COUNCIL *on* FOUNDATIONS

Frequently Asked Questions: HR 4

The information provided here is based on our continuing analysis of the Pension Protection Act of 2006 (HR 4). Every effort has been made to ensure the accuracy of the statements herein. Please understand, however, that this information is subject to change, due to the complexity of the bill and to the fact that many of these provisions introduce issues that are new to the Internal Revenue Code. The information provided here is not a substitute for expert legal, tax or other professional advice, and we strongly encourage grantmakers and donors to work with their counsel to determine the impact of this legislation on their particular situations. This information may not be relied upon for the purposes of avoiding any penalties that may be imposed under the Internal Revenue Code.

Contents:

Overall Law

Which provisions in HR 4 are effective immediately?

Several provisions of HR 4 took effect on August 17, 2006— the day that President Bush signed HR 4 into law—and a few are retroactive. Among the ones that require immediate attention by grantmakers are:

- *The provision that requires expenditure responsibility on the part of a private foundation for grants it makes to Type III supporting organizations (other than those that are "functionally integrated") and that bars such grants from counting toward a private foundation's payout requirement. Basically, a functionally integrated Type III supporting organization is one that supports an organization by carrying on activities that the supported organization would otherwise have to do for itself. The provision also requires expenditure responsibility for grants to any type of supporting organization if someone who is a disqualified person with respect to the private foundation controls the supporting organization or the organization it supports. These grants also do not count toward payout. Note that this provision only limits grants to the supporting organization. It does not affect grants made directly to the supported organization, even if control is present.*
- *The provision that prohibits the payment of grants, loans, compensation or similar payments from a donor-advised fund to the donor, the advisor, members*

of their families, or businesses they control. Because expense reimbursements are considered to be similar payments, community foundations may not use the advised fund's assets to reimburse donors' expenses for charitable activities carried out directly by the donor, including fundraising expenses.

- *The provision that prohibits all three types of supporting organizations from the payment of grants, loans, compensation or similar payments to the supporting organization's substantial contributor, members of his or her family, and businesses they control. This prohibition is retroactive, applying to any transaction occurring after July 25, 2006.*
- *The IRA charitable rollover incentive, effective for contributions made during 2006 and 2007. This incentive permits individuals who have reached 70½ to distribute up to $100,000 a year in retirement plan assets to a qualifying charity without having to report the distribution as income. Split-interest gifts and gifts to donor-advised funds, supporting organizations and private foundations do not qualify for the incentive.*

For additional information on the charitable provisions, please visit the Council's HR 4 Resources Page.

IRA Charitable Rollover

What is an IRA charitable rollover?

Although popularly known as the IRA charitable rollover, the plan is not a true "rollover"—the act uses the term "qualified charitable distribution." A qualified charitable distribution is a distribution from a traditional IRA of an individual who is 70½ or older to an eligible charitable organization. An individual may exclude up to $100,000 from his/her gross income for each tax year for qualified charitable distributions from IRAs.

To which charities may donors make qualified charitable distributions?

Most contributions to public charities—other than to supporting organization—are considered qualified charitable contributions. However, distributions to donor-advised funds (for a definition see "What Is a Donor-advised Fund?" on www.cof.org/hr4) held by public charities are not qualified charitable distributions.

Qualified charitable distributions may also be made to private operating foundations or to private foundations that elect to meet the conduit rules in the year of the distribution. Distributions to private non-operating foundations and split interest trusts are not eligible for special treatment as qualified charitable distributions under the new law.

Will an IRA distribution to a scholarship fund qualify for this special treatment?

Yes, distributions to all funds, other than donor-advised funds, typically held by community foundations qualify (e.g., scholarship, field-of-interest and designated funds).

What if a donor contributes more than $100,000 to a qualified charity from an IRA?

Since the amount that the donor is able to exclude from income is limited to $100,000 under the act, the remaining amount would be reported as income on the donor's tax return. The donor may be able to deduct the additional amount as a charitable contribution; however, the deduction will be subject to the general rules about percentage limitations and the itemized contribution reduction discussed below.

Can a donor contribute IRA assets to a donor-advised fund?

Yes. However, since such distributions do not count as qualified distributions under these special rules, the donor will have to first recognize those distributions as income. The donor's charitable deduction must then be calculated, taking into account general principles relating to percentage limitations and the itemized contribution reduction discussed below.

Is there a policy reason why gifts to donor-advised funds, supporting organizations and private foundations will be ineligible for the IRA charitable rollover?

No. Last year, the only explanation that the Council received for the exclusion of donor-advised funds and supporting organizations from the Katrina legislation incentive (Katrina Emergency Tax Relief Act of 2005, H.R. 3768) was that they were largely unregulated. HR 4 takes care of that issue by providing new regulations for donor-advised funds and supporting organizations. They may have been excluded to lower the cost of the provision.

