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Room 5203

Via e-mail to [Notice.Comments@irs.counsel.treas.gov](mailto:Notice.Comments@irs.counsel.treas.gov)

These comments by the Council on Foundations respond to IRS Notice 2007-21 in which the Department of the Treasury and the Internal Revenue Service invited public comment in connection with a study being conducted on the organization and operation of donor advised funds (as defined in § 4966(d)(2) of the Internal Revenue Code) and of supporting organizations described in § 509(a)(3). This study is required by § 1226 of the Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780 (2006) (the PPA).

The Council on Foundations is a membership association of more than 2,100 grantmaking foundations and corporations worldwide. For more than 55 years, the Council has served the public good by promoting and enhancing responsible and effective philanthropy. The Council's membership includes 561 community foundations, all of which have assets held in donor advised funds and many of which also are supported by supporting organizations. The Council's membership also includes about 130 other public charities that are primarily grantmakers. Some of these members also offer donor advised giving as an option to their donors and some also have supporting organizations. Some public charities in this latter group focus on international grantmaking, while other support a community of interest such as the environment or women's issues.

For the sake of convenience and brevity, references to "donors" in the comments that follow should be interpreted as including donors and advisors to donor advised funds, substantial contributors to supporting organizations, and all related parties.

**What are the advantages and disadvantages of donor advised funds and supporting organizations to the charitable sector, donors, sponsoring organizations, and supported organizations, compared to private foundations and other charitable giving arrangements?**

## Donor Advised Funds

First created at a community foundation in 1931, donor advised funds have grown enormously in popularity over the last fifteen years. As the July 2006 Government Accountability Office study, “Tax-Exempt Organizations: Collecting More Data on Donor advised Funds and Supporting Organizations Could Help Address Compliance Challenges,” reported, there are no reliable data concerning the total number of donor advised funds, the assets they hold, or the grants they make. However, 85 of the 125 largest community foundations recently reported to the Council on Foundations that they held 21,647 donor advised funds in 2005 with assets that totaled \$6.55 billion. Overall, donor advised funds made up about 26 percent of these foundations’ total assets and about 40 percent of their total number of funds.

Donor advised funds contribute substantially and critically to the resources available to communities. The 85 community foundations reported making more than \$1.05 billion in grants in 2005, for an aggregate payout of 16 percent from their donor advised funds. Advised funds are also a crucial source of new gifts – donors contributed \$1.36 billion to new and existing donor advised funds in 2005, about 45 percent of all gifts the community foundations received that year.

Donors have spoken with their hearts, and with their pocketbooks. The tremendous growth in donor advised funds clearly evidences the many advantages that advised funds offer to donors and the key role they play in increasing the philanthropic resources available to American communities and to communities around the world. Donor advised funds provide the money and the passion for positive change.

There are probably as many reasons for establishing advised funds as there are donors. However, the most important is that donors are generous and committed people with a passion for their causes and their communities. Through their donor advised funds, they provide support for charities today and, in many cases, create a legacy for the future.

Increasing Participation in Philanthropy: Donor advised funds offer donors several advantages over both private foundations and supporting organizations. Chief among them is that they give a broader segment of society the ability to participate in philanthropy. Many community foundations permit donors to maintain advised funds with as little as \$10,000 and some even offer “acorn” funds that allow donors to create a fund with even less, bringing their funds to the minimum level over a specified period of time. This low cost structure has allowed many middle-income families to participate in philanthropy and their participation has brought major benefits to communities. As one of our members writes:

Donor advised funds have enabled our less than wealthy citizens to participate in philanthropy and the result has been beneficial to the entire community. Programs and projects would never have seen the light of day without our donor advised program.

– Sharon Stredde, President & CEO, Community Foundation of the Fox River Valley (IL).

An excellent example that illustrates both how donor advised funds are enabling many Americans to learn and practice philanthropy and how those funds are woven into a community foundation's overall strategy for assisting its community comes from Indiana:

The Community Foundation of St. Joseph County established the African American Community Fund in September, 1999. Thanks to a Million Dollar Campaign led by Richmond and Virginia Calvin, this initiative consists of the primary African American Community Fund and more than twenty individual donor advised and scholarship funds established by African American families and organizations. Various members of the group work collectively to determine worthy programs addressing four key areas: the Arts, Education, Leadership Development, and the Special Challenges Facing African American Males. Through donor advised and scholarship funds, we are adding a new dimension to local African American philanthropy by promoting the concept of permanent charitable legacy. Prior to this initiative, we had no funds established by people of color. Now we have a group of committed individuals who want to bring leadership, influence, and resources to programs that will improve the lives and opportunities of local African American citizens.

The following quote from Dr. Virginia Calvin captures the spirit of this effort: "African Americans have always been givers. They have been donating to their churches and to help out others in need. When they couldn't give money, they gave time and aid. The African American Community Fund adds a new dimension to this tradition of giving by creating a permanent legacy. Some African American families are creating named family funds that will be invested forever, giving back to this community long after they are gone. All gifts, large and small, come together to make a big difference."

—Virginia Calvin, Co-Chair, African American Community Fund Campaign

**Efficiency:** Donor advised funds offer efficiencies that could not normally be achieved in comparably sized private foundations or supporting organizations. Donors are attracted to advised funds because they are relatively simple and inexpensive to create and maintain. Many community foundations permit donors to establish advised funds with as little as \$10,000 and also offer "acorn" funds that give donors a period of time to bring their funds to the minimum level.

The active oversight of the public charity that holds the funds replaces the need to create a nonprofit corporation or trust, seek IRS recognition of its charity status, and file annual information returns with the IRS and the states. Relying on the sponsoring charity to provide oversight, and to serve as a single point of contact with regulators, not only reduces administrative costs for the donor, but also benefits both the state and federal government by reducing the total number of exempt entities each must oversee. For the IRS alone, the reduction in the number of exemption applications and information returns that would otherwise have to be filed each year is significant.

