these proposed changes. *Id.* at 27-31.

40 *Id.* at 15-16.

During the administrative process, the IRS also claimed that the Lapham Foundation failed to satisfy the responsiveness test, alleging that the AEF-appointed director lacked the requisite "significant voice" in the activities of the Foundation.[41] However, the Court found that the IRS did not satisfy its burden in that regard. The Court noted that although the Foundation had few assets requiring active management, the IRS had not shown that future revenue would not be earned to render the management role increasingly material. Moreover, the Court stated that certain of the IRS' statements "seem to conflate influence with control" to a degree unsupported by the regulations and the case law.[42] Interestingly, the Court noted favorably the fact that the AEF-appointed director would serve on the advisory committee of the Foundation's donor-advised fund account at AEF and would therefore have a significant voice in recommending grants. The Court also noted favorably the fact that AEF exercises final authority over distributions from the Foundation's donor-advised fund account because the Foundation may only make non-binding recommendations.[43]

The Court next analyzed whether the Foundation satisfied the integral part test, and concluded it did not. First, the Court addressed the "but for" test and noted that this test has been interpreted by the Tax Court to generally apply to situations where the supporting organization actually engages in specific functions or activities, as opposed to mere grant making.[44] Similarly, the IRS argued that the "but for" test applies only in cases where the supporting organization's involvement extends beyond mere grant making.[45] The Court did not reach a definitive view on this issue in this case because it found that the Foundation did not satisfy the second prong of the "but for" test, namely that but for the involvement of the supporting organization, the activities carried out by the supporting organization would normally be engaged in by the supported charity itself. The Foundation argued that it was providing the only support for AEF's activities in Northville, Michigan and therefore, but for the Foundation's support, those activities would not exist. However, according to the Court, AEF is not bound by the Foundation's

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41 *Id.* at 34.

42 *Id.* at 35-36.

43 *Id.* at 36.

44 *Id.* at 38, *citing Roe Foundation Charitable Trust v. Commissioner*, TC Memo 1989-566 (1989), at 89-2810.

45 *Lapham,* T.C. Memo 2002-293 at 38-39.

recommendations and theoretically could use the Foundation's support anywhere in the United States. Moreover, the Court found that distributing grant funds is an activity in which AEF is and will continue to be engaged regardless of the Foundation's support. The Foundation, therefore, could not demonstrate the type of dependency required by the "but for" test.[46]

The Court next turned to the "substantially all" test, focusing in particular on the requirement that the amount of support received by the supported charity ensure the attentiveness of the supported charity and that the amount of support represent a sufficient part of the supported charity's total support so as to ensure attentiveness. The Court found that anticipated annual contributions from the Foundation of $7,600, when measured against annual contributions received by AEF in excess of $7 million, was not sufficient to ensure attentiveness.[47]

But the Foundation argued that it supported a particular activity of AEF -- supporting charities in Northville, Michigan – and that without the Foundation's support, this activity would be interrupted.[48] The Court did not accept this argument. First, the Court stated that this approach is only available if the supporting organization or the supported charity earmarks the support. Because the Foundation could only make non-binding recommendations with respect to its donor-advised fund account, it could not earmark its contributions. Moreover, the Foundation had not established that AEF had earmarked the Foundation's contributions. Second, the Court stated that there was no evidence that benefiting Northville, Michigan is a substantial activity of AEF or that AEF's minimal expenditures in Michigan would be interrupted absent the Foundation's support.[49]

Finally, the Foundation argued that evidence of AEF's actual attentiveness existed, citing the Foundation's intention to provide AEF with annual reports and AEF's appointment of a Northville, Michigan resident to the Foundation's Board. The Court was not persuaded. In light of the vast difference in the size and scope of the programs of the Foundation and AEF,

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[46] *Id.* at 39-41.

[47] *Id.* at 42-43.

[48] *Id.* at 44.

