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# Legislating in the Dark: How Congress Regulates Tax-Exempt Organizations in Ignorance

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# LEGISLATING IN THE DARK: HOW CONGRESS REGULATES TAX-EXEMPT ORGANIZATIONS IN IGNORANCE

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## I. INTRODUCTION

In responding to emergencies as it did recently in the Emergency Economic Stabilization Act of 2008[1] and the American Recovery and Reinvestment Act of 2009,[2] Congress necessarily acts largely in the dark. In the midst of a crisis, time simply does not permit gathering the desirable information, assuming that the information could actually be found. Unfortunately, however, Congress's tendency to legislate in the dark is not restricted to emergencies that require immediate action. This phenomenon is particularly marked in the area of tax-exempt organizations.

This legislative tendency might be excused if the tax-exempt sector were a minor sideshow. In fact, it is a large and vital part of our economy and society. It produces more than eleven percent of U.S. gross domestic product.[3] One of every eleven paid employees in the United States is employed in the tax-exempt sector, and almost six million people volunteer their services to tax-exempt organizations.[4] Tax exempts play a particularly important role in health care and education. Exempt hospitals constitute

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1. Pub. L. No. 110-343, 122 Stat. 37.
2. Pub. L. No. 111-5, 123 Stat. 115.
3. *Overview of the Tax Exempt Sector: Hearing Before the H. Comm. on Ways & Means*, 109th Cong. 6, 14 (2005) (statement of David M. Walker, Comptroller General, United States Government Accountability Office).
4. *Id.* at 14–15. For comparison, food and lodging also account for nine percent of the workforce, while manufacturing and retail each account for fourteen percent. *Id.* at 15.

almost ninety percent of the entire hospital sector.[5] Not-for-profit institutions constitute almost sixty percent of all private four-year colleges and universities in the United States.[6] Without the contributions of exempt organizations, both health care and higher education would literally collapse.

Proper regulation of the tax-exempt sector poses many difficult questions. For example, there are important open issues about executive compensation[7] and, in the area of health care, the level of charity care hospitals should be required to provide if they are to be tax-exempt.[8] In the area of education, questions have been raised recently about the enormous endowments of certain elite institutions.[9] Generally, there are serious questions about the underlying rationale for tax-exempt status and the range of activities that should qualify.[10]

From time to time, Congress commissions the Internal Revenue Service ("IRS") to study a particular issue relating to exempt organizations,[11] and it generally holds hearings before enacting specific legislation.[12] It lacks, however, a strong ongoing base of information for legislation in this area.[13] Congress ignores tax-exempt organizations for long periods of time until a scandal

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5. Press Release, U.S. Census Bureau, Doctors & Dentists Account for 27 Percent of $1.6 Trillion in Health Care Revenue (Dec. 13, 2007), *available at* http://www.census.gov/Press-Release/www/releases/archives/health_care_insurance/011077.html (summarizing data from 2006 Service Annual Survey: Health Care and Social Assistance).

6. *See* U.S. DEP'T OF EDUC., INST. FOR EDUC. SCIS., DIGEST OF EDUC. STATISTICS 2007, tbl. 255 (2007), *available at* http://nces.ed.gov/programs/digest/d07/tables/dt07_255.asp.

7. *See, e.g.*, Jill S. Manny, *Nonprofit Payments to Insiders and Outsiders: Is the Sky the Limit?*, 76 FORDHAM L. REV. 735, 735 (2007).

8. *See, e.g.*, Jessica Berg, *Population Health and Tax-Exempt Hospitals: Putting the Community Back into the "Community Benefit" Standard*, 43 GA. L. REV. (forthcoming 2010) (manuscript at 2), *available at* http://ssrn.com/abstract=1243963.

9. *See, e.g.*, Mark J. Cowan, *Taxing and Regulating College and University Endowment Income: The Literature's Perspective*, 34 J.C. & U.L. 507, 508–09 (2008).

10. *See, e.g.*, *id.* at 509.

11. *See, e.g.*, I.R.S. HOSPITAL COMPLIANCE PROJECT FINAL REPORT (2009), *available at* http://www.irs.gov/pub/irs-tege/frepthospproj.pdf (discussing IRS study of non-profit hospitals in determining how non-profit hospitals establish and report executive compensation).

12. *See generally* U.S. Treasury, Fact Sheet on Writing & Enacting Tax Legislation, http://www.treas.gov/education/fact-sheets/taxes/writing.shtml (explaining the process by which Congress enacts legislation) (last visited Dec. 18, 2009).

13. *See, e.g.*, Pablo Eisenberg, *Looking Ahead: What is the Future for the Nonprofit World?*, 8 INT'L J. OF NOT-FOR-PROFIT L. 81, 83 (2005).

draws the attention of the press to a real or purported problem.[14] It then reacts to the public outcry, often without really knowing the extent of the problem or whether the remedies it imposes will solve or aggravate it.[15] This is due in large part to the fact that the IRS, the agency charged with overseeing tax-exempt organizations and providing Congress the information it needs for legislation, has not been given sufficient resources to develop the necessary information and would be ill-suited to the task even if properly funded.[16] This article illustrates this phenomenon through a case study of the legislation on donor-advised funds enacted as part of the Pension Protection Act of 2006.[17]

Donor-advised funds are charitable-giving vehicles widely used by those who want to make a charitable contribution and receive a tax deduction while waiting to decide how the contributed money will be used.[18] They can support a wide range of charitable causes ranging from scholarships to soup kitchens and from museums to clinics in low-income neighborhoods. They have existed for more than seventy-five years, but Congress paid no attention to them until articles appeared in the press alleging abuses at a small number of donor-advised funds.[19]

The resulting legislation contained in the Pension Protection Act of 2006 restricts donor-advised funds in ways that Congress hoped would prevent future abuses.[20] It is not at all clear that abuses were sufficiently widespread or serious to justify the legis-

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14. *See id.*

15. *See id.*

16. *See* U.S. GEN. ACCOUNTING OFFICE, GAO-02-526, TAX-EXEMPT ORGANIZATIONS: IMPROVEMENTS POSSIBLE IN PUBLIC, IRS, AND STATE OVERSIGHT OF CHARITIES 20–21 (2002).

17. Pub. L. No. 109-280, 120 Stat. 780, 1094–1102 (codified as amended in scattered sections of 26 U.S.C.).

18. *See* Jilian Mincer, *Time to Convert? A Number of Philanthropists Are Shutting Down Private Foundations and Turning to Donor-Advised Funds; Here's Why You Should—and Shouldn't—Do It,* WALL ST. J., Nov. 9, 2009, at R8; *see also* I.R.C. §§ 170(a), (f)(18), 4966(d)(2) (2006).

19. *See* Victoria B. Bjorklund, *Charitable Giving to a Private Foundation: The Alternatives, the Supporting Organization, and the Donor-Advised Fund,* 27 EXEMPT ORG. TAX REV. 107, 114 (2000); Ashlea Ebeling, *The Coming Charity Crackdown,* FORBES, Aug. 15, 2005, at 67 (discussing abuses and upcoming potential legislation for donor-advised funds).

20. *See* INDEP. SECTOR, ANALYSIS OF CHARITABLE REFORMS & INCENTIVES IN THE "PENSION PROTECTION ACT OF 2006" 1 (2007), *available at* http://www.independentsector.org/programs/gr/Pension_Bill_Summary.pdf; *see generally* Pension Protection Act of 2006, Pub. L. No. 109–280, 120 Stat. 780.

lation, which may discourage the creation of donor-advised funds and makes it more difficult for them to continue to perform worthwhile activities.[21]

Part II introduces donor-advised funds and briefly summarizes their history. Part III examines the private and public advantages of donor-advised funds, which could be lost through ill-advised legislation or regulation. Part IV explores some of the ways in which donor-advised funds can be and have been abused and summarizes the reform proposals that preceded the Pension Protection Act of 2006. Part V sets forth the provisions of the Pension Protection Act of 2006 that affect donor-advised funds and argues that most of their weaknesses stem from the fact that Congress lacked the information necessary to determine how extensive abuses of donor-advised funds were and assess the potential positive or negative effects of the legislation. Part VI concludes that if Congress is to regulate the tax-exempt sector intelligently, it needs to appropriate more money for its oversight and regulation and should consider creating a new entity to regulate it.

## II. DONOR-ADVISED FUNDS[22]

Writing a check to a public charity like the Red Cross gives rise to a current tax deduction, but once the contribution has been made, the donor has no control over how the money will be used.[23] Rather than contributing directly to a public charity, larger donors sometimes establish private foundations which permit them to retain a high degree of control over how their donations will be used.[24] A private foundation is a legal entity with its own board of directors that decides which charities will receive foundation funds, how much they will get, and when.[25] By using a private

21. *See* INDEP. SECTOR, CHARITABLE REFORMS AND INCENTIVES IN SENATE VERSION OF TAX RECONCILIATION BILL 1–2 (2006); Independent Sector, Background on Charitable Incentive and Reform Provisions in Tax Legislation, http://www.independentsector.org/programs/gr/charityreform_back.html (last visited Dec. 18, 2009).