Effectiveness: Donor advised funds at Council members offer donors the benefit of access to the members' professional expertise. By choosing to establish advised funds at community foundations and similar public charities, donors bring themselves within the organization's web of knowledge about the communities the organization serves. Through various means described later in these comments, donors and foundations, working together, can establish goals for the donors' philanthropy, then explore the wide range of charities working in the community to identify those that efficiently and effectively offer the services the donors want to support.

Stewardship: Donors benefit as well from the prudent stewardship of their charitable gifts. Council members employ professional investment managers and investment consultants to advise on the investment of the foundations' assets. These managers are overseen by volunteer boards and generally by volunteer investment committees that also possess investment expertise. Many small private foundations are unable to access similar expertise.

Focus on Mission: Yet another benefit to donors from choosing an advised fund over a private foundation or supporting organization is that they do not have to concern themselves with the administrative details of running a small organization. Instead, they can focus their efforts on supporting their charitable causes, while relying on the sponsoring organization to ensure that fund investments and distributions are fully compliant with IRS and state requirements.

Facilitating Giving: Donor advised funds are well-suited to the needs of donors who are planning to sell a substantial asset such as a business or real property. The proceeds from the sale will significantly increase the donors' income, enabling them to make a generous gift, but they may not know how their gift can be employed most efficiently and effectively. Donor advised funds allow these donors to make a substantial gift, permanently dedicated to support charity, yet still have the opportunity to consider how those funds can be most effectively used to promote the public good. Without such flexibility, many charitable gifts would be delayed and some ultimately might never be made.

Finally, advised funds benefit many small charities. Many smaller organizations lack the expertise to accept and process even fairly simple gifts of property such as publicly traded stock. Further, they would incur substantial fees if donors, for example, were to break up a gift of securities into odd lots. This benefit is even more pronounced when donors contribute a substantial asset, such as real property, that requires liquidation to free up assets for charitable use. Donors in these situations often want to benefit more than one charity. An advised fund allows them to do so, by making their gift to a single organization and then recommending grants to the charities they wish to support.

## Supporting Organizations

Supporting organizations that support Council members offer many of the benefits of advised funds. Typically, donors establish supporting organizations when they have substantial assets to contribute – many Council members require gifts of at least \$1 to \$5 million to justify the expense of creating a supporting organization. Most supporting organizations at Council members are Type I, although there are some Type IIs established to accept gifts of real property and a scattering of Type IIIs.

Donors who establish supporting organizations generally are also weighing the benefits of setting up a private foundation. The factors they consider often turn on the more favorable income tax deduction rules that apply to gifts to supporting organizations because of their public charity status compared with the control they are permitted to exercise if they establish a private foundation. Donors who choose a supporting organization over a donor advised fund generally do so because they want to play an active role in the organization's governance, even though they are not permitted to control it, or because the supporting organization will pursue an investment strategy that differs from that of the supported organization.

Some supporting organizations are established not by donors, but by the supported organization either acting alone or in partnership with several donors. Some community foundations, for example, have established supporting organizations to accept gifts of real property in order to protect the community foundation's assets from potential risks that might be associated with the gifts. Some larger community foundations also have established supporting organizations that are the community foundations for smaller neighboring communities.

The Pension Protection Act has made the choice of philanthropic vehicle more difficult. This is particularly the case for the comparison between supporting organizations and private foundations because the rules that apply to supporting organizations are now stricter than the comparable rules for private foundations. This has led some supporting organizations to convert to private foundation status and is likely to lead to fewer supporting organizations in the future.

### **Response to Question Two:**

Introduction: Generally, the Council supports the approach of the Pension Protection Act of 2006 in imposing penalties on the individual responsible for abuses. This is a targeted approach that allows the penalty to reflect the relative gravity of the offense.

Determining whether a donor properly claimed a charitable deduction for a gift should be made using principles already well established in the tax code and applied consistently across all charitable gifts, regardless of the charitable vehicle used. Similarly, revoking or changing the exempt status of the donee public charity should be reserved for situations in which the entity engages in a pattern of systematic abuse.

Both the Council's community foundation members and our other public charity grantmaker members have long relied on the material restriction rules found in section 1.507-2(a)(8) of the Tax Regulations. While these rules apply literally only to community foundations in trust form, all community foundations use them as guidelines, as do our other public charity members with advised funds. A key focus of the material restriction rules is ensuring that the public charity to which assets are contributed can freely and effectively employ those assets, or the income they produce, in carrying on its charitable activities. The Council's responses to the questions under this heading are informed by those rules and by the National Standards for Community Foundations, which comprehensively regulate all aspects of operating a community foundation, including the prevention of private inurement, the prudent stewardship of donated assets and the maintenance of board control.

The Council's Community Foundations Leadership Team approved the National Standards for Community Foundations in June, 2000. The first stage in the standards process was the adoption by community foundations of a declaration of their intent to comply. Five hundred forty-seven community foundations took this step. The next stage involved the preparation and submission of "record books," documenting the community foundation's compliance with the standards. These are comprehensive manuals that typically take up to 18 months to compile. The record books are reviewed by trained, experienced community foundation practitioners, with the assistance of Council on Foundations professional and legal staff. Reviewers must have at least ten years of experience with or knowledge of community foundations of varying asset sizes, staff resources, organizational longevity and geographical service areas.

Since the review process began in 2005, 339 community foundations have been found to be in compliance, four have failed and an additional eighteen withdrew. There are 88 community foundations in the group currently being reviewed, while the remaining 105 will be reviewed in the next group. Although most community foundations are members of the Council on Foundations, there is no membership requirement for the review process or for certification that the community foundation complies with National Standards.

Community foundations that comply with the standards gain recognition on the Council's website and on the Community Foundations Locator, [www.communityfoundationlocator.org](http://www.communityfoundationlocator.org), as compliant with National Standards and are authorized to use the National Standards Seal indicating compliance with the most rigorous standards in philanthropy. They also gain access to certain marketing and communication tools.

We have included a copy of the National Standards with this response. Additional materials, including the Participant's Handbook, which is the guide to preparation of the record books, can be found on [www.cof.org](http://www.cof.org) under community foundations.

