



Why Donor Advised Funds  
and Supporting Organizations  
are a Gift Planner's Friend

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**Donor Advised Funds and Supporting Organizations**  
**The “Other” Grantmakers**  
*by Wendy Chou and Brigit Kavanagh*

*“All of our major donors are giving to their donor advised funds instead giving to our charity!”*

*“Donor advised funds and supporting organizations are taking all the gifts away from us!”*

We have noticed these sentiments run throughout the gift planning community. At their core, however, donor advised funds and supporting organizations are grantmakers. They are close relatives of their more famous sibling, the private foundation. And yet, we seldom, if ever, hear anyone complain that private foundations are taking gifts away from public charities. In addition, donor advised funds and supporting organizations may be ideal vehicles for receiving complex assets whose stewardship and liquidation may impose a burden on the charity receiving the gift.

In this paper, we explore donor advised funds and supporting organizations from a legal perspective and consider some case studies that demonstrate the similarities between these gift vehicles and private foundations, as well as ways in which these vehicles are entirely compatible with the work of a gift planner. The case studies presented are geared toward gift planners and are meant to be representative of the kinds of issues that might arise in connection with donor advised funds and supporting organizations. The case studies also address some common traps for the unwary.

**Donor Advised Funds (DAF)**

Legal Structure

A donor creates a DAF by making a gift to a public charity (the sponsoring organization), for which the charity separately accounts and over which the donor (or a designee) has an advisory privilege as to the use or investment of the fund. Importantly, the fund is simply part of the sponsoring organization and not a separate legal entity; the donor retains no ownership and no legal control over the fund. By relinquishing dominion and control over the completed gift, the donor’s ongoing relationship to the fund is in an advisory capacity only. DAFs are defined in Section 4966 of the Internal Revenue Code (“Code”) as:

- i. a fund (or account);
- ii. separately identified by reference to contributions of a donor or donors;
- iii. owned and controlled by the sponsoring organization; and
- iv. with respect to which a donor (or any person appointed by the donor) has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in the fund or account by reason of that person’s status as a donor.

## Practical Application

### *What Donors Like About DAFs:*

Generally, what donors like about DAFs is the availability of an income tax charitable contribution deduction for a gift to a public charity, the ability to control the timing of the charitable contribution (i.e., the year in which the donor needs/wants the deduction), the ability to advise gifts from the fund, and not having any administrative responsibilities with respect to the fund. Also, for donors who wish to remain anonymous, the sponsoring organization can serve as a firewall between donors and the charities to which the donors advise grants.

DAFs are grantmaking funds, similar to the typical private foundation. Grants from a DAF to a U.S. public charity are uncomplicated and very common. Sponsoring organizations of DAFs generally respect the wishes of their donors, and except in rare circumstances will make the grants the donor advises. Therefore, the gift officer's continued stewardship of donors who have DAFs is essential to increase the likelihood that a donor will advise grants to those charities from the DAF. As with a private foundation, a grant from a DAF to entities other than U.S. public charities may require expenditure responsibility or other forms of diligence.<sup>1</sup>

### *What Donors Don't Like About DAFs:*

You can't use the DAF to conduct an active charitable program. The chief complaint we hear about DAFs usually centers around the prohibition on making distributions to individuals. Code section 4966 imposes excise taxes on *distributions* to any natural person. An additional excise tax arises if a *distribution* from a DAF confers a "more than incidental benefit" on a donor, advisor, or family member. The penalty is imposed on the individual who received the benefit and on the fund management of the sponsoring organization.<sup>2</sup> Below is a case study that might involve this type of prohibited transaction.

### **Active Program Case Study**

PART I. Donor created a DAF and then asked the sponsoring organization to make payments to an independent contractor that the donor hired as a program manager to operate a program serving underemployed youth. The program manager also anticipated hiring additional contractors who would deliver services to the individuals participating in the program.

*Is this a problem?* As noted above, the law prohibits distributions to natural persons. Without Treasury Regulations (as of the date of writing this article Treasury has not issued regulations interpreting Internal Revenue Code Sections 4966 and 4967), we do not definitively know whether a "distribution" for these purposes is limited to a donative gift or whether it also includes payments

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<sup>1</sup> DAFs, unlike private foundations, can also make grants to private operating foundations without exercising expenditure responsibility. Like a private foundation, however, a DAF may make grants to a broader class of potential grantees if the sponsoring organization either determines that a foreign grantee is the equivalent of a U.S. public charity or by exercising expenditure responsibility over the grant. Equivalency determinations and expenditure responsibility are both outside the scope of this paper.

<sup>2</sup> Code Section 4967.

for services rendered. Therefore, it may not be possible to pay the program manager from the DAF in the case study.