Under what circumstances will this special treatment of an IRA charitable rollover most likely benefit a donor?

Generally, donors who itemize deductions and whose charitable contributions will be reduced by the percentage of income limitation or by the itemized deduction reduction stand to benefit from these special rules. In addition, donors who do not itemize their deductions may also benefit. Finally, donors in some states may recognize greater benefits of a charitable rollover due to state income tax law. Donors will need to work with their professional advisors to determine the effect of these new rules on their specific tax situations.

What are the percentage limitations?

In any year, donors may not deduct more than 50 percent of their income for gifts of cash to public charities (or 30 percent for gifts to private foundations). Although amounts over 50 percent can be carried forward and deducted in future years, taxpayers will face an immediate tax bill and may lose some of the benefit of the deduction if they die before the gift has been fully deducted. Donors who consistently give above the limit will not be able to take advantage of the carry-forward provisions.

Is an individual required to pay state income tax on a qualified charitable distribution?

In many states, a qualified charitable distribution will be excluded from income for the purposes of calculating an individual's state income tax obligations. Other states may include such a distribution when calculating taxable income. For specific information on the treatment of a distribution in your state, check with local counsel or the relevant state revenue department.

How does an individual make a qualified charitable distribution?

An individual should instruct his or her IRA trustee to make the contribution directly.

Should a charity receiving a contribution directly from an IRA provide a gift acknowledgement?

Yes. An individual must obtain a contemporaneous written acknowledgement of the contribution to take advantage of the treatment of the contribution under this new provision. IRS Publication 1771, Charitable Contributions–Substantiation and Disclosure Requirements (www.irs.gov/pub/irs-pdf/p1771.pdf), contains information about substantiation of charitable contributions.

May a charity provide any goods or services in return for the contribution?

No. If a donor receives any goods or services (e.g., tickets to a fundraiser) that would have reduced the donor's charitable deduction if the donor had made an outright gift to the charity, the rollover of assets from an IRA will not qualify for the tax-free treatment under this provision. Gifts to the donor that are disregarded (i.e., public recognition, token gifts and insubstantial benefits) will not disqualify the contribution from the tax-free treatment. IRS Publication 1771, Charitable Contributions–Substantiation and Disclosure Requirements (www.irs.gov/pub/irs-pdf/p1771.pdf) contains information about disregarded benefits.

Can an individual make a qualified charitable distribution for split interest gifts?

No. Charitable lead trusts and charitable remainder trusts are examples of giving vehicles that are not eligible to receive qualified charitable distributions. Moreover, because an individual may not receive a benefit in return for an IRA distribution, a contribution in return for a charitable gift annuity would not be eligible for the tax-free treatment.

Do donors also receive a charitable deduction when they roll over assets to a charity under this provision?

No. The benefit under this provision is that the individual does not recognize the amount contributed directly from the IRA to a qualifying charity. Because a donor does not include the amount in his or her gross income, the individual may not take a charitable contribution deduction for the contribution. A charitable contribution deduction would allow a donor to receive a double benefit from the contribution, and therefore is explicitly prohibited.

How will charitable distributions affect the minimum required distributions from a taxpayer's IRA?

Shortly after an individual reaches the age 70½, he or she is generally required to receive distributions from his or her traditional IRA. Distributions from an IRA to a charity will receive the same treatment as a distribution to the individual taxpayer for the purposes of minimum required distributions.

Is a qualified charitable distribution technically an IRA rollover?

No. While this charitable distribution is popularly known as an IRA charitable rollover, it is not technically a rollover. Generally, an IRA rollover allows an individual to withdraw money from an IRA and transfer the money to another IRA within 60 days of the withdrawal. However, as noted above, a qualified charitable distribution must be transferred directly from the IRA administrator to the charity.

Supporting Organizations

What is a supporting organization?

Generally stated, a supporting organization is a 501(c)(3) that qualifies as a public charity (and not a private foundation) because it has a close relationship with another publicly supported 501(c)(3). Usually, in order to qualify as a public charity, an organization must receive at least one-third (or, in special cases, as little as 10 percent) of its support each year from gifts, grants and contributions from a variety of sources. A supporting organization is not required to meet this public support test on its own if it provides meaningful support (financial, programmatic or both) and gives some degree of structural and operational control to another organization that is already classified as a public charity rather than a private foundation. Based upon the relationship of the supporting organization to the public charity it supports, a supporting organization will be classified as a Type I, II or III. A supporting organization may not be controlled by someone who is a disqualified person with respect to the supporting organization.