22. I will use the term "donor-advised fund" only to refer to individual accounts. The individual account often bears the name of the donor or donor's family. For clarity's sake, I will refer to the charity that establishes the accounts as the sponsor.

23. *See* Pauley v. United States, 459 F.2d 624, 626–27 (9th Cir. 1972); Treas. Reg. § 1.170A-1 (a)–(b) (2009).

24. *See generally* LDS Philanthropies, Private Foundations, http://ldsphilanthropies.org/planned-giving/ways-i-can-give/tools/private-foundation-1.html (last visited Dec. 18, 2009); *see also* I.R.C. § 509(a)(2)-(3), (f)(2) (2006).

25. *See* 1-16 PLANNING TAX-EXEMPT ORGANIZATIONS § 16.01 (2009); *see also* I.R.C. §

foundation, donors can obtain immediate tax deductions while still retaining control over how and when their funds will be used.[26] Private foundations are, however, expensive to establish and require considerable ongoing attention and expense.[27]

Donor-advised funds offer donors many of the advantages of private foundations at considerably lower cost in time and money.[28] They are sponsored and administered by independent public charities.[29] Donors contribute to the sponsoring charity not to support its charitable activities but rather to establish a separate fund or account from which distributions can be made to other charities suggested by the donor.[30]

The money contributed to a donor-advised fund is usually not distributed immediately.[31] The donor need not, however, wait for the funds to be distributed to claim a charitable contribution deduction for tax purposes.[32] Because the assets immediately and irrevocably become the property of the charity to which they are contributed, the donor is entitled to a deduction when the contribution is made.[33] Donors to donor-advised funds do not have legal control over the distribution of the funds they contribute, but in practice they can have a high degree of confidence that the sponsoring charity will respect their wishes.[34] Donor-advised funds

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509.

26. *See* Maroko & Landau, P.C., *Why Establish a Private Foundation?* (1999), http://library.findlaw.com/1999/August/1/131037.html.

27. Thomas F. Horton, *Effective Charitable Planning Strategies After the 2001 Tax Act*, 29 EST. PLAN. 580, 586 (2002).

28. *See* Bjorklund, *supra* note 19, at 108.

29. *See* I.R.C. § 4966(d)(1)–(2); Elfrena Foord, *Philanthropy 101: Donor-Advised Funds*, 16 J. FIN. PLAN. 66, 66 (2003).

30. Foord, *supra* note 29.

31. *See* Sara Hansard, *Concerns May Foil a Tax Break Eyed by Donor-Advised Funds*, INVESTMENT NEWS, Oct. 22, 2007, at 2, *available at* http://www.investmentnews.com/article/20071022/free/710220342.

32. *See* I.R.C. § 170(a)(1), (f)(18).

33. *See id.*

34. Most sponsoring organizations impose some restrictions beyond those imposed by the Internal Revenue Code on all deductible charitable contributions. For instance, the vast majority of sponsoring organizations will not make grants to foreign charities. VICTORIA B. BJORKLUND, THE PROS AND CONS OF DONOR-ADVISED FUNDS AS ALTERNATIVES TO PRIVATE FOUNDATIONS app. at D–3 (2004), *available at* http://www.abanet.org/rppt/meetings_cle/joint2004/JointSectionPrograms/PhilanthropyinEstatePlanning/VictoriaBjorklund.pdf. Certain sponsors require that all or part of the distributions from donor-advised funds go to specific causes. *See* Foord, *supra* note 29, at 66, 72. The Domini Global Giving Fund, for instance, allows donors to earmark money solely to benefit the U.N. Foundation's programs. *See* Leah Kerkman, *A Soaring Year*, CHRON. OF

thus combine immediate deductibility with on-going practical control, without the expense in time and money required to establish and maintain a private foundation.

The first donor-advised fund was created by the New York Community Trust in the early 1930s.[35] For many years, community foundations were the principal sponsors of donor-advised funds.[36] Little public attention was paid to donor-advised funds until 1991, when Fidelity Investments created the Fidelity Investments Charitable Gift Fund, the first commercially backed sponsor of donor-advised funds.[37] The Charitable Gift Fund is an independent public charity with the broad mission of "further[ing] the American tradition of philanthropy by providing programs that make charitable giving simple and effective."[38] The Charitable Gift Fund serves as a sponsor for donor-advised funds, whose assets it invests primarily in Fidelity mutual funds.[39] Other brokerage houses quickly saw that establishing charities that would sponsor donor-advised funds was a way of attracting new money to their mutual funds.[40] Currently, donor-advised funds are sponsored by community foundations, other public charities (particularly universities and groups like the Jewish Communal Foundation), and charities formed by brokerage houses and banks.[41]

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PHILANTHROPY, May 4, 2006, at 27.

It is rare for a donor-advised fund not to act upon advice that does not violate the Internal Revenue Code or its own internal funding guidelines, but there have been some cases. For instance, the family of the donor of $300 million to the Searle Fund at the Chicago Community Trust sued the Chicago Community Trust for failing to seek or honor the family's advice. *See* Stephen Greene, *Seeking Control in Court*, CHRON. OF PHILANTHROPY, Nov. 28, 2002, at 6.

35. Bjorklund, *supra* note 19, at 114.

36. *See id.*

37. Wendell R. Bird, *How to Establish Donor-Advised Funds and Community Foundations*, 13 TAX'N EXEMPTS 68, 69 (2001).

38. Fidelity Charitable Gift Fund, Learn About the Gift Fund and Our Charitable Mission, http://www.charitablegift.org/learn-about-charity/overview.shtml (last visited Dec. 18, 2009).

39. *See id.*; Fidelity Charitable Gift Fund, Quarterly Pool Performance, http://www.charitablegift.org/charity-giving-programs/daf/investments/performance/legal-information.shtml (last visited Dec. 18, 2009).

40. *See, e.g.*, Tamar Lewin, *Mutual Fund Giants Are Now Competing for Charitable Donors, Too*, N.Y. TIMES, Jan. 21, 2001, § 1, at 24.

41. *See, e.g.*, *id.*

Thanks in large part to the aggressive advertising of Fidelity Investments and its commercial competitors, as well as the efforts of community foundations to compete with them, donor-advised funds have grown very rapidly.[42] In 2005, 85 of the 125 largest community foundations reported that they held more than 21,000 donor-advised funds with total assets of $6.55 billion.[43] They made grants of more than $1 billion.[44] New gifts to donor-advised funds at those community foundations totaled $1.36 billion in 2005.[45] The New York Community Trust alone held $700 million in more than 1,000 donor-advised funds ranging from $5,000 to $99 million in size.[46] Among commercially sponsored funds, the Fidelity Charitable Gift Fund, the largest single sponsor of donor-advised funds, has almost 48,000 donor-advised funds with combined assets of over $4.7 billion as of 2008.[47]

Donor-advised funds are widely used by wealthy donors. According to one study published in 2006, sixteen percent of all high net-worth households have established a donor-advised fund.[48] The popularity of donor-advised funds increases with wealth. For example, only 8.2% of households with wealth of $1 million to $5 million have donor-advised funds, but 23.1% of households whose wealth exceeds $50 million (the highest category in the survey) have donor-advised funds.[49] Perhaps because donor-advised funds involve some degree of ongoing involvement of the donor, wealthy individuals who volunteer frequently are more likely to have donor-advised funds than those who do not.[50] More than twenty-five percent of those who volunteer frequently have donor-advised funds, whereas about sixteen percent of all other wealthy households have donor-advised funds.[51]

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42. *See id.*; Letter from Steve Gunderson, President and Chief Executive Officer, Council on Founds. to the I.R.S. 2 (Apr. 9, 2007) (on file with author).

43. *Id.*

44. *Id.*

45. *Id.*

46. *Tax-Exempt Charitable Organizations: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways & Means*, 110th Cong. 216, 216 (2007) (statement of New York Community Trust).

47. FIDELITY CHARITABLE GIFT FUND, 2008 ANNUAL REPORT 5 (2008).

48. THE CTR. ON PHILANTHROPY AT IND. UNIV., BANK OF AMERICA STUDY OF HIGH NET-WORTH PHILANTHROPY, INITIAL REPORT 7 (2006).

49. THE CTR. ON PHILANTHROPY AT IND. UNIV., BANK OF AMERICA STUDY OF HIGH NET-WORTH PHILANTHROPY, PORTRAITS OF DONORS 18 (2007).

50. *Id.* at 101.