**2. How should the amount and availability of a charitable contribution deduction for a transfer of assets to a donor advised fund or a supporting organization, and the tax-exempt status or foundation classification of the donee, be determined if:**

**a. the transferred assets are paid to, or used for the benefit of, the donor or persons related to the donor (including, for example, salaries and other compensation arrangements, loans, or any other personal benefits or rights)?**

The most basic requirement for charitable tax-exempt status for sponsoring organizations of donor advised funds and for supporting organizations is that their assets must be used exclusively for charitable purposes. Providing improper benefits to donors/advisors of donor advised funds or to a supporting organization's substantial contributors jeopardizes the organization's tax-exempt status. Further, both donor advised funds and supporting organizations are now prohibited from making grants, loans, compensation or similar payments to donors and related parties. Penalties apply when violations occur and a systematic pattern of violations could jeopardize the organization's exempt status.

Although the question posed refers only to contributions to donor advised funds and supporting organizations, the underlying premise appears to be that a donor's deduction should be limited or denied if contributed assets are used to provide compensation to a donor for services provided to the charity. The implication is that donors to an organization must either provide services to the organization without compensation, and bear their own out-of-pocket expenses, or face the limitation or denial of their charitable deductions for gifts to the organization. If this is case, the question has implications for all charitable organizations. Private foundations are permitted to pay compensation to the foundation's substantial contributors and related persons as long as the compensation is reasonable and the services provided to the foundation are personal in character. Public charities frequently employ and pay compensation to persons who are also donors to the organization.

We believe the law should continue to firmly distinguish between abusive and non-abusive situations. Persons who provide services to charitable organizations are entitled to reasonable compensation for those services and to reimbursement for their out-of-pocket expenses in providing those services. The payment of compensation should not affect these donors' charitable contributions deductions for gifts to the organization.

Loans to donors raise more complex issues. An obvious question is whether a donor who borrows back the assets he or she contributed has actually made a completed gift. In these cases, the IRS can challenge the donor's deduction under current law, so a specific rule denying deductions would not be necessary. We note again, however, that these issues are not different because the gift was to a donor advised fund at a public charity or to a supporting organization than to another type of fund at a public charity or to a public charity that is not a supporting organization.

**b. the donor has investment control over the transferred assets?**

Donors do not and should not retain investment control over transferred assets. Under current law, a donor may not take a charitable deduction if the donor's retained control of the contributed assets prevents the gift from being complete. The retention of unfettered investment rights with respect to the gift would be such a retention. Accordingly, there is no need to further limit donors' deductions to account for retention of investment control.

The material restriction rules deal comprehensively with issues of donor control over contributed assets in section 1.507-2(a)(8)(iv) where subsections (B) through (G) provide that a material restriction exists if:

- A donor requires the donee to take or withhold action with respect to the transferred assets if the action or withholding is not designed to further the donee's charitable purposes
- A donor requires the retention of transferred securities or any other investment asset (unless the transferred asset is employed directly in furtherance of the donee's charitable purposes)
- Transferred assets are taken subject to leases, contractual obligations, or liabilities of the donor for purposes inconsistent with the donee's charitable purposes or best interests
- Transferred assets are subject to a right of first refusal (we discuss this point later in the document)
- As part of the transfer, the donee is required to establish irrevocable relationships with banks, brokerage firms, investment counselors, or other advisors with regard to the investments
- Any other condition which prevents the donee from exercising ultimate control over the contributed assets.

**c. there is an expectation that the donor's "advice" will be followed, or will be the sole or primary consideration, in determining distributions from, or investment of the assets in, the supporting organization or the donor advised fund?**

The Council does not believe that donors' deductions should be limited or denied because the donor's advice is generally followed in making grants from donor advised funds. The Council also believes that donors should be able to provide limited advice about investments in the manner that the IRS has previously approved for donor advised funds.

Advice With Respect to Distributions

Neither donors to advised funds nor substantial contributors to supporting organizations have the unilateral right to direct distributions from the fund or organization. In the case of donor advised funds, recommendations are reviewed by the public charity's board or by professional staff to whom the board has delegated approval authority. In the case of

supporting organizations, the substantial contributor must gain the assent of at least a majority of the organization's board.

Question 2(c) appears to equate following donor recommendations with giving donors control. The Council submits that the question is not the right or the relevant question to ask with respect to distributions.

The Council believes believe that public charities with donor advised funds should review donors' grant recommendations with two principal goals in mind. First, the review process should identify the limited number of situations in which a donor recommends a grant that does not further a charitable purpose and those grant recommendations should be refused. Second, the process should guard against the equally limited number of situations in which the donor or a related party receives an improper benefit from a grant and grant recommendations that would lead to this result also should be refused. This appropriately focuses the review process on assuring that grant recommendations further the charitable purposes of the public charity.

Education: While we do not think that the review process should be directed at whether a donor should have chosen Charity A, rather than Charity B, as the recipient of a recommended grant, we do believe that public charities with donor advised funds should inform and educate donors about community needs and about charitable organizations that efficiently and effectively meet those needs. Questioning the frequency with which donor recommendations are approved ignores much of the value that the public charity sponsoring organization brings to the table in the donor advised relationship. In addition to performing basic due diligence checks on recommended grantees, and taking steps to assure that donors are not receiving impermissible benefits from donor advised grants, Council members educate donors about community needs,

Council members that offer donor advised grantmaking do not do so as their sole activity – in fact, the survey data noted earlier in these comments showed that for the reporting foundations, assets in advised funds were only 26 percent of their total assets. In addition to their advised funds, a typical member also holds an unrestricted endowment or permanent fund, with the charity's board making distribution decisions. Most members also hold funds that are restricted to the support of a particular charity or charities (these funds are usually referred to as "agency endowments" if the assets were transferred by the beneficiary charity or as "designated funds" if the assets were contributed by individual donors). Finally, most also hold funds that are restricted to a particular charitable purpose or purposes, such as funds that award scholarships and funds that support, for example, health or the environment. As a direct consequence, Council members offer their donor advised donors an unparalleled wealth of knowledge about community needs and about the organizations in the community that are meeting these needs.

