

Pending Regs Call for Closer Look at Donor-Advised Gifts

By Dennis Walsh, CPA

The Internal Revenue Service is aware that gifts to public charities remitted through donor-advised funds have been used to circumvent public support rules and avoid foundation status of recipient organizations.

A DAF sponsoring organization is a public charity, and distributions received from a public charity have generally qualified as public support without application of the substantial contributor rule.

In response to this practice, charities need to be ready for pending Treasury regulations that will require more attention to donor-advised gifts. Advisors can help donors and donee organizations alike by recognizing proposed gifts that might threaten public charity status and reduce grant support as a result, and lessen donor tax incentives as well if a donee organization is reclassified as a private foundation.

Foundation effect

Most private foundations will not grant to another private foundation, including an operating foundation. In the case of such a grant, the grantor must exercise stringent expenditure responsibility under IRC Section 4945(h), which is not required for a grant to a public charity. Loss of foundation support as the result of “tipping” may in turn place the mission of a nonprofit lacking widespread public support at greater risk of underperformance or failure.

A foundation must also pay an annual excise tax, equal to 2% and in some cases 1% of net investment income, including capital gains.

Unless qualified as an operating foundation, income tax deductions for gifts of cash and property to a foundation are limited to 30% and 20% of the donor’s adjusted gross income, , respectively, as opposed to 60% and 30% for gifts to a public charity. And except for limited gifts of publicly traded stock, a deduction for a gift of appreciated property to a private foundation is reduced by any long-term capital gain that would have been realized if the property had been sold instead, erasing perhaps the greatest tax-related giving incentive of all.

Other less favorable effects of private foundation status include public disclosure of donor identities and amounts of large gifts, self-dealing rules prohibiting transactions with persons

connected with the foundation, loss of limited lobbying privileges, and a fixed minimum annual charitable payout of 5%.

Once reclassified, an organization must demonstrate over a 5-year period that it is publicly supported before it can regain public charity status.

Public support

An organization that is funded by contributions from the general public, government agencies, or grants and contributions from publicly-supported charities must usually receive at least one-third of support from such sources over the most recent five-year period in order to maintain standing as a public charity.

If this purely mathematical test cannot be met, the organization may still qualify as a public charity if at least 10% of support is public support and facts and circumstances indicate that it is publicly supported.

Substantial contributor

In computing public support, excess contributions from “substantial contributors” must be excluded. A substantial contributor is any individual or entity, other than a government agency or publicly supported charity, whose total contributions over the five-year period exceed 2% of total support from all sources.

Thus, gifts received from a substantial contributor are counted as public support only to the extent that total gifts over the 5-year period do not exceed 2% of the organization’s total support for the period.

Earmarked gifts

Under existing Treasury regulations, a grant or other contribution is considered to be received directly from a contributor if made through an intermediary organization and earmarked by a donor as expressly or implicitly for the benefit of a donee organization. {1} This prevents channeling grants and contributions through a public charity in order to avoid the less favorable consequences of foundation status.

This earmarking provision applies to gifts made to entities claiming public charity status under the alternative revenue-based support test of Section 509(a)(2) as well.

For example, a gift by an individual earmarked for a donee organization and arranged to be passed through a public charity would clearly be considered a contribution received directly from the individual within the meaning of the Regulation and therefore subject to the substantial contributor rule.

On the other hand, intermittent gifts from an individual made through a donor-advised fund to a public charity with a history of significant support from the general public have, in the past, generally qualified as public support received from the sponsoring organization.

Pending provisions

In response to compliance concerns regarding the earmarking rule, the IRS stated in Notice 2017-73 that it considers support received from donor-advised funds to be support received directly from the donor-advisor. Thus, following the interim guidance, solely for purposes of the public support computations, a donee organization needs to treat:

- (1) A sponsoring organization's distribution from a DAF as coming from the donor (or donors) that funded the DAF rather than from the sponsoring organization
- (2) All anonymous contributions received (including a DAF distribution for which the sponsoring organization fails to identify the donor that funded the DAF) as being made by one person
- (3) Distributions from a sponsoring organization as public support without limitation only if the sponsoring organization specifies that the distribution is not from a DAF or states that no donor or donor advisor advised the distribution

Donor planning

As with other gifts that raise tipping concerns, donors may need counsel to help assess whether the timing and amount of a gift will create a public support problem for the donee. Since public support is relative and involves a percentage computation, there is no specific dollar threshold that will trigger a tipping situation and the effect of each gift must be analyzed individually.

In most cases, a quick look at the donee organization's publicly-available IRS Form 990/ Schedule A is all that is needed to assess the likelihood the donee has the capacity to absorb the proposed gift without endangering public charity status. In closer cases, often involving small nonprofits, the donee organization may need to be contacted to evaluate its immediate

funding needs and projected support from other sources, and to coordinate the timing and amount of a substantial gift.

Fortunately, a DAF is ideally suited to alter the timing of distributions. Contributions to a DAF may be planned to maximize the present value of tax savings to the donor and tax-free investment growth of gifts while held by the DAF sponsor.

Donor-advised distributions may then be delayed or staggered as needed to smooth the effect on the public support percentage without a corresponding change in the timing of contributions to the DAF or interference with donor tax objectives.

Since anonymous gifts should be aggregated by the recipient as gifts from a single donor under the interim guidance, donors might be encouraged to make named gifts where tipping is a concern, so that their gifts are assured to be counted as public support to the extent of the 2% threshold applicable to each separate contributor.

Although insiders must be trusted to protect donor confidentiality, charities are generally willing to honor a donor's request for anonymity, and the names and addresses of major donors must be redacted on the public inspection copy of Form 990 if qualified as a public charity.

In situations where tipping is at issue, a donor might alternatively consider recommending a low or no-interest loan from a DAF account held by a sponsoring organization that supports program related investing (PRI). This can make funds immediately available along with loan terms the charity can manage, while providing time needed for the donee to increase public support.

At a later time, the donor might advise the sponsoring organization to make a cash distribution in the amount of the interest paid or, if so inclined, forgive all or part of the loan principal in a time and manner that does not result in tipping the donee.

Compliance

Donee systems may need to be modified for tax compliance and donor management purposes in order to capture and summarize DAF gifts from separate categories including:

- Gifts subject to the substantial contributor rule
- Anonymous DAF gifts to be aggregated as a single donor for public support testing

- Gifts from a DAF sponsoring organization to be treated as public support without limitation
- DAF gifts by specific donor combined with any non-DAF gifts from the same donor for donor management purposes

Sponsoring organizations should assure that donor-advised distributions are identified by donor name where anonymity is not requested, and in other cases make an affirmative statement to the donee charity as to whether the distribution is donor advised.

{1} Treas. Reg. Sec. 1.170A-9(f)(6)(v) (and 1.509(a)-3(j))