51. *Id.*

## III. ADVANTAGES OF DONOR-ADVISED FUNDS

A donor can choose between donating directly to a charity which will use the funds for its own activities, establishing a private foundation, or donating to a donor-advised fund. Donating directly to a charity is the easiest and least expensive route, but in doing so the donor gives up all future control. In contrast, establishing a private foundation gives the donor considerable control over how the funds will be used in the future.[52] Donor-advised funds are an intermediate solution, since they allow donors to retain significant control over how their money will be used in the future; donors of donor-advised funds, however, retain somewhat less control than they otherwise would have over a private foundation.[53] From the point of view of the donor, the principal advantage of donor-advised funds over private foundations is that establishing a private foundation requires formation of a not-for-profit organization and obtaining IRS recognition of its exempt status.[54] The time, effort, and expense is often prohibitive for donations of less than several million dollars.[55] By contrast, setting up a donor-advised fund is simple and inexpensive or free. It usually requires nothing more than filling out a short form and writing a check to the sponsoring charity.[56] Most sponsors of donor-advised funds charge little or nothing to establish a donor-advised fund.[57]

Once a private foundation has been established, it is necessary to manage the investments, make grants, and comply with legal requirements, including the annual filing of Form 990 PF.[58] All of this can involve considerable effort and expense. The operating expenses of donor-advised funds are typically quite small, and the donor need do nothing more than recommend contributions from time to time.[59]

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52. Bjorklund, *supra* note 19, at 108.

53. *See id.*

54. *See* Nina J. Crimm, *A Case Study of a Private Foundation's Governance and Self-Interested Fiduciaries Calls for Further Regulation*, 50 EMORY L.J. 1093, 1150 (2001).

55. RON JORDAN & KATELYN L. QUYNN, INVEST IN CHARITY: A DONOR'S GUIDE TO CHARITABLE GIVING 134 (2001).

56. *See* Foord, *supra* note 29, at 70.

57. *Id.*

58. *See id.* at 72 tbl.2.

59. *See id.* at 70.

Another advantage of donor-advised funds is that their sponsors frequently have the expertise and staff to handle contributions of interests in real estate and businesses, which often are an important element in large contributions.[60] Small charities and private foundations usually lack the resources necessary to accept such gifts.[61]

In addition to their obvious advantages for donors, donor-advised funds have some advantages over private foundations from a public policy point of view. A fund for which the donor has advisory rights but is under the ultimate control of a public charity is arguably less open to abuse than a private foundation controlled by a single family or business.[62] The managers of the public charity that sponsors the donor-advised fund will, in most cases, be independent of the person who set up the donor-advised funds, have responsibilities to people other than the donor, and be aware of their personal liability.[63] Public charity managers have an interest in seeing that the activities of donor-advised funds do not compromise the exempt status of the sponsor, who will frequently be their employer.[64] The managers of public charities also will often have an interest in fostering charitable interests in the community.[65] The fact that donors need to present recommendations to independent, unrelated directors of the sponsoring charity may also lead to a certain degree of self-regulation by donors.[66] These factors taken together suggest that donor-advised funds may well be less subject to abuse than private foundations.

The public charities which sponsor donor-advised funds typically have professional staff, whereas according to one estimate, only

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60. *See* Gunderson, *supra* note 42, at 4.

61. *See id.*

62. Letter from Timothy W. Townsend, Gen. Counsel, Nat'l Christian Charitable Found., to the I.R.S. 12 (Mar. 26, 2007) (on file with author). For a discussion of the types of abuses to which both are subject, see *infra* Part IV.

63. Letter from Reynolds T. Cafferata, Attorney, Rodriguez, Horii & Choi LLP, to the I.R.S. 2 (Apr. 9, 2007) (on file with author).

64. *See* Townsend, *supra* note 62, at 12–13.

65. *See id.* at 4–5. It seems less likely that the executives of sponsoring charities established by investment firms like Fidelity have any special commitment to advancing charitable interests, but they do have an interest in maintaining the exempt status of their organizations. Given the size of those organizations, no single donor or group of donors is likely to represent a large enough percentage of the charity's assets to have much influence over them.

66. Cafferata, *supra* note 63, at 2.

five percent of all private foundations have any professional staff.[67] The presence of professional staff makes it easier to oversee compliance with the law and to conduct due diligence on recipients.[68] The New York Community Trust, for instance, reviews potential grantees to make sure that they have current financial statements or audits, operate with independent boards, have timely filed their Form 990, and have an adequate structure to carry out the programs for which the grant is to be made.[69] Sponsoring community foundations which limit their operations to a restricted area may also be in a position to conduct face-to-face due diligence of potential grantees.[70]

For these reasons, in 2005 the IRS Advisory Council on Tax Exempt and Government Entities advised encouraging greater use of donor-advised funds rather than formation of small organizations with free-standing tax exemptions.[71] The head of the New York Charities Bureau (part of the office of the state attorney general) went even further and recommended banning private foundations with less than $20 million in assets, observing that "the donors to and managers of small private foundations, who want to maintain their philanthropic commitment, would be able to transfer assets to donor-advised funds in community foundations and to other public charities, which are generally sufficiently professional."[72]

In evaluating existing legislation and in considering potential reforms, the benefits that donor-advised funds bring with them need to be kept in view because measures designed to curb potential abuses (which will be discussed in the next section) will almost invariably impose significant costs on legitimate entities and may discourage potential donors from giving to charity.

67. Letter from Kim Wright-Violich, President, Schwab Charitable Fund, to the I.R.S. (Apr. 5, 2007) (on file with author).

68. *See id.* at 3.

69. *See* Letter from Lorie A. Slutsky, President, N.Y. Cmty. Trust, to Robert Fontenrose and Susan J. Kassell, Counsel, I.R.S. (Apr. 9, 2007) (on file with author).

70. *See* E-mail from Karen Krei, Executive Dir., Piedmont Cmty. Found., to the I.R.S. 1 (Apr. 6, 2007) (on file with author).

71. I.R.S., ADVISORY COMM. ON TAX EXEMPT & GOV'T ENTITIES, PUBL'N 4344, REPORT OF RECOMMENDATIONS 17 (2005).

72. Grant Williams, *Making Philanthropy Accountable,* CHRON. OF PHILANTHROPY, June 26, 2003, at 23.

## IV. POTENTIAL ABUSES OF DONOR-ADVISED FUNDS AND REFORM PROPOSALS

Although there is no consensus over the justification for exempting charities from taxation and for granting a deduction to donors for contributions made to them, their tax-favored status is ultimately rooted in the belief that charities confer important public benefits on society. For this reason, to qualify as a charity, an organization must be "organized and operated exclusively" for certain charitable purposes listed in I.R.C. section 501(c)(3).[73]

A charity may not use its assets for the benefit of any person or entity with a close connection to the organization, such as directors, officers, and key employees, whether by paying excessive salaries, lending money at less than market rates, purchasing assets for more than their fair market value, or in any of the myriad other ways that unscrupulous insiders have invented to benefit personally from connections to exempt organizations.[74] In addition to this prohibition against benefits to insiders ("private inurement"), charities are also prohibited from using their assets to benefit private individuals more than incidentally, even if those individuals are not insiders ("private benefit").[75] Like private inurement, private benefit can occur in many different ways, for example, by paying excessive compensation, rent, or paying more

73. I.R.C. § 501(c)(3) (2006).

74. *See id.* ("[N]o part of the net earnings . . . [may] inure[ ] to the benefit of any private shareholder or individual."). In addition to obviously abusive transactions, unscrupulous individuals can use exempt organizations for transactions which do not violate any legal rule but which may be inappropriate. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-06-799, TAX EXEMPT ORGANIZATIONS: COLLECTING MORE DATA ON DONOR-ADVISED FUNDS AND SUPPORTING ORGANIZATIONS COULD HELP ADDRESS COMPLIANCE CHALLENGES 4 (2006). A loan at market rates to an insider who needs a loan quickly, for instance, is not a prohibited transaction, but may not be the best way of investing the exempt organization's funds. *See id.* at 4–5. Similarly, an exempt organization might purchase property from an insider at fair market value that the insider needs to sell even though the exempt organization has no particular need for the property and could find other more suitable investments. *See id.* at 4.

75. Treas. Reg. § 1.501(c)(3)–1(c)(2), (d)(1)(ii) (2009); *see* I.R.C. § 501(c)(3). The prohibition against private benefit is rooted in the statutory requirement that charities be operated exclusively for certain specified purposes. *See* BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS 599–601 (2007). For benefits to be incidental, they must be necessary concomitants of an activity that benefits the public at large. *See id.* Education, for instance, necessarily benefits the specific individuals who are educated. Incidental benefits must also be insubstantial when compared to the public benefit conferred by the activity. *See id.*

than market prices for goods even though the recipient is not technically an insider.