Council members take a variety of approaches to educating donor/advisors about community needs. Information on web sites and in newsletters is common. Many also host gatherings of donors to introduce them to local charities that are doing excellent

work but with which the donors may be unfamiliar. Some invite donors on site visits to these local charities so they can see them in action. Some circulate lists of “grant opportunities” -- in some cases giving donors an opportunity to add their grants to ones the member is making from other resources and in others offering donors the chance to fund worthy projects that the member was unable to fund. One community foundation using these techniques reported that donor advised grants doubled the amount of discretionary grants the community foundation was able to provide.

Not all donors need or want advice on their grantmaking recommendations. However, many do benefit from the information and services that community foundations provide. Accordingly, before asking whether donor grant recommendations are routinely approved, Treasury and the IRS should first ask about the donor education and information that informs those grant recommendations.

The material restriction rules recognize that whether donor recommendations are routinely followed is one among several negative factors to consider in determining whether donors have excessive control. Those rules also offer five favorable factors, which are:

- (i) There has been an independent investigation by the staff of the public charity evaluating whether the donor's advice is consistent with specific charitable needs most deserving of support by the public charity (as determined by the public charity);
- (ii) The public charity has promulgated guidelines enumerating specific charitable needs consistent with the charitable purposes of the public charity and the donor's advice is consistent with such guidelines;
- (iii) The public charity has instituted an educational program publicizing to donors and other persons the guidelines enumerating specific charitable needs consistent with the charitable purposes of the public charity;
- (iv) The public charity distributes funds in excess of amounts distributed from the donor's fund to the same or similar types of organizations or charitable needs as those recommended by the donor; and
- (v) The public charity's solicitations (written or oral) for funds specifically state that such public charity will not be bound by advice offered by the donor.

Treas. Reg. Section 1.507-2(a)(8)(iv)(A)(2)(i)-(v).

If new rules are to be developed for advised funds, the Council recommends that Treasury and the IRS incorporate the five positive factors. These appropriately focus on the sponsoring organization making opportunities available to donors that will improve their grant recommendations and make them more effective philanthropists. We also recommend that any new rules focus, not on whether donors' grant recommendations are generally followed, but on the compliance systems and methods that sponsoring organizations maintain in order to prevent or deter the provision of improper benefits to donors.

Compliance: Council members conduct appropriate levels of due diligence prior to approving recommended grants. While problems occur infrequently, these investigations do lead community foundations to refuse recommendations if, for example, the prospective grantee is not a public charity as in the occasional request by a donor to make a grant to a hospital that is now a for-profit. Another example of recommendations that are refused occurs when grants are requested for the support of a fund set up to benefit a specific identified individual or family that has encountered an unexpected hardship such as the death of a parent or a fire that destroyed a home. While the events are tragic and the donor's impulse to help is charitable, these funds do not serve a charitable class and are refused for that reason.

Community foundations also typically take several steps to prevent donors and advisors from benefiting personally from grants from donor advised funds. Handbooks given to advisors inform them that grants may not be used to pay for memberships, to satisfy personal pledges, or to obtain other benefits. Grant request forms repeat this information and usually ask the donor to execute a written affirmation that the requested grant will not be used for a prohibited purpose. Finally, letters or transmittal forms to grantees state that a condition of the gift is that the recipient organization not provide benefits to the donor or advisor. Transmittal documents also normally state that cashing the foundation's check indicates acceptance of the conditions. From time to time, facts come to the attention of community foundations that suggest that donors may be receiving improper benefits as a consequence of advised grants. Community foundations follow up in these cases with the donors and the grantees and seek to recover any improper benefits.

#### Advice with Respect to Investments

Council members generally do not allow donors to advise with respect to investments. However, many community foundations do offer donors a choice of investment pools. These community foundations typically maintain three or more investment pools that offer a range of investment strategies (e.g., aggressive, moderate, conservative). Donors do not select the investment managers nor do they have any voice in determining the assets in which the pools are invested. In June 2000, the Service issued a private letter ruling to a community foundation finding that allowing donors to allocate fund investments among three investment pools did not constitute a material restriction where the community foundation's board was solely responsible for the selection of the investment managers and the investment options for each pool. The Service has also approved similar arrangements offered by charities sponsored by mutual fund companies and other financial institutions. We are not aware of any policy or other reason that should limit this option for donors.

Some community foundations allow donors to recommend a particular investment advisor to manage the investment of assets in the donor's fund. Typically, these recommendations are allowed only for donors who are making substantial gifts. What is substantial varies from community to community, but many foundations require a gift of at least \$1 million before they will consider adding an investment advisor to separately

manage a fund's investments. Before adding an investment advisor, the community foundation's board, or the board's investment committee, reviews the manager's performance to assure that the advisor will produce returns comparable to those of the foundation's investment pools. Once retained, the advisors are required to follow the community foundation's investment policies and to take direction on investments from the community foundation, not the donor. And, as one community foundation put it, if the manager's performance is not up to par, "we fire them." The Council does not believe that this practice is the same as allowing donors to advise with respect to investments since the recommended manager's investments are guided by the community foundation, not the donor.

**d. the donor or the donee has option rights (e.g., puts, calls, or rights of first refusal) with respect to the transferred assets?**

As a general rule, option rights should not affect whether a gift is deductible. Under current law, option rights will be taken into account in the valuation of the contributed property and a donor's deduction will be reduced if the options reduce the valuation of the property. PPA reforms add substantial new and increased penalties for donors and appraisers when donated property is materially overvalued. Thus, current law should protect the Treasury from valuation abuses.

Further, the self-interest of the donee charity provides an additional safeguard against overvaluation. Donees seek to receive full value when they liquidate contributed assets, including assets to which option rights apply. Accordingly, the proceeds from the liquidation should reflect the market value of the asset as encumbered by the option rights. The donee, therefore, should receive approximately what the asset was valued at for tax deduction purposes unless changes in external circumstances occurring between the date of the gift and the date of disposition either increase or decrease the asset's value.