What are the different classifications of supporting organization?

In general, supporting organizations fall into three categories: Type I, Type II and Type III. The type refers to the nature of the relationship between the supporting organization and the charity being supported.

- ***Type I****: By far the most common, this is often described as a parent-subsidiary relationship and generally involves the charity appointing a majority of the board of the supporting organization.*
- ***Type II****: The least common of the three, this type usually involves an overlapping board relationship where a majority of the members of the supporting organization board are also members of the supported charity's board.*
- ***Type III****: This type operates with a greater degree of independence from the organization it supports. Typically the supported organization appoints one member of the governing board of the supporting organization and institutes other procedures designed to ensure that the supporting organization is responsive to it. Type III supporting organizations may provide financial support to their supported organization, or they may directly carry out a program or function for it.*

When is a Type III supporting organization functionally integrated?

One of the tests required for Type III status is a demonstration that the supporting organization is an "integral part" of the organization it supports. There are two options for meeting this test, one of which is that the supporting organization performs the functions of, or carries out the purposes of, the supported organization and, but for the supporting organization, the supported organization would normally engage in those activities directly. For example, a Type III supporting organization that operated a printing press for a university would meet this "but for" test because without the supporting organization, the university would carry out the activity directly. An organization that satisfies the "integral part" requirement under this "but for" test is "functionally integrated." Organizations that meet the "integral part" test simply through payments to a supported organization will not be considered "functionally integrated."

Functionally integrated Type III organizations that are controlled by a disqualified person of the private foundation or that support an organization controlled by the private foundation lose the benefit of that special status. Accordingly, grants from the private foundation to a controlled Type III organization will not count toward the private foundation's qualifying distribution requirement and must be made in accordance with the expenditure responsibility rules.

Does HR 4 expand the definition of disqualified persons under the intermediate sanction rules?

Yes. HR 4 expands the class of disqualified persons in several ways. Relevant to all supporting organizations is the provision that treats disqualified persons of a supporting organization as disqualified persons of the organization(s) it supports.

Example: A board member of a supporting organization that supports a community foundation is also a disqualified person of the community foundation even if the board member has no other relationship with the community foundation. The community *foundation cannot enter into any transaction with the board member that provides the board member—a disqualified person—with an excess benefit.*

Note that when a payment is made by a community foundation for services provided to the community foundation, penalties apply only if the amount paid is excessive. A stricter rule applies to payments by a supporting organization to its substantial contributor and related parties. This stricter rule may also apply to payments made by a community foundation to a supporting organization's substantial contributor and to related parties, if the payment is for services provided to the supporting organization and is charged to the supporting organization.

Does HR 4 expand the types of excess benefit transactions?

Yes. HR 4 creates several new categories of automatic excess benefit transactions. Two of these new categories are directly applicable to all supporting organizations:

Grants, loans, payments of compensation or similar payments to substantial contributors. *The entire amount of any grant, loan, payment of compensation or similar payment to a substantial contributor, family member of a substantial contributor or business controlled by a substantial contributor is an automatic excess benefit transaction.*

A "similar payment" includes expense reimbursement. However, payments for the sale or lease of property, for example, would not be treated as an automatic excess benefit transaction because they are not similar payments.

Loans to disqualified persons. *Loans to any disqualified person of a supporting organization are an automatic excess benefit transaction. Disqualified persons are persons who are in a position to exercise substantial influence over the supporting organization. Disqualified persons include, but are not limited to, people who have served in the role of board member, chief executive officer or chief financial officer within the past five years.*

Loans to other public charities that are not supporting organizations are permissible even if the public charity has previously provided substantial contributions to the supporting organization.

Who are substantial contributors, family members and controlled entities?

Substantial contributors are defined as persons who contributed or bequeathed an aggregate amount that is more than $5,000 and more than 2 percent of the total contributions and bequests received by the supporting organization before the close of the organization's taxable year in which the contribution or bequest is received by the organization from that person.

Example: A supporting organization received $5 million in contributions during its existence. If a new contributor made a contribution of $1 million in 2006, the new contributor would be considered a substantial contributor. The $1 million contribution is both more than $5,000 and more than 2 percent of the total contributions received by the supporting organization.

The new legislation states that rules similar to those used for identifying a substantial contributor to a private foundation should be used in the context of the new rules for supporting organizations. The private foundation rules provide that a contribution or bequest is valued at fair market value on the date of receipt. In determining whether an individual is a substantial contributor, one should take into account all contributions and/or bequests by his/her spouse.

If the supporting organization is a trust, the term "substantial contributor" also includes the creator of the trust.