Congress has long believed that abuse of exempt organizations, whether in the form of private inurement or private benefit, is more likely to occur in organizations that are controlled by a few people than in those organizations that are responsive to the public at large. For this reason, since the early 1940s private foundations, which receive their support from a small number of people, have been subject to greater scrutiny and greater restrictions than public charities.

The increased scrutiny began in 1944 with a requirement that organizations that were not publicly supported charities file informational returns not required of publically supported charities.[76] In 1950 Congress imposed on private foundations an arm's-length standard in transactions with insiders and prohibited unreasonable income accumulations, use of income for non-exempt purposes, and investments that jeopardize the achievement of exempt purposes.[77] This legislation was ineffective, both because of the difficulty of determining whether transactions met the arm's length standard, and because the only penalty for violations—loss of exempt status—was so severe that the IRS prosecuted only the most egregious abuses.[78] Even when it did prosecute, the severity of the penalty made courts reluctant to impose it.[79]

The most important step in the process of imposing more onerous requirements on private foundations was triggered by a 1965 report in which the Treasury identified six major problems related to them: (1) self-dealing; (2) undue delay between the time a charitable contribution deduction was claimed and the time when the public benefited; (3) involvement in business by foundations; (4) use of foundations by families to control various property; (5) financial transactions not justified by any charitable function; and (6) involvement by donors in the management of foundations.[80] The Tax Reform Act of 1969 attempted to counter these

76. *See* Revenue Act of 1943, Pub. L. No. 78-235, § 117(a), 58 Stat. 21, 36–37 (1944); J. COMM. ON TAXATION, JCX-29-05, HISTORICAL DEVELOPMENT AND PRESENT LAW OF THE FEDERAL TAX EXEMPTION FOR CHARITIES AND OTHER TAX-EXEMPT ORGANIZATIONS 85–86 (2005).

77. Revenue Act of 1950, Pub. L. No. 81-814, § 331, 64 Stat. 906, 957–59.

78. J. COMM. ON TAXATION, *supra* note 76, at 91.

79. *Id.*

80. *Id.* at 88.

perceived abuses. It defined private foundations.[81] It generally forbade self-dealing, imposed a mandatory payout, limited permissible business holdings, prohibited jeopardizing investments, and imposed restrictions on foundation expenditures including grants to individuals and for any non-charitable purpose.[82]

For the next thirty years, although private foundations were subject to excise taxes for self-dealing, there was no sanction other than revocation of exempt status for public charities that engaged in self-dealing. In 1996 Congress introduced "intermediate sanctions"—excise taxes for acts of self-dealing by public charities that confer "excess benefits" on "disqualified persons."[83]

Donor-advised funds are potentially subject to all the abuses that could afflict both public charities and private foundations, including private inurement, private benefit, undue delay in distributions, and being used as vehicles to maintain family or personal control over businesses or other assets.[84] They share with private foundations a significant degree of post-donation control by donors, but the private foundation rules were not applicable to them.[85] Neither did the excise tax on excess benefit transactions apply to them because those provisions regulate transactions with "disqualified persons" but the definition of "disqualified person" did not cover donors to donor-advised funds.[86]

Despite the potential for abuse of donor-advised funds, for many years neither the government nor the public showed any interest in regulating them. In the early years of this decade, a

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81. Tax Reform Act of 1969, Pub. L. No. 91-172, § 509(a), 83 Stat. 496, 496–98 (codified as amended at I.R.C. § 509(a) (2006)).

82. *Id.* §§ 4941–45, 83 Stat. 499, 499–515 (codified as amended at I.R.C. §§ 4941–45).

83. Taxpayer Bill of Rights 2, Pub. L. No. 104–68, § 1311(a), 110 Stat. 1452, 1475–77 (1996) (codified as amended at I.R.C. § 4958).

84. *See* PANEL ON THE NONPROFIT SECTOR, STRENGTHENING TRANSPARENCY GOVERNANCE ACCOUNTABILITY OF CHARITABLE ORGANIZATIONS 39 (2005), *available at* http://www.nonprofitpanel.org/Report/final/Panel_Final_Report.pdf. Donor-advised funds could also be used to avoid the minimum disbursement rule for private foundations contained in I.R.C. section 4942. The private foundation would make a contribution to a donor-advised fund, thereby fulfilling its annual obligation to spend at least five percent of its assets for charitable purposes. The donor-advised fund, in turn, would make a contribution back to the private foundation. This abuse was known as "round-tripping." *Id.*; *see also* I.R.C. § 4942(a), (d), (e).

85. *See* PANEL ON THE NONPROFIT SECTOR, *supra* note 84, at 39.

86. I.R.C. § 4958(f)(1) (2000). However, donor-advised funds and their donors are now considered "disqualified persons" for purposes of the excise tax on excess benefit transactions. I.R.C. §§ 4958(f)(7), 4966(d)(2)(A)(iii).

number of factors converged to arouse public and governmental interest. Enron, WorldCom, Tyco, and the other great corporate scandals pointed to the potential of abuse of large organizations by powerful insiders.[87] Problems at United Way, the American Red Cross, and the Nature Conservancy demonstrated that the potential for abuse was not limited to the for-profit sector.[88] The involvement of major investment houses and their aggressive advertising led both to the rapid growth of donor-advised funds and to increased awareness of these previously little-known entities.[89]

A number of journalists began to investigate abuses in the nonprofit sector. The most significant effort was made by *The Boston Globe*, which published a series of articles between October 9 and December 29, 2003.[90] Important articles also appeared in *The Washington Post*.[91] These articles do not, however, provide any justification for the provisions of the Pension Protection Act of 2006 regarding donor-advised funds. None of the abuses brought to light in the articles involved donor-advised funds. Furthermore, all of the abuses uncovered appear to involve clear violations of existing law and require better enforcement, not new legislation.[92] In an editorial published at the end of its series, *The*

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87. *See, e.g.*, *America's Capital Markets: Maintaining Our Lead in the 21st Century: Hearing Before the Subcomm. on Capital Mkts., Ins., and Gov't Sponsored Enterprises of the H. Comm. on Fin. Serv.*, 109th Cong. 1 (2006) (opening statement of Rep. Richard Baker, Chairman, Subcomm. on Capital Mkts., Ins., and Gov't Sponsored Enterprises.); Andrew Ross Sorkin, *Ex-Tyco Officers Get 8 to 25 Years*, N.Y. TIMES, Sept. 20, 2005, at A1.

88. *See, e.g.*, Kathleen Day, *Donating, with Cause; Now More Cautious, Some Are Keeping Philanthropy Close to Home*, WASH. POST, Nov. 19, 2006, at F1; Jacqueline L. Salmon, *United Way Official Resigns, Alleges Inflated Numbers*, WASH. POST., May 22, 2006, at B1; Stephanie Strom, *Senator Questions Finances of United Way*, N.Y. TIMES, Aug. 22, 2002, at A20.

89. *See* J. COMM. ON TAXATION, *supra* note 76, at 98–99.

90. Beth Healy et al., *Charity Money Funding Perks*, BOSTON GLOBE, Nov. 9, 2003, at A1; Beth Healy, *Foundations Veer Into Business*, BOSTON GLOBE, Dec. 3, 2003, at A1; Beth Healy et al., *Foundations' Tax Returns Unchecked*, BOSTON GLOBE, Dec. 29, 2003, at A1; Beth Healy et al., *Some Officers of Charities Steer Assets to Selves*, BOSTON GLOBE, Oct. 9, 2003, at A1; Michael Rezendes & Sacha Pfeiffer, *Underfunded IRS Unable to Monitor Trusts*, BOSTON GLOBE, Oct. 9, 2003, at A43.

91. *See, e.g.*, Andrea Caumont, *Giving Funds Provide Flexibility; Foundations, Circles Redefine Ways to Donate to Charity*, WASH. POST, Nov. 6, 2005, at F7; Andrea Caumont, *Reflect on Personal Interests to Find the Right Charity*, WASH. POST, Nov. 7, 2004, at F8; Albert B. Crenshaw, *Tax Abuse Rampant in Nonprofits, IRS Says*, WASH. POST, Apr. 5, 2005, at E1.

92. *See* Sean Delany, Letter to the Editor, CHRON. OF PHILANTHROPY, Aug. 4, 2005, at 51.