[49] *Id.* at 44-45. Because the Court ruled that the Foundation did not satisfy the integral part test, it did not reach the question of whether the Foundation was controlled by disqualified persons by virtue of the Laphams' control of the Foundation's primary asset. *Id at 45.*

establishing attentiveness would require more than "pointing to a few administrative formalities."[50]

Accordingly, the Court concluded that the Lapham Foundation should be classified as a private foundation.[51]

***Cuddeback***

The Christie E. Cuddeback and Lucille M. Cuddeback Memorial Fund (the "Cuddeback Fund" or the "Fund") was created as a testamentary trust. Upon the death of the testator's niece, the income of the Cuddeback Fund was to be paid to three organizations – two churches and a section 509(a)(1) nursing home care facility, Keswick Multi-Care Center ("Keswick"). The two churches were each to receive ten percent of the Cuddeback Fund's income and Keswick was to receive eighty percent.[52]

In conjunction with its adult daycare program, Keswick offers grants to some participants who could not otherwise afford to pay Keswick's charges.[53] The testator's will provided that the income paid to Keswick should be used by it "to cover not more than one-half (1/2) of the cost of such elderly persons enrolled in the Day Care Program operated by Keswick, who do not have financial means to pay all costs thereof."[54]

Several years after the death of the testator and her niece, the Cuddeback Fund filed a Form 1023 seeking recognition as a supporting organization.[55] Along with the Form 1023, the Cuddeback Fund submitted a letter from Keswick's chief financial officer describing the Fund's

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50 *Id.* at 43-44.

51 *Id.* at 46.

52 *Cuddeback,* T.C. Memo 2002-300 at 2-4.

53 *Id.* at 4.

54 *Id.*

55 *Id.* at 6.

participation in Keswick's activities.[56] Nonetheless, the IRS issued a proposed adverse ruling, concluding that the support provided by the Cuddeback Fund was not sufficient to ensure Keswick's attentiveness and that therefore the Fund did not satisfy the integral part test.[57]

In its appeal, the Cuddeback Fund argued that Keswick's adult day care program is a substantial activity and that without the Fund's support, the "grant program" would be interrupted. Accordingly, the Fund argued that its support of Keswick's grant program would ensure the attentiveness of Keswick.[58] The Fund also submitted supplemental letters from Keswick with additional information regarding the number of participants in the adult daycare program and the extent to which the Fund's support defrayed the costs of the grant program. The correspondence from Keswick claimed that without the Cuddeback Fund's support, there would be a "significant reduction in the number of seniors served" at Keswick.[59] Nonetheless, the IRS issued a final adverse ruling that the Fund failed to qualify as a supporting organization.[60]

The Cuddeback Fund did not claim to satisfy the "but for" test, and the Court noted that the Fund does not engage in any activities on behalf of Keswick, other than distributing funds to Keswick.[61] Therefore, the Court's analysis focused on the "substantially all" test, and in particular on the "attentiveness" requirement. The Fund and the IRS disputed several key points: (i) whether the Fund's support was earmarked for the adult daycare program generally or specifically a program to provide support to needy participants, (ii) whether "interruption" means discontinuance of a program, as opposed to curtailment, and (iii) whether the adult daycare program and the grant programs are "substantial" activities as required by the regulations.[62] The Court, in large part, did not resolve these questions. Rather, in ruling against the Fund, the Court relied on what it viewed as a sketchy and inconsistent record. According to the Court, the record did not provide sufficient information to evaluate the financial impact of the adult daycare

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56 *Id.* at 6-7.

57 *Id.* at 9-10.

58 *Id.* at 11.

59 *Id.*

60 *Id.* at 12-14.

61 *Id.* at 22.

62 *Id.* at 32-33.

program or the grant program on Keswick as a whole, and critically, the impact the Cuddeback Fund's support had on these programs.[63] The Court emphasized that the existence of other funding sources for the grant program suggested that Keswick might not depend on the Fund to the extent asserted by the Fund and Keswick.[64] The Court held that the Fund did not demonstrate that Keswick would be sufficiently attentive to the Fund's operations in order to avoid an interruption of either the adult daycare program or a program to provide grants to needy participants.[65] In addition, the Court found that there was no evidence that Keswick exercised actual attentiveness, notwithstanding Keswick's letters of support to the contrary.[66]

Accordingly, the Court did not resolve the interesting question of whether interruption requires actual discontinuance of a program or activity, as the IRS argued.