PART II. As a variation on Part I, the donor wishes to advise a general support grant to the local Youth Charity that operates a program for disadvantaged youth. The donor is also the executive director of Youth Charity and is paid a reasonable salary for her services.

*Is this a problem?* Also as noted above, the law prohibits a “more than incidental benefit” to the donor, the donor advisor, and family members. With a general support grant to Youth Charity where the donor is paid staff, it is probable that some of the grant will go toward the donor’s salary. The sponsoring organization should consult legal counsel to explore whether or how to make a grant to Youth Charity.

You can’t use the DAF to pay for chicken dinners. Another common complaint about DAFs is the prohibition against using a DAF to pay for the annual gala/fundraising dinner because of the benefit (the chicken dinner) that flows back to the donor. As we show in case study below, we also do not think it works to bifurcate the gift and have the donor personally pay for the chicken dinner while the DAF pays for the gift portion of the gala tickets.

### **Gala Dinner Case Study**

Each year your charity hosts a gala dinner to raise money. Each ticket is \$1,000, of which \$100 is the value of the return benefits (the dinner) and \$900 is a charitable contribution. As you start to receive \$1,000 grants from various DAFs, you realize that a number of donors are advising grants to pay for the gala tickets.

*Is this a problem?* This transaction may confer a “more than incidental benefit” on the donor or the donor advisor because he/she will get gala tickets as a result of the advised grant. Many practitioners also advise that bifurcation does not work. That is, advising a \$900 grant from the DAF and paying the \$100 ticket price personally may not work because the right to attend the gala requires a \$1,000 donation – the donor is essentially getting for \$100 something for which he/she would otherwise have to pay \$1,000 were it not for the gift from the DAF.

You can’t use the DAF to pay a binding pledge. Donors often sign pledges in their personal capacities. Often, they do so before determining which bucket (the DAF, the private foundation, personal funds) will satisfy the gift. If the pledge is legally binding and it is in the donor’s name, it is the donor’s legal obligation and the donor’s DAF or private foundation cannot pay that legal obligation without providing a prohibited benefit to the donor.

### **Binding Pledge Case Study**

You have been working with a donor on a gift for a capital campaign and you ask the donor to make a pledge to support the project. The pledge agreement states that the donor understands that she is creating a legal obligation to pay the pledge. The charity books the pledge as a receivable. A month later, your charity receives a grant from the donor’s DAF at the Community Foundation for a gift in exactly the same amount as the pledge. On the same day, you receive a handwritten note

from the donor that reads, “I just advised a grant from my DAF to pay my pledge. I am so glad to support this project!”

*Is this a problem?* Yes. Paying the pledge from the DAF results in a more than incidental benefit to the donor because it relieves her of a personal obligation. As the gift planner, this is not directly your problem, but stewarding your donors remains important and the donors here could be liable for an excise tax if they satisfy a binding pledge from their DAF. While in the case study the pledge was legally binding, if it had instead been a mere statement of the donor’s intention to make a gift, then there would be no problem. In order to avoid this situation, many charities have turned to asking donors to sign letters of intent rather than binding pledge agreements; however, note that this approach may affect the charity’s ability to book the pledge as a receivable.

## **Supporting Organizations (SO)**

### Legal Structure

An SO is a separate legal entity that is organized and operated for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified public charities<sup>3</sup>. SOs come in four varieties and most often function as grantmaking organizations.<sup>4</sup> The type of SO informs the relationship between the SO and the charity(ies) it was formed to support. In addition, an SO must not be controlled by a disqualified person, including a substantial contributor, a family member of the substantial contributor, or an entity that is 35 percent controlled by the substantial contributor or family member.<sup>5</sup> Plainly stated, if an SO has a board of three, one of whom is the donor, the other two must not be related to the donor. In a typical Type I SO structure, the majority of directors are appointed by the publicly supported organization.

### Practical Application

#### *What Donors Like About SOs:*

Donors appreciate that this is a separate legal entity that can exist in perpetuity. Because an SO is a public charity, the enhanced income tax charitable contribution deduction for gifts to public charities is available. This is in contrast to the more limited deduction available for gifts to private foundations. Many donors appreciate having a seat on the board and the ability of the SO to hire staff to conduct and manage the SO’s grantmaking or direct charitable programs. SOs, unlike private

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<sup>3</sup> Code Section 509(a)(3). “Specified public charity” in some instances can mean a class of public charities. An SO can also obtain public charity status by supporting the charitable activities of a publicly supported organization that is tax exempt under Code Sections 501(c)(4), (5), or (6); a discussion of this is beyond the scope of this paper.

<sup>4</sup> An in-depth discussion of the legal requirements of Types I, II, III Functionally Integrated, and III Non-Functionally Integrated SOs is beyond the scope of this paper. Many, but not all, SOs function as grantmaking entities.