*Boston Globe* called for more vigorous enforcement of both state and federal laws, but did not suggest new legislation.[93]

The first movement on the governmental front came from the executive branch. In his final budget, President Clinton proposed legislation to regulate donor-advised funds, but Congress did not act upon the proposal.[94] In other executive branch action, the IRS mentioned the abuse of donor-advised funds in its "dirty dozen tax scams" for 2005 and 2006, but offered no specific information justifying including donor-advised funds in the list.[95]

In 2004 the Senate Finance Committee held hearings on tax-exempt organizations.[96] The hearings produced some anecdotal evidence of abuse of donor-advised funds, but no systematic or reliable information about them.[97] Most of the abuses described were violations of existing law.[98] Hearings before the House Committee on Ways and Means in 2005 regarding the tax-exempt sector produced no reliable information about donor-advised funds.[99] Virtually the only source of statistical information was the annual surveys *The Chronicle of Philanthropy* had begun to publish in 2000. The survey for 2005 showed that donor-advised funds had become an important part of the not-for-profit sector.

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93. *See* Editorial, *Protecting Charity*, BOSTON GLOBE, Dec. 30, 2003, at A14.

94. The Clinton administration proposed that any charity which had more than fifty percent of its assets in donor-advised funds would be treated as a public charity only if three conditions were met:

> (1) there [was] no material restriction or condition that prevent[ed] the organization from freely and effectively employing the assets in such donor advised funds, or the income therefrom, in furtherance of its exempt purposes; (2) distributions [were] made from such donor advised funds only as contributions to public charities . . . or governmental entities; and (3) annual distributions from donor advised funds equal[ed] at least five percent of the net fair market value of the organization's aggregate assets held in donor advised funds.

DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2001 REVENUE PROPOSALS 106 (2000).

Failure to meet those requirements would not lead to loss of public charity status for such a sponsor of donor-advised funds, but all assets maintained in donor-advised funds would be subject to the private foundation rules and excise taxes. *Id.* at 106–07. Finally, the administration proposed treating donors to donor-advised funds as disqualified persons for purposes of the self-dealing and excess benefit rule. *Id.* at 107.

95. I.R.S. News Release IR-2006-25 (Feb. 7, 2006), *available at* http://www.irs.gov/newsroom/article/0,,id=154293,00.html; I.R.S. News Release IR-2005-19 (Feb. 28, 2005), *available at* http://www.irs.gov/newsroom/article/0,,id=136337,00.html.

96. *See generally Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities: Hearing Before the S. Comm. on Fin.*, 108th Cong. (2004).

97. *See id.* at 37, 81, 200–03.

98. *See* Delany, *supra* note 92.

99. *See generally Overview of the Tax-Exempt Sector*, *supra* note 3.

Respondents to the survey reported that they sponsored more than 92,000 donor-advised funds, an increase of ten percent over 2004.[100] Total assets were $15.5 billion—up twenty-two percent from the previous year.[101] Collectively, the funds distributed $3.3 billion to charity, an increase of nearly twenty-one percent over the previous year.[102] The *Chronicle* survey understates the number of donor-advised funds and their assets since it reports only the data from the sponsoring groups who responded, making no attempt to extrapolate to the entire universe of donor-advised funds.[103]

A staff discussion draft issued by the Senate Finance Committee in June 2004 proposed a number of reforms. To deal with concerns about the use of donor-advised funds to retain family control of businesses and other property, contributions other than cash or publicly traded securities would have to be sold within one year, and a plan for their sale would have to exist at the time of the gift (alternatively, a donor-advised fund would be limited to receiving only cash or publicly traded securities).[104] To lessen the probability of abusive grants to insiders, a donor-advised fund "would not be permitted to make grants to a non-operating private foundation or to individuals."[105] It would also "be required to secure from the grantee an acknowledgment that the grant will not convey a private benefit to the advising donor."[106] To meet concerns about "parking" of assets, donor-advised funds held by a single sponsor "would be required to meet an aggregate annual payout consisting solely of grants paid of [five] percent of the [donor-advised fund]'s assets," and "individual accounts in a [donor-advised fund] would have to meet a minimum activity thre-

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100. THE CHRON. OF PHILANTHROPY, HOW THE CHRONICLE COMPILED ITS DONOR-ADVISED FUND SURVEY (2006), http://www.philanthropy.com/premium/articles/v18/i14/14002901.html (on file with author). In 2006, the *Chronicle* sent questionnaires to the fifty community foundations which raised the most money in 2005 and to all other organizations other than community foundations that it knew sponsored donor-advised funds; it received responses from forty-one community foundations, eighteen commercial investment companies, and twenty-nine other groups such as universities and Jewish foundations. *Id.*

101. *Id.*

102. Kerkman, *supra* note 34.

103. *See* THE CHRON. OF PHILANTHROPY, *supra* note 100.

104. *See* STAFF OF S. COMM. ON FIN., 108TH CONG., TAX EXEMPT GOVERNANCE PROPOSALS: STAFF DISCUSSION DRAFT 1–2, *available at* http://finance.senate.gov/hearings/testimony/2004test/062204stfdis.pdf (last visited Dec. 18, 2009).

105. *Id.* at 2.

106. *Id.*

shold."[107] To facilitate regulation by the IRS, sponsors of donor-advised funds would be required to disclose the existence of the funds on their "Form 990 and show satisfaction of the payout and all other requirements."[108] Due to concerns about money reaching terrorist organizations, grants by a donor-advised fund to non-domestic organizations would be permitted only if the grantee appears on an IRS list of approved foreign organizations.[109] Because of concerns about self-dealing, a donor-advised fund would be required to hire investment managers utilizing arm's-length principles.[110] To limit potential abuses in the form of paying travel expenses of donors and similar items, a donor-advised fund "generally would not be permitted to expend amounts for grantee selection, such as site visits, that extend beyond basic due diligence of grant approval."[111] Finally, to deal with concerns about excessive finder's fees and similar items, the limitation of fees for referrals or transfers of funds to a donor-advised fund was proposed.[112]

At the request of the Senate Finance Committee, Independent Sector, a coalition of charitable nonprofit organizations, philanthropic foundations, and corporate giving programs convoked a twenty-four member panel on the nonprofit sector.[113] The panel issued an extensive report and accepted the substance of the Finance Committee staff's recommendations (1) prohibiting grants to non-operating foundations and individuals (though allowing grants to individuals chosen by a committee independent of the donor), (2) requiring an aggregate five percent minimum payout rate and a minimum activity level in each individual fund, and (3) requiring reporting of information about donor-advised funds on sponsoring organizations' Form 990.[114] The panel rejected the proposal to require donor-advised funds to sell within one year all assets received other than cash or publicly traded securities, or to limit contributions to cash or publicly traded securities.[115] It also did not adopt the staff's recommendations (1) that

107. *Id.*
108. *Id.*
109. *See id.*
110. *See id.*
111. *Id.*
112. *See id.*
113. *See* PANEL ON THE NONPROFIT SECTOR, *supra* note 84.
114. *Id.* at 40–42.
115. *See id.* at 55.

donor-advised funds be prohibited from contributing to foreign groups other than those on a list of approved organizations, (2) that investment managers be hired according to arm's-length principles, or (3) that fees for referrals or transfers of funds be limited.[116] Although the panel also rejected the staff's proposal regarding expenses of grantee selection, it proposed prohibiting substantial benefits to donors, advisers, and related parties in connection with grant recommendations.[117]

The panel went beyond the staff's proposals in several areas. On the substantive level, it suggested prohibiting both compensation and reimbursement of expenses to donors, advisers, and related parties.[118] On the formal level, it suggested requiring a number of written statements (1) by the donor that the sponsoring charity would have legal control over the contributed assets and that the donor would not receive any substantial benefit; (2) by the sponsoring charity, self-certifying that the donor would receive no substantial benefit; and (3) by grant recipients that the grant would involve no substantial benefit to the donor, an adviser, any related party, or any person outside the charitable class.[119]

Many of these measures were incorporated into the Tax Relief Act of 2005, which was not enacted.[120] This proposed legislation required an aggregate five percent annual payout as well as minimal levels of activity in individual donor-advised funds.[121] It also included an account-level distribution requirement for accounts that hold illiquid assets.[122] The bill treated donors, donor advisers, and investment advisers to donor-advised funds as disqualified persons with respect to the sponsoring organization.[123] As recommended by the panel on the nonprofit sector, it made the entire amount of any distribution from a donor-advised fund to a donor or donor adviser an excess benefit transaction subject to excise tax.[124] The bill prohibited distributions to individuals and

116. *See id.* at 40–41.
117. *See id.* at 43.
118. *See id.*
119. *Id.* at 44.
120. Tax Relief Act of 2005, S. 2020, 109th Cong. §§ 331–334 (2005).
121. *Id.* § 331.
122. *Id.*
123. *Id.* § 332.
124. *Id.* §§ 332–33.

to all organizations not described in I.R.C. section 170(b)(1)(A).[125] In addition, it imposed an excise tax whenever a donor or donor adviser receives, directly or indirectly, a benefit as a result of a distribution from a donor-advised fund.[126] On the formal level, the bill required sponsoring organizations to acknowledge in writing that they have exclusive legal control over contributed assets.[127] It also required them to report on their Form 990 the total number of donor-advised funds they own, the aggregate value of assets held in those funds, and the aggregate contributions to and grants made from those funds during the year.[128] Although this bill was not enacted, many of its provisions found their way into the Pension Protection Act of 2006.