Puts and calls: Generally speaking, puts and calls are option agreements that allow for the purchase or sale of securities at a predetermined price within a specified period of time. The holder of a put can compel the repurchase of securities; the holder of a call can compel their sale. In the experience of our members, puts are unusual in connection with donated securities, but can occur, and are sometimes negotiated for, when the donated securities are subject to external restrictions (such as underwriter restrictions) limiting their sale for a period of time. In this context, the put acts to protect the charity in the event the market price drops substantially during the holding period.

Calls permit the donor of the securities to compel their repurchase at a predetermined price. The presence of a call should be reflected in the valuation of the gift.

Rights of first refusal: These rights often arise as part of a shareholder's or partnership agreement, in which case they are applicable to a charity donee in the same way and to the same extent as they apply to other shareholders/partners. For example, a common provision in a shareholders agreement for a closely-held company gives the company or

existing shareholders a right of first refusal on shares that are to be offered for sale. The option may prescribe a formula, such as book value, for the exercise of the right, or it may provide for repurchase at a price being offered by a willing buyer. When this is the case, the charity receives exactly the same rights that the shareholder had prior to the date of gift.

As noted earlier, rights of first refusal can be material restrictions. However, many rights of first refusal predate the gift because they are part of an existing shareholders agreement. The limited available guidance suggests that a material restriction arises only where the right is granted as part of the gift transaction. Thus, the Service has approved pre-existing rights of first refusal of the type commonly found in shareholder agreements to allow gifts to a private foundation and a charitable remainder trust. Private Letter Ruling 9611047 (December 15, 1995) and Private Letter Ruling 9452020 (September 28, 1994).

Further, even rights that are part of the gift agreement may not be a material restriction if they require that the holder of the right pay what is otherwise being offered by a third-party for the asset. When this is the case, the donee receives full fair market value and the right has not prevented the donee charity from freely and effectively employing the transferred assets for charitable purposes. An example of this is Private Letter Ruling 8416033 (Jan. 17, 1984) where the charity donee gave the company the right to purchase stock at an appraised price that was no less than the offer from a third party.

Based on the foregoing, we believe that retention of a right of first refusal should not limit a donor's deduction unless the right prevents the charity from freely and effectively using the donated asset for charitable purposes. This would not normally occur when the right was pre-existing, although the terms of the repurchase arrangement may affect the valuation of the gift. It also would not normally occur when the right is exercisable only at a price established by a bona-fide third-party purchase offer. However, if the right is drafted in such a way that it can stop the charity from selling the transferred asset, the donor has not relinquished control and should not be allowed a deduction.

**e. the transferred assets are appreciated real, personal, or intangible property that is not readily convertible to cash?**

There have been various suggestions that donors be limited in the deduction they are allowed for gifts of property that take time to liquidate. Suggestions have included disallowing the deduction until the gift is liquidated, allowing as a deduction only the amount the charity receives upon liquidation, or by some combination of the two approaches. The Council believes that taking either of these steps would significantly deter giving at a time when we need to encourage more donors to make larger gifts to address the pressing problems our communities face.

A substantial amount of personal wealth in the United States is in the form of assets, such as real property and closely-held businesses, that may not be readily convertible to cash. However, these assets also are often the largest gifts that community foundations and

other public charities receive. It is of the utmost importance that tax policy encourage, not discourage, donors from making these gifts of property to philanthropic institutions. Reduction or elimination of the tax incentives for making these gifts would dramatically affect the capacity of Council members to meet community needs.

Council members generally have policies that require the prompt liquidation of gifts. Prompt liquidation is part of the prudent stewardship of donated assets in order to prevent investment portfolios from becoming unbalanced. Generally speaking, both donors and donees favor prompt liquidation. Donees seek to dispose of contributed property without unnecessary delay because many property gifts involve carrying costs that the donee must bear until the property is sold and income from the property may be insufficient to meet those costs. Further funds holding unliquidated assets may be unable to bear their proportional share of the donee's operating expenses. In the experience of our members, most donors also are interested in prompt liquidation because they are eager to begin recommending grants from their funds. Nonetheless, prudent and responsible stewardship of donated assets requires that Council members take reasonable steps to secure the best possible price for what is being sold.

Thirty of the 85 community foundations that responded to the Council's recent survey received gifts of business interests, including private REITS, closely-held stock, or interests in LLCs to 102 of their donor-advised funds. On average, it took 13 of the 27 foundations (3 foundations did not answer this question) less than 3 months to sell these assets; another eight disposed of the gifts in 3-to-6 months, on average, and two foundations took 7-to-12 months to sell these assets. However, in four cases liquidation took more than 12 months and ten gifts have not yet been sold – in one of these cases the gift was income producing property that the community foundation decided to retain.

Real property gifts generally took somewhat longer to liquidate. In 2005, 15 of the 85 respondents, or 18 percent, received gifts of real estate to 31 of their donor-advised funds. On average, it took three of the 15 foundations less than 3 months to sell these assets; another three disposed of the gifts in 3-to-6 months and two foundations took 7-to-12 months to sell these assets. It took more than 12 months for seven of the 15 foundations (47%) to sell these assets: nine of the 15 are still holding 11 real estate gifts.

These survey data illustrate that foundations are committed to prompt liquidation of complex gifts, but that prudent stewardship of those gifts may necessitate holding assets for a period of time to make sure that the sale is for a price that reflects the market's asset value. Changes to the deduction rules that delayed or denied a deduction when a gift took a period of time to liquidate would significantly deter complex gifts and deprive communities of substantial assets that would have been employed for the good of all.