Grants, loans, compensation or similar payments to persons related to substantial contributors are also considered automatic excess benefit transactions. The affected family members are a substantial contributor's spouse, ancestors, children, grandchildren, great grandchildren, brothers, sisters and the spouses of children, grandchildren, great grandchildren, brothers, sisters. Other related parties are 35-percent-controlled entities. These are entities in which a substantial contributor and family members described above:

- *Own more than 35 percent of the total combined voting power if the entity is a corporation,*
- *Own more than 35 percent of the profits interest if the entity is a partnership, or*
- *Own more than 35 percent of the beneficial interest if the entity is a trust or state.*

The term substantial contributor does not include other public charities that are not supporting organizations.

Example: A community foundation established a supporting organization to hold real estate. Even if the community foundation transferred a large piece of real estate to the supporting organization, the community foundation would not be considered a substantial contributor. The supporting organization would be permitted to make grants to the community foundation without penalty.

However, private non-operating foundations may be substantial contributors.

Once designated a substantial contributor, is a person always a substantial contributor?

Relying on the rules set forth for private foundations, once a person is a substantial contributor to a supporting organization the person generally remains a substantial contributor. However, a person can cease to be treated as a substantial contributor at the close of any taxable year if:

- *The person and all related persons have not made any contribution to the supporting organization during the ten-year period ending at the close of the year, .*
- *The person and all related persons have not served as a foundation manager during the ten-year period ending at the close of the year, and*
- *The aggregate contributions made by the person (and all related persons) are determined by the Secretary of Treasury to be insignificant when compared to the aggregated amount of contributions to the foundation by one other person.*

Have the penalties for entering into an excess benefit transaction changed?

Yes. Under the excess benefit transactions rule, tax is imposed on a disqualified person who enters into an excess benefit transaction as well as on organization managers who knowingly participated in the transaction.

***Tax Imposed on a Disqualified Person**. The tax rate for penalties imposed on disqualified persons did not change. The initial tax remains 25 percent of the excess benefit amount. Typically, this tax is imposed on the amount of the excess benefit received by the disqualified person. For example, if a disqualified person received $5,000 for services for which the fair market value was $4,000, the 25 percent tax would be imposed on $1,000 (i.e., the difference between the benefit received and the fair market value of the services). In addition the affected person must correct the violation by repaying the excess amount. Uncorrected transactions are subject to a tax of 200 percent of the excess benefit.*

However, under the new legislation, if the transaction is considered an automatic excess benefit transaction because the supporting organization provided a substantial contributor a grant, loan, compensation or other similar payment or a loan to a disqualified person, the tax is applied to the entire amount of the transaction. For example, if a substantial contributor received an expense reimbursement of $5,000, the 25 percent tax would be imposed on the entire $5,000. In addition, the affected person must correct the violation by repaying the entire amount of the payment to the sponsoring charity. Payments that were not corrected would be subject to a tax of 200 percent of the entire payment.

***Tax Imposed on Organization Managers**. Organization managers who participate in a transaction knowing it is an excess benefit transaction are also subject to tax. HR 4* *increases the maximum tax imposed on organization managers from $10,000 to $20,000. This change is applicable to all public charities, not just supporting organizations.*

Background on Intermediate Sanctions prior to this legislation:
www.cof.org/Action/content.cfm?ItemNumber=751

Private Foundation Grants to Supporting Organizations

Can a private non-operating foundation make a grant to a supporting organization?

Yes. A private foundation clearly can make grants to supporting organizations of all types. However, the supporting organization's technical type will determine whether you need to follow specific grant procedures and how the grant is treated for purposes of determining your payout.

For most Type I and Type II supporting organizations and those Type III supporting organizations that qualify as "functionally integrated", the private foundation may count the grant toward its minimum distribution requirement (also known as the "5% payout" requirement). In awarding such grants, the foundation is not *required to follow expenditure responsibility.*

Grants to Type III supporting organizations that are not "functionally integrated" may legally be made but will not count toward the private foundation's payout requirement and must be made using expenditure responsibility procedures. The same is true for grants to those Type I and Type II organizations for which a disqualified person of the grantor private foundation either controls the supporting organization or the public charity it supports.

Can a private operating foundation make a grant to a supporting organization?

Yes. Such grants will count toward the organization's payout. However, private operating foundations must exercise expenditure responsibility for grants to Type III supporting organizations that are not "functionally integrated" and to any supporting organization (Type I, II or functionally integrated Type III's) for which a disqualified person of the grantor private foundation controls the supporting organization or the public charity it supports.

Which Type I and Type II supporting organizations require special procedures?

A grant to a Type I or II organization will not count toward the payout requirement, and must be made following expenditure responsibility, if:

- *A disqualified person of the private foundation directly or indirectly controls the supporting organization, or*
- *A disqualified person of the private foundation directly or indirectly controls the charity that the Type I or II organization is supporting.*

How can I tell if a grantee is a supporting organization?