## V. THE PENSION PROTECTION ACT OF 2006

The Pension Protection Act of 2006 created for the first time a statutory category of donor-advised funds and applied to them a set of provisions intended to prevent abuses.[129] The provisions are modeled in part on the rules applicable to private foundations and on the intermediate sanction provisions, but in some cases are harsher than even the private foundation rules.[130]

A donor-advised fund is defined as a fund or account (1) owned and controlled by any organization (other than a governmental entity or a private foundation) eligible to receive deductible contributions (the "sponsoring organization"), (2) separately identified by reference to the donor, and (3) with respect to which the donor has (or reasonably expects to have) advisory privileges relating to the distribution or investment of the account because of his status as donor.[131]

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125. *See id.* at § 331.

126. *See id.*

127. *Id.* § 334.

128. *Id.*

129. Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780 (codified as amended in scattered sections of 26 U.S.C.).

130. *Compare* I.R.C. § 4966(a)–(d) (2006) (imposing an excise tax of twenty percent on distributions from a donor-advised fund to an individual, with one exemption), *with id.* § 4945(a)–(d), (g) (allowing grants to individuals under more lenient circumstances).

131. *Id.* § 4966(d). A fund or account is not a donor-advised fund (1) if it makes grants only to a single identified organization or governmental entity, (2) if the donor has advisory privileges only as a member of a committee which awards grants for travel or study to individuals on an objective and non-discriminatory basis, and (3) if he does not directly or

Contributions to donor-advised funds are generally deductible under the rules applicable to contributions to publicly supported charities.[132] Congress did not choose to limit contributions to cash or publicly traded securities or to require that all other assets be sold within a year. Rather, it dealt with the concern that donor-advised funds might be used to retain control over closely-held businesses by subjecting donor-advised funds to the excess business holding rules applicable to private foundations.[133] Under these rules, donor-advised funds are not permitted to have an ownership interest in a proprietorship, and the interests they may hold in other businesses are limited.[134]

Application to donor-advised funds of the excess business holding rules lessens the risk of use of donor-advised funds to retain family control over businesses while obtaining a tax deduction for contributions of assets that may produce little current income and little immediate benefit to charitable causes. On the other hand, it makes unavailable to donor-advised funds potential sources of large gifts, which might in some cases provide significant support for charitable activities.

The Pension Protection Act of 2006 does not contain any provision regarding minimum aggregate payouts nor minimum levels of activity of individual donor-advised funds.[135] Apparently, in this area Congress recognized that it did not have enough information to make a decision. It limited itself to directing the Secretary of

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indirectly control the committee. *See id.* § 4966(d)(2)(B). The Secretary of the Treasury has authority to exempt a fund from being treated as donor-advised if it benefits a single identified charitable purpose or whose activities extend beyond awards or grants for travel or study if the donor has advisory privileges only as a member of a committee which he does not control. *See id.* § 4966(d)(2)(C).

132. A deduction may be claimed only if the donor receives a contemporaneous written acknowledgement from the sponsoring organization that it has exclusive legal control over the assets contributed. *Id.* § 170 (f)(18)(B). Contributions to donor-advised funds are not deductible if the sponsoring organization is a non-functionally integrated Type III supporting organization, a veterans organization, a fraternal society, or a cemetery company. *See id.* § 170 (f)(18)(A).

133. *See id.* § 4943(e).

134. *Id.* § 4943(c)(2), (3) (stating that generally, a donor-advised fund is permitted to hold twenty percent of the voting stock of a corporation, of the profit interests in a partnership, or of the beneficial interests in other unincorporated enterprises, reduced by amount of voting stock, profit interests, or beneficial interests held by a donor and donor advisor or persons related to them).

135. *See* Pension Protection Act of 2006, Pub. L. No. 109–280, 120 Stat. 780 (codified as amended in scattered section of 26 U.S.C.).

the Treasury to conduct a study of the subject and to make recommendations to Congress.[136]

It is far from clear that there is any need for a mandatory aggregate payout requirement. Starting with fiscal year 2008, the information collected in Schedule D of the redesigned Form 990 permits the IRS and the Treasury to determine a payout rate for each sponsor of donor-advised funds.[137] Until that information becomes available, the meager existing evidence suggests that a payout requirement in the range most frequently discussed (five to six percent) would have little positive effect.[138] The median payout rate for donor-advised funds covered by *The Chronicle of Philanthropy*'s survey for 2005 was 17.5%, while only three sponsors failed to distribute at least five percent.[139] In view of the voluntary character of the responses and of the survey's focus on the largest and best-known sponsors, the data the survey provides cannot be considered representative of all donor-advised funds, but it suggests that the impact of a five or six percent aggregate payout requirement would be small.[140]

Payout rates for private foundations hover near the legally mandated five percent, and it seems that many private foundation managers view the legally imposed five percent payout as a ceiling as well as a floor.[141] If the donors to donor-advised funds were to interpret an aggregate payout requirement in the same manner, it is possible that a legally imposed aggregate payout rate might lead to smaller rather than larger payouts overall.[142]

If there is a serious problem of insufficient payouts, it resides primarily at the level of individual donor-advised funds. There seems to be a consensus among fund sponsors that requiring a minimum payout percentage from each individual fund would be extremely burdensome from an administrative point of view.[143]

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136. *Id.* § 1226, 120 Stat. 780, 1094.

137. *See* I.R.S., SCHEDULE D (FORM 990) SUPPLEMENTAL FINANCIAL STATEMENTS, OMB NO. 1545-0047, Part I (2008), *available at* http://www.irs.gov/pub/irs-pdf/f990sd.pdf.

138. *See* Kerkman, *supra* note 34.

139. *Id.*

140. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 74, at 16.

141. *See* Memorandum from Individual Members of the Am. Bar Ass'n, Section of Real Prop., Probate and Trust Law, Charitable Planning and Orgs. Group to the I.R.S. (Apr. 9, 2007) (on file with author).

142. *See id.*

143. *Id.*

Currently there is no factual basis for imposing such a requirement. There is no reliable information about payouts from individual donor-advised funds,[144] and even the revised Schedule 990 will not produce that information.[145]

A minimal level of activity requirement (say at least one grant of some minimum amount every three years) would be less burdensome to administer than an annual percentage distribution requirement. Many of the funds connected with investment houses have such a requirement.[146] Their experience suggests, however, that it has little practical effect, since the vast majority of donor-advised funds voluntarily meet or surpass the required activity level.[147] In view of the minor impact a minimum activity requirement could be expected to have, it is not clear that the benefits would outweigh the costs.

Three separate, codified provisions of the Pension Protection Act of 2006 are designed to prevent the assets of donor-advised funds from being used for the benefit of the donor or of persons related to the donor or for any non-charitable purpose.

The first provision imposes an excise tax on taxable distributions from donor-advised funds. If a taxable distribution is made, the sponsoring organization is subject to a tax equal to twenty percent of the distribution, and any fund manager who knowingly approved the distribution is subject to a tax equal to five percent of the distribution, not to exceed $10,000.[148] The new provision is inspired by the tax on taxable expenditures of private foundations, but is less sweeping.[149]

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144. U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 74, at 16–17.

145. I.R.S., *supra* note 137. Rather, the revised Schedule 990 will provide information with regard to sponsors of donor-advised funds. *Id.*

146. *See, e.g.*, FIDELITY CHARITABLE GIFT FUND, GIFT FUND POLICY GUIDELINES: PROGRAM CIRCULAR 19 (2009), *available at* http://www.charitablegift.org/docs/Gift-Fund-Policy-Guidelines.pdf. If a donor-advised fund does not distribute at least $250 during any given seven-year period, the Gift Fund will attempt to contact the account holder and require one or more distributions totaling $250. *Id.* If the accountholder does not respond, the Giving Fund will transfer the entire balance of the Giving Account to the Trustees' Philanthropy Fund. *Id.*

147. *See, e.g.*, Letter from David L. Giunta, Fidelity Charitable Gift Fund, to the I.R.S. 6–7 (Apr. 5, 2007) (on file with author) (according to Fidelity, less than 0.2% of the funds in the Fidelity Investments Charitable Gift Fund are inactive under the standard set forth in the preceding footnote).

148. I.R.C. § 4966(a)–(b) (2006).

149. *See id.* § 4945(a) (imposing excise tax on the taxable expenditures of private foundations).

