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To: Concerned Fiscal Sponsors and Projects

From: Greg Colvin, Esq.

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Re: IS A FISCAL SPONSORSHIP ACCOUNT MAINTAINED FOR A PROJECT BY A PUBLIC CHARITY ALSO A "DONOR ADVISED FUND?"

With the enactment of the federal Pension Protection Act in August 2006, the concept of a "donor advised fund" was defined by statute for the first time. For a 501(c)(3) public charity, the consequences of being a sponsor of a donor advised fund (DAF) are many: (1) the charity must report annually on Form 990 the number of DAFs it has, as well as the total contributions to, grants from, and year-end value of its DAFs, (2) certain written disclosures must be made, (3) there are prohibitions on payments to individuals and other limitations on the use of DAF funds, and (4) heavy taxes and penalties can result from violations of these rules.

Thus far, the Internal Revenue Service (IRS) has not issued any regulations interpreting the new statute, so we can rely only on the statutory language, legislative history, and common sense to answer questions about how the new law applies.

Basically, a fiscal sponsor should review the circumstances of its various project funds to determine whether any of them are DAFs under the new Internal Revenue Code (IRC) definition.

IRC Section 4966(d)(2)(A) provides a **three-part definition** of a donor advised fund.

The **first** prong of the definition is found in section 4966(d)(2)(A)(i) and states that a donor advised fund "is separately identified by reference to contributions of a donor or donors."

The **second** prong of the definition is found in section 4966(d)(2)(A)(ii) and states that a donor advised fund "is owned and controlled by a sponsoring organization."

The **third** prong of the definition is found in section 4966(d)(2)(A)(iii) and provides that a donor advised fund is a fund or account "with respect to which a donor (or any person appointed or designated by such donor) has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in such fund or account by reason of the donor's status as a donor."

If the fund fails to meet any one of the three prongs of the definition, it is not a DAF.

1. Regarding the first prong, we believe that a fund in which multiple unrelated donors pool their contributions is not a DAF.

(a) Typically, with a DAF, the sponsoring organization tracks a separate donor balance by adding a specific donor's contributions (and income earned on the fund) and subtracting distributions (and administrative costs, etc.) charged against the fund. Generally, fiscally-sponsored projects do not do so.

(b) If all the donors are related to each other, the first prong would be met. The following would appear to be "related" under IRS rules:

- A donor and any advisors appointed or designated by a donor;
- Their spouses and ancestors;
- Their children, grandchildren, great grandchildren, and their spouses;
- Their brothers and sisters, including half-siblings, and their spouses; and
- Entities, 35 percent controlled by any combination of those described above.

(c) The legislative history in the Joint Committee Report[1] indicates that a fund "that pools contributions of multiple donors" generally will not meet the first prong of the DAF test so long as there is no tracking of a separate donor balance for each specific donor or group of related donors. How many donors constitute "multiple" donors? More than one, certainly, but the IRS has not yet said how many. *To be relatively safe, we suggest that a project fund would not meet the first prong if it has three or more unrelated donors or groups of unrelated donors, and no single donor or related group has given more than half of all donations.*

2. A fiscal sponsor would obviously meet the second prong, because it does own and control the funds in the sponsored project account.

3. Regarding the third prong, most fiscally-sponsored projects will not give donors continuing advisory privileges over the payment or investment of amounts in the project fund, and so the fund would not be a DAF. However, sometimes a donor is represented on an advisory committee for the project, or might even act as the (unpaid) project director, so a closer look should be taken to see whether "advisory privileges" are involved.

(a) The legislative history indicates that restrictions on a donation to a charity, i.e., specifying a particular use or purpose, with no ongoing role for the donor to advise upon specific payments made from the fund, are not "advisory privileges" but are enforceable legal rights.

[1] Staff of the Joint Committee on Taxation, Technical Explanation of H.R. 4, The "Pension Protection Act of 2006," as Passed by the House on July 28, 2006, and as Considered by the Senate on August 3, 2006 ("Joint Committee Report").

Therefore, donations to a fiscal sponsor simply earmarked for the purposes of a particular project do not meet the third prong.

(b) If the donor sits on a project advisory committee, but is not involved in deciding upon the amounts paid to specific recipients, we do not think that the donor is exercising the kind of "advisory privileges" associated with a DAF.

(c) Although no guidance has been issued yet by the IRS, the legislative history points to a possible exception to the DAF definition for "committee advised funds" where the committee gives advice on specific amounts and recipients, but the donor sits on the committee as a minority voice and does not control the committee.

Finally, it is important to note, in regard to Model C ("re-grant") fiscal sponsorships, that IRC Section 4966(d)(2)(B)(i) provides an exception from the DAF definition for any fund that "makes distributions only to a single identified organization…." So, even if the fund meets all three prongs of the basic definition, it is not a DAF by virtue of the fact that only one entity will receive grants from the fund. The donor advisor does not retain any ability to issue variable advice on the selection of recipients.

The hardest cases to evaluate may be those where a single private foundation or individual is funding a sponsored project, so that the first prong of the DAF definition is met. The foundation would probably have a grant agreement designating funds for the project and requiring reports back on the use of funds; that system would not constitute "advisory privileges" under the third prong. However, if the foundation has one or more of its people on the project advisory committee, to avoid the third prong they should be (1) in the minority on the committee, (2) appointed by an authority within your organization rather than by the foundation, and (3) not involved in decisions about specific amounts paid to specific recipients.

In some situations, a fiscally-sponsored project will not be able to avoid the DAF definition under the IRC. The result is not fatal for the sponsorship. In those cases, certain sponsorship practices may need to be modified. For instance, in order to make fee-for-service payments to individuals, the sponsor may need to transfer lump-sum amounts from the DAF project fund to a separate administrative fund, which the sponsor uses to make service payments to individuals with no input from the donor-advisor.

We believe that there is a reasonable basis for each of our interpretations in this memo on how to mold compliance to the new DAF rules given the current state of the federal tax authorities and level of IRS guidance, which, of course, could change at any time.

Any tax advice contained in this memo was not intended to be used, and cannot be used, for the purpose of avoiding penalties that may be imposed under federal tax law. A taxpayer may rely on our advice to avoid penalties only if the advice is reflected in a more formal tax opinion that conforms to IRS standards. Please contact us if you would like to discuss the preparation of a legal opinion that conforms to these rules.