While neither IRS Publication 78 (searchable at apps.irs.gov/app/pub78) nor Guidestar (www.guidestar.org) currently indicates whether an organization is a supporting organization, it is likely that either or both of these resources will eventually be modified to provide that information. In the meantime, there are several documents you can consult in determining whether an organization is a supporting organization:

- ***Determination Letter**: The letter from the IRS that confirms that an organization is tax exempt will say something similar to "you are not a private foundation within the meaning of Section 509(a) of the Code, because you are an organization described in Section 509(a)(3)." Section 509(a)(3) is the section of the code that covers supporting organizations; this specific reference should appear in the letter.*

- ***Form 990**: Part IV of Schedule A to the 990 requires each organization to check a box indicating why it is not a private foundation. Supporting organizations are required to check box 13 to indicate the basis of their public charity status.*
- ***IRS Master File**: While you can't casually browse or search it, the IRS maintains a cumulative database of information on all exempt organizations in its Business Master File (BMF). For foundations with the software and staff capacity, the database can be downloaded from the IRS at www.irs.gov/taxstats/charitablestats/article/0,,id=97186,00.html. Organizations that are tagged as Foundation Code 17 in the Exempt Organization Master Listing are supporting organizations.*

How can you tell what type a supporting organization is?

That may be difficult. Until recently, the IRS neither requested that the information be reported on Form 990 nor tracked the information in its data files. Form 990 for the 2005 tax year now requires a charity to indicate in part IV of Schedule A which type of supporting organization it is. If a grantee has not yet filed its 2005 Form 990, you can ask it what type of supporting organization it is. If you can't ask or they don't know (which happens), you can review the governing instruments and the Application for Exempt Status (Form 1023) that the organization filed with the IRS. Admittedly, such a review may only be helpful to someone with a solid understanding of the technical aspects of supporting organization status.

How do I determine whether a Type III organization is functionally integrated?

Only a careful review of the facts and circumstances of a particular organization will allow you to conclude whether a Type III organization is functionally integrated or not. As a practical matter, only the potential grantee is in a good position to make such a determination. While it may be reasonable to require potential grantees to certify that they are functionally integrated, it is unclear whether reliance on such certification would be sufficient to protect the private foundation from penalties. Until there are regulations or other guidance from the IRS clarifying what is acceptable due diligence, *private foundations should consult with legal counsel to determine what procedures to follow in awarding grants to Type III supporting organizations.*

What if I can't tell what type of supporting organization a grantee is?

If in doubt, you can either decide not to award the grant or you can exercise expenditure responsibility and not count the grant for purposes of satisfying your qualifying distribution requirement for the year.

What is expenditure responsibility?

Expenditure responsibility is designed to ensure that a grant is used for a charitable purpose and that a private foundation maintains appropriate oversight and documentation of the grant. Expenditure responsibility entails five steps:

> 1. *Conducting a pre-grant inquiry, including a reasonable investigation of the grantee to ensure that the proposed activity is charitable and that the grantee is able to perform the proposed activity.*
> 2. *Executing a written agreement with the grantee that specifies the charitable purposes of the grant and includes provisions that prohibit use of the funds for lobbying activities and that require the grantee to return any funds not used for the designated purposes.*
> 3. *Requiring the grantee to maintain the grant funds in a separate account so that charitable funds are segregated from non-charitable funds.*
> 4. *Requiring the grantee to provide regular reports on the use of the funds and the charitable activity support by the grant.*
> 5. *Including a report on Form 990-PF about the grant, with a brief description of the grant and its amount, charitable purpose and current status.*

More details about the expenditure responsibility process and sample forms can be found in Expenditure Responsibility Step by Step *by John Edie.*

Do the bill's limitations on supporting organization payments to disqualified persons prevent even the payment of reasonable compensation for necessary services?

If the payment of compensation is being paid to a substantial contributor and/or his or her family, it is prohibited.

Definition of a Donor-Advised Fund

What is a donor-advised fund?

A fund must possess three characteristics to be a donor-advised fund:

1) *It must be separately identified with reference to the contribution of a donor or donors,*
2) *It must be owned and controlled by a sponsoring organization, and*
3) *The donor or a person appointed by the donor must have, or must reasonably expect to have, the privilege of providing advice with respect to the fund's investments or distributions.*

If any one of these characteristics is absent, the fund is not a donor-advised fund. For more information, see the flowchart Is the Fund a Donor-Advised Fund?

What does it mean for a fund to be separately identified with reference to the contribution of a donor or donors?