Donor-advised funds generally incur a penalty tax if they make grants to individuals.[150] The only exception is for scholarships to individuals for study or travel.[151] To qualify for the exception from the penalty tax, scholarships must be granted on an "objective and non-discriminatory basis," and the donor may participate in the selection of the scholarship recipients only as a member of a committee that the donor does not control.[152] These limitations on grants to individuals constitute an easily administered bright-line rule that prohibits certain grants that would violate the more-difficult-to-apply rules against private inurement and private benefit, such as scholarships awarded to the children of the donor.

The prohibition, however, also sweeps in other grants to which there is no serious objection from a policy point of view. For instance, scholarships to individuals unrelated to the donor but in which the donor plays a major role in selecting recipients are included in the provision.[153] In testimony before Congress in 2007, a number of sponsoring organizations argued that the new rules will be a serious obstacle to the operation of many small scholarship funds that have functioned efficiently in the past thanks to the direct involvement of the families or individuals that created them.[154] They also suggested that severely limiting donor involvement in the selection of scholarship recipients may discourage the creation of scholarship funds.[155] Even without the new

150. *Id.* § 4966(c)(1)(A).

151. *See id.* § 4966(d)(a)(B)(ii).

152. *Id.* § 4966(d)(2)(B)(ii).

153. *See id.* § 4966(c)(1). Donor involvement in the choice of scholarship recipients does not seem in itself objectionable if it does not lead to favoring persons related in some way to the donor.

154. *Tax-Exempt Charitable Organizations: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways & Means*, 110th Cong. 202–03 (2007) (letter of Nancy Tate, President, League of Women Voters of Arlington, Virginia); *id.* at 218 (statement of New York Community Trust); *id. at* 224 (statement of Putnam Scholarship Fund); *id.* at 157 (statement of Community Foundation of Western Massachusetts). The Community Foundation of Western Massachusetts testified that it provides one thousand scholarships each year from one hundred funds. *Id.* at 157. Under the Pension Protection Act of 2006, it classified forty-one of the one hundred funds as donor-advised funds. *Id.* After what the foundation described as extensive and costly negotiations with the donors, seventeen of the forty-one opted out. *Id.* The foundation expressed its fear that "many, unfortunately, will never be heard from again." *Id.* It also complained that "[t]he award process for the remaining twenty-four went from being personalized, often family centered opportunities for pioneering community engagement to impersonal, assembly line selection forced marches dictated by the tyranny of the majority selected by us." *Id.*

155. *Id.* at 218 (statement of New York Community Trust); *see also id.* at 224 (state-

rule, grants to individual family members would be illegal.[156] There is no evidence that abusive grants were sufficiently widespread to require a bright-line rule with its associated costs.

Grants to organizations are permitted without penalties if made to the sponsoring organization of the donor-advised fund, to another donor-advised fund, or to a "fifty-percent charity" (generally governmental units, churches, schools, hospitals, and other publicly supported charities).[157] Grants to other types of organizations are subject to penalty taxes unless the distribution is for charitable purposes, and the donor-advised fund exercises expenditure responsibility with respect to the distribution.[158] Expenditure responsibility means that the grantor must establish procedures and make reasonable efforts (1) to ensure that the grant is spent only for the purpose for which it is made, (2) to obtain reports from the grantee on how the funds are spent, and (3) to make detailed reports on the expenditures to the IRS.[159] Requiring expenditure responsibility when distributions are made for charitable purposes to organizations that are not public charities seems a reasonable requirement and has not provoked any protest from the not-for-profit community.

A second set of provisions subjects donor-advised funds to the excess benefit rules applicable to charities and social welfare organizations other than private foundations. Under these rules, if a donor-advised fund confers any economic benefit on a donor or donor advisor, or a person related to either of them, the transaction will be tested to see if any excess benefit was conferred on them.[160] There will be an excess benefit if the value of the benefit conferred exceeds the value of the consideration provided for it.[161] If, for example, a donor-advised fund were to sell to a donor stock worth $200,000 for $100,000, there would be an excess benefit of $100,000.

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ment of Putnam Scholarship Fund).

156. *See supra* notes 74–75 and accompanying text.

157. I.R.C. § 4966(c)(2) (referring to organizations listed in I.R.C. § 170(b)(1)(A)).

158. *Id.* § 4966(c)(1)(B).

159. *Id.* § 4945(h).

160. *Id.* § 4958(c). This provision applies to transactions properly viewed as being with the donor-advised fund, not with the sponsoring organization. *See* J. COMM. ON TAXATION, JCX-38-06, TECHNICAL EXPLANATION OF H.R. 4, THE "PENSION PROTECTION ACT OF 2006," AS PASSED BY THE HOUSE ON JULY 28, 2006, AND AS CONSIDERED BY THE SENATE ON AUGUST 3, 2006 347–48 (2006).

161. I.R.C. § 4958 (c)(1)(A).

An initial tax of twenty-five percent of the excess benefit is imposed on the person to whom the excess benefit was conferred, and an initial tax of ten percent is imposed on any organization manager who knowingly and willfully participated in conferring the benefit.[162] If the initial tax is imposed and the excess benefit is not corrected within the taxable period, an additional tax of two hundred percent of the excess benefit is imposed on the person to whom the benefit was conferred.[163] This aspect of the application of the excess benefit rules to donor-advised funds is unobjectionable; it simply applies to donor-advised funds the rules applicable to public charities.[164]

Quite another matter are the rules applicable when the transaction involves a grant, loan, payment of compensation, or any similar transaction, including expense reimbursement.[165] In these cases the entire amount is considered an excess benefit, even if there is no excess.[166] Thus, for example, if a donor-advised fund pays a donor who is a lawyer $25,000 for services whose fair market value is $35,000, the entire $25,000 will be subject to the excise tax. Similarly, if a donor-advised fund reimburses a donor for expenses incurred in organizing a fund-raising event, the entire amount of the reimbursement will be considered an excess benefit. The rule is harsher than the self-dealing rules applicable to private foundations, which permit reasonable compensation and reimbursement of disqualified persons.[167] It amounts to an absolute prohibition against all grants, loans, compensation, and similar transactions between donor-advised funds and donors, donor advisors, and persons related to them.

It is difficult to see any reason for prohibiting donor-advised funds from paying donors market rates for services performed or reimbursing them for expenses incurred when private foundations are permitted to do so. It is certainly no easier for a donor to manipulate a donor-advised fund than it is for the creator of a private foundation to manipulate the foundation. Yet Congress has not chosen to prohibit the payment of reasonable salaries to

162. *Id.* § 4958(a).

163. *Id.* § 4958(b).

164. *Id.* § 4958(c)(2).

165. *See id.*; J. COMM. ON TAXATION, *supra* note 160, at 347 (stating that expense reimbursements are similar transactions).

166. I.R.C. § 4958(c)(2)(B).

167. *Id.* § 4941(d)(2)(E).

those who perform services for private foundations or to prohibit reimbursing them for expenses incurred on behalf of the foundation.[168]

The prohibitions are far from costless. Donors may be particularly well positioned to provide services to the funds they created but unable or unwilling to provide them gratis. The legislation prohibits them from receiving any compensation for their services, even at discounted rates. The prohibition against reimbursing legitimate expenses of donors may well discourage donors from running fund-raisers for donor-advised funds they have created.[169] A few cases of abuse referred to in congressional hearings are hardly a sufficient basis for believing that such measures are necessary.

A third rule imposes an excise tax on donors, donor advisors, and persons related to them, who advise a sponsoring organization to make a distribution from a donor-advised fund that results, directly or indirectly, in more than incidental benefit to a donor, a donor advisor, or a person related to them.[170] The tax is 125% of the benefit received.[171] A ten percent excise tax of no more than $10,000 is also imposed on any fund manager who knowingly agrees to the distribution.[172] Thus, for example, if a donor advises a donor-advised fund to contribute $1,000,000 to a university and the university sends the donor football tickets worth $1,000, the donor would potentially be subject to a tax of $1,250 if the IRS chose to consider the tickets a more than incidental benefit.[173]

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168. *See* I.R.C. § 4941.

169. *See Hearings on Tax-Exempt Charitable Organizations, supra* note 155, at 178 (statement of Karen Krei, Piedmont Community Foundation). A man who lost his wife to breast cancer established a donor-advised fund using his own name to make contributions to the fight against cancer. *Id.* at 178. The man, who was well-connected and a good salesman, ran a fundraiser every year. *Id.* In this way, he was able to raise significant funds, but under the new rules, if he wishes to continue the fundraiser, he will have to bear all of the expenses personally. *Id.*

170. I.R.C. § 4967(a)(1). Neither this tax nor the tax on managers will be imposed if excess benefit tax has been imposed with respect to the distribution. *Id.* § 4967(b).

171. *Id.* § 4967(a)(1).

172. *Id.* §§ 4967(a)(2), (c)(2). A benefit is more than incidental if it would reduce the amount of the charitable contribution deduction if it were received in connection with a charitable contribution. J. COMM. ON TAXATION, *supra* note 160, at 350.