**Lessons Learned from the Cases**

A number of lessons may be learned from these cases.

*First, the facts must support the required relationship.*

The *Lapham* and *Cuddeback* cases illustrate the importance of a factual record that can support the relationship required by the regulations. The Court in *Cuddeback* relied heavily on what it viewed as an incomplete and inconsistent record in reaching its decision. Despite several supportive letters submitted by Keswick, the Court nonetheless concluded that the record did not provide sufficient information to conclude that Keswick would be attentive to the Cuddeback Fund. While the *Lapham* case did not suffer from a deficient record, the facts convinced the Court that the Lapham Foundation's support was insubstantial in relation to AEF's overall support.

Moreover, newly-formed organizations may face a particular challenge in demonstrating attentiveness since there is no history of its support of the supported charity. This is not

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63 *Id.* at 33-43.

64 *Id.* at 39-40.

65 *Id.* at 43.

66 *Id.* at 44.

necessarily an insurmountable obstacle so long as the organization's anticipated contributions in relation to the total support of the supported charity or a specific and identifiable program of the charity is sufficient to persuade the IRS that the supported charity will be dependent upon the organization, and therefore attentive to the supporting organization.

But the cases also illustrate the inherent subjectivity of the regulations. Attentiveness and dependence are not necessarily quantifiable, and to rely solely on numerical information to draw conclusions in this regard can possibly yield disparate results. For example, in another Tax Court case from 1986, the income from a testamentary trust was to be used to provide scholarships to students attending college in Oregon, with a preference for students attending Northwest Christian College ("Northwest").[67] Although the support provided by the trust amounted to only eight percent of the scholarship funds at Northwest and affected only nine percent of the full-time students, the Court nonetheless found that there was sufficient evidence of actual attentiveness. The Court took into account all of the pertinent circumstances, including the amount of funds distributed, the number of students affected, and the history and nature of the relationship between the trust and Northwest.[68] Testimony from Northwest's president that a reduction in funds from the trust would cause Northwest to "expend efforts to obtain offsetting funds elsewhere" was given credence as well.[69] If the trust had been a newly-formed organization seeking recognition as a supporting organization, query whether the fact that the trust's support amounted to only eight percent of Northwest's scholarship funds and affected only nine percent of the students would have persuaded the IRS or the Court that Northwest would be sufficiently attentive to the trust. Furthermore, contrast this holding with the IRS' position that the "rule of thumb" in testing attentiveness is that the supporting organization's grants must represent at least *ten* percent of the supported charity's total support.[70]

Some degree of subjectivity in this analysis is unavoidable. Yet, the extent to which subjectivity affects the outcome may be ameliorated through the submission of a thorough and strong record of facts to support a conclusion that, as required by the regulations, the amount of support provided by the supporting organization is sufficient to ensure a meaningful degree of dependence by the supported charity upon the support provided by the supporting organization.

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67 *Cockerline Memorial Fund v. Commissioner*, 86 T.C. 53 (1986) at 54-55.

68 *Id.* at 61-62.

69 *Id.* at 62.

70 GCM 36379 (August 15, 1975).

*Second, the "interruption" approach requires demonstration of a substantial and separately identifiable activity, and in the IRS' view, may require a showing of discontinuance.*

Both the Lapham Foundation and the Cuddeback Fund argued that they supported a specific program or activity of the supported charity and that a reduction in their support would interrupt the program or activity. These arguments failed to sway the IRS or the Tax Court.

Substantial Activity. First, the Court correctly noted, as specified by the regulations, that the purported program or activity must be substantial. In neither case did the Court find that the organization satisfied its burden in this regard. In the *Lapham* case, the Foundation failed to convince the Court that the activity in question really was a separate and identifiable program or activity. In the *Cuddeback* case, there was a clear dispute regarding the nature of the separate program or activity being supported by the Cuddeback Fund. If an organization seeking recognition as a supporting organization relies on the "interruption" approach to demonstrate attentiveness, the record should reflect that the activity supported is indeed a separately identifiable and substantial activity.