Some donated assets are subject to restrictions that prevent immediate liquidation or use. Where this is the case, the donor's deduction is appropriately discounted to reflect the fact that the donee charity lacks full dominion and control over the donated assets. For example, the deduction for gifts of the remainder interest in residential real property and farms is discounted to reflect the fact that the charity will not take possession of the

property until the expiration of the life interest. Similarly, IPO stock is generally subject to SEC or underwriter restrictions that prescribe waiting periods before company insiders can sell their shares. When these restrictions carry over to a charity donee, the donor must obtain a qualified appraisal that discounts the valuation to reflect the restriction. However, where the contributed assets become the immediate property of the donee, the donor's deduction should reflect the fair market value of what the donor has surrendered as of the day he or she surrendered it.

The National Standards for Community Foundations states: "A community foundation accepts and administers a diversity of gift and fund types to meet the varied philanthropic objectives of donors." The rationale for this standard is to attract donors and additional gifts that may not otherwise come to the use of the community and which represent all aspects of the community. Accepting gifts of real property and closely-held business interests is one way that community foundations meet this standard.

To assure responsible decision-making, most community foundation gift acceptance policies require that gifts of property (other than cash or marketable securities) must be reviewed by the foundation's gift acceptance committee (or by its board or executive committee if it does not have a gift acceptance committee). Considerations in gift acceptance decisions typically include:

- The value of the gift;
- Whether it is readily marketable (or the projected income that the gift will generate for grantmaking);
- Risks to the community foundation (these range from environmental concerns with gifts of real property to the possibility of cash calls for gifts of limited partnership interests);
- Carrying costs if the gift will require time to liquidate properly; and
- Possible unrelated business income tax consequences.

Community foundation gift acceptance policies generally stipulate that gifts will be liquidated as quickly as possible. However, there are circumstances in which community foundations will hold contributed property. Most commonly, retention occurs when work is needed to make the property marketable or to improve its marketability; when purchase offers are not forthcoming or do not fairly reflect the property's market value; and when holding the property for a reasonable period of time will produce a substantial gain compared with the projected return if sold immediately. On occasion, a foundation's investment committee may decide to retain a contributed asset because the committee reasonably believes that the overall return on the asset justifies a place for it in the foundation's investment portfolio. On other occasions, a foundation accepts a gift of property that it will employ directly in furtherance of its charitable purposes – for example, a gift of an historic residence that a community foundation will use as its offices.

Council members also employ a variety of mechanisms to ensure that the disposition price of a complex gift reflects its market value. Seventy of the 85 responding community foundations in the Council's recent survey answered a question relating to disposition practices (respondents could check more than one response). Ninety-three percent obtained an independent appraisal as to the value of the asset, 74 percent consulted with one or more individuals who are expert in valuing similar kinds of assets; 71 percent obtained and reviewed information about sales of comparable assets; and 70 percent reported that the terms of the sale were reviewed and approved by their board, or by a committee reporting to the board, the members of which were independent of the donor.

What follows is a list of common gifts that may be adversely affected if Congress were to limit donors' deductions.

Business interests. Donors often give community foundations closely-held stock, limited partnership interests, and interests in limited liability companies. Due to the potentially unlimited liability such a gift would present, community foundations generally will not accept gifts of general partnership interests. These gifts may take up to several years to dispose of completely at a reasonable price and, in appropriate cases, may be retained as an investment.

Oil and gas interests. Some community foundations receive substantial gifts of this type. These are complex gifts that require careful review, but can generate a significant stream of revenue for grantmaking. These assets are generally retained because of the revenue they produce.

Real estate. Gifts of residential property are generally easy to value and easy to liquidate. However, gifts of commercial property, farms, and undeveloped land may be both harder to value accurately and more difficult to sell. In some cases, the community foundation may undertake improvements to the property prior to marketing it. These can range from simple repairs to obtaining the permits and waivers needed to subdivide undeveloped property. The time needed to dispose of real property on favorable terms varies, but can easily exceed twelve months. As in the case of gifts of business interests, a community foundation may decide to hold donated property for investment purposes.

Restricted stock. Some gifts of stock are subject to restrictions imposed by the Securities and Exchange Commission, or by the underwriters of an initial public offering, that may prevent sale for more than twelve months. Because the stock is subject to restrictions, its trading value does not accurately reflect the value of the gift and a qualified appraisal is required to determine the discount that needs to be applied. Even after the restrictions have lapsed, in the case of substantial stock gifts, the community foundation may liquidate the stock over time in order not to artificially depress the price.

Working with donors of appreciated real, personal or intangible property is more challenging and labor intensive for the recipient charity than accepting gifts of cash and publicly traded securities, causing some charities to elect not to accept such gifts.

However, a prohibition on accepting such gifts, or a requirement that they be disposed of under fire sale conditions, would have a substantial negative effect on charities that are prepared to work with donors to facilitate these gifts. Restrictions on deductions that are limited to gifts to donor advised funds and supporting organizations would also have a significant discriminatory effect in limiting the ability of donors with real estate and closely-held business assets to take advantage of those giving options. In fact, because community foundations are sometimes the only organizations within a community that have the capacity to accept and liquidate privately held assets, the proposed exclusion would disallow many of these donors from using these assets philanthropically within their own communities.

**3. What are the effects or the expected effects of the PPA provisions (including the § 4958 excess benefit transaction tax amendments applicable to donor advised funds and supporting organizations) on the practices and behavior of donors, donor advised funds, sponsoring organizations, supporting organizations and supported organizations?**

The most significant effect of the PPA that our members are reporting is an increasing number of small public charities and private foundations being formed by donors. This appears to be occurring primarily in three areas. First, the Act's apparent prohibition on reimbursing donors for legitimate charitable expenses (and the uncertainty about whether the sponsoring organization can pay these expenses directly) is leading donors to create freestanding charities that are not subject to the prohibition. Because many of the affected funds engage in fundraising, the new organizations can be expected to meet the public support test and will be classified as public charities. Second, there are substantial uncertainties about the classification of scholarship funds created by civic and social organizations. Are these advised funds or, because they have multiple donors, do they fail the first prong of the definitional test? If they are advised funds, must the composition of the scholarship committee be changed so that a majority is not members of the organization? These and similar uncertainties are leading some organizations to form independent public charities to administer their scholarship programs so that their members can continue to play a significant role in the selection of scholarship recipients. Third, as noted earlier, some supporting organizations are electing to become private foundations, and some donors are electing to form private foundations rather than supporting organizations, because supporting organizations are now completely barred from compensating donors and family members.