173. It is not clear whether a distribution by a donor-advised fund to fulfill a donor's pledge to a charity indirectly confers a benefit on the donor. The Treasury is expected to issue guidance on this issue.

This rule is in some ways reminiscent of the rules that deny a charitable contribution deduction under I.R.C. section 170 for contributions (whether to a public charity or to a private foundation), which produce a more than incidental benefit to a private individual.[174] The rule, however, is much harsher. Where it applies, the donor is not deprived of a deduction (which is never worth more to the taxpayer than the highest marginal rate of tax), but rather, is subject to a penalty equal to 125% of the value of the benefit received.[175] This rule has no equivalent in the private foundation area, where the same sort of abuses that the rule is intended to prevent could occur at least as easily as in the donor-advised fund context.[176] Nothing in the legislative history of the Pension Protection Act of 2006 justifies this rule, nor does there seem to be any logical reason for subjecting donor-advised funds to rules that do not apply to private foundations.[177] The rule also has the disadvantage of being extremely difficult to enforce. In the example given above, only an extraordinarily diligent and lucky auditor could connect an individual's receipt of football tickets from a university with the university's receipt of a contribution from a donor-advised fund to which the recipient of the tickets had contributed money (perhaps years earlier). Congress seems to have decided to clamp down on potential abuses without any clear basis for thinking that draconian measures were needed and without any consideration of the measures' effects on legitimate transactions.

## VI. CONCLUSION

The problem with the Pension Protection Act of 2006 provisions regarding donor-advised funds is not that they are clearly ill-conceived. It is at least possible that they may be appropriate responses to widespread abuses that cannot be remedied in ways that impose fewer costs on legitimate operations. But they may equally well be an overreaction to isolated reports of abuse that unnecessarily impose significant costs on the nonprofit sector and divert badly needed charitable funds into compliance. There

174. *See* I.R.C. § 170(c)(2)(C).
175. *Id.* § 4967(a)(1).
176. *See id.* §§ 4940–4948.
177. *Tax-Exempt Charitable Organizations*, *supra* note 154, at 130 (statement of the American Bar Association Section of Taxation).

simply is no way of knowing. Congress lacked even the most elementary factual basis for its decisions, and supporters and critics of the legislation today are equally bereft of solid factual foundations for their opinions.[178] The IRS cannot provide the necessary information because it has almost no reliable data about donor-advised funds.[179]

The IRS's lack of information about donor-advised funds, although lamentable, is hardly surprising. At one level, it is the result of inadequate funding. The excise taxes which Congress imposed on private foundations in 1969 were supposed to have been used to fund IRS oversight of exempt organizations, but that never happened.[180] In the absence of special appropriations for oversight of exempt organizations, this function suffered disproportionately from cuts in the overall budget of the IRS. Faced with a shrinking budget, the IRS understandably emphasized areas that directly produce tax revenue rather than areas like exempt organizations which are primarily regulatory.[181] As a former Commissioner of Internal Revenue testified:

> The Commissioner generally has a rule that he won't ask for a dollar unless he can bring in large multiples of that. . . . [A]s you cut the Commissioner's budget and personnel . . . you find that . . . the first thing that is cut is . . . compliance, because that is the only optional money he has. He has to produce returns. He has to process returns. He has to collect money. There are a number of functions that he has to do, and so he has no leeway there. He can audit more returns or less returns. He can audit the returns more intensively or less intensively.[182]

Since 1974 the number of charitable organizations has more than doubled, but the staff of the IRS's Tax Exempt and Government Entities Division has grown by only three percent.[183] Between 1995 and 2005, the number of charities registered with the IRS increased from 1.3 million to 1.8 million, but the IRS staff

178. *See Overview of the Tax-Exempt Sector*, *supra* note 3, at 21–22 (statement of David M. Walker, Comptroller General, U.S. Government Accountability Office).

179. *See* U.S. GOV'T ACCOUNTABILITY OFFICE *supra* note 74, at 16–17.

180. PANEL ON THE NONPROFIT SECTOR, *supra* note 84, at 24.

181. *Overview of the Tax-Exempt Sector, supra* note 3, at 19 (statement of David M. Walker, Comptroller General, U.S. Government Accountability Office).

182. *Id.* at 102 (statement of Sheldon S. Cohen, Former Comm'r of the Internal Revenue Service).

183. PANEL ON THE NONPROFIT SECTOR, *supra* note 84, at 13.

dedicated to exempt organizations shrank.[184] As a result, the IRS lacks much basic information about exempt organizations. It cannot, for example, locate a significant percentage of the exempt organizations listed in its master business file or even say if they still exist.[185] Until fiscal year 2003, the returns of exempt organizations did not even need to indicate that they sponsored donor-advised funds,[186] and information about the assets of donor-advised funds and their payouts will be collected for the first time for fiscal year 2008.[187]

The IRS lacks the financial and human resources to perform audits and other studies needed to develop reliable information about donor-advised funds and more generally about the exempt sector. In 1995, the IRS audited only two percent of returns filed by exempt organizations, and in subsequent years, things got worse.[188] In no year between 1996 and 2001 did it examine even one percent of the returns.[189] In several years it examined less than 0.5%.[190] The number of returns audited hit a low point in 2005 when less than 5,000 audits were performed.[191] The number increased slightly in recent years, but the 7,580 audits performed in 2007 still represented only a miniscule percentage of the returns filed.[192]

Providing the IRS with more adequate funding is only a first step toward developing well-informed legislation regarding donor-advised funds and tax exempt organizations more generally. The IRS is essentially a tax collection agency, and its culture reflects that reality. An organization whose primary function is to collect

184. Ebeling, *supra* note 19.

185. THOMAS H. POLLAK & JONATHAN D. DURNFORD, THE SCOPE AND ACTIVITIES OF 501(C)(3) SUPPORTING ORGANIZATIONS 14 n.13 (2005), *available at* http://www.urban.org/UploadedPDF/411175_501c3_support_orgs.pdf (noting that in 1994, the IRS could not locate twenty-one percent of the exempt organizations listed in its Business Master File).

186. *See* I.R.S. SCHEDULE A (FORM 990) ORGANIZATION EXEMPT UNDER SECTION 501(c)(3) OMB NO. 1545-0047, PART III (2003), *available at* http://www.irs.gov/pub/irs-pdf/f990sa.pdf.

187. *See* I.R.S., *supra* note 137.

188. Ebeling, *supra* note 19.

189. *See* U.S. GEN. ACCOUNTING OFFICE, GAO-02-526, TAX EXEMPT ORGANIZATIONS: IMPROVEMENTS POSSIBLE IN PUBLIC, IRS, AND STATE OVERSIGHT OF CHARITIES 22 (2002).

190. *Id.*

191. I.R.S., FISCAL YEAR 2007 IRS ENFORCEMENT AND SERVICES STATISTICS 9 (2007), *available at* http://www.irs.gov/newsroom/article/0,,id=177701,00.html (follow "FY 2007 IRS Enforcement and Services Tables" hyperlink).

192. *See id.*

taxes is not likely to dedicate its best financial or human resources to tasks unrelated to raising revenue. In explaining the IRS's lack of focus on the tax exempt sector, former Commissioner Cohen quoted the famous response of bank robber Willie Sutton to the question why he robbed banks: "That is where the money is."[193] An agency whose primary mission is to collect taxes is inevitably drawn to focusing on those activities that directly produce revenue.

There is much to be said for eventually transferring a large part of the functions currently carried out by the IRS in the exempt arena to the state attorneys general and to a federal agency specifically charged with overseeing the exempt sector.[194] To craft such legislation intelligently, however, Congress needs a much clearer, more detailed, and more accurate picture than it currently has of the sector. To avoid legislating in the dark as it did in the Pension Protection Act's donor-advised fund provisions, Congress needs to provide the IRS the necessary resources, direct it to use them to develop the required information, and have the patience to wait for the results. Otherwise it will continue to respond in knee-jerk fashion to isolated reports of abuses, enacting measures that may be beneficial, but may equally well do more harm than good.

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193. *Overview of the Tax-Exempt Sector*, *supra* note 3, at 70 (statement of Sheldon S. Cohen, former Comm'r of the Internal Revenue Service).

194. *See, e.g.*, Marion R. Fremont-Smith, *Is It Time to Treat Private Foundations and Public Charities Alike?*, 52 EXEMPT ORG. TAX REV. 257 (2006); Robert M. Lang, Jr., *Philanthropy Needs Its Own Federal Agency*, CHRON. OF PHILANTHROPY, Apr. 28, 2005, at 41; John C. McGee, Letter to the Editor *How Lawmakers Can Best Help Nonprofit Groups*, CHRON. OF PHILANTHROPY, Aug. 4, 2005, at 51.