Interruption vs. Discontinuance. The IRS argued in *Cuddeback* that "interruption" of a program or activity requires its discontinuance. The Court did not address this question in reaching its decision. It can be argued, though, that "interruption" should not require a showing that the program or activity would be discontinued. As discussed above, the regulations governing the integral part test seek to ensure that the supported charity is motivated to be attentive to the supporting organization. Presumably, a reduction in support for a particular program or activity that has a material impact on the program (e.g., a substantial reduction in the number of charitable beneficiaries that can be served by the program), short of requiring its discontinuance, would nonetheless motivate a supported charity to be attentive to the supporting organization.

*Third, grant making organizations may have difficulty satisfying the "but for" test.*

In the *Lapham* case, the IRS argued that the "but for" test applies only in cases where the supporting organization's involvement extends beyond mere grant making. The Court supported this view as well. The IRS has made this same argument in several general counsel memoranda.[71] However, in GCM 38417, which, like *Lapham*, also involved an organization

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[71] See GCM 36523 (December 18, 1975); GCM 36379 (August 15, 1975). See also Internal Revenue Service Continuing Professional Education Text for Fiscal Year 1997, Chapter I., "Public Charity Status on the Razor's Edge."

seeking recognition as a supporting organization to a community trust, the IRS Chief Counsel took a different approach:

> "The argument that grant-making is not an activity which performs the functions of or carries out the purposes of a publicly supported community trust ignores the fact that grant-making is frequently the means by which such trusts accomplish their charitable purposes . . .. Consequently, while the only activity of the supporting organization is grant-making, we do not believe that activity falls outside the scope of term 'activities' in section 1.509(a)-4(i)(3)(ii)."[72]

However, it should be noted that in GCM 38417 the supporting organization made grants directly to the class of charitable beneficiaries that were also supported by the community trust. This distinction is clearly significant in the IRS' view. In GCM 36043, for example, two supporting organizations were operating their own scholarship programs rather than making grants to the colleges' scholarship programs. The Chief Counsel was of the view that the supporting organization was performing a function of the colleges:

> "Both the *** trusts are operating their own scholarship programs rather than simply making grants to the publicly supported organizations. Since the granting of scholarships is an accepted function of the colleges, the trusts may be considered to be performing a function of the colleges."[73]

*Finally, supporting organizations to donor-advised funds can learn several lessons from the Lapham Case.*

The *Lapham* case raises several interesting issues for organizations seeking recognition as supporting organizations to public charities that sponsor donor-advised funds.

The Court, in holding that the Lapham Foundation satisfied the responsiveness test, noted favorably the fact that the AEF-appointed director would serve on the advisory committee of the Foundation's donor-advised fund account at AEF and would therefore have a significant voice in

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72 GCM 38417 (June 20, 1980).

73 GCM 36043 (October 9, 1974). Nonetheless, the Chief Counsel was of the view that the second prong of the "but for" test was not satisfied because there was no evidence that the colleges would have engaged in the scholarship programs without the trusts.

recommending grants. The Court also noted favorably the fact that AEF exercises final authority over distributions from the Foundation's donor-advised fund account. Accordingly, the fact that the supporting organization may make only non-binding recommendations with respect to distributions from the donor-advised fund can be seen a positive factor in demonstrating satisfaction of the responsiveness test. Another positive factor is the participation by the officer or director appointed by the supported charity in making such recommendations.

In the *Lapham* case, the Court stated that the "interruption" approach is available only if the supporting organization or the supported charity earmarks the support. Because the Lapham Foundation could only make non-binding recommendations with respect to its donor-advised fund account, it could not earmark its contributions. But must actual earmarking be a prerequisite to the availability of the "interruption" approach? While it is true that the regulations state that that interruption of an activity or program "may be the case" where the contributions are earmarked, this language could be interpreted as illustrative, rather than mandatory. Moreover, while a supporting organization (like any donor) may not formally earmark its contributions to a donor-advised fund, the supporting organization could in its account opening documentation commit to supporting a substantial program or activity of the supported charity. Therefore, while the supported charity retains the discretion with respect to each recommendation, the same result is achieved, from an "interruption" perspective, as if the funds had actually been earmarked.