The Council believes that these changes caused by the PPA do not promote good public policy. The end result of the changes will be that legitimate donors will bear the burden and expense of forming and operating small charities, while the abuses that have been identified in connection with some donor advised funds and supporting organizations will not be stopped, but simply transferred to a myriad of small charitable organizations over which there will be no effective oversight. The active oversight that Council members exercise over their advised funds and supporting organizations has been an effective check against abuse and we submit that tax policy should encourage the formation of

advised funds and supporting organizations to relieve the burdens faced by the IRS and state regulators. It also lessens the audit burden for both the IRS and state regulators because a single audit of a sponsoring organization can replace what would otherwise be numerous audits of small charities.

Even prior to the enactment of the PPA, Council members did not pay compensation to donors of donor advised funds, nor did they make loans to them. Further, most limited grantmaking from donor advised funds to entities that are public charities or their foreign equivalents or they exercised the equivalent of expenditure responsibility in making grants.

Consequently, the major effects of the PPA at community foundations have been in the following areas:

- All Council members are struggling to implement the new requirements for grants to non-functionally integrated Type III supporting organizations in the face of the inability of the Service to identify the organizations that fall within this definition. For example, we recently learned of a grant to pay for mammograms for poor women that has been delayed over a month, with no end in sight, while the community foundation awaits the grantee's paperwork justifying why it is functionally integrated. We again urge the suspension of penalties until such time as the IRS can identify organizations that fall within this category.
- All community foundations have had to review their scholarship and award funds to determine whether they might be "donor advised" as defined in the PPA and, if they are, to bring them into compliance with the requirements for exemption. There are still several areas where guidance would be helpful in making this assessment. These include:
  - Funds with selection committees appointed by position or title in the gift instrument
  - Funds created by civic organizations, such as Rotary or alumni associations, that have multiple donors and selection committees made up of club or organization members.
  - Funds created by public charity donors to provide scholarships to disadvantaged students who successfully complete a prescribed program.
- Many community foundations have had to either discontinue or suspend grantmaking from funds that make emergency hardship grants to needy individuals or require donors to step down entirely from the selection process.
- The lack of guidance with respect to the definition of "distribution" in new Code section 4966 has led to the suspension of activity in some funds that must purchase goods and services in order to carry out their charitable purpose.

**4.a. What would be appropriate payout requirements, and why, for donor advised funds?**

The Panel on the Nonprofit Sector recommended that

Each sponsoring charity should be required to make an aggregate minimum distribution (across all of its donor advised funds) equivalent to 5 percent of the aggregate asset balance of all its donor advised funds at the end of the previous year. The Secretary of the Treasury should be authorized to create reasonable exceptions to the distribution requirement and alternative methods for performing the calculations. The Secretary shall define distributions that qualify for this purpose, including administrative expenses.

In footnote 5, the Panel recommended that the exceptions should include:

- a three-year exemption from the proposed payout requirement for charities that have held donor advised funds for fewer than three years, and
- an exception for charities that have historically exceeded the required minimum payout but do not meet the payout requirement in a single year.

The footnote also recommended that regulations “should make clear that all distributions from the donor advised funds to public charities, including distributions to the sponsoring charity for reasonable expenses incurred in administering the funds, should be included in calculating the aggregate minimum distribution.”

The Council on Foundations supports the Panel’s recommendation, although we note that all available data, including our recent survey cited earlier in these comments, support the proposition that donor advised funds annually distribute amounts that are substantially in excess of five percent of aggregate assets.

The Council would not support the imposition of a payout requirement on a fund-by-fund basis because a fund-by-fund determination would add substantial complexity and cost without producing a corresponding public benefit. The comparable private foundation rules on calculating payout exemplify the complexity that would result if payout had to be determined fund-by-fund, as they take into account such issues as the circumstances under which a foundation can meet its payout obligations through set-asides for future distribution and the rules that apply to program-related investments. Further, so long as distributions from the collective assets held in a charity’s donor advised funds meet or exceed five percent, the public interest in assuring a reasonable contemporaneous distribution from tax-deductible gifts is met.

**4.b. What would be appropriate payout requirements, and why, for funds that are excepted from donor advised fund treatment by statute or by the authority of the Secretary, but for which the donor retains meaningful rights with respect to the investment or use of the transferred amounts?**

The experience of Council members is that donors create funds in order to make grants. Because donors generally have little interest in delaying or withholding grant recommendations, we believe that there should not generally be a need for separate payout requirements for exempted funds.

The Council also believes that the characteristics of exempted funds are likely to make a mandatory payout obligation unnecessary. For example, the PPA exempted funds that make awards for travel, study or similar purposes. A condition for exemption is that the participation of donors in the selection process is carefully circumscribed. The safeguards required should protect against any risk that a fund would go for long periods of time without awarding a reasonable level of scholarships. Similarly, the PPA also exempted funds that make distributions to a single designated charity. In these situations, the designated charity's interest in receiving distributions would balance any hypothetical interest a donor might have in limiting them. Finally, the single category of fund to which the Secretary has extended an exemption – funds that make distributions to employees in the case of a qualified disaster – is not well suited to a payout requirement since distributions will occur only sporadically and the amount distributed will be determined in part by the magnitude of the underlying event.

#### **4.c. What would be appropriate payout requirements, and why, for supporting organizations?**

Congress has directed the Secretary to adopt regulations setting a payout requirement for Type III supporting organizations that are not functionally integrated. The Council supports the recommendation of the Panel on the Nonprofit Sector that these supporting organizations should be required to distribute annually an amount equal to 5 percent of average net assets. We also support the Panel's recommendation that assets held for charitable use be excluded from the base and that the supporting organization's reasonable and necessary administrative expenses should count toward the payout requirement.