Examples of separate identification include naming the fund after a donor or persons related to the donor, and tracking contributions to the fund with respect to the specific donor or donors on the organization's books.

Are funds for a single designated organization or a single governmental entity donor advised?

No. These funds are exempted by the legislation even if a donor provides advice with respect to investments or distributions. This exemption covers both designated funds and agency endowments.

Are field-of-interest funds donor advised?

Funds that attract contributions from several donors are not donor advised as long as the fund is not tracked with reference to the gift of any particular donor. This remains the case even if the fund is advised by an advisory committee that includes some donors to the fund.

Is any fund with a specific charitable purpose a field-of-interest fund?

No. A fund that is tracked by the gift of a particular donor is a donor-advised fund if the donor reasonably expects to provide advice about the fund's investments or distributions even if the fund agreement restricts grants for a particular purpose such as supporting the arts or improving the environment.

I have a donor who would like to create a restricted fund to protect the environment. Apart from specifying the fund's purpose in the gift agreement, the donor will not provide advice about the fund's investments or distributions, nor will she appoint anyone else to do so. Does specifying the fund's purpose make it a donor-advised fund?

No. Even though the fund will be tracked by reference to the donor's gift, the legislative history clearly differentiates between advisory privileges and legal obligations. Legal *restrictions, such as a designated purpose, are not advice and will not make the fund a donor-advised fund.*

A donor would like to create a fund, to be named for the donor, to benefit arts organizations. The donor would like to recommend three individuals with expertise in the arts to serve as an advisory committee to the fund. Is this a donor-advised fund?

No. As long as the donor only recommends the individuals, and they are persons with expertise that can be documented, the donor will not be considered to have designated or appointed them. Therefore, the fund is not donor advised.

Memorial funds usually have many donors. Are they donor advised?

A memorial fund is generally a separate fund tracked by reference to the decedent. Although the decedent is not a donor, the legislative history makes clear that contributions by related persons, such as the decedent's spouse or a child, can constitute a fund that is separately identified by the contribution of a donor or donors. If the fund is one for which family members of the decedent will provide advice, the fund should be treated as a donor-advised fund, even though it has multiple contributors, unless it is otherwise exempt because it is, for example, an exempt scholarship fund or a fund designated for a single charitable organization.

Are funds that provide disaster relief or emergency hardship grants to individuals donor advised?

They are not donor advised if the donor does not sit on, or designate the members of, the advisory committee. We plan to ask the Treasury Department for guidance on whether funds that provide assistance to employees of a particular employer, and that are advised by employee committees, are donor advised. If they are, we will ask the secretary of the Treasury to exercise his authority to exempt such funds.

Changes in Intermediate Sanctions for Donor-Advised Funds

Does HR 4 expand the definition of disqualified persons under the intermediate sanction rules?

Yes. HR 4 expands the class of disqualified persons in several ways. The changes directly affecting community foundations follow.

> ***Donors and donor advisors*** *are disqualified persons with respect to the donor-advised fund. Donors and donor advisors include a donor or any person appointed or designated by a donor that reasonably expects to have advisory privileges with respect to the distribution or investment of the amount held in the fund or account in question. These terms also include family members (spouse, ancestors, children,*

grandchildren, great grandchildren, brothers, sisters and the spouses of children, grandchildren, great grandchildren, brothers, sisters) of the donor and donor advisors. Finally, donor and donor advisors include 35-percent-controlled entities. Thirty-five-percent-controlled entities are those in which donors or donor advisors described above:

- *Own more than 35 percent of the total combined voting power if the entity is a corporation,*
- *Own more than 35 percent of the profits interest if the entity is a partnership, or*
- *Own more than 35 percent of the beneficial interest if the entity is a trust or estate.*

Example: A donor contributes land to the Smith Family Fund. If the donor's daughter purchases the piece of land held by the donor-advised fund for less than fair market value, the transaction would be treated as an excess benefit transaction because the donor's daughter would be considered a disqualified person with respect to the Smith Family Fund.

***Investment advisors** to a community foundation or other sponsoring organization are disqualified persons. Investment advisors are any person compensated by the sponsoring organization for either managing the investment of or providing investment advice with respect to assets maintained in donor-advised funds held by the sponsoring organization. This includes advisors to investment pools that include donor-advised assets as well as assets held by other types of funds. The definition of investment advisor does not include employees of the sponsoring organization. The term investment advisor includes members of investment advisors' families and 35-percent-controlled entities using the description above.*

An investment advisor to a community foundation's investment pools in which donor-advised funds are invested is prohibited from receiving more than fair market value for the services provided. Note that this individual is a disqualified person even if the investment pool is only partially funded by donor-advised funds and even though she or he would not otherwise be a person with substantial influence over the affairs of the community foundation.