<sup>5</sup> Under Code Section 509(a)(3)(C), an SO must not be controlled by a disqualified person as defined in Code Section 4946, other than foundation managers and other public charities. Disqualified persons under Code Section 4946 include lineal family members of certain enumerated insiders.

foundations, can also make grants to individuals without needing to obtain prior IRS approval of the grantmaking program, as long as the individual grantees are members of the charitable class benefitted by the publicly supported organization.

*What Donors Don't Like About SOs:*

Paying compensation to a substantial contributor, family member, and related entities, is prohibited. This is in contrast to a private foundation where it is permissible to hire a disqualified person to provide reasonable and necessary personal services to the foundation. In addition, the donor cannot control the SO. Finally, unlike a private foundation or a DAF, an SO is permitted to support only the charity or charities named in its charter documents.<sup>6</sup>

### **Uses for DAFs and SOs**

Sometimes, a donor already has a DAF or SO and the gift planner's role is continued stewardship of the donor and grant solicitations from the DAF or the SO. Other times, however, a donor arrives with a particular philanthropic goal or a complicated asset and looking for advice on what sort of entity or fund to set up. Sometimes it may make sense for the gift planner to suggest a DAF or an SO to a donor, as shown in the next two case studies. The gift planner will continue to steward the donor, as before, even if the donor makes the initial gift to a DAF or an SO.

#### **Closely Held Stock Case Study**

The donors propose to make a gift of stock in a closely held corporation (the Company) that is owned by the donors and several close family members. During conversations with the donors, you learn that the Company has relatively low cash assets, but it owns half of all the commercial office spaces in town. All of the Company's available rental spaces are occupied and there are plans to increase rent on current tenants and to reinvest some of the available cash into purchasing additional office space. All of the shares in the Company are voting shares. Each shareholding party has the right to demand that the Company purchase up to \$100,000 of its shares each calendar year, so long as the other financial obligations of the Company have been met.

*Should the Charity accept this gift?* In doing diligence on this gift, the charity will need to think about a number of factors, such as cost of holding the asset, potential for income generation, voting concerns as the only non-family member shareholder, and exit strategy.<sup>7</sup>

*Is there a "right" vehicle for this gift?* This gift could be made directly to the charity, to a sponsoring organization for inclusion in a DAF, or to an SO. If made to a DAF or an SO, this would alleviate the risks to the charity of being a shareholder in the company, yet still results in the possibility of the assets being used to further your organization's work. If your charity has the capacity to control an

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<sup>6</sup> Many Type I SOs mitigate this issue by naming a class of publicly supported organizations instead of, or in addition to, naming specific organizations.

<sup>7</sup> The charity's gift acceptance policy should include these considerations.

SO, then you can do this in-house; alternatively, you may refer this donor to a community foundation to open a DAF or form an SO, with your charity named as a supported organization of the SO.

### **Family's Long-Term Philanthropy Case Study.**

The donor is in her seventies and owns stock purchased at an initial public offering 40 years ago. The stock is highly appreciated and the donor would like to donate and liquidate it so that her family can make grants to support a number of philanthropic interests. The donor would like to involve her children and grandchildren in identifying charities to support. While the donor is unfazed by the idea of hiring staff and attending board meetings, her son and daughter-in-law have school-aged children and little time to manage a charitable organization. They are, however, interested in pursuing family philanthropy from a joint fund to which all members of the family could add and from which they could make grants.

*Should the Charity accept this gift?* Unlike the asset described above, this is a publicly traded stock that can be easily liquidated. Many of the concerns about the gift in the example above are not present in this gift.

*Is there a "right" vehicle for this gift?* The donor seems to want to form a stand-alone entity, such as an SO or a private foundation, to engage the family in both grantmaking and board service. The next generation worries that this is more than they can reasonably take on at this point in their lives, though they fundamentally like the idea of shared family philanthropy. As the gift planner, you might suggest a DAF at the local community foundation for this family.

### **Conclusion**

Donors have a number of ways to support charities that are meaningful to them. In addition to making gifts outright to their charity or charities of choice, donors may choose to donate first to DAFs or SOs due to tax planning advantages. Donors may also choose these forms over traditional charities due to their ability to accept and liquidate certain complex or unmarketable assets. As stated in the introduction, at their core, DAFs and SOs are grantmaking vehicles and using these vehicles allows donors to advise grants to charities that may not otherwise have been able to receive the original funding asset directly from the donor.

For these reasons, it is incumbent on gift planners to understand that donors who have chosen to use a DAF or an SO are fundamentally still their donors and that these tools complement, rather than hinder, their work. Good stewardship of these donors, which includes having an understanding of how DAFs and SOs function and when it is permissible to receive gifts from them, will increase the likelihood that additional grants will be recommended from these vehicles by donors to the gift planners' organizations.