#### **4. d. What would be appropriate payout requirements, and why, for any other types of charities?**

Since 1969, section 4942 of the Internal Revenue Code has required private foundations to make annual expenditures for charitable purposes equal to a statutorily prescribed annual payout rate. Congress imposed this requirement after Treasury and Congressional investigations found that in a significant number of cases, donors were receiving substantial charitable deductions for gifts to private foundations while the foundations were subsequently failing to make significant charitable distributions. Thomas A. Troyer, The 1969 Private Foundation Law: Historical Perspective and Its Origins and Underpinnings 3, 10, 18 (2000). Congress imposed the payout requirement to ensure that the public benefited from a reasonable flow of distributions out of foundations and—using the terminology common at the time—“into the charitable stream.”

The preceding questions were premised on whether similar obligations should be extended to donor advised funds and supporting organizations and in response the

Council noted its support for a similar requirement applied to aggregate holdings in donor advised funds and to certain Type III supporting organizations.

Endowment funds at public charities share some of the characteristics of private foundations, supporting organizations and private foundations in that they are expected to last in perpetuity while providing an income stream for the support of the charity. As with private foundations, some critics question whether the draw on these endowments is set at sufficiently high levels. Data collected by Commonfund suggests that annual spending from endowments held by or for educational institutions has been declining for the past several years and is now below the 5 percent required of private foundations. Thus, spending was an average 4.6 percent of endowments in FY 2005, compared with 4.8% in 2004, 4.9% in FY 2003, and 5.1% in FY 2002. Commonfund Institute News Release, Jan. 12, 2006, [http://www.commonfund.org/Commonfund/Archive/CF+Institute/CBS\\_educational\\_press\\_0106.htm](http://www.commonfund.org/Commonfund/Archive/CF+Institute/CBS_educational_press_0106.htm). Preliminary data suggest FY 2006 spending was in the 4.5-4.6% range. Commonfund Institute News Release, Oct. 25, 2006, [http://www.commonfund.org/Commonfund/Archive/CF+Institute/CBS\\_Education\\_preliminary07.htm](http://www.commonfund.org/Commonfund/Archive/CF+Institute/CBS_Education_preliminary07.htm).

The Council is not recommending that public charities generally be subject to a payout requirement on their endowments. The preceding data, for example, may simply reflect spending rules that smooth distributions from endowed funds by using multi-year averages. However, to the extent that Treasury and the IRS were to consider recommending that Congress enact payout requirements for public charities, they should consider whether the private foundation payout model is the appropriate one to follow or whether, as many argue, it is too high to sustain the purchasing power of an endowment over time. Attention should also be given to the use of a three or five-year average of assets in order to moderate the effect of sudden upward or downward shifts in valuation.

## **5. What are the advantages and disadvantages of perpetual existence of donor advised funds or supporting organizations?**

Virtually all community foundations permit at least one or two generations of successor advisors and the trend has been toward allowing unlimited succession at least for funds with substantial assets. Supporting organizations are permitted an unlimited life unless their organizing documents dictate otherwise.

Donors who establish endowed or permanent funds intend to make a gift that will provide lasting benefits to their communities and to causes for which they care deeply. Even when advisory privileges cease after a defined period, the fund itself continues in existence making grants in the name of the donors.

There is a large body of literature debating the pros and cons of perpetual existence for private foundations. We will not repeat those arguments here. Rather, the Council believes that the question of whether a private foundation should have perpetual existence

is a decision that should be left to the good judgment of the generous individuals who create the foundation and provide it with its assets. We believe the same principle should apply to donor advised funds and supporting organizations, although in both of those situations the decision will also be affected by the policies of the sponsoring or supported organization, because donor advised funds and supporting organizations involve donors partnering with community foundations and other public charities to best meet their communities' needs.

As the Community Foundation for Greater Atlanta wrote:

DAFs and SOs offer donors a philanthropic vehicle that can encourage continuous philanthropy over time, by allowing multiple generations of a donor's family to become involved in matching their individual passions for giving in the community with nonprofit agencies and organizations that address those issue areas of interest. The beauty of such an arrangement is that families involved in philanthropy together widen a community's donor base and stimulate giving back to the community, for the benefit of the community. With the community foundation serving as a facilitator, donors can focus on their giving while letting the community foundation manage the details (e.g. providing research and expertise on community needs, back office processes, investment management in many cases).

## **6. What other types of charitable giving arrangements give rise to any of the above issues?**

In our responses to question two, we discussed some of the issues that arise with respect to gifts of certain kinds of property. These issues append to the gift, not to the recipient. For example, a gift of an interest in the donor's closely-held business will be subject to the same shareholders agreement whether the gift is used to establish a donor advised fund or given to a university in return for naming rights for a building. If time is needed to liquidate a gift to the maximum advantage of a donee, that time will not be different for a donor advised fund than for a hospital foundation. Donors do not have any greater, or any lesser, influence over the liquidation of a gift because the gift is to an advised fund. Any public charity will listen to and respect the advice of a major donor concerning the liquidation of a gift – in most cases, the donor is the person with the greatest knowledge of the value of the gift and how to maximize that value in liquidation.

Similarly, in our response to question 4(b), we note that issues of what is an acceptable spending rate from a fund intended to last in perpetuity arise for all charities that hold such funds, including private foundations and any public charity with an endowment. Many charities also struggle with donors who make major gifts, then seek improper levels of control as part of the exchange.

The Council on Foundations believes that Treasury should not recommend changes in the charitable deduction rules for any of the reasons cited in the request for comments. We believe even more strongly that if Treasury and the IRS do believe changes are needed,

these changes should not single out donor advised funds and supporting organizations but should be made broadly applicable to all charitable entities. Finally, we urge Treasury and the IRS to carefully consider the substantial good that has been accomplished through donor advised funds and supporting organizations and the substantial harm that would occur if donors are discouraged from contributing to them..

Sincerely,

A handwritten signature in black ink that reads "Steve Gunderson". The signature is written in a cursive style with a large, prominent "S" at the beginning and a long, sweeping underline that extends across the name.

Steve Gunderson  
President and CEO