APPENDIX II

PROFILE OF A SUPPORTING ORGANIZATION ("SO")
UNDER IRC § 509(a)(3) AND TREAS. REG. § 1.509(a)-4

I. IRC: A. Organized & operated test — Operated, supervised, or controlled by or in connection with a public charity ("PC") and — B. Not controlled directly or indirectly by disqualified persons or non-PCs

II. Treasury Regulations:

A. Organization Test[74] - Articles of organization (charter, trust, articles of association) must

1. Limit the purposes to 509(a)(3)(A) purposes: to benefit, perform functions of, or carry out purposes of specified PC(s),
2. Not expressly empower organization to engage in activities beyond those above,
3. State the specified PC(s) to be benefitted, and
4. Not expressly allow the SO to support any but the specified PC(s).

Operational Test[75]

a. Permissible beneficiaries: payments to or for use of specified PC(s), providing payments, services, or facilities to individuals in charitable class benefitted by specified PC(s), and certain grants to organizations
b. Permissible activities: pay income to specified PC(s) or use income for independent activity to benefit specified PC(s) or its charitable beneficiaries

[74] Treas. Reg. § 1.509(a)-4(c) and (d) (specified-organization rules).

[75] Treas. Reg. § 1.509(a)-4(e).

B. Relationship Test[76]

All require: SO must be responsive to specified PC(s)'s needs, demands and SO will be integral part of or significantly involved in PC operations. Three types of relationships:

| TYPE 1 | TYPE 2 | TYPE 3 |
|---|---|---|
| Operated, supervised, controlled BY PC(s) | Supervised or controlled IN CONNECTION WITH PC(s) | Operated IN CONNECTION WITH PC(s) |
| Analogy: Parent-subsidiary | Analogy: Brother-sister affiliates | Analogy: Responsive and significantly involved private foundation |
| Key Features: PC elects or appoints majority of SO's officers, directors, or trustees. PC can exercise power through its governing body, their designees, officers acting in their official capacity or membership | Key Features: PC and SO are under common control of same persons who can thereby insure that SO will be responsive to PC's needs | Key Features: SO must prove responsiveness by having one or more of the SO's officers, director or trustees elected or appointed by PC(s); or overlap between PC(s)' and SO's officers, directors, trustees, or other important officers, or SO's officers, directors, or trustees maintain a "close and continuous working relationship" with PC counterparts AND PC managers have significant voice in SO's investment policies, grant timing, grant making, selection of recipients, directing use of income or assets.<br><br>Special trust responsiveness test: Each PC is named in trust and can enforce trust and compel accounting under state law.<br>Integral part test for all Type 3 SOs: PC(s) |

[76] Treas. Reg. § 1.509(a)-4(f)-(i).

for" SO, PC would do what SO does or (ii) SO pays "substantially all" of its income to PC and amount is sufficient to assure PC's attentiveness.

C. Disqualified Persons Do Not Control SO[77]

One or more disqualified persons under IRC § 4946 cannot directly or indirectly control SO. IRC § 4946 substantial contributors, 20%+ owner of corporation, partnership, or trust, their families and their corporations, trusts, or partnerships. Foundation managers who are not otherwise DQPs and PCs are not counted in testing for control. "Control" means DQPs can aggregate votes or positions of authority to require SO to perform or refrain from performing an act.

Indirect control: Facts and circumstances including asset analysis and appointment of a DQP's employees.

Church rule: Church SO won't be controlled by DQPs if governed by individuals each of whom is a substantial contributor if bishop or other church representative controls policies and decisions.

D. Non-PC SOs[78]

"Flush left" language in Code allows SOs for charitable, etc. purposes of organizations described in § 501(c)(4) (social welfare or labor organizations); (c)(5) (agricultural organizations); or (c)(6)(business leagues) that meet the one-third support test of a § 509(a)(2) PC.

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[77] Treas. Reg. § 1.509(a)-4(j).

[78] Treas. Reg. § 1.509 (a)-4(k).

APPENDIX III

**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.**

G*rant 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.*