



## Taxable Distributions for Donor-Advised Funds

**Summary:** Section 1231 of the Pension Protection Act of 2006 (HR 4) adds new section 4966 to the Internal Revenue Code. The new provision imposes penalties on the sponsoring charity and fund managers if certain distributions are made out of a donor-advised fund.

**Effective Date:** Tax years beginning after date of enactment (January 1, 2007 if the foundation is on a calendar year).

**What payments are prohibited?** Distributions from a donor-advised fund to an individual are prohibited. So too are distributions to any organization if not for a charitable purpose. Other payments that are not prohibited but that will be “taxable distributions” unless expenditure responsibility is followed include:

- an organization that is not described in section 170(b)(1)(A) – notably non-charities and private non-operating foundations
- a type III supporting organization that is not “functionally integrated”
- a supporting organization (even a “functionally integrated” type III) if the organization that is being supported is controlled by either the donor or an advisor appointed by the donor

### **What is a donor-advised fund?**

See COF analysis of “What is a donor-advised fund?” on [www.cof.org/hr4](http://www.cof.org/hr4).

### **Can a donor-advised fund pay administrative fees to the sponsoring organization?**

Yes, payments from a donor-advised fund to the sponsoring organization are specifically permitted by the Act without limitation and without the need to exercise expenditure responsibility.

### **Can a donor-advised fund make a grant to a scholarship fund, a designated fund or any another fund at the sponsoring organization?**

Yes, all payments from a donor-advised fund to the sponsoring charity are explicitly permitted without the need for expenditure responsibility. This includes payments to any other fund at the organization, including to other donor-advised funds.

### **Can a donor-advised fund make a distribution to a donor-advised fund maintained by another organization?**

Yes. The Act specifically allows distributions from a donor-advised fund to another donor-advised fund without limitation and without the need to exercise expenditure responsibility.

**Can a grant be made to an operating foundation from a donor-advised fund?** Yes, the Act specifically permits grants to all organizations described in section 170(b)(1)(A) of the Internal Revenue Code without the need to exercise expenditure responsibility. Operating foundations are among the organizations listed in section 170(b)(1)(A).

**Can a donor-advised fund make a distribution to a private non-operating foundation?** We recommend against making grants to private foundations. While HR 4 lets a donor-advised fund make a distribution to any organization (including a private non-operating foundation) as long as it follows expenditure responsibility, the legislation does not address preexisting concerns that a grant from a donor-advised fund to the donor's private foundation is evidence of excessive donor control that could cause recharacterization of the advised fund as a private foundation. The legislation also does not address the problem that arises when donors attempt to use gifts to donor-advised funds to circumvent the deduction limits that otherwise apply to gifts to private foundations. While there are situations where it may be appropriate to make a grant from a donor-advised fund to a private non-operating foundation, you should only do so after consulting with your tax advisor to evaluate these risks.

**Are grants to international organizations permitted?** Yes. The legislative history makes clear that you have two choices in making such distributions. You may either make a good faith determination that the organization is equivalent to a domestic charity (equivalency determination) or you must exercise expenditure responsibility. For more information on expenditure responsibility and equivalency determination in the context of international grantmaking, visit <http://www.usig.org/legal/er-ed.asp>.

**Can a donor be reimbursed for expenses incurred hosting a fundraising event?** No, this section prohibits all distributions to individuals from advised funds, regardless of the purpose. Additionally, changes to the intermediate sanctions rules that take effect the date HR 4 is enacted prohibit expense reimbursement to donors, advisors and related parties from a donor-advised fund. The charity may choose to reimburse the individual out of unrestricted funds, but any effort to circumvent the rule by making a distribution from the general funds of the charity followed by a distribution from the donor-advised fund back to the charity will likely trigger penalties.

**Can a donor-advised fund pay expenses directly to the caterer for a fundraising event?** We are seeking guidance on whether the prohibition on distributions to individuals includes payments to vendors, who are individuals, for goods and services and whether expenditure responsibility is required for payments to corporate vendors, and, if so, what form expenditure responsibility should take.

**Can a donor-advised fund award a scholarship grant?** No. Grants to individuals are prohibited out of donor-advised funds. However, grants to individuals out of funds other than donor-advised funds are permissible. For a definition of donor-advised fund see "What is a donor-advised fund?" on [www.cof.org/hr4](http://www.cof.org/hr4).

**Can a donor-advised fund make a distribution to a supporting organization?** Yes, however you must exercise expenditure responsibility for grants from a donor-advised fund to type III supporting organizations that are not “functionally integrated” and to any supporting organization (type I, II or functionally integrated type III’s) where a donor or an advisor designated by the donor controls an organization that the supported organization supports.

### **Supporting Organization FAQs**

- What is a supporting organization?
- What are the different classifications of supporting organization?
- How can I tell if a grantee is a supporting organization?
- How can you tell what type a supporting organization is?
- When is a type III supporting organization functionally integrated?
- How do I determine whether a type III is functionally integrated?

For answers to the above questions, please click [here](#).

**What if I can’t tell what type of supporting organization a grantee is?** If in doubt, follow the expenditure responsibility procedures for that grant. The law allows grants from donor-advised funds to all supporting organizations so long as expenditure responsibility procedures are followed.

**What are the penalties?** If a taxable expenditure is made, the charity that administers the fund must pay a penalty equal to 20% of the expenditure. Further, any fund manager who agrees to make the distribution “knowing that it is a taxable distribution” must pay a 5% penalty. These penalties may be abated (excused) for good cause.

**Who are fund managers?** A fund manager is an officer, director or trustee of the sponsoring organization. Also, any employee who has the authority or responsibility over any act (or failure to act) is a fund manager with respect to that particular act (or failure to act).

**What is “expenditure responsibility”?** While the Council will be seeking guidance as to what expenditure responsibility means for public charities, the regulations for private foundations provide some guidance. Charities that make grants from donor-advised funds to non-charities or affected supporting organizations for lobbying, nonpartisan voter registration activity or for regranting should consult with counsel as to how expenditure responsibility should be handled in those situations.

Expenditure responsibility is designed to ensure that a grant is used for a charitable purpose and that appropriate oversight and documentation of the grant is maintained. Expenditure responsibility as described for private foundations consists of 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 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 fund 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 including a brief description of the grant, the amount, the charitable purpose and the current status of the grant.

More details about the expenditure responsibility process and sample forms can be found in [Expenditure Responsibility Step by Step](#) by John Edie.

**The information provided here is based on our continuing analysis of the bill. Every effort has been made to ensure accuracy of these documents. However, due to the complexity of the bill and the fact that many of these provisions introduce issues that are new to the Internal Revenue Code, please understand that this information is subject to change. The information 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.**