Can we provide compensation to donors or pay or reimburse expenses they incur?

No. HR 4 provides that any grant, loan, compensation or other similar payment from a donor-advised fund to a person who is a donor or donor advisor (defined above) is automatically treated as an excess benefit transaction and the entire amount of the payment is considered an excess benefit. A "similar payment" includes expense reimbursement. However, payments for the sale or lease of property, for example, would not be treated as an automatic excess benefit transaction because they are not similar payments.

If a person is a donor or donor advisor and *also serves as a service provider to the sponsoring organization, the donor or advisor could receive a grant, loan, compensation* *or other similar payment if the payment was from the sponsoring organization and not a payment with respect to the donor-advised fund. If a community foundation enters into an automatic excess benefit transaction, the entire amount paid to the donor, advisor or related party is considered an excess benefit.*

Prohibited Benefits from Donor-Advised Funds

Who is prohibited from receiving a benefit from a donor-advised fund?

The law uses the term "donors or donor advisors" to describe the individuals who are prohibited from receiving more than an incidental benefit as the result of a distribution from a donor-advised fund. Donors and donor advisors include the donor and any person appointed or designated by the donor who reasonably expects to have advisory privileges with respect to the distribution or investment of amounts held in the fund or account in question. The prohibition also covers family members—the donor's or advisor's spouse, ancestors, children, grandchildren, great grandchildren, brothers, sisters and any of their spouses. Finally, the prohibition includes 35-percent-controlled entities—entities in which donors or donor advisors as described above, either individually or together:

- *Own more than 35 percent of the total combined voting power if the entity is a corporation,*
- *Own more than 35 percent of the profits interest if the entity is a partnership, or*
- *Own more than 35 percent of the beneficial interest if the entity is a trust or estate.*

Who is penalized and what are the penalties?

Penalties apply when the donor, advisor or a related party receive more than incidental benefits from a grant from their advised funds. Penalties also apply to the individual who provided the advice that resulted in the improper benefit. In addition, any fund manager who agrees to make such a distribution knowing that it will confer a prohibited benefit is subject to penalties.

Individuals who recommend or benefit from a prohibited distribution must pay a penalty equal to 125 percent of the amount of the benefit. Managers who approve a transaction knowing *that it will confer a prohibited benefit must pay a penalty equal to 10 percent of the benefit.*

How does this relate to the new "excess benefit transaction" penalties under Section 4958 for payments to donors and related parties?

The new Section 4958 penalties apply when a sponsoring organization makes prohibited payments directly to a donor, advisor or related party. Section 4967, which creates the prohibited benefit penalty, applies when the donor, advisor, or related party receives a benefit from an organization that received a grant or other payment from the donor or *advisor's advised fund. For example, Section 4958 penalties would apply if a sponsoring organization made a grant directly to a donor to pay for the donor's child's tuition at a private school. Section 4967 would apply if the sponsoring organization made a grant to the private school that was then applied to payment of the donor's child's tuition.*

Are the Section 4958 and Section 4967 penalties the same?

The penalties are effectively the same in monetary terms. In both cases the donor or advisor is required to repay the entire amount of the grant plus a 25 percent penalty. However, the entire amount of the prohibited benefit (Section 4967) penalty must be paid to the government, while in the case of the Section 4958 penalty the government receives only 25 percent of the payment, with the remainder paid to the sponsoring organization, which may not credit the repayment to the advised fund.

Can someone be penalized twice for the same transaction?

No. If an individual can be penalized under either Section 4958 or Section 4967, the Section 4958 penalty will apply.

What is an incidental benefit?

The Council plans to seek guidance on the distinction between a benefit that is merely incidental and one that is prohibited because it is "more than incidental." The legislative history states that a benefit is more than incidental if the fact that the donor receives it "would have reduced (or eliminated) a charitable contribution deduction if the benefit was received as part of the contribution to the sponsoring organization." To illustrate, the committee report states that a grant from a donor-advised fund to the Girl Scouts of America will not result in an impermissible benefit to the donor advisor merely because that person's daughter is a Girl Scout.

Other examples of contributions that are permissible because the benefit is merely incidental include:

- *A distribution to the local chapter of the American Red Cross, motivated by gratitude, for providing food and temporary shelter after the donor's home was destroyed by a tornado.*
- *A contribution to the volunteer fire department that serves the area where the donor owns a home.*
- *An unrestricted contribution to a combined charity fund, such as the United Way, which distributes funds to its member charities according to a formula and provides support for a home for the elderly in which a dependent parent of the donor is a resident.*

These examples, which are from an IRS Revenue Ruling cited in the legislative history of HR 4, describe situations in which the donor really received no benefit at all. Until the IRS publishes guidance on what benefits may be disregarded as incidental, we *recommend that you consult with legal counsel before approving a distribution that will result in a tangible benefit to a donor or advisor that could not be completely disregarded if the donor were claiming a charitable deduction for the same payment.*

Can't we require advisors to certify that their recommendation will not result in an impermissible benefit?

Since fund managers are only subject to penalties if they know that the distribution will result in an impermissible benefit, requesting such a statement should help protect fund managers from penalties. However, such a statement will offer no protection if the fund manager actually does know that a prohibited benefit will be received.

Is a token gift like a key chain or coffee mug more than an incidental benefit?

No. Under the token exception rules for contributions to charities, insubstantial goods or services received do not reduce the amount of the donor's deduction. Goods or services are insubstantial if the payment occurs in the context of a fund-raising campaign and:

- *the fair market value of the benefit does not exceed of 2 percent of the payment or $86* (whichever is lower), or*
- *the payment is at least $43* and the only items provided bear the organization's name or logo (e.g., calendars, mugs, posters) and the cost of these items is within the limit for "low-cost articles"— currently $8.60*.*

**The figures are adjusted annually for inflation..*

Is it more than an incidental benefit if the donor splits a payment to a fundraising event, paying the non-charitable portion individually and the deductible part out of a donor-advised fund?

We recommend against doing so unless the IRS issues additional guidance permitting it. In interpreting the self-dealing rules for private foundations (which also prohibit all but incidental benefits), the IRS has stated that splitting payments (or bifurcation) is not permitted. While it is unclear whether this same interpretation will apply to distributions from donor-advised funds, the nature and extent of the penalties are such that making such distributions is inadvisable. Consult with legal counsel if you have questions.

Is it more than an incidental benefit if a grant satisfies the donor advisor's personal pledge?

We recommend against using donor-advised funds to satisfy pledges unless the IRS issues additional guidance permitting it. Under existing law, the IRS has taken the position that using charitable funds to satisfy legally binding personal pledges of an individual results in an impermissible benefit to that individual.

If a for-profit corporation establishes a fund within a community foundation to provide disaster and hardship relief for its employees, and the fund is funded by

individual employee contributions, will the fund be considered a donor-advised fund?

If the company is the donor and company officials make recommendations about which employees the fund should assist, the fund is donor advised. The same would be true of funds to which both the employer and the employee contribute. We are seeking guidance about whether funds are advised if non-management employees constitute a majority of the selection committee. Getting clarification on this issue will be one of our top priorities in the coming weeks.

Scholarship Funds

Are scholarship funds donor advised if a donor is a member of the selection committee?

A scholarship fund is not a donor-advised fund, even if a donor or fund advisor is a member of the selection committee, if it meets the following criteria:

- *The sponsoring organization appoints all of the members of the committee and the donor gives advice solely as a member of the committee.*
- *The donor, and parties related to the donor, do not control the committee directly or indirectly.*
- *All grants are awarded on objective and nondiscriminatory bases, using a procedure that has been approved in advance by the board of directors of the sponsoring organization and that is designed to ensure that all such grants meet the requirements of paragraphs (1), (2) or (3) of Section 4945.*

What are the requirements of paragraphs (1), (2), and (3) of Section 4945?

Grants to individuals for travel, study or similar purposes must fit into one of three categories:

- *Paragraph (1) allows grants that are qualified scholarships and fellowships. These are scholarships that pay for tuition, books, room, board and so forth.*
- *Paragraph (2) sanctions grants that are prizes or awards. The recipient must be chosen from the general public, without any action to enter a contest or proceeding, and must not be required to provide services as a consequence of receiving the award.*
- *Paragraph (3) permits grants to achieve a specific objective, produce a report or other similar product, or improve or enhance a literary, artistic, musical, scientific, testing or other similar capacity, skill, or talent of the grantee. This is the broadest category and covers, for example, awards to artists to create works of art, and scholarships that do not fit under paragraph (1).*

The Council publication Grants to Individuals by Community Foundations *offers a detailed discussion of these requirements.*

Can the donor recommend the other members of a scholarship selection committee?

Yes, as long as it is clear that the recommendation is based on objective criteria related to the expertise of the person recommended. As an example, the legislative history states that if a donor recommends the heads of the science departments at local secondary schools to be on a committee to award grants for the advancement of sciences at those schools, the persons so recommended will not be considered to be designated or appointed by the donor.

The donor's attorney is among those she has recommended for the selection committee. May the community foundation appoint the attorney?

Yes, the attorney can be a member of the selection committee, but the attorney must be considered to be appointed or designated by the donor in determining whether the donor and parties related to